

# 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

February 2020



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## The case for emerging markets

### Highlights

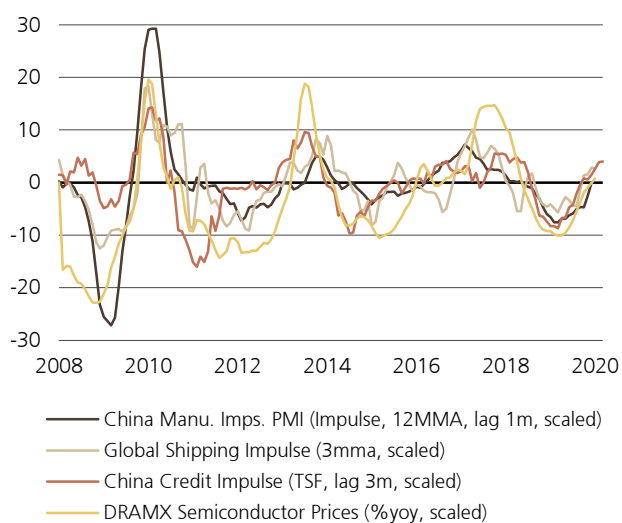
- Amid considerable uncertainty about the risks it poses, investors are understandably concerned about the potential impact of the coronavirus on global growth
- While the virus should negatively impact Chinese and global growth this quarter, we do not expect it to derail the healing in global manufacturing that began in Q4 and should carry on well into 2020
- Even if the impact is bigger than we currently expect, the Chinese authorities have the full policy mix at their disposal to provide additional stimulus should it prove necessary
- Assuming the impact of the virus is not protracted, we see global growth continuing to trend higher as last year's monetary policy easing feeds through developed and emerging market economies and as the de-escalation of US/China trade tensions boosts corporate confidence
- As the most geared to this late cycle bounce, we remain positive on the outlook for all emerging market assets classes

At the time of writing, Lunar New Year celebrations in China have been curtailed by the spread of the deadly coronavirus. With full details about the global spread of the virus, its symptoms, incubation period and mortality rates unclear, investors are behaving entirely rationally in the face of uncertainty by selling risk assets and buying safe havens. We cannot say with confidence how or how quickly things are likely to progress. But human tragedy aside, history would suggest that such epidemics have a limited short-term impact on the wider economy that is often followed by a sharp rebound, as pent-up demand is unleashed. We suspect this particular geopolitical risk will end up an opportunity to accumulate emerging market assets at more attractive valuations.

That positive view begins with our conviction that global growth is experiencing a cyclical rebound after the sharp manufacturing slowdown of 2018-2019. Over recent months, global growth leading indicators have clearly bounced. High frequency macroeconomic data across both developed and emerging universes further supports the view that overall manufacturing demand momentum is re-accelerating. While the coronavirus is likely to impact that momentum in the short-term, we do not believe it will derail it.

In our view, there is more to come from this rebound than markets are currently discounting. We see global demand growth supported by the lagged impact of aggressive monetary policy easing across developed and emerging markets in 2019. This kind of sharp move in accommodation has historically eased credit conditions, setting the stage for a V-shaped economic recovery. Central banks are set to remain accommodative in 2020 and we have already seen further easing in Turkey, South Africa and Malaysia in early 2020. In our view, there is scope for EM monetary policy in aggregate to provide further stimulus should it prove necessary.

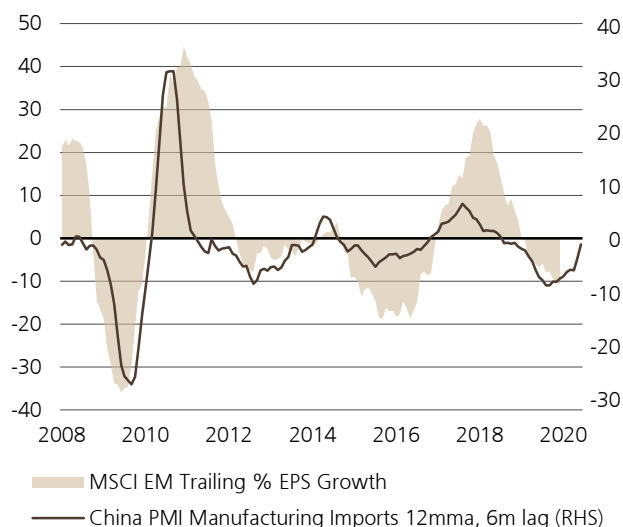
**Exhibit 1: Leading indicators for emerging markets' profits growth are turning**



Source: UBS Asset Management, Refinitiv as of January, 2020.

