Macro Monthly

For global professional / qualified / institutional clients and investors and US retail clients and investors. For marketing purposes.

UBS Asset Management | Economic insights and asset class attractiveness
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The power of currency

Highlights

– Amid the rebound in equity valuations and a still very uncertain path for trade negotiations, we move our outlook for equities to neutral from overweight.
– Active currency management may provide hedging properties for portfolios against particular risks, like trade policy.
– We like short AUDUSD and short USDJPY over the medium term for economic and valuation reasons, but also see these trades as useful hedges against US-China trade escalation.

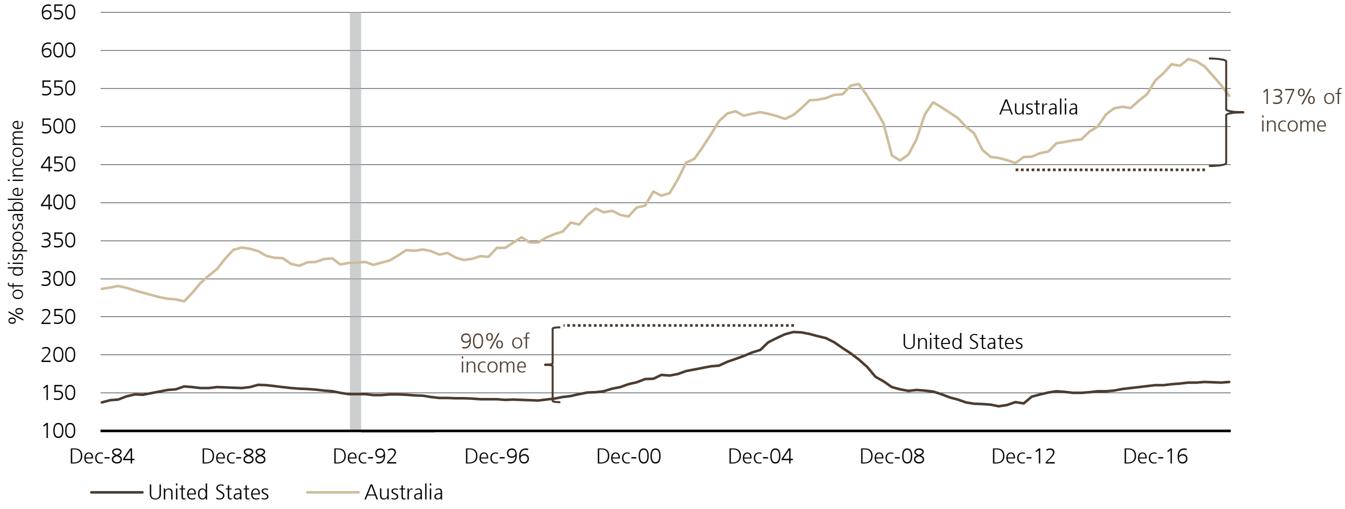
We write this Macro Monthly just before the June G20 meeting, when Presidents Trump and Xi are scheduled to meet and discuss the prospects for renewing trade talks. While our base case is that the two leaders ultimately strike a deal at some point over the coming twelve months, there is plenty of uncertainty on (1) whether we will get that final outcome and (2) the path to get there. Given ongoing cooling in economic data and high levels of uncertainty on potential trade outcomes, we have downgraded our outlook for equities to neutral from overweight. Indeed, economic and market pressures may need to rise on both countries before their respective leaders are prepared to make a deal which sticks. At the same time, both presidents could move towards active de-escalation, removing prior tariffs and catalyzing a further re-rating of risk assets. The unpredictability of the (geo)-political process is what makes a neutral, rather than aggressively overweight or underweight position sensible at this juncture.

Sovereign fixed income, such as US Treasuries, will likely provide some protection from adverse trade scenarios but there are a few reasons why they may be suboptimal for hedging these specific types of shocks. For one, tariffs are inflationary by nature, given that they drive up the costs on businesses and consumers. Second, market pricing for the Fed and other central banks is already substantial, with the rates market pricing about 75 basis points of easing from the Federal Reserve (Fed) by year end. Relatedly, there may be some hesitance by the Fed to deliver the full easing priced into markets given uncertainty about the outlook for trade policy and its true economic effects.

