

Asset allocation in a challenging macroeconomic environment

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A look at the 3-9 month geopolitical risk and macroeconomic outlook and our 5-year return expectations for publicly traded and alternative assets.

Massimiliano: What's driving the volatility we are currently seeing in the markets and what is your outlook over the next several months?

Evan: Clearly, the main issue has been inflation. But we can break that into three shocks that play important roles.

First, is the central bank reaction to inflation. Central banks around the world went from extraordinarily easy policies to quite hawkish stances, excluding the Bank of Japan. Even the ECB is talking about 50 basis point hikes.

Second is the Russia/Ukraine war, which has led to a surge in commodities prices, which is a stagflationary shock. That is going to weigh on real incomes and particularly in European countries.

And then the third shock has been the zero COVID policy in China, which is also stagflationary but particularly a headwind for growth, as opposed to inflation. And that has slowed progress in healing supply chains.

These all combine to generate a very unique macro environment and so it makes sense to see this kind of cross-asset volatility. The trajectory of these three shocks will be key to market performance from here.

Massimiliano: What is your outlook for these three drivers?

Evan: The bad news is that these are going to remain headwinds. But the good news is that we think all three are going to get less bad. And this could be just what markets need. We've had de-risking, multiple contractions, credit spread widening, and valuations have improved. Conditions on the ground are not as bad as they were, which provides room for stabilization.

On inflation and central banks, we believe we have seen peak inflation, certainly on an annualized basis, but on a sequential basis as well. Core goods pricing has come down. But we still have extremely tight labor markets across developed economies. We are seeing wages pick up and central banks remain quite vigilant.

The war and Russia and Ukraine will continue to impact natural gas and oil prices which will remain a headwind. The oil embargo does leave Europe vulnerable if there is tightening supply. But the risk of direct military conflict between Russia and NATO has lessened. So, this this driver is also moving towards a 'less bad' direction.

And then finally, China's COVID situation. It's not going away. President Xi has made it very clear that China is going to continue with its zero COVID strategy. But things are getting better. Shanghai is reopening. Beijing is not going to have nearly the kind of mobility restrictions that we saw in Shanghai. Fiscal stimulus is starting to come through, which will provide more support for the economy.

So, these headwinds will remain, but they are improving. Ultimately, it comes down to economic growth and there are valid concerns. Inflation has hit real incomes. We've seen a sharp tightening of financial conditions led by central banks. We'll likely see a slowdown, but we think the foundations of the global economy are strong enough, led by the strength of private sector balance sheets in developed economies, that the economy will be able to avoid a recession over the next over the next 12 months. We do think market volatility will remain elevated but will come down from the very high levels we're seeing right now,

Massimiliano: There is a growing focus on the long term implications on de-globalization and whether these events are accelerating a slowdown in globalization. What is your view?

Evan: I think that started a few years ago with the trade war, then the first round of COVID. And then the Russia/Ukraine war, and then this latest round of COVID in China, causing corporations to consider moving supply chains closer to home. We're moving from corporations and governments supporting just-in-time supply chains to just-in-case. What does that mean? It means a lot of spending in developed economies to build out capacity at home.

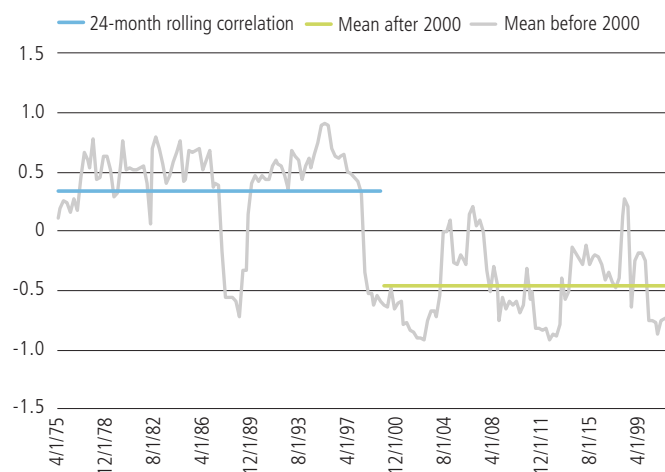
And as you move away from the most efficient supply chains to safer supply chains, then inherently you're increasing costs, which should lead to a higher inflation regime. That, combined with the energy transition, which is certainly not going away, will likely mean a lot of spending.

I think over the long term, it's a good thing. But that process is going to take some time to play out. And it means a higher inflation regime. And that's something that asset allocators are going to have to deal with.