Of course, the outlook for China and for global trade is of particular relevance to emerging markets. China's central position in the global manufacturing, commodities and the investment cycle leaves emerging markets' growth and profits heavily reliant on the region's largest economy. The reduction in tariffs (and tensions) under the US and China's 'Phase 1' trade deal therefore represents a welcome moderation of geopolitical risk.

**Exhibit 2: Emerging market profits have been closely connected to Chinese manufacturing growth**

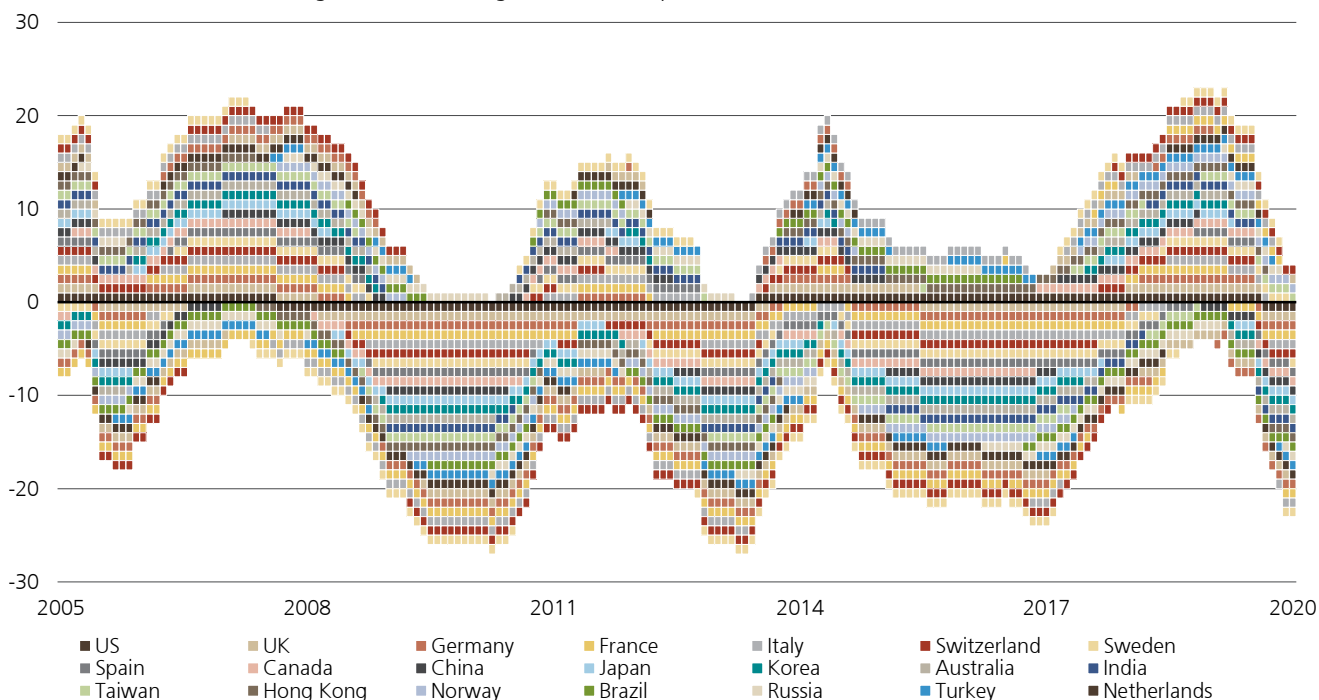


Source: UBS Asset Management, Refinitiv as of January, 2020.

