

# Macro Quarterly

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

Macroeconomic themes and tactical asset allocation opportunities  
1Q2020 | UBS Asset Management



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## The next decade in asset allocation

After the exceptional risk-adjusted returns of the past ten years, what do the 2020s hold in store? *Macro Quarterly* considers whether a structural regime change in asset class performance and correlations is likely in the next decade, what might drive it, and how investors can prepare.

From a macroeconomic perspective, one thing seems clear: monetary policy in major developed economies has come close to running its course. The fact that growth and inflation expectations reflected in government bond yields across the developed world remain so muted despite such a sustained period of low rates and quantitative easing, tells its own story about the waning effectiveness of monetary policy in the wake of the financial crisis.

A change in the overall policy mix is, in our view, necessary and inevitable, with the case for a step change in government spending to work alongside monetary policy intensifying. Given the potential for tax and debt-funded higher fiscal spending to also address widely-held concerns about social inequality, underinvested infrastructure and underfunded public services, we do not expect many major elected officials in larger developed economies to ignore the call for increased fiscal spending as the 2020s progress.

This policy evolution has potentially significant implications for capital markets. The broader risk and returns environment is likely to evolve into something strikingly different to the low volatility, strongly negative equity/bond correlation and high risk asset returns regime that investors have enjoyed for the majority of the past decade.

Indeed, the valuation starting point and prospects for higher volatility suggest risk-adjusted returns will be significantly lower in the 2020s for the majority of major traditional asset classes. Given the very low and negative yields in major government bond markets, this is particularly the case for fixed income; there is the very real prospect of negative returns for developed world government bonds for 'buy and hold' investors.

What should multi asset investors do? This decade-ending issue of *Macro Quarterly* explores our view of the 2020s policy outlook, its implications for markets and for the optimal strategic asset allocation of multi asset portfolios.



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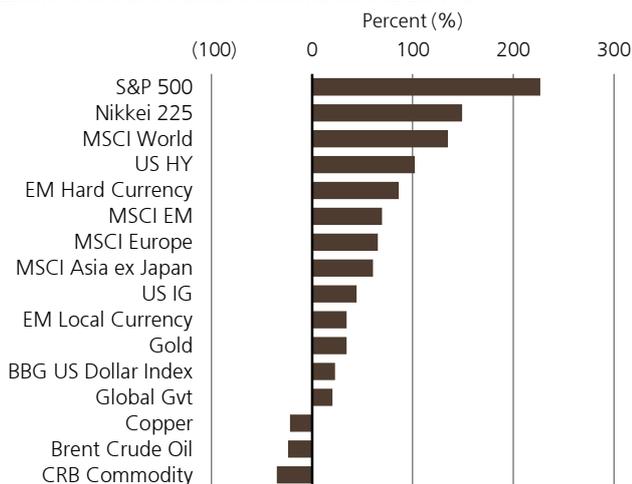
**Ryan Primmer**  
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"If you don't know where you've come from, you don't know where you're going." Maya Angelou.

### The 2010s: buy everything

To understand the likely paths of macroeconomics and capital markets in the coming decade, it is worth reminding ourselves where we start from. In particular, it is worth remembering just how remarkable the past decade has been.

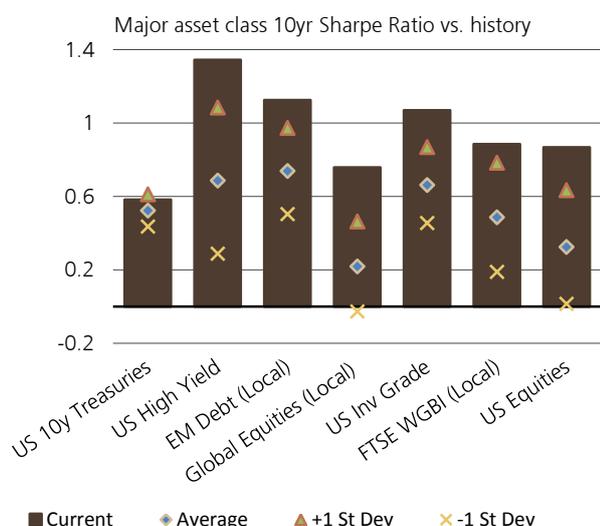
**Exhibit 1: Asset Class Returns in the 2010s**



Source: UBS Asset Management, Macrobond as at December 2019. Local currency.

