Macro Monthly

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For marketing purposes.

UBS Asset Management | Economic insights and asset class attractiveness

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Evan Brown
Head of Multi-Asset Strategy
Investment Solutions

Luke Kawa
Director
Investment Solutions

From peak inflation to higher trend inflation

Highlights

- We believe that global equities are less attractive than bonds or credit due to elevated macroeconomic uncertainty and expensive valuations relative to bonds.
- Elevated inflation is at the root of this macroeconomic uncertainty, and the evolution of price pressures is likely to cause investors to consider a wide range of possible regimes in the near term.
- In our view, prioritizing a diversified trade set with positions that are asymmetrically skewed for different individual regimes is the most appropriate approach to asset allocation at this time.

Macroeconomic uncertainty is high – and for good reason. It's been over four decades since the Federal Reserve was faced with inflation running this hot, and engineering a soft landing as monetary stimulus is aggressively curtailed will be challenging. Russia's invasion of Ukraine is leaving ripple effects, and perhaps scars, on the economic and geopolitical landscapes. COVID-19 flare-ups in China are being met with stringent mobility restrictions, dampening production and threatening to increase supply chain snarls and weigh on domestic consumption. And commodity price shocks are causing hits to real income that dampen the outlook for consumer spending.

Elevated inflation is the cause or product of these various macroeconomic flash points, and the proximate cause of elevated volatility in bond markets. This stands in stark contrast to last cycle, when low and stable inflation meant that market participants could focus on the ebbs and flows of growth alone. We believe we are migrating from an environment of "peak inflation" to "higher trend inflation," and that market participants are likely to entertain a wide range of outcomes for both inflation and growth during this transition period.

Seasoned mountaineers are no doubt aware that the descent can be even more treacherous than the climb. So too is this the case with inflation, which we believe will have staying power as a catalyst for cross-asset performance based on how fast, how much, and the reasons why price pressures recede. In our view, stocks are unattractive at the headline level. The global equity risk premium is near its tightest level over the past decade, suggesting that investors are not being adequately compensated for the risk of surprisingly negative scenarios for growth or inflation. We believe that it is not prudent to aggressively pre-judge the eventual macro outcome or overweight risk assets during this time of heightened uncertainty, but rather to prioritize diversification and allocate to relative value positions that offer the best risk-reward in different scenarios: an inflationary boom, stagflation, a growth scare, and a moderation of both activity and inflation to levels relatively similar to the previous cycle. For some, valuations are sufficiently inexpensive that there is limited downside even if macroeconomic outcomes turn out to

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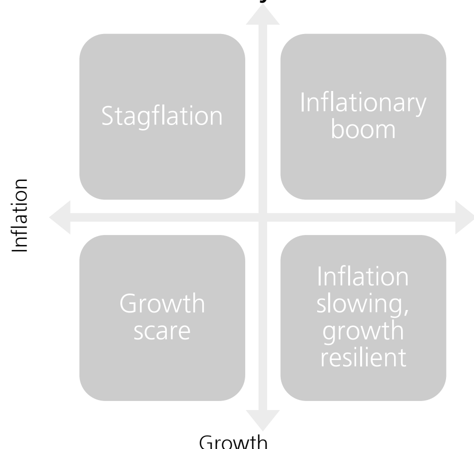
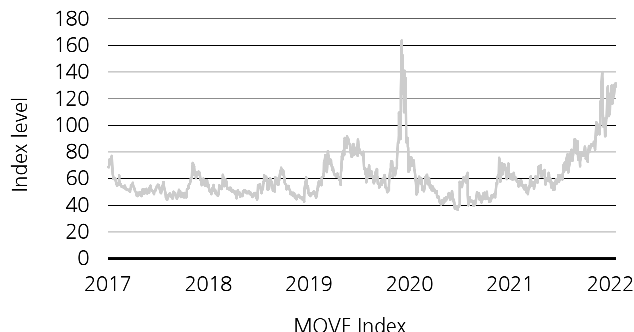
Exhibit 1: Lack of clarity on near-term macro regime



Source: UBS-AM.

Exhibit 2: High rate volatility reflects high macroeconomic uncertainty



Source: UBS-AM, Bloomberg. Data as of 27 April 2022.

be in the least favorable quadrant for that trade. Other positions may not be cheap, but have positive momentum and return potential is asymmetrically skewed to the upside, in our view, particularly in the stagflation or growth scare scenarios.

Inflationary boom

Evidence that China is able to reopen and deliver sufficient stimulus to stabilize the domestic economy would be an important catalyst to get investors to take a more favorable view on the strength and durability of this expansion.

Broadly speaking, price pressures could stay elevated because they are indicative of robust demand growth that gives the supply side a reason to continue playing catch-up – a virtuous cycle. Wage growth staying strong in the US and continuing to accelerate in Europe would likely help increase the longevity of the capex cycle, which may well also be bolstered by more structural trends like investment in national defense and energy security. All else equal, a higher level of resource mobilization means higher price pressures.

In this scenario, we believe European banks would be particularly well-positioned to outperform given the group has discounted a substantial amount of recession risk in light of the negative spillovers to growth on the continent from the energy price shock. This backdrop would likely be generally positive for risk assets, and therefore also benefit higher beta EM currencies, the Australian dollar/stocks, and US equal weight equities.

Stagflation

Negative supply shocks from geopolitical developments, the persistence of the pandemic and associated production interruptions, or severe weather events could intensify. An acute increase in the cost of necessities like food, energy, and shelter would leave households with less spending power on discretionary items. And because of how hot realized inflation has been, central banks will be unlikely to look though such sources of upward pressure on prices even if they are unrelated to excess demand. Tightening monetary policy would also weigh on the forward outlook, adding to the squeeze on real incomes.