In our view, there is an understandable degree of market skepticism about whether the US/China trade truce will hold. More specifically, investors are questioning the viability and enforcement mechanisms for the Phase 1 deal's agreements on China's purchase of US agricultural commodities, the new rules on intellectual property and technology, and improved

**Exhibit 3: Easier monetary policy globally**

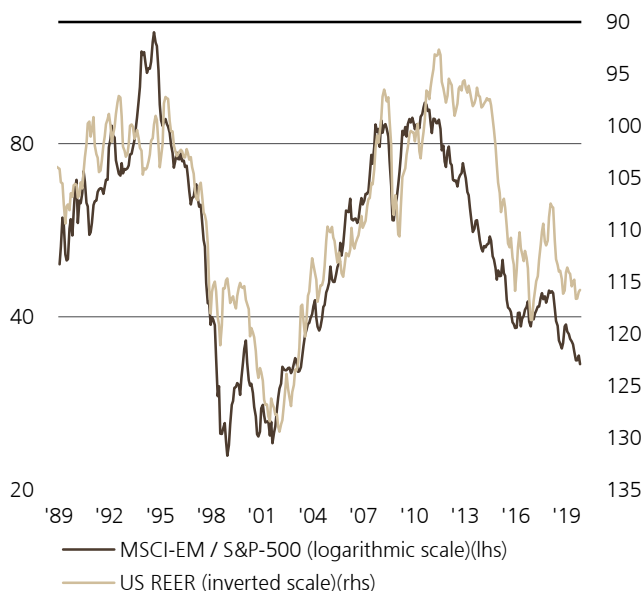
Balance of markets with an easing (-1) versus hiking (+1) bias over past 12-18m



Source: UBS Asset Management, Refinitiv as of January, 2020

market access for US companies in China. But while both short-term and structural questions remain, we believe that there is little appetite in the White House in a US election year to threaten global risk assets by renewing trade hostilities. Given the uncertainties of 2019, we believe the absence of any renewed trade tensions is sufficient in itself to bolster business confidence across EM as the year progresses. Our positive view on EM equities therefore assumes neither de-escalation nor re-escalation in the US/China trade talks in 2020. We would also emphasize that the risks to the US-China relationship are balanced. Investors should not discount the possibility of further tariff reduction should China show early compliance. Like the Fed, President Trump now owns the ability to 'cut rates,' providing stimulus via tariff reduction in an effort to ease financial conditions.

**Exhibit 4: The historical relationship between the USD and EM v DM equity performance is well established**  
MSCI EM v S&P 500 (LHS), USD (RHS, inverted)



Source: UBS Asset Management, Bloomberg as of January 2020. Past performance is not indicative of future results.

Meanwhile, China's targeted support for its manufacturing sector and broader policy stimulus appears to be working. There is compelling evidence that the slowdown is now stabilizing. This suggests that despite its ongoing focus on structural deleveraging, China is willing and able to provide the necessary stimulus to cushion its economy against cyclical domestic and international headwinds.

But does any of this matter in light of the coronavirus? The coronavirus is a wildcard and its impact is hard to quantify. Our current base case is that the virus meaningfully impacts Chinese consumption growth in Q1 and then subsequently fades, setting the stage for a sharp rebound. Importantly, the Chinese authorities have the full policy mix at their disposal to mitigate any more protracted negative impact should it prove necessary: further moderate easing through cuts in benchmark

interest rates, and on the fiscal side through increasing government spending on infrastructure investment and other high multiplier spending initiatives. Crucially, we do not currently see the virus derailing the pickup in Chinese manufacturing momentum that began late last year.

### The importance of USD

For many investors, it is hard to separate the outlook for emerging market equities from the outlook for emerging market currencies. We see both reacting positively to the improvement in manufacturing and the broader healing of the global economy. We currently favor a number of Latin America currencies including the Brazilian real and Chilean peso, where we see particularly attractive valuations.