Following on from the 2000s, a decade book-ended by the dot-com crash and the 2008/9 financial crisis, high returns (excepting commodities) and low volatility have been the defining characteristics of the 2010s across asset classes amidst an increasingly consensual 'lower for longer' narrative.

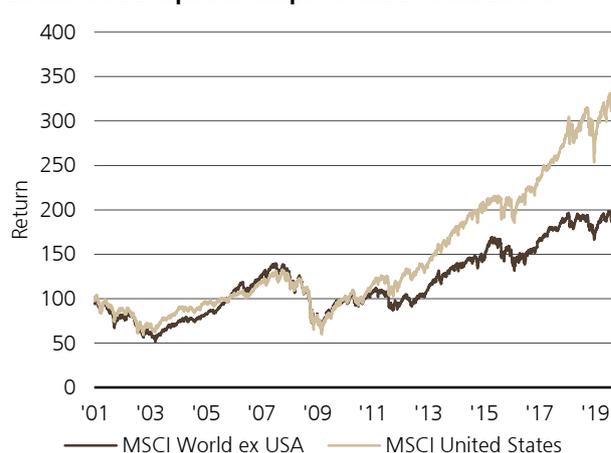
**Exhibit 2: Risk-adjusted returns were high in the 2010s**



Source: UBS Asset Management, Refinitiv, as at December 2019. Historical data from Dec 1989 (US equities, US bonds, US high yield, global equities), Jan 1992 (EM debt), Jan 1993 (US inv Grade, Global Bonds)

The principal driver to the reflation of financial assets has, of course, been monetary policy. It was, after all, an explicit goal of monetary policy in the wake of the 2008/9 financial crisis to boost the US economy via the portfolio rebalancing effect. But even as the impact of low policy rates and central bank quantitative easing on the real economy has diminished, the policy stimulus and forward guidance provided by central banks have supported asset prices while suppressing volatility.

**Exhibit 3: US equities outperformed in the 2010s**

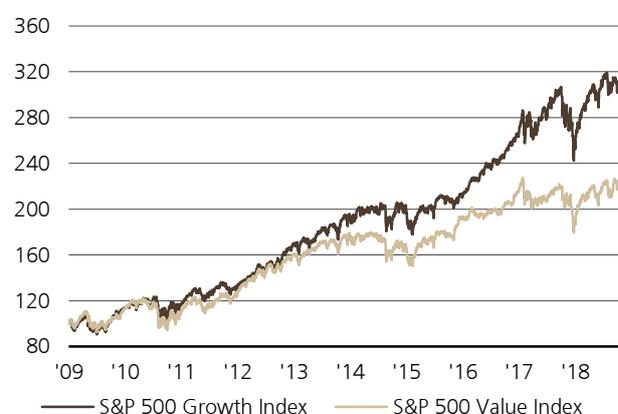


Source: UBS Asset Management, Macrobond as at December 2019.

The combination of high returns, low volatility and a negative correlation between developed world equities and developed world government bonds has clearly aided the risk-adjusted returns potential of multi asset portfolios.

The same forces have prompted the shift from active to passive – a key feature of the 2010s – as the case for active has been diminished by the high beta component of returns.

**Exhibit 4: Growth stocks benefited disproportionately from low rates in the last 10 years**

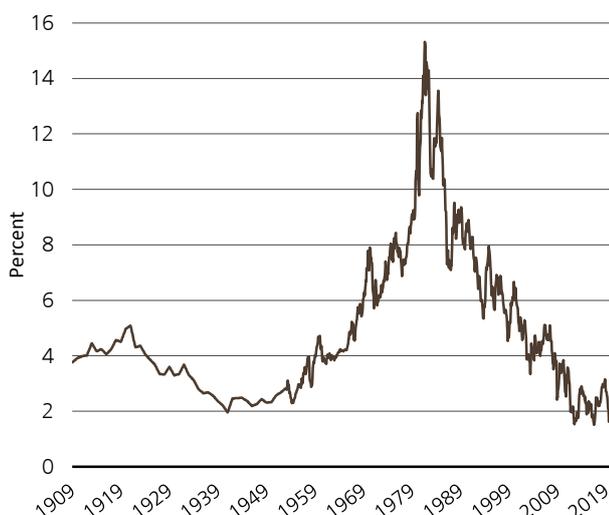


Source: UBS Asset Management, Macrobond as at December 2019.

