Macro Monthly

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UBS Asset Management | Economic insights and asset class attractiveness

August 2021

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From micro to macro: Lessons from earnings season

Highlights

- Insights from corporate executives during earnings season provide an alternative lens to enhance our understanding of the economic outlook.
- Business leaders have a much more optimistic view on future nominal growth than what is implied by the bond market.
- The better starting point for household balance sheets and prospects for capital spending are key differentiators that we believe will drive superior macroeconomic outcomes in this recovery compared to the one that followed the 2008-09 recession.
- Commentary from corporations reinforces our view that bond yields overstate the risks to activity and also supports procyclical equity positions on a regional and sectoral basis.

We're approaching the end of earnings season, a period when corporate executives offer assessments of the business climate and how they're addressing operational challenges and opportunities. Aggregating their bottom-up micro views provides a useful lens through which to augment our top-down analysis.

Collectively, their strategies will play a key role in not just reflecting but also shaping macroeconomic outcomes going forward. Corporate plans are particularly important to watch at this juncture: as fiscal policy becomes less stimulative, a strong handoff from public to private-led growth is needed to keep activity running at robust levels.

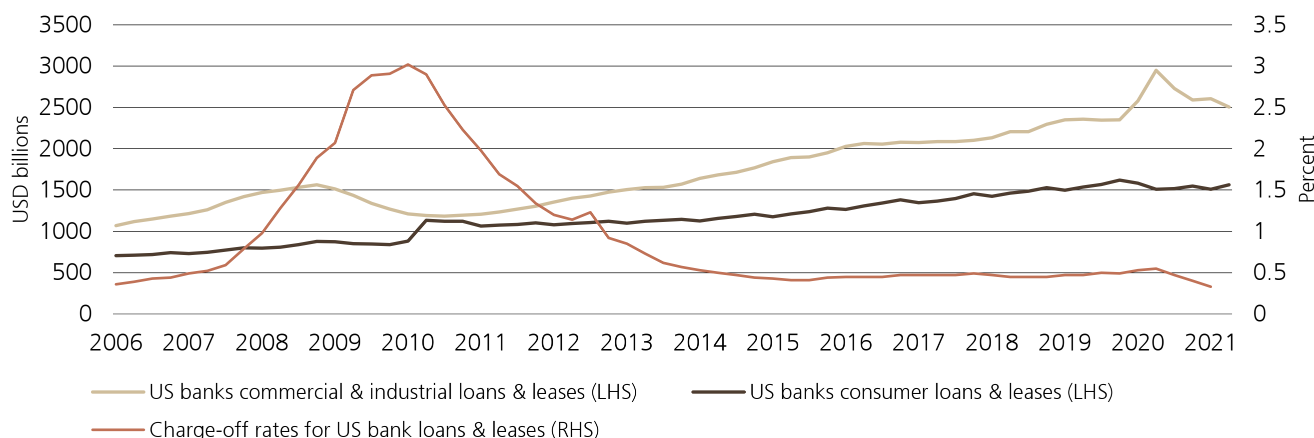
The bond market is telling you we are headed for another low nominal growth environment. But when we actually listen to leaders in the private sector, we believe the outlook is much more constructive. Our review of US and European quarterly earnings calls shows executives pointing to a longer runway for above-trend growth – both in terms of increases in real output as well as inflation.

Firms are upbeat about the financial health of their customers. Companies are generally confident in their ability to pass through higher prices, thanks in part to excess household savings. The business-to-business demand pipeline is buoyed by high levels of current activity, a need to replenish inventories drawn down during the early recovery phase, and an inability to do so in some cases due to supply constraints. And while the delta variant is viewed as downside risk, it is not currently crimping activity in developed markets or prompting downgrades to corporate guidance.

The better starting point for household balance sheets, which should underpin consumption, and substantial business investment are, in our view, the key differentiators that will improve macroeconomic results this cycle compared to the relatively sluggish growth following the 2008-09 recession.

UBS

Exhibit 1: Credit quality is strong: weak loan growth a function of private balance sheet strength



Source: UBS Asset Management, Bloomberg. Data as of 30 June 2021.

Better balance sheets

In our view, the starting points for private balance sheets provide a far sturdier foundation for this expansion compared to the aftermath of the 2008-09 recession.