Of course, the USD plays a central role in developing economies both as the most popular 'hard' currency for debt and as the pricing currency for key export commodities. Reduced demand for US Treasuries after the recent fall in real yields and the likelihood that monetary policy remains accommodative for the foreseeable future are all likely to limit the upside for the USD. Concerns about this year's presidential election race and the possibility of a significant change in US policy may well disadvantage the USD and US risk assets on a relative basis as 2020 progresses. With explicit penalties for devaluing against the USD embedded in recent trade deals with China, and with Canada and Mexico, the US also appears

**Exhibit 5: EM Forward EPS starting to turn relative to US**  
MSCI EM v MSCI USA FY1 EPS Rebased



Source: UBS Asset Management, Bloomberg as of January 2020.

to be pursuing a quasi-fixed exchange rate regime. To be clear, we do not believe that the USD is set for a material downward repricing. But a number of obvious supports to the USD are now less powerful than they were, and as the fiscal impulse in the US begins to fade and ex-US global growth stabilizes, the risks of a materially stronger USD are diminishing. For EM corporates whip-sawed by currency volatility in recent years, stabilization against the USD represents welcome and important progress in itself.

We see this improving demand and profits backdrop benefiting EM credit too, and expect continued flows towards both local and hard currency EM debt in a world where attractive real yields remain scarce. Within EM credit we believe that Asian bonds offer one of the most attractive risk/reward trade-offs, with Asian corporates benefiting from the lagged impact of recent Chinese monetary policy loosening. Spreads for Asian bonds over US Treasuries are only about average for this stage of the Chinese demand cycle, but this compares favorably to the stretched valuations elsewhere in global credit.

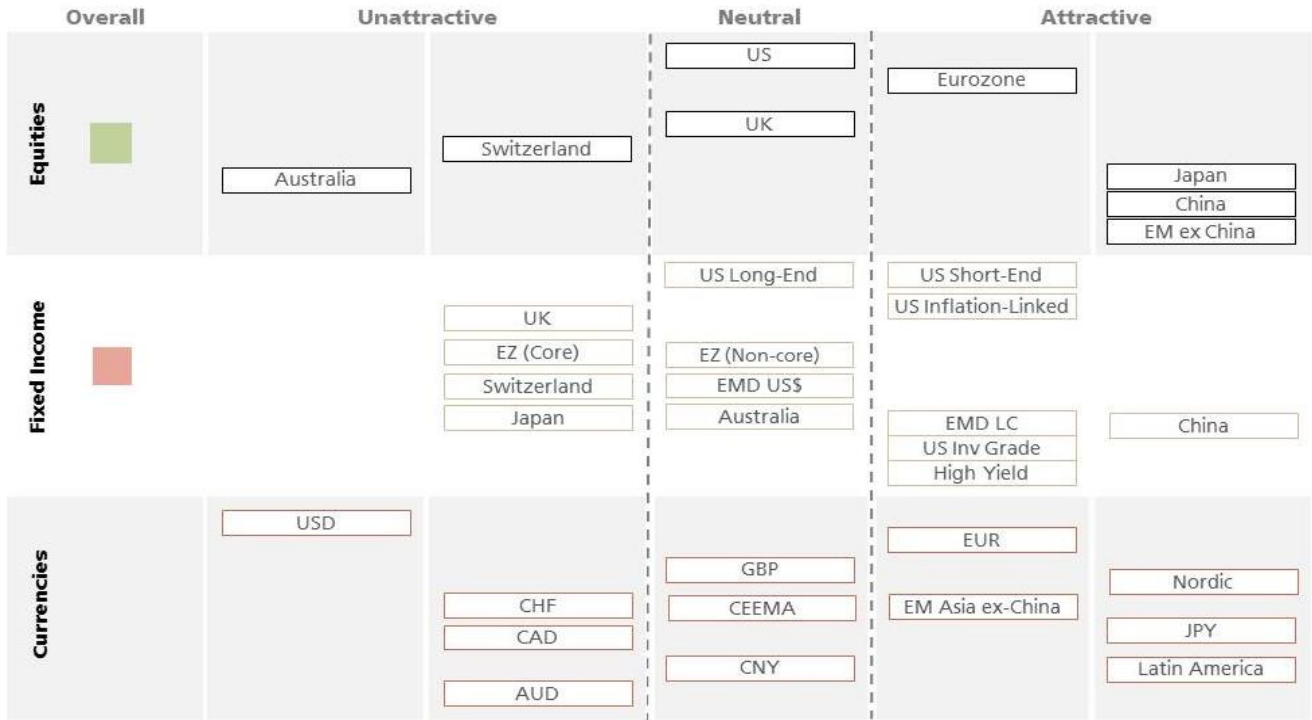
EM equity valuations also stand broadly in line with their long-term average on most major valuation metrics, including P/E. In the developed world, equity valuations vary markedly, but with the heavyweight US in particular standing out as stretched on traditional earnings measures, EM equities compare favorably to DM overall. Yes, there is scope for relative multiple expansion for EM equities. But this is not our