At a more granular level, buying American assets (and, connectedly, buying 'growth' equities over 'value' in an environment where low rates have had a significantly greater benefit on the valuation of longer-term growth cash flows) has also been a defining feature of the 2010s.

But the most persistent theme over the past two decades – indeed, the most consistent theme over the past 40 years – has been the containment of inflation and the fall in nominal government bond yields across the developed world.

**Exhibit 5: US Treasury 10y yields have been trending down for 40 years**



Source: UBS Asset Management, Macrobond as at December 2019.

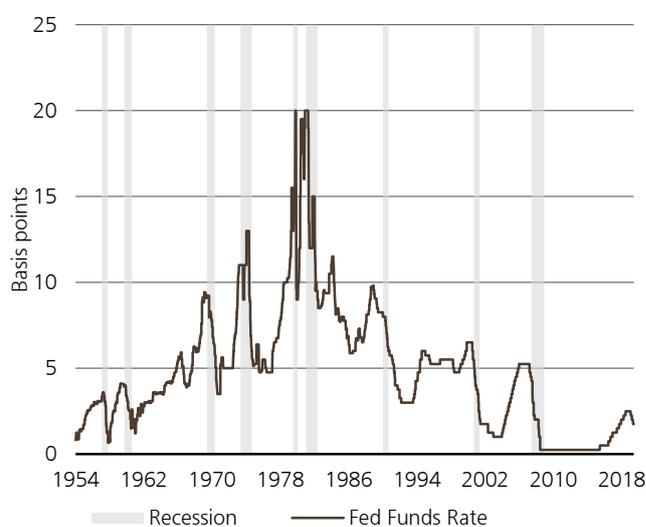
We have written on a number of occasions about the structural decline in productivity, inflation expectations and population growth, plus the growth in demand for income from ageing populations and excess savings, and the role that all of these factors have played in suppressing yields alongside quantitative easing. Are these forces going to continue to weigh on the world's discount rate, the US 10y treasury yield, in the 2020s?

**Policy in the 2020s**

Our view is that we will not see a global recession in 2020. But whenever the next recession does arrive in the coming decade, neither the US Federal Reserve (the Fed) nor other major central banks appear to have sufficient room to ease policy rates enough to reinvigorate growth and inflation.

In previous cycles going back to the 1950s, the Fed's response to a collapse in demand has been to cut the Federal Funds rate by an average of 550 basis points. At the time of writing, the Fed has room for only another 175 basis points of cuts, having publicly stated its opposition to moving below the zero lower bound and into negative interest rates.

**Exhibit 6: Running out of room? Fed has cut an average 550bp in recessions historically**



Source: UBS Asset Management, Macrobond as at December 2019.

In the Eurozone, Japan and Switzerland, policy rates are already negative, giving respective central banks next to no ammunition in the next downturn via the policy rates channel. Quantitative Easing (QE) could be increased again, but like official policy rates, the impact of QE on the real economy and on asset prices has diminished over time. This leaves major central bankers with a limited and increasingly ineffective toolkit with which to address the next recession.

So when the next downturn does come, we do not believe that monetary policy in isolation will be able to perform its usual counter cyclical role. Instead, we see the burden of providing the major stimulus to demand and inflation landing on government spending. Elected officials will therefore face a stark choice: let the economy stagnate, or spend. Given the very obvious electoral benefit incentive, we don't believe that many senior politicians will deliberate very long before embracing the fiscal mantra.

But there is more to the fiscal story than political expediency. In our view, the social and economic arguments for fiscal policy playing a significantly greater role in the overall policy mix in the 2020s are strong. We believe that current low borrowing costs provide further momentum. Indeed, with the cost of borrowing below current growth rates in major economies, it is theoretically possible for governments to borrow to fund fiscal stimulus and to address social imbalances without increasing overall net budget deficits. We also sympathize with the view that any fiscal multiplier (the benefit to the economy for every USD of government spending) may be greatest precisely at the point where monetary policy stimulus is at its least effective. If we are not already at that point, we do not believe that it is very far away.

If the arguments appear compelling, there are still hurdles to overcome. The blurring of the lines between elected officials and central bankers is far from straightforward and, at first glance, appears unlikely to evolve swiftly. We would highlight Germany in particular as a country with the scope for a significant fiscal stimulus to boost growth, but with little apparent political will currently to counter the balanced budget requirement enshrined in German law to progress such a move.