Massimiliano: One victim of current market conditions has been the so-called balanced portfolio. We've had change in the relationship between equities and fixed income. Can we expect a shift to a positive correlation between stocks and bonds to continue?

Evan: This chart shows the stock bond correlation over time. Since the late 1990s, we had a negative stock-bond correlation. When your stocks went down, your bonds were there to protect you. But during the 30 years prior to the late 90s, we actually had a positive stock bond correlation.

Exhibit 1: The most important chart for asset allocators

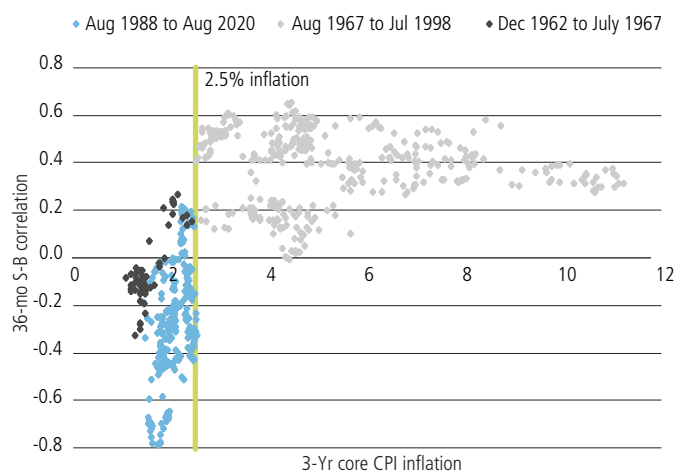


Source: UBS Asset Management, Macrobond, SPDJI. Data as of April 2022.

Over the last few months, the stock bond correlation began moving positive again. We've seen a bond selloff and a stock selloff at the same time. When we look at history (Figure 2), we see that as inflation rises above 3% or so, the stock-bond correlation moves in a positive direction. Compare that to the last twenty years, when low inflation and a negative stock-bond correlation went hand in hand.

So if we're in a higher inflation regime, towards 3%, and the Fed has essentially endorsed this in its forecasts, that gets you in this environment towards the upper right hand corner where you have a positive stock-bond correlation. And we have to think about that as asset allocators.

Exhibit 2: History suggests a structural shift in the stock-bond correlation



Source: Morningstar Direct. Analysis by UBS Asset Management.

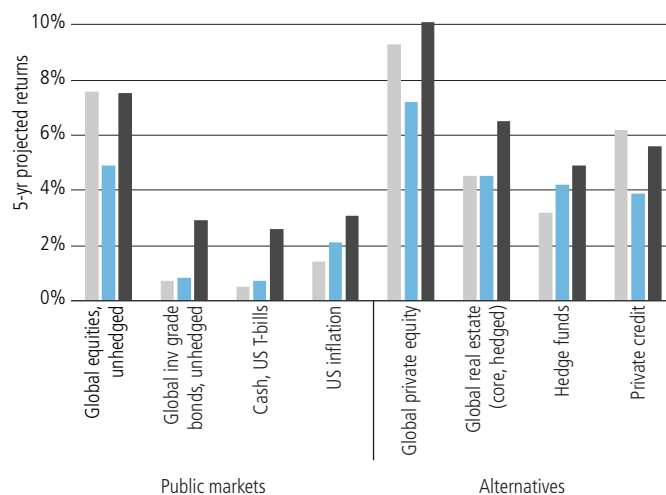
Massimiliano: I'd like Louis to help explain to us how these changing dynamics affect our longer-term capital market expectations, and how asset allocators can adjust.

Lou: What Evan is talking about is very important. In the world of alternative assets, returns are not independent of what we see in public markets. When we look at private equity and real estate, both had terrific years in 2021. But so did the public markets. Then, all of a sudden in 2022, equities go down, the cost of financing goes up, and IPO activity slows down, which is an important exit strategy for private equity. So, there is definitely a link between the two. It's not as strong. There's a different type of a beta. But it's not a zero correlation between the macroeconomic conditions in the capital markets and the expected returns that we have on alternatives.

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Exhibit 3: Capital markets expectations



Source: UBS Asset Management, Investment Solutions, as of April 2022, Alternative estimates are considered net-of-fees. *April 2020 estimate

The gray bars in Figure 3 show our current expected 5-year returns in nominal USD terms, while the blue bars show our numbers at the start of the pandemic and the orange bars show the low in interest rates in the summer of 2001. With the recent drop of the equity markets and the increase in expected inflation which flows through to earnings growth, we've increased return expectations. In the bond markets, we had very low interest rates two years ago, and expected returns were barely positive. As interest rates pop back up, we see the rise of investment grade and cash returns as well.