base case. Our positive view is based predominantly on improving fundamentals for EM demand and corporate profitability rather than being driven by relative valuation. We simply ascribe a greater likelihood of earnings upgrades in EM as we see the region's corporates benefitting from a more stable currency backdrop and from a manufacturing and trade-led global demand bounce.

Is 2020 going to be the year the EM asset classes return to the spotlight? We think so. While the coronavirus has the potential to impact demand significantly, our base case is that the virus has only a short-term impact on demand that does not extend into the second half of the year. Emerging market economies were hardest hit by the downturn in manufacturing and trade in 2018 and 2019. Simply put, we believe that they are the most leveraged to the rebound.

### Asset class attractiveness

The chart below shows the views of our Macro Asset Allocation Strategy team on overall asset class attractiveness, as well as the relative attractiveness within equities, fixed income and currencies, as of 28 January 2020.



Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as at 28 January 2020. 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.

Asset Class	Overall signal	UBS Asset Management's viewpoint
<b>Global Equities</b>	■	<ul style="list-style-type: none"> <li>– We expect a moderate rebound in global growth in the coming months that we do not believe is fully reflected in global equity prices. Key to the moderate demand pickup we expect is the delayed boost to economic activity from the significant easing of global financial conditions. Importantly, the shift to looser policy has not taken place only in the US, but has been broad based across both developed and emerging markets. Absent any extraneous demand shock, we see this supporting equities throughout the early part of 2020 as the boost from lower rates feeds through and equities rerate against a backdrop of supportive monetary policy. Should growth falter, we believe that calls for fiscal stimulus to play a greater role in the overall policy mix will grow louder in a number of major economies.</li> </ul>
<b>US Equities</b>	■	<ul style="list-style-type: none"> <li>– US equities trade at a premium relative to other markets due in part to a resilient domestic economy and a lower exposure to global growth factors. But as the global demand impulse strengthens, we see these factors as more headwind than tailwind; more cheaply valued and cyclical ex-US equity markets are likely to react more strongly. Meanwhile, headlines around the 2020 US presidential election and potentially dramatic changes in US economic policy will likely prompt bouts of volatility that disadvantage US equities over their international peers given their substantial valuation premium. The long period of US equity outperformance may be drawing to a close.</li> </ul>
<b>Ex-US Developed market Equities</b>	■	<ul style="list-style-type: none"> <li>– Given historically high equity risk premia and a greater sensitivity to improving global manufacturing demand, we prefer developed equity markets outside of the US. In Europe, recent economic data and business surveys have been improving. We expect demand momentum to further accelerate in the coming months and for European equities to rerate accordingly. In September, the European Central Bank (ECB) delivered a stimulus package which is growth supportive and the broad based easing of financial conditions globally is likely to continue to bolster demand. Furthermore, geopolitical headwinds have somewhat diminished with Italy now in a coalition government. These developments are also positive for European equity valuations.</li> <li>– We see Japanese equities as one of the best ways to play the global growth rebound. We believe that they are positively correlated to the external demand environment, attractively valued and supported by the larger-than-expected domestic fiscal package taking effect in early 2020. Furthermore, investment is likely to accelerate as we move closer to the 2020 Tokyo Summer Olympics. Improving corporate governance is also a positive.</li> </ul>
<b>Emerging Markets (EM) Equities</b>	■	<ul style="list-style-type: none"> <li>– In our view there are also strong arguments currently for broad emerging market equities on a tactical basis. We see EM as a major beneficiary of a global demand bounce, an improvement in global trade in the wake of a US/China tariff truce and of the cut in USD borrowing costs. After interest rate cuts across the EM universe, monetary policy conditions have loosened significantly. The stabilization of growth in China that we expect is also likely to be positive for wider emerging markets.</li> </ul>
<b>China Equities</b>	■	<ul style="list-style-type: none"> <li>– Notwithstanding short-term risks to consumption and intra-Asia tourism from the coronavirus, we remain positive on China as policy measures continue to cushion the economy. The Chinese authorities have shown themselves willing and able to provide additional monetary, fiscal and regulatory support to help smooth the rebalancing of the Chinese economy. Chinese equities still trade at a small PE discount to other markets and further market liberalization could prompt a re-rating. International capital should increasingly flow into Chinese assets following the inclusion of onshore Chinese equities in MSCI's widely followed EM equity indices.</li> </ul>
<b>Global Duration</b>	■	<ul style="list-style-type: none"> <li>– A modest rebound in global demand suggests there will be at least some upward pressure on longer-dated government bond yields given the very low growth and inflation assumptions reflected in the 10yr government bond prices of developed countries including Japan, Germany and Switzerland. With monetary policy likely to remain loose even in the face of improving data, we see developed world nominal yield curves steepening.</li> </ul>