Enter foreign exchange

Taking active positions in currencies is one way to express particular macro views or hedge against specific risks, such as an escalation in trade tensions. In Investment Solutions we run a pure FX portfolio named the Currency Absolute Return Strategy (CARS), which focuses on idiosyncratic economic and valuation signals for the world's liquid currencies. As a whole this strategy offers diversification to largely long-only portfolios that are driven substantially by market beta. But we also leverage our research for CARS to run currency overlays for other allocation strategies. Specifically, we can identify currency trades that we expect to work over time due to economic and valuation

Exhibit 1: Gross real estate assets as a percentage of disposable income, Australia vs. United States



Source: Minack Advisers, ABS, Federal Reserve, UBS-AM, Macrobond. Data as of 30 March 2019. Australia Q1 2019 data estimated. Australia's most recent recession, Sept. 1990-Sept. 1991, represented by gray bar.

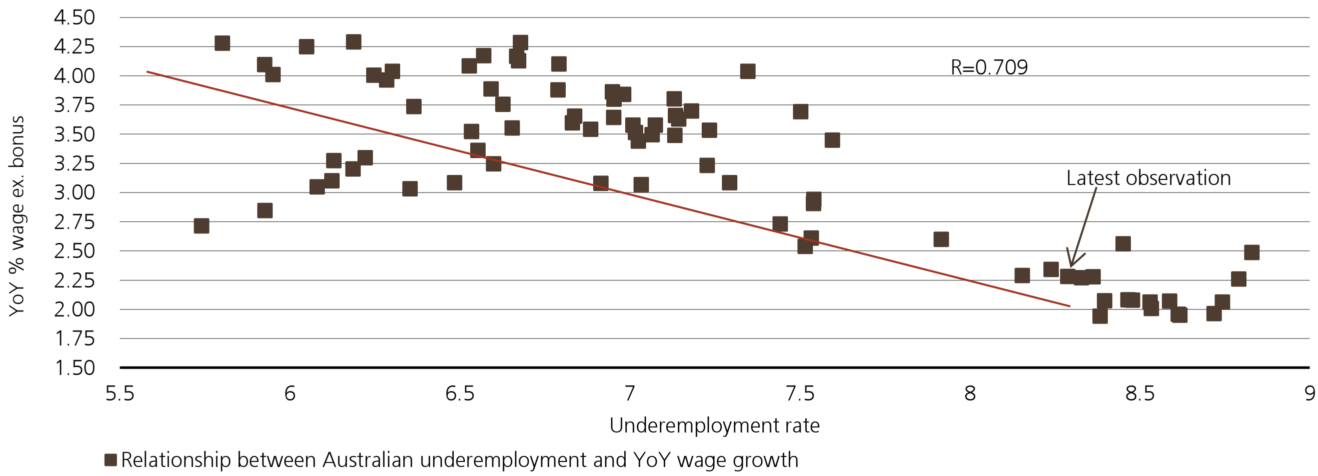
reasons, but also offer particularly attractive hedging properties around specific risks. Ideally, they provide an asymmetric risk profile—moving a great deal if a risk outcome we are hedging happens, while only moving somewhat if the event does not. We believe that short AUDUSD and short USDJPY are two trades that fit the bill.

Short AUDUSD

Australia is a small open economy with significant commodity exports, many of which go to China, an engine for global trade. This makes the Australian dollar highly sensitive to global growth and China's economic prospects. As such, AUDUSD is likely to depreciate meaningfully if US-China trade tensions escalate, raising downside risks to China (and global) economic prospects. The Korean won and Taiwanese dollar are also tied into China's supply chain (via tech as opposed to commodities), and would likely also weaken in an adverse trade scenario.

What makes AUDUSD particularly interesting as a short though, besides being a highly liquid currency, are Australia's idiosyncratic domestic economic pressures. Core to this is Australia's cooling housing market, which had previously been a meaningful support to household wealth and consumption. With activity and prices cooling, the Australian economy faces significant downside risks. This is especially true given how large household wealth is compared to disposable income—a fall in house prices may lead to negative 'wealth effects' for the consumer and weigh on consumer spending (Exhibit 1). And income growth itself is fading: Wage growth is softening because underemployment is still high, and trending higher (Exhibit 2). The Reserve Bank of Australia (RBA) is cutting rates to offset some of these