But the political backdrop can also change quickly. The pressure on governments including the UK, Germany, Japan and elsewhere to borrow and spend more is increasing – witness the promises of the major parties ahead of the UK general election. The finer details of a significant fiscal package are expected in the coming months in Japan where the government is already seeking to spend its way to higher growth.

Our conclusion then on government spending is more general than specific in nature: even if a major increase in fiscal spending isn't necessarily imminent across all major economies, the direction of travel for the coming decade seems very clear indeed.

**More fiscal likely to push yields higher**

The shift from monetary policy to fiscal policy could have a significant impact on asset prices and volatility. Increased monetary stimulus over the past decade has lowered interest rates across the yield curve – directly at the short end through the official policy rate and across the curve through QE, indirectly through forward guidance.

**Exhibit 7: Higher fiscal = higher nominal GDP and 10y Yields**



Source: UBS Asset Management, Macrobond as at December 2019.

All things equal, we believe that increased fiscal stimulus is likely to increase interest rates across the curve as economic growth and inflation expectations increase, and likely at the long end due to an increased supply of debt.

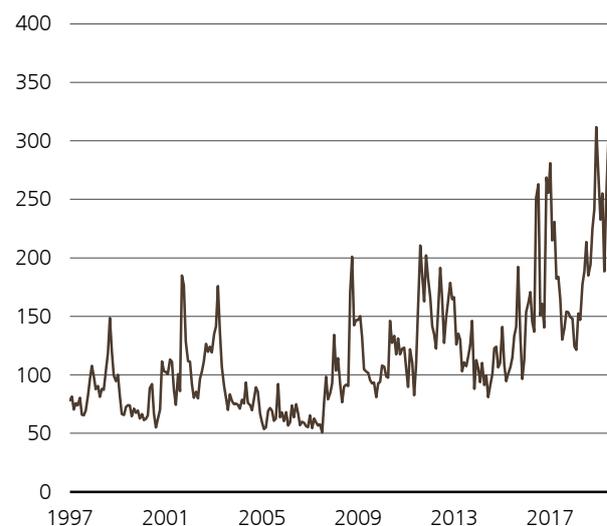
But a key question about the impact of increased fiscal spending on yield curves is how central banks will react to the shift in overall policy dynamics. Will they continue to keep interest rates suppressed even in the face of rising growth and inflation expectations in order to steepen the yield curve, benefit banks and supercharge the growth outlook – or will they raise rates as growth and inflation momentum accelerates to allow more room to cut in the next downturn?

All the recent rhetoric suggests strongly to us that major central banks in the developed world are much more likely to let growth and inflation 'run hot' over time before hiking rates. This is a key reason why we believe developed world yield curves will steepen in the coming years.

As confident as we are in the increasing role of fiscal policy, there are other reasons to believe that the era of very low inflation may be coming to an end. The defining story of markets in 2019 has been the impact of geopolitics. The long-term trend of globalization and the removal of barriers to trade has been a key downward force on global prices in the last few decades. The recent rise of economic nationalism, itself a consequence of many of the same pressures that we expect to drive an increase in fiscal spending, is now prompting globalization to slow.

**Exhibit 8: Rising geopolitical risks**

Global Economic Policy Uncertainty Index (Current Price GDP Weights)



Source: UBS Asset Management, Macrobond as at December 2019.

And like fiscal spending, we do not see the forces behind protectionism abating anytime soon. By way of example, it seems clear that the US/China conflict isn't just about trade, but about ideology, technological superiority, strategic competition in regional spheres and capital flows. None of these issues appears likely to be resolved quickly.

What does all this mean for markets in the 2020s?