In our view, commodities would be likely to play a key role in creating a stagflationary environment of growth slowing to below trend and inflation remaining stubbornly above target. We believe broad commodities as well as energy and agriculture stocks would be among the few beneficiaries if such a macroeconomic backdrop comes to pass, and are also attractive if the inflationary boom scenario plays out.

Growth scare

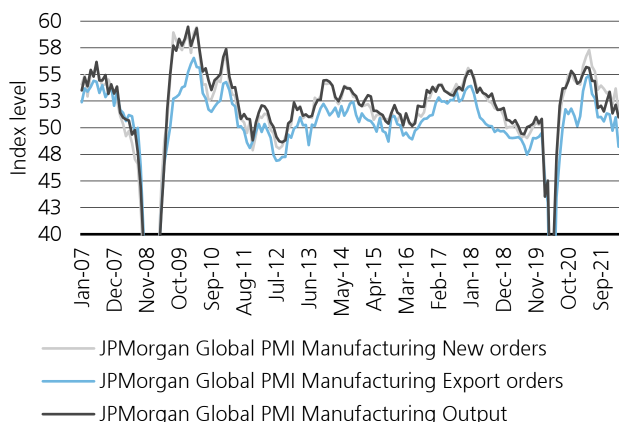
As we expect growth and inflation will moderate, it is also within the realm of possibility that market participants extrapolate that deceleration becomes an outright deterioration. This would particularly be the case if the current rotation of economic growth from goods to services sectors becomes more a story of the nascent softness in goods spreading to services.

Long positions in the US dollar vs. cyclical Asian currencies and the euro – the regions we believe would be most likely to be on the leading edge of a global economic downturn – are attractive on a fundamental basis and should display strong momentum. Within equities, we also prefer health care, the defensive sector with both the cheapest valuations and the strongest forward earnings revisions over the past six months.

Inflation slows, growth resilient

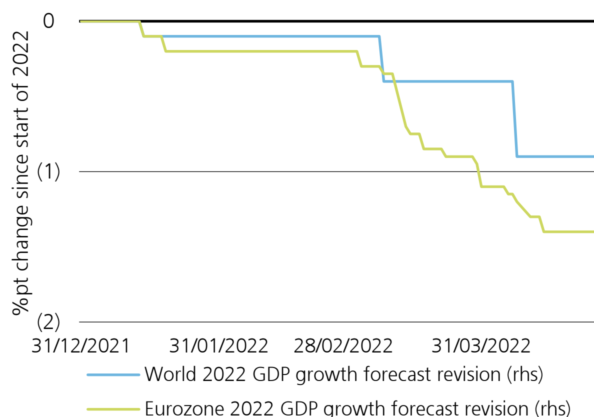
If improving public health outcomes reduce supply chain risks, core goods prices normalize as demand shifts to services, and there is an end to Russia's war on Ukraine, some upward pressure on prices would likely abate without any dent to the growth outlook.

Exhibit 3: Manufacturing activity decelerating



Source: UBS-AM, Macrobond. Data as of 31 March 2022.

Exhibit 4: Growth forecast lower on Russian invasion



Source: UBS-AM, Macrobond. Data as of 27 April 2022.

But we believe the odds of the market pricing a migration to such a "Goldilocks" regime in the near term is relatively low, for two reasons. First, because inflation has broadened, surprised to the upside, and run above target for an extended period, so it will take time for investors to become convinced that this threat has diminished substantially. Second, two of the world's biggest economic regions – the European Union and China – face different and significant downside risks that are clouding the economic outlook, and the magnitude of the lasting effects is uncertain.

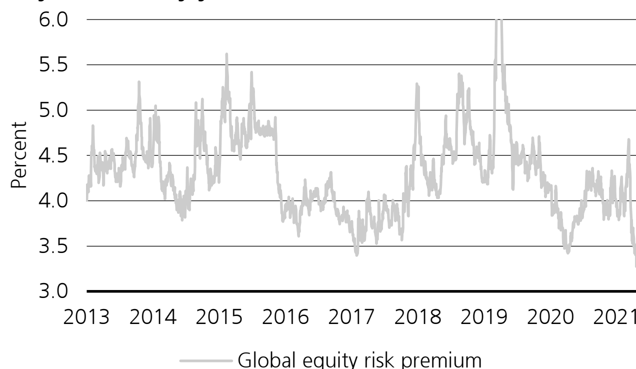
Accordingly, our trade set has the least weighting towards this scenario at present. We retain some exposure to quality stocks that typically perform well as growth becomes more sluggish but remains positive, and also have some defensive characteristics should perceived recession risk rise materially. It is very important to monitor for indications that both inflation and growth risks are sustainably receding, as this would likely be a signal to increase gross exposure to financial assets.

Asset allocation

Over the coming weeks, we expect the market will be whipsawed by these inflation cross-currents and competing narratives. For the time being, we remain cautious on risk at the headline level, with an underweight stance on global equities, neutral positions in credit and government bonds and an overweight to commodities. Expensive valuations suggest that the market is ruling out the potential for a growth scare or a stagflationary outcome, a stance we believe is too sanguine. In this environment of high cross-asset volatility, we believe it is prudent to select relative value trades that give us the opportunity to weather different macroeconomic outcomes rather than aggressively betting on the ultimate destination.

We expect to have more clarity on important macroeconomic milestones we are monitoring late in the second quarter or in the second half of 2022. These include the magnitude of Chinese policy support as well as the wherewithal to deliver it, the extent of the sequential moderation in inflation to shed light on how restrictive monetary policy becomes (if at all), and an end game or steady state for relations between Russia and the rest of the world. We plan to be nimble in reacting to new information and increasing risk judiciously as the inflation-induced fog over markets begins to dissipate.