Reports from financial institutions show the degree of fiscal income supports during the crisis is proving a mixed blessing for banks during the recovery phase. Most importantly, mass insolvencies were prevented and credit quality preserved. The share of loans and leases that banks expect will not be repaid is below pre-pandemic levels. This, in turn, has allowed banks to reduce the amount of money they set aside to cover bad loans – a dynamic that contributed to meaningfully higher than expected profits this reporting period. But on the other hand, household and corporate balance sheets are in such a strong position that loan growth has been lackluster.

In 2009, slow credit growth was a function of lingering damage to the financial system that impeded intermediation. Now, it is a reflection of broad financial health.

Inflation has staying power

Commentary from corporate leaders suggests inflation will have staying power as a macro driver, even as bond markets remain sanguine about elevated price pressures. And within the equity market, pricing power will continue to serve as key differentiator of winners and losers. The varied abilities of companies to pass on higher material and labor costs reinforces our view that this environment is more attractive for active management than broad equity market beta.

Some firms are able to pass on higher prices with no impact on demand. Others are unwilling to fully pass higher input costs on to customers, so margins suffer. Because of pre-existing contracts, some firms are unable to immediately implement price increases, but plan to do so with a lag. Others have a strategy to pass along inflation smoothly over time.

It is important to note that in aggregate, US companies are exceeding expectations on earnings by more than on revenues. This suggests that, for now, fears about margin pressure have been overstated. But a more prolonged stretch of price pressures could either challenge profitability, or the longevity of ultra-accommodative central bank policies. Inflation could either continue to remain uncomfortably high, or margin compression could ensue.

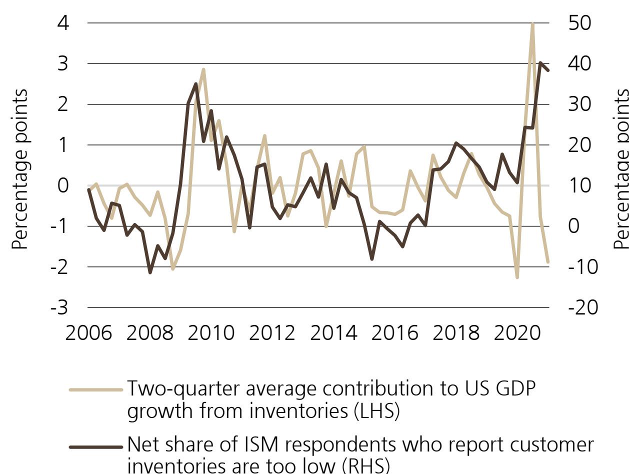
The great restocking

Shortages are the product of a surprisingly quick economic recovery, and also a reason why growth can continue to stay strong. Meeting high levels of current demand and a stated desire to rebuild inventories mean that supply frictions – most notably relating to semiconductors – may linger broadly across different industries for some time, while gradually lessening in intensity. To paraphrase one semiconductor CEO, traffic jams take 15 minutes to start, but an hour to get resolved. Greater capital expenditures to unlock additional production downstream is a virtuous process that allows for pent-up demand to be delayed, then realized, rather than destroyed.

Companies are also planning to use any near-term soft patches in demand, whether seasonal or otherwise, to restock inventories rather than curtail output. Firms that have been able to replenish inventories are talking this point up as a competitive advantage that allows them to grow the top line and market share. Conglomerates are giving business units more leeway to tilt working capital towards inventories, and don't see any buildup of inventories downstream – a signal of strong end user demand. Similarly, retailers are already concerned about having enough product in stock for the Christmas season.

Companies are indicating that the low hanging fruit for increasing production via current levels of property, plant, and equipment has been picked. Meeting higher levels of demand requires additional capital expenditures. In transportation and semiconductors, two industries with high sensitivity to global trade and activity, executives are signaling business investment will need to stay elevated well into 2022, a major catalyst for the global economy.

Exhibit 2: Inventory drag could soon turn into a tailwind



Source: UBS-AM, Bloomberg. Data as of 30 June 2021.

Exhibit 3 Bright outlook for business investment

Expected capital expenditures in six months' time relative to their five-year average

Source: UBS-AM, Bloomberg. Data as of 30 June. 2021. Data based on manufacturing and services sector surveys from New York, Dallas, Philadelphia, Richmond, and Kansas City regional Federal Reserve banks.