Exhibit 2: Australia has high underemployment and low wage growth



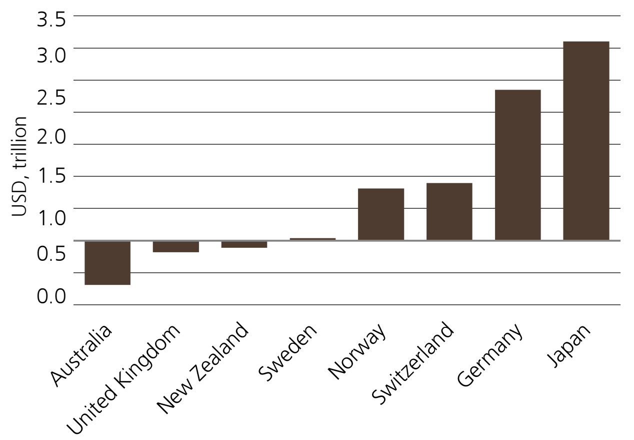
Source: Minack Advisers, ABS, UBS-AM, Macrobond. Data as of 1 January 2019.

pressures (which should also help to weaken the currency), but when large imbalances that have grown over a long time start to unwind, it is difficult to achieve a soft landing. Thus even if there is a trade deal which helps lead to a temporary bounce in AUD, the domestic economic pressures will remain a headwind.

Short USDJPY

Another trade that may offer protection against an escalation in trade tensions and/or more significant slowdown in global growth is short USDJPY. Historically USDJPY has been particularly sensitive to rate differentials, so aggressive easing from the Fed should help this trade. And of course, JPY remains a popular safe haven currency. Japanese investors have the largest net international investment position of any G10 country (Exhibit 3). In other words, they have the most money to repatriate when market volatility picks up.

Exhibit 3: Net total international investment position- USD



Source: IMP, UBS-AM, Macrobond. Data as of 31 March 2019.

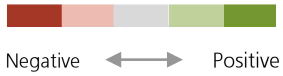
Like short AUDUSD, there are other reasons why we like short USDJPY. First, the currency is very cheap on a real effective exchange rate basis (Exhibit 4). Over time we would expect some valuation-based appreciation of the JPY. Moreover, the Bank of Japan has already used much of its policy arsenal. The public appetite for the BoJ to drive interest rates materially more negative is limited and the Bank is already on pace to own half of JGBs outstanding. The medium term risk-reward for USDJPY looks to the downside, even if the US and China reach a trade deal.

Exhibit 4: Japan's real effective exchange rate is near historical lows

Source: BoJ, UBS-AM, Macrobond. Data as of 1 May 2019.