Our inflation expectations have increased to over 3% expected inflation for the next five years. And as Evan mentioned, this has severe implications on the stock-bond correlation, which in turn has implications for the risk premia that the markets will demand.

Now, how does this apply to the alternatives markets? We believe that a premium is going to exist there. So we're up to double digit returns now expected on private equity, In real estate, we've got the movement of working-to-home and other problems in central business districts, which has hurt the office rental space. But there are other sectors doing quite well there—in particular industrial. With the increase of inflation expectations, we have a much higher expected return now on real estate than we did two years ago. Hedge fund returns are related to interest rates and volatility, and we see increased opportunity here as well.

Finally, another thing I want to note about these expected returns in the alternatives arena is alternatives offer tremendous opportunity to have alpha of 1%, 2%, even 3%. So, if you take these returns and add on the strong managers that can be found out there, that may add in another 200 basis points to these returns. Those are very difficult alphas to find in the public markets. That's one of the attractions of alternatives is the ability not only to systematically diversify a portfolio further, but to really augment returns with alpha and skill in that set.

Massimiliano: Many clients are asking which asset classes within the alternative universe can provide the best edge against inflation. What's your view on that?

Lou: I look at inflation protection in two ways. First, there's short term inflation protection. How do you protect the purchasing power of a portfolio in the short run? That's very difficult to do with the public markets.

There are inflation-linked bonds that can help. But the alternatives sector, particularly real estate and infrastructure, which often have CPI components built into them, may offer protection against inflation. A lot will depend upon growth as well. Growth will be an overwhelming factor here on the alternative side. If we have low growth and high inflation, we're only going to expect some modest inflation protection and modest returns overall. But I would think those are the two sectors that offer the best alternative best opportunities here in the private markets.

Massimiliano: When clients approach alternatives, they also look at what's going on in the public markets. What type of headwinds do alternative assets face as we move into this new regime of higher inflation and higher yields?

Lou: One of the headwinds is going to be the cost of financing. Many of these strategies rely on arbitrage borrowing in order to increase returns. That was one of the tailwinds for risk assets two years ago—the commitment of central banks to provide liquidity, but it could be a headwind going forward. But one of the tailwinds is going to be the rise of volatility. Hedge funds can take huge advantage of that.

Massimiliano: What is the role of infrastructure?

Lou: Infrastructure is a relatively new asset class that started in the early 2000s. It's much longer dated compared to private equity. On the equity side, you've got funds that will last 10 to 15 years. And with the world moving towards more recognition of ESG objectives, you're going to see an opportunity set with infrastructure to take advantage of that and offer green energy projects, solar wind and so on. So there's a big opportunity set there as well.

Massimiliano: Two asset classes that are put into the alternatives category are gold and commodities, which are both getting attention lately. Gold has historically been used as a hedge against inflation or a major geopolitical event. What do you think of the role of gold?

Lou: Gold is a highly idiosyncratic asset class. It has shown pretty much zero correlation with inflation overall. There's no cash flow attached to it so it's difficult to ascertain what a true value would be. We set a slight premium over cash on it, same thing with commodities, but commodities do have a clear cycle related to inflation. If you look at the long-run history of commodities, real prices for iron, copper and so on, they've been declining for hundreds of years overall, and the spot prices continue to decline in real terms.

But commodities are usually implemented through futures contracts. And by definition, futures contracts are going to have the opportunity cost of capital built into them. So there's at least a cash-like return, but we see a huge variance around that cash-like return. In the last four months commodities are up 30-40% while the rest of the markets are experiencing a negative return, but that's a rare occurrence. I believe it's more a tactical play, than a true strategic play in a portfolio. Same thing with gold. I wouldn't quite recommend gold as a strategic asset class. But tactically there are times when gold can definitely help add alpha to a portfolio.

Massimiliano: From an historical perspective, the traditional listed market fixed income/equity portfolio did very well. When we think about clients looking at carving out part of that balanced portfolio into alternatives, what is the impact on the risk/return profile of the portfolio?

Lou: When I compare a 60% global equity 40% global aggregate bond portfolio, right now, we would estimate a Sharpe ratio of about 0.37. We believe that alternatives can get you a slightly higher return. And slightly higher risks too mostly

because of the private equity component. I estimate that we get a Sharpe ratio moving from about 0.37 to about 0.40. This doesn't sound like a lot, but when you look at strategic asset allocation, that's a big move in the improvement of the Sharpe ratio. So, the real benefit is you're augmenting return. You're increasing risk a little bit but because of the diversification benefits, you may be well rewarded for that with a higher Sharpe ratio going forward.

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