Delta

The decline in bond yields and outperformance of defensives relative to cyclical stocks in recent weeks suggests that investors are increasingly concerned about a loss of growth momentum, in part exacerbated by the spread of the delta variant. However, the message from corporates is that delta is not a drag – it's a risk.

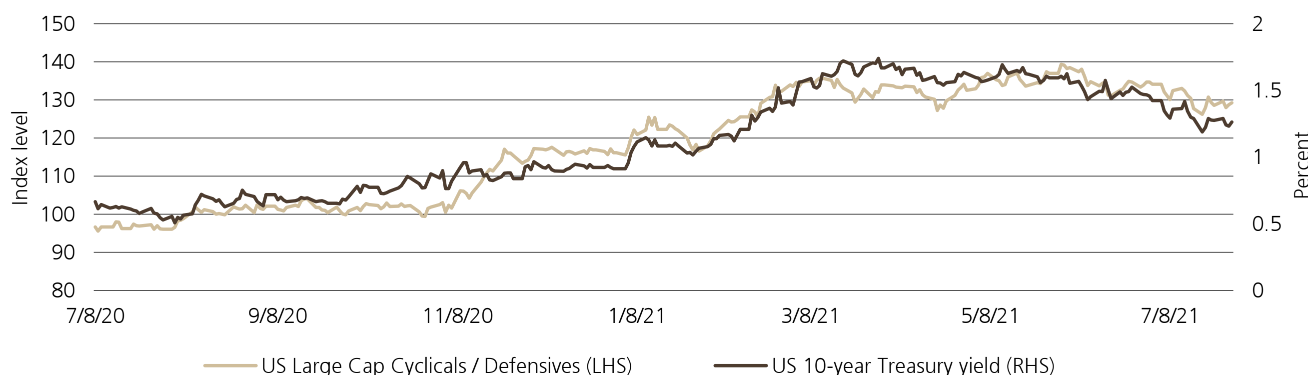
The airline industry was among the most affected by the spread of the pandemic in 2020, and sensitive to changes in sentiment on public health outcomes. So far, the variant is not adversely impacting booking activity or guidance. European carriers expect short-haul flights to continue to improve, just as the US has, and are seeing strong bookings for August and September. Members of the C-Suite have remarked that proof of vaccines has fueled the surge in airline activity, and vaccines remain largely effective against the variants. One airline CEO observed that the typical connection between increases in negative COVID-19 headlines and no shows/cancellations has weakened recently, suggesting that their customers are either vaccinated or sufficiently desensitized to bad news on this front.

Conclusion

Bond markets and equity market internal dynamics are hinting at a return to the lackluster cycle of economic growth that followed the financial crisis. But corporate executives appear to be preparing for and shaping a brighter future, one with healthy household balance sheets, shortages and low inventory levels across industries, and capital expenditures needed to meet this growing demand from consumers and businesses.

In our view, bond yields are exaggerating the medium-term risks to both activity as well as inflation and are poised to move higher. Likewise, we believe cyclically-sensitive equity regions such as Europe and sectors like financials and energy are well positioned to outperform in this more vigorous economic expansion.