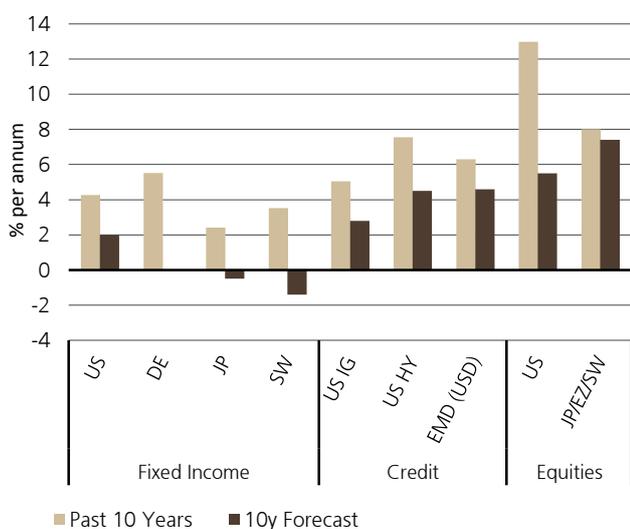
**Lower returns**

To cap off what had already been a strong decade, 2019 has seen an aggressive rally in fixed income, the closing of credit spreads and a rerating in global equities as the monetary policy stance has undergone a dramatic pivot. The 'lower for longer' narrative has returned.

We believe that index returns are likely to be lower in the coming decade across traditional asset classes in the 2020s, particularly in fixed income. The 10-year annualized return forecasts from our Strategic Asset Allocation team for selected asset classes are set out below.

**Exhibit 9: Returns are likely to be lower across asset classes in the 2020s, particularly in fixed income**

10yr forecast returns vs. past 10yr actual returns



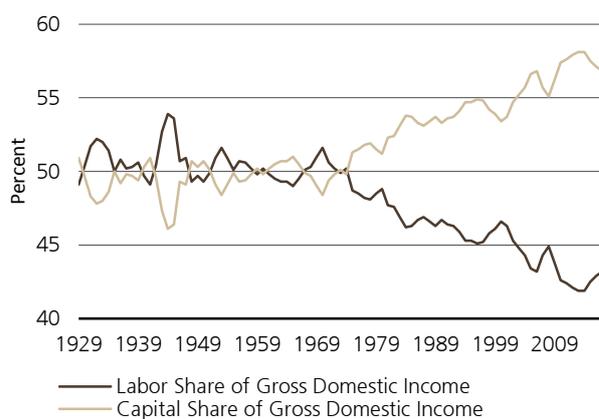
Source: UBS Asset Management Investment Solutions, Refinitiv, as at December 2019. Historical returns in local currency unless stated. Equity forecasts made on unhedged basis, fixed income on hedged basis

More than anything the outlook for lower returns reflects the valuation starting point across asset classes relative to history. But for US equities in particular there are potentially other pressures than the valuation multiple investors are willing to pay for US corporate profits. Remarkably little of the outsized US equity returns of the past decade can be attributed to an expansion of PE multiples. Despite mediocre to lackluster US demand growth, by far the biggest contributor to US equity returns has been earnings, which have grown at a compound annual rate of over 12% over the past decade vs. US GDP growth of around 2.5% per annum, according to data provided by Refinitiv. In our view, that profits growth has been so strong relative to real economy measures is ultimately

unsustainable; profits and demand growth are inextricably linked over the long term. Indeed, that such a large share of US GDP should go to shareholders at the expense of labor is part of the social argument for higher fiscal spending.

In the past, quasi-monopolistic profits have either been competed or regulated away. We see increased regulation or a change in tax and accounting rules impairing US corporate profitability in the 2020s in a bid to address some stark imbalances.

**Exhibit 10: Corporate profitability expanding at the expense of labor**



Source: UBS Asset Management, Macrobond as at December 2019.

In our view, the valuation of US equities in particular limits the potential upside for the 2020s. Professor Robert Shiller's widely-watched cyclically adjusted Price to Earnings ratio, which has shown a statistically strong relationship with subsequent 10 year returns in the past, also points to lower returns in the 2020s.

After a sustained period of very low volatility, we also expect overall asset class volatility to edge higher in the 2020s to reflect continued geopolitical risks, the shift in the policy narrative from unelected central bankers to electorally sensitive politicians, and the gradual increase in inflation expectations and longer-dated yields as fiscal policy goes to work.

It is therefore on a risk-adjusted basis that, to us, US equities look most stretched relative to history. And after a decade of US outperformance driven in part by the boost from low rates to 'growth' equity valuations, we therefore expect more 'value'-oriented equity markets outside of the US, such as Europe, Japan, China and emerging markets, to prosper on a relative basis as yields rise.

**Higher correlation between equities and bonds**

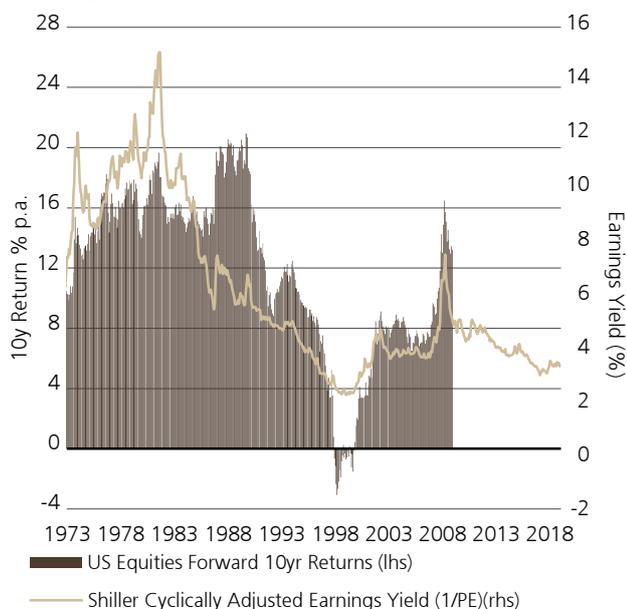
So what can individuals and institutions do to meet return targets in this environment? If the overall returns environment is lower, it is self-evident that investors are going to have to take more risk to achieve the same returns.

The correlations between asset classes are the statistical bedrock to the principle of multi asset diversification and to

improved risk-adjusted returns potential. But portfolio risk itself is not a constant. And the strongly negative correlation between US equities and US Treasuries over the past 20 years that has given investors such simple diversification benefits has been abnormal in a longer-term context.

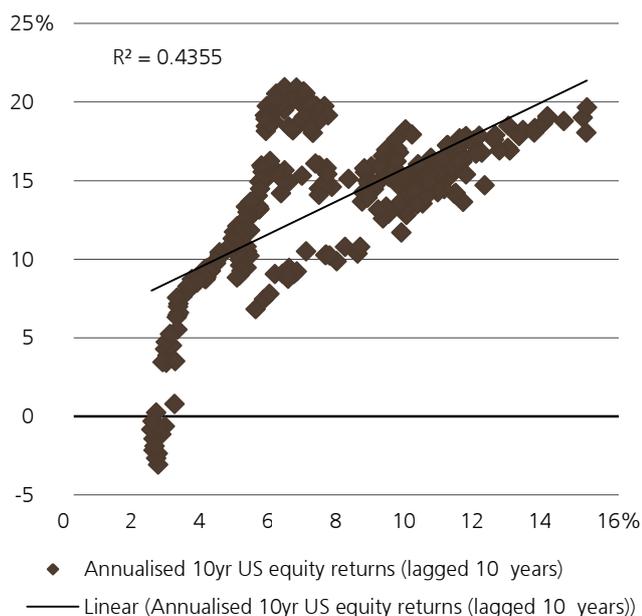
**Exhibit 11: Strong equity returns unlikely to persist**

Shiller cyclically adjusted earnings yield vs. subsequent 10yr US equity returns



Source: UBS Asset Management, Refinitiv, as at December 2019.

**Exhibit 12: Shiller cyclically adjusted earnings yield vs. forward 10yr US equity returns 1973-2009**

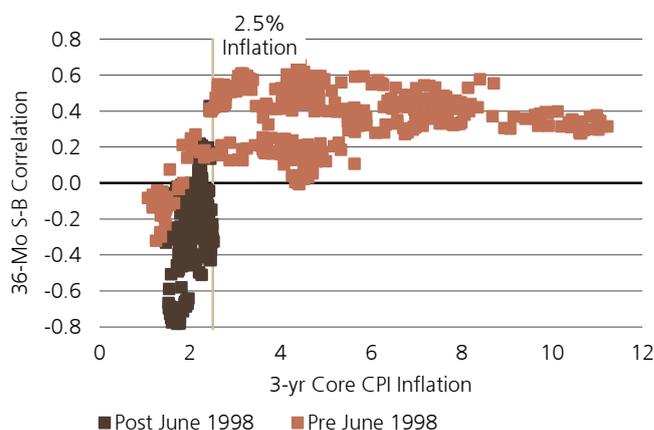


Source: UBS Asset Management, Refinitiv, as at December 2019.

In a previous paper (*Investment Insights, Relationship Troubles*, Feb 2018) we highlighted how the inflation backdrop – both the absolute level of inflation and the volatility of inflation – was the principal driver to the equity/bond relationship. We were able to identify four distinct inflation regimes over the past 90 years.

Given our core belief that increased fiscal spending will reinvigorate growth and inflation in the developed world in the 2020s, we expect the key correlation between US equities and government bonds to become less negative as the 2020s progress. We also see the range of potential macroeconomic scenarios broadening from the narrow range of the past decade. There is therefore a risk that any spike in the level and volatility of inflation could prompt the equity/bond correlation into meaningfully positive territory again.

**Exhibit 13: US equity/bond rolling 3yr correlation 1963-2019 vs. Inflation**



Source: UBS Asset Management, Macrobond as at December 2019.

**A second act for bonds**

Clearly, any regime change in correlations has potentially significant implications for the risk-adjusted returns potential of the wall of money invested in multi asset portfolios predicated on a significantly negative correlation between these two key asset classes.

Indeed, there has been a host of recent commentary seeking to address this issue, some of it even sounding the death knell for the traditional 60:40 equity/bond multi asset portfolio. We agree that after a decade of outsized capital growth and low volatility that the outlook for risk-adjusted returns in global equities and in developed world government bonds is commensurately lower.

But while the outlook for capital growth in nominal government bonds in the 2020s looks limited given the yield starting point, that is not to say that bonds do not still have an important role to play in a multi asset portfolio context as a potential store of value. Our work shows that bonds have

generally (but not always) provided important diversification benefits during large equity drawdowns even in positive equity/bond correlation regimes. We also believe that there are likely to be a growing array of tactical opportunities both within and across yield curves on a relative basis globally in a more volatile market backdrop.

Overall, we see the prospect of lower risk-adjusted returns and higher equity/bond correlations strengthening rather than weakening the arguments for multi asset portfolios. But genuine diversification is about differing macroeconomic sensitivity, not about an arbitrary number of asset classes. The anticipated combination of lower returns and higher volatility also suggests strongly that a more careful and potentially sophisticated approach to portfolio diversification and optimization is going to be required than has been the case for the past decade. In short, we see investors needing a broader investment universe of traditional and alternative asset classes diversified by macroeconomic driver.

This potentially includes a strategic allocation to inflation-linked government bonds and to currency, and to real assets including gold and real estate that might benefit from higher inflation. We would also highlight infrastructure. The increase in fiscal spending that we expect is likely to mean a growing global opportunity set across economic and social infrastructure assets in both the developed and emerging worlds, that may offer stable and attractive cash flows to investors across the capital structure.

In our view, buy and hold is likely to be a sub-optimal strategy in the 2020s. We see both tactical and secular active manager skill, or alpha, contributing much more significantly to overall returns than it has done overall in the past decade. High conviction active approaches across private and public markets are likely to prosper in a more volatile and challenging environment.

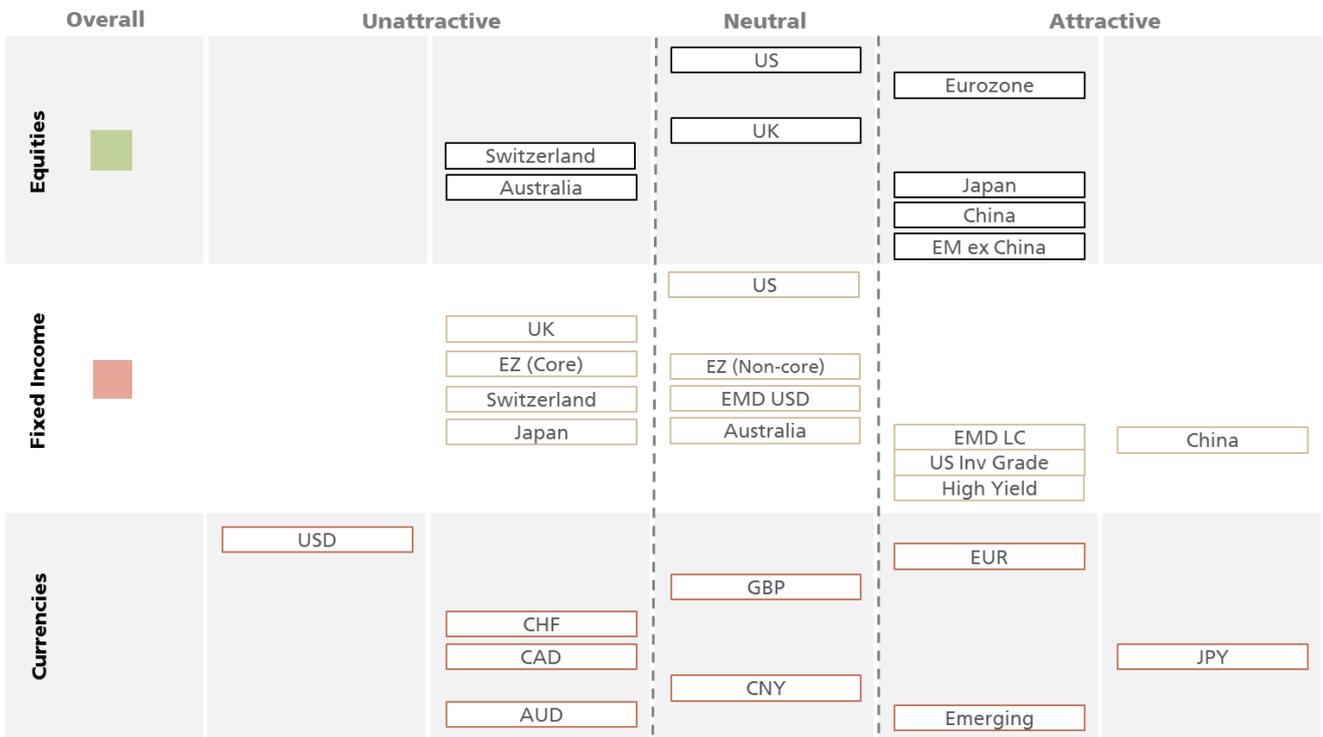
Incorporating alternative sources of alpha from advanced sentiment models, big data, as well as the ability to exploit the increase in tactical opportunities we expect are also likely to play a major role in improving the risk-adjusted returns' potential of any multi asset portfolio.

In our view, access to the broadest possible tool set to implement views in an optimal manner is also likely to be critical to overall risk-adjusted returns in the coming decade. This includes, where appropriate to the mandate, incorporating non-linear pay off structures to generate income, and to both benefit from and protect from the more volatile backdrop we expect.

The asset allocation outlook for the coming decade may appear challenging at first glance given the headline forecasts of lower returns, higher volatility and higher correlation from equities and government bonds. But there is little doubt in our mind that it will be a period rich in potential for those with the tools and expertise to exploit the opportunities that may arise across the full universe of traditional and alternative asset classes.

### Asset class attractiveness

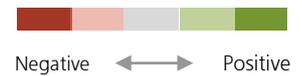
The chart below shows the views of our Asset Allocation team on overall asset class attractiveness, as well as the relative attractiveness within equities, fixed income and currencies, as of 30 November 2019.



Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as at 30 November 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.



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 pick up 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 somewhat disappointing but we expect demand momentum to improve over the coming months and for European equities to rerate accordingly. In September, the ECB delivered a stimulus package which is growth supportive and the broad based easing of financial conditions around the world will likely put a bottom under the previously bleak external demand picture. Furthermore, geopolitical headwinds have somewhat diminished in the region with Italy in a coalition government and no-deal Brexit risks subsiding substantially. These developments are also positive for European equity valuations.</li> <li>– We remain constructive on Japanese equities. They are attractively valued and supportive fiscal measures taking effect in the aftermath of the tax hike should soften the spending slowdown. Furthermore, investment is likely going to accelerate as we move closer to the 2020 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 the major beneficiary of a global demand bounce, an improvement in global trade in the wake of any 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>– 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 rerating. 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 US curve to steepen. On a relative basis the scarcity of positive yielding safe assets should continue to drive flows into US Treasuries, keeping term premiums significantly negative and limiting the scope for longer-dated yields to rise more materially. However, in the longer run, we expect US Treasury supply to increase given the US budget deficit dynamics.
<b>Ex-US Developed-market Bonds</b>	■	– In aggregate, we see ex-US developed market sovereign bonds as unattractive. The ECB and BoJ have committed to low rates for some time, limiting 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 a 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 a 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 scheduled inclusions to global bond market indices in coming years 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 weaker. 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 of 30 November 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.

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**Americas**

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