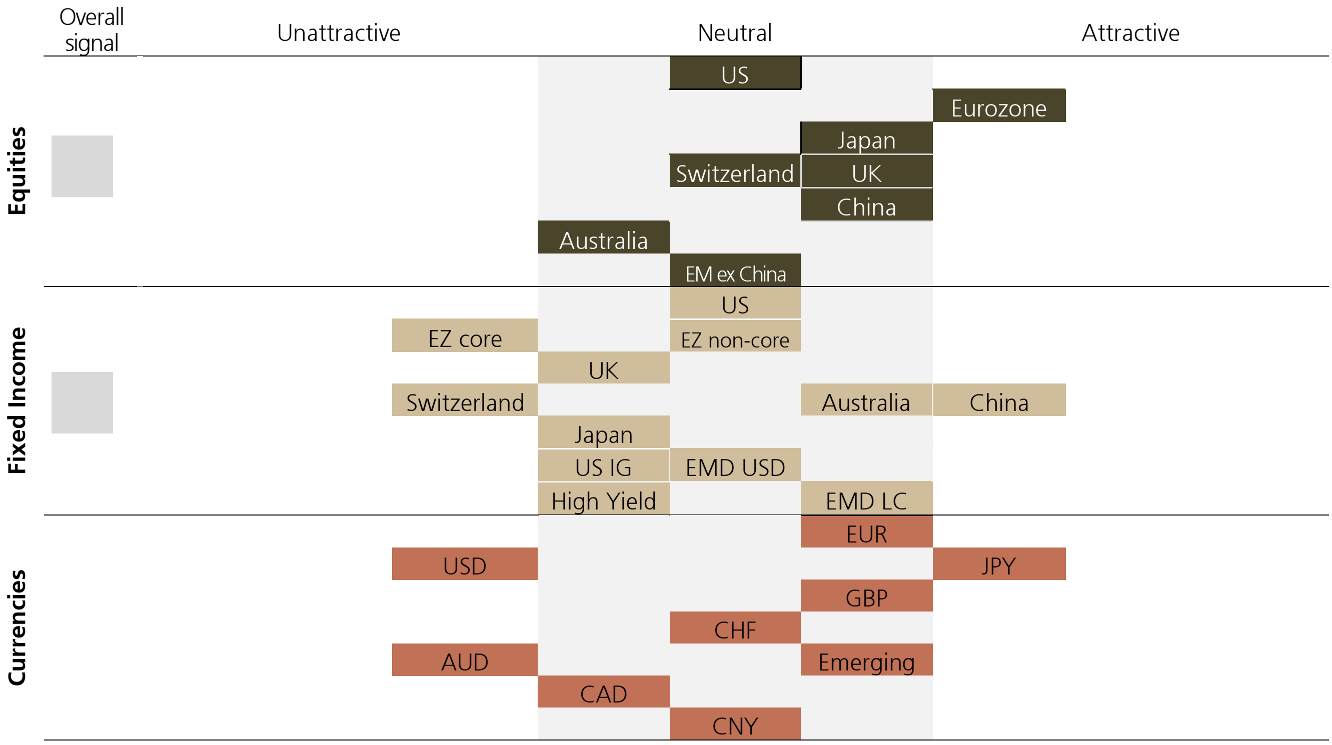
The bottom line: Asset allocation

Valuations for risk assets are back near the highs, various economic data are still slowing, and there remains ongoing potential for escalation in trade tensions. On the plus side, the Fed's sharp pivot from hiking to easing bias increases the chances of this historically long US expansion extending. Put together, this justifies a neutral stance towards equities. The Fed's easing, which we think will be seen as preemptive, should lead to a steepening of the yield curve. It should also put downward pressure on the dollar. And as discussed above, we are short AUDUSD and USDJPY to hedge against further escalation in upcoming trade negotiations.



Asset class attractiveness

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness, as well as the relative attractiveness within equities, fixed income and currencies, as of June 26, 2019.



Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as at 26 June 2019. Views, provided on the basis of a 3-12 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change.

Negative ⟷ Positive

Asset Class	Overall signal	UBS Asset Management's viewpoint
Global Equities **Global Duration**		– Global growth risks have risen as a result of trade war escalation and we have moved our equity outlook to neutral from overweight. While we still expect the global economy to ultimately steady without a hard landing, it now looks to be slipping below trend over coming quarters. Our view that a soft landing is achievable is built on resilience of developed economy labor markets and consumption, along with policy responses from the Fed and China to protect their economies. After inconsistent Fed rhetoric prompted fears of a US monetary policy mistake in late 2018, an unequivocally more accommodative Fed approach has emerged. In our view, the Fed is now likely to cut rates in order to rebase inflation expectations and provide insurance against downside risks to growth. With scant evidence of significant momentum in US core inflation, the Fed has breathing room. – The ability of China to cushion its economy continues to be key to the global economy and markets. The Chinese authorities have a broad range of policy tools at their disposal and have shown willingness to use the full breadth in achieving a difficult balancing act between de-risking a highly leveraged Chinese economy and softening the slowdown prompted by those deleveraging initiatives. – The key variable remains the relationship between the US and China in regards to trade and technology. While in our base case major escalation is ultimately avoided, we acknowledge that tensions are likely to simmer and act as a headwind for the global economy and earnings. As such, the risk-reward in equities has turned less positive, even if we are still constructive that the fundamental underpinnings of the global economy are sound. The likelihood of further material upside for risk assets in the short term is, in our view, now dependent on no further material escalation of trade tensions. Moreover, the effectiveness of the broad array of ongoing policy initiatives from the Chinese authorities to cushion their growth slowdown remains critical. – We have moved neutral from underweight developed market duration, as central banks globally shift towards easing. Central banks have shifted into risk management mode, attempting to move early and aggressively so as not to find themselves behind the curve with less policy ammunition as in earlier cycles. We are of the view that central banks will be successful in achieving a soft landing for the economy, but the path may prove bumpy. And while central banks (the Fed specifically), may not deliver as much easing as priced, they are unlikely to be raising rates anytime soon. A neutral duration position should help protect against negative shocks such as an escalation in trade tensions.
US Equities		– During the first half of the year, US equities benefited from a resilient domestic economy, a lower exposure to global growth factors compared to other major indices, and a more accommodative message from the Fed. However, we believe that the risk-reward compared to other markets has deteriorated as growth concerns begin to feed through to the US economy and risks to the technology sector as a result of geopolitics and regulation start to mount. US equities trade at a premium relative to other markets, suggesting they may underperform over coming months.