Asset Class	Overall signal	UBS Asset Management's viewpoint
<b>US Bonds</b>	■	– With the Fed likely to let the US economy 'run hot' before starting to tighten policy again, there is scope for the nominal US Treasury curve to steepen. While we expect increased supply to push yields higher over the longer term, the scarcity of positive yielding safe assets should continue to drive flows into US Treasuries and limit the scope for longer-dated yields to rise more materially on a relative basis in the short term. We also expect US inflation expectations to rise and are therefore positive on US 'breakeven' rates – the yield difference between 10y US index-linked Treasuries and their nominal counterparts.
<b>Ex-US Developed-market Bonds</b>	■	– In aggregate, we see ex-US developed market sovereign bonds as unattractive. The ECB and Bank of Japan (BoJ) have committed to low rates for some time, limiting the attractiveness of these markets. Upcoming fiscal stimulus measures in Japan and modest cyclical easing in Europe may also contribute to higher ex-US yields.
<b>US Investment Grade (IG) Corporate Debt</b>	■	– Given the large proportion of fixed income markets with a negative yield, we believe that US IG is more attractive in relative terms. We expect a cyclical rebound and therefore think IG debt will remain well bid. – That said, we acknowledge high levels of corporate debt and the potentially large number of "fallen angels" when economic growth slows down significantly and downgrades begin. Hence, this is closer to 3m rather than a 12m view.
<b>US High Yield Bonds</b>	■	– 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. This is a 3m rather than 12m view.
<b>Emerging Markets Debt</b>		– We see the rebound in global manufacturing and lower USD funding costs as being supportive for emerging market assets in general. Spreads on both hard and local currency EM debt relative to US Treasuries remain attractive in an environment where positive real yields are scarce. As we do not anticipate a broadening economic downturn, we do not see a major spread widening in EM. An environment of still low developed market yields and decent growth is a positive one for EM carry. However, we believe local currency bonds are in a better position to take advantage of this given very cheap FX valuation.
US dollar	■	
Local currency	■	
<b>Chinese Bonds</b>	■	– 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. We believe that slowing economic growth, and inclusions to global bond market indices should continue to push yields down during the next 3-12 months.
<b>Currency</b>		– The USD has been stubbornly strong, but we see the next big move as lower. The USD is overvalued on a real trade-weighted basis. Meanwhile, US economic growth is moderating and the Fed is easing. Over time, we anticipate economies outside of the US will stabilize and investment capital will seek out opportunities in those countries, sending the dollar lower. 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.

Source: UBS Asset Management. As 28 January 2020. 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.

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