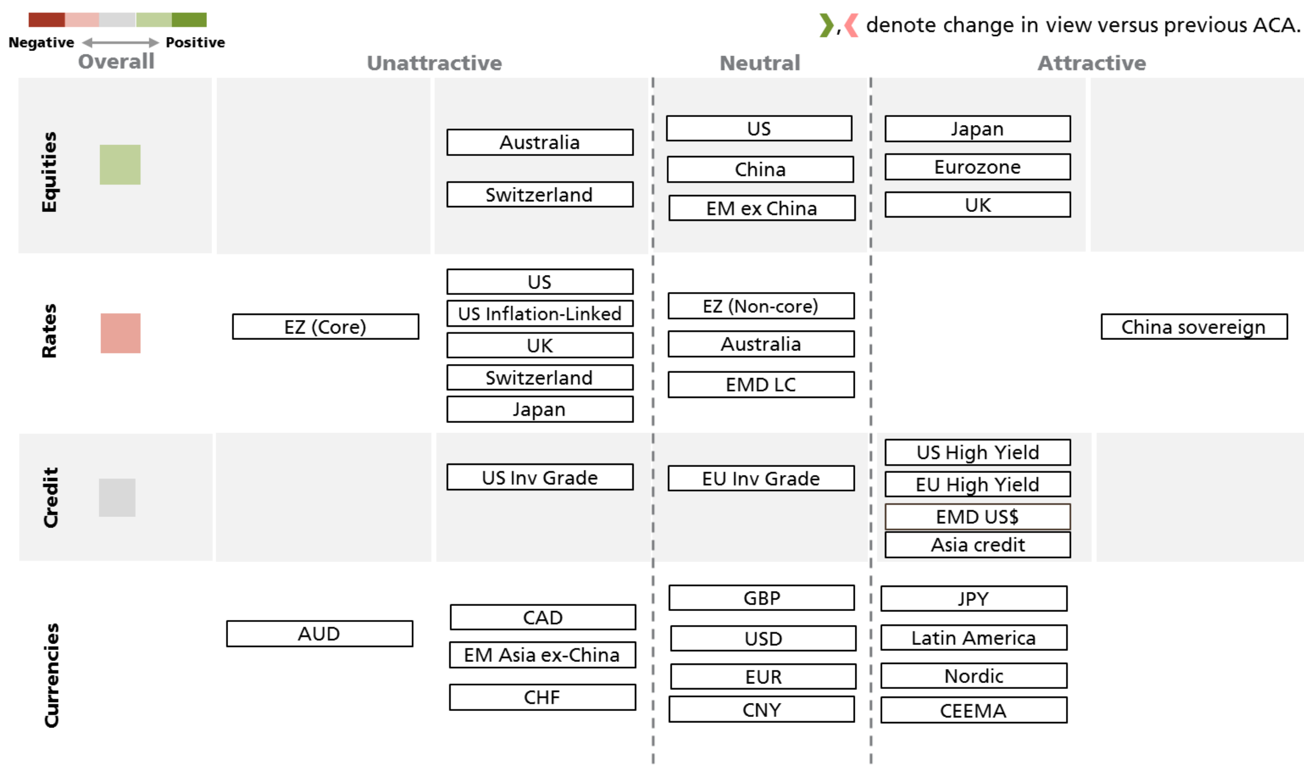
Exhibit 4: Bond yields, equity internals point to ebbing optimism on economic outlook



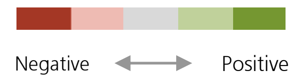
Source: UBS Asset Management, Bloomberg. Data as of 29 July. 2021.

Asset class attractiveness (ACA)

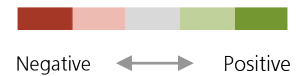
The chart below shows the views of our Asset Allocation team on overall asset class attractiveness, as well as the relative attractiveness within equities, fixed income and currencies, as of 30 July 2021.



Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as at 30 July 2021. 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
Global Equities		– Our outlook for stocks over the next 12 months remains positive. The economic recovery is likely to continue this year on the back of additional global fiscal stimulus, still accommodative financial conditions, and progress on the broad administration of effective COVID-19 vaccines. – However, in the near term we expect a choppier environment for equities at the headline level, as is common during the second year of a new bull market. The equity risk premium is near the floor of the previous cycle, which may cap upside as policy risks start to become more two-sided and growth momentum peaks. – Given the magnitude of the equity rally in recent months, we see more upside in relative value opportunities that offer attractively priced exposure to what will still be a very robust global growth backdrop compared to beta exposures.
US Equities		– US equities continue to command premium valuations. The sectoral composition drives this dynamic, with a higher weighting towards acyclical defensive technology than other markets. This characteristic may not prove a boon in the event that investors aim to boost cyclical exposure. So we prefer US equal weight to market cap indexes. – Continued strong earnings, robust balance sheets, and unprecedented support from the Federal Reserve should continue to support US equities, but fiscal/tax policy risks are becoming more two-sided.
Ex-US Developed market Equities		– Non-US developed market equities are attractively valued and have significant exposure to the global economic recovery. – We believe earnings growth in Europe and Japan is poised to outstrip that of US, and this is not well reflected by the recent relative performance of these regions. – Both earnings and valuations should have more room to run in ex-US developed market equities. – Europe and Japan lagged on vaccine administration but are catching up, which should improve investor sentiment.
Emerging Markets (EM) Equities (ex-China)		– Robust growth in China even as stimulus ebbs, one of our macroeconomic themes, is a positive for the asset class, particularly for countries with the tightest economic and financial linkages. Resilience in industrial metals, even during a rally in sovereign bonds, is another leading indicator that points to a solid foundation for real activity. – However, EM equities continue to face near-term challenges that include a negative turn in forward earnings growth relative to DM, and less access to the most efficacious vaccines.
China Equities		– We expect gains in Chinese equities so long as there is no abrupt withdrawal of accommodation, but prefer international equities where the recoveries are less mature. – Policy actions designed to limit the power of major internet companies may linger as a headwind for this important pocket of the equity market. – The well-telegraphed deceleration in China's credit impulse warrants close watching, as it constitutes a key downside risks to commodity prices and procyclical positions across asset classes. – The recent cut in the reserve requirement ratio (RRR) by the People's Bank of China may be an indication that the peak in credit tightening has passed. – The new US administration will be more predictable in its relations with China, while continuing the process of economic decoupling in areas of strategic importance.
Global Duration		– Long-term bond yields have retraced aggressively ahead of the turn in global growth momentum and signs of incremental hawkishness from the Federal Reserve. However, inflation risks remain tilted to the upside and global economic activity is poised to remain robust well into 2022. – As such, we expect increases in real rates and market-based measures of inflation compensation to contribute to a renewed rise in yields. – Sovereign fixed income continues to play an important diversifying role in portfolio construction, and remains particularly effective in hedging downside in procyclical relative value equity positions.