Negative ⟷ Positive

Asset Class	Overall signal	UBS Asset Management's viewpoint
Global (Ex-US) Equities		– In Europe, growth decelerated considerably in 2018, due to external and domestic factors. Externally, China's slowdown and trade uncertainty negatively affected European exports. Domestically, political upheaval in Italy and France along with disruptive auto emissions regulations weighed on the economy. However, we expect those headwinds will continue to fade over the coming months and have moved overweight European equities. European stocks remain supported by solid domestic demand dynamics and earnings growth, attractive valuations and by a likely stabilization of global economic conditions towards the second half of 2019. Decreased political risk and stronger domestic fiscal support should also help the region. – We remain constructive on Japanese equities despite the recent headwinds from weak Chinese imports. Diminished political uncertainties and ongoing structural reforms are supportive of higher price multiples while a solid underlying domestic economy suggests the outlook for profits is stronger than markets are discounting.
Emerging Markets (EM) Equities including China		– Emerging market equities continue to underperform developed market equities driven by an ongoing deterioration in earnings and a reescalation of US-China trade war worries. While the surge in Chinese social financing bodes well for EM growth eventually, the increased probability of a full trade war escalation will likely pressure tech heavy Asian firms until resolved. – We remain broadly positive on China in light of further economic stabilization in the second half of the year. Any broadening of the current trade standoff with the US is likely to hamper Chinese growth, but Chinese authorities have shown themselves willing to provide additional monetary, fiscal and regulatory support to help smooth ongoing developments. Chinese equities still trade at a small PE discount to other markets and further market liberalization could prompt a rerating as international capital starts to flow into Chinese assets following the inclusion of onshore Chinese equities in MSCI's widely followed EM equity indices.
Currency		– As fiscal stimulus in the US fades, US economic growth is moderating and the Fed looks on the cusp of a mini-easing cycle. Over time, we anticipate capital will flow from the US into earlier-cycle economies and that the USD will weaken, especially as the USD remains somewhat expensive on a real trade-weighted basis. Indeed, the Fed has much more room to ease monetary policy compared to its G10 peers—we move USD positioning to underweight. Elsewhere, we continue to see strong valuation support for the JPY and see short AUD as an effective hedge against ongoing China weakness in an economy where domestic household leverage is likely to constrain growth.
US Bonds		– With the Fed's rather abrupt dovish shift towards risk management, 10yr nominal US Treasury yields have dropped significantly. Nonetheless, US nominal yields look attractive relative to most other developed government bond markets on an unhedged basis. In the absence of a material pickup in inflation or term premium, yields are likely to be range-bound. Our overall assessment is neutral.
Global (Ex-US) Bonds		– In aggregate, we see global sovereign bonds outside of the US as unattractive. The ECB and BoJ have committed to low rates for some time, limiting attractiveness of core euro area bonds. We find Italian BTPs attractive on diminishing political risks. – Elsewhere we are more positive on Australian duration on a relative basis. We see the Reserve Bank of Australia easing given slow inflation along with domestic and external economic risks which are skewed to the downside.
US Investment Grade (IG) Corporate Debt		– Although we do not believe that a sharp demand slowdown is imminent, we think IG spreads troughed for the cycle in early 2018. Moreover, we are concerned about increased supply, reduced demand, and potentially large number of "fallen angels" when economic growth slows down significantly and downgrades begin. However, given the more accommodative Fed, in the near term we believe the balance of risks is roughly equal both to upside and downside.

Negative ⟷ Positive

Asset Class	Overall signal	UBS Asset Management's viewpoint
US High Yield Bonds		– Current default rates in high yield are very low by historical standards. Given the still relatively positive economic backdrop and accommodative Fed, we do not expect a material pickup in US defaults in the near term.
Emerging Markets Debt		– Spreads on EM debt, both hard currency and local currency, relative to US Treasuries widened substantially in 2018 in the face of higher geopolitical risks, a strengthening USD and higher USD funding rates. However, this year both hard currency and local currency EM yields have rallied together with Treasuries. Given this large move, the escalating trade tensions, higher tariffs, and slowing global trade volume, we expect that both curves will begin to price in additional credit/term premium. We are neutral until we are closer to the resolution of trade uncertainty.
US dollar		
Local currency		
Chinese Bonds		– Chinese bonds have the highest nominal yields among the 10 largest fixed income markets globally and have delivered the highest risk-adjusted returns of this group over the last 5 and 10 years. Slowing economic growth and inclusion to the Bloomberg Barclays Global Aggregate index next year should continue to push yields down during the next 3-12 months.

Source: UBS Asset Management. As of 26 June 2019.

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