Asset Class	Overall signal	UBS Asset Management's viewpoint
US Bonds		– US Treasuries remain the world's preeminent safe haven and top source of risk-free yield. The Fed's responsiveness to inflation risks has undermined the appeal of curve steepeners (a rise in the spread between long-term and short-term yields) until price pressures recede and economic activity remains elevated. – The looming peak in global growth, concerns about a potential Fed policy mistake, strong foreign demand, and over-extended short positioning have contributed to a sharp decline in US Treasury yields and flattening of yield curves. – We expect this to reverse going forward, with a combination of strong growth and inflation driving Treasury yields higher across the curve. – The Fed will likely lay out formal plans to taper its asset purchasing program by year end, and the extent of the deceleration in price pressures during the fourth quarter will play a key role in determining whether the removal of stimulus is expedited or delayed.
Ex-US Developed-market Bonds		– We continue to see developed-market sovereign yields outside the U.S. as unattractive. The Bank of Japan's domination of the Japanese government debt market and success in yield curve control diminishes the use of the asset class outside of relative value positions. The potential for European fiscal integration and solid commitment to supporting economies during the pandemic are factors that may compress periphery spreads, but perhaps at the expense of rising core borrowing costs, as well.
US Investment Grade (IG) Corporate Debt		– Spreads have fully retraced thanks to policy support and an improving economic outlook, while all-in borrowing costs are well below pre-pandemic levels. US IG is one of the few sources of quality, positive yield available and therefore a likely recipient of ample global savings. However, the duration risk embedded in high-grade debt as the economy recovers as well as the potential for spread widening should threats to the expansions arise serve as material two-sided risks that weigh on total return expectations for this asset class.
US High Yield Bonds		– We expect carry, rather than spread compression, to drive total returns in HY going forward. Coupons available will continue to attract buyers in a low-yield environment. – More attractively valued and has less sensitivity to rising interest rates than IG bonds.
Emerging Markets Debt US dollar Local currency		– We have a positive view on emerging market dollar-denominated bonds due to the balance of carry opportunity and duration risk. Asian credit is enticingly valued and poised to perform well in environments in which growth expectations improve or plateau, so long as highly adverse economic outcomes fail to materialize. – The more rangebound environment for the US dollar removes one previous tailwind for the outlook for total returns in EM local bonds.
Chinese Bonds		– Chinese government bonds have the highest nominal yields among the 10 largest fixed income markets globally as well as defensive properties that are not shared by most of the emerging-market universe. We believe that cooling domestic economic growth and inclusions to global bond market indices should put downward pressure on yields during the next 3-12 months.
Currency		– The Federal Reserve's signal of concern about inflation risks, as seen by the increase in the 2023 median for the dot plot, puts a higher floor under the dollar and meaningfully reduces the prospect of a retest of its late-May lows in the near term. – EMFX like RUB and BRL, which are supported by continued monetary tightening, are well-positioned to outperform even in a rangebound USD environment, while cyclical Asian currencies and select G10 commodity exporters are poised to struggle.

Source: UBS Asset Management. As of 30 July 2021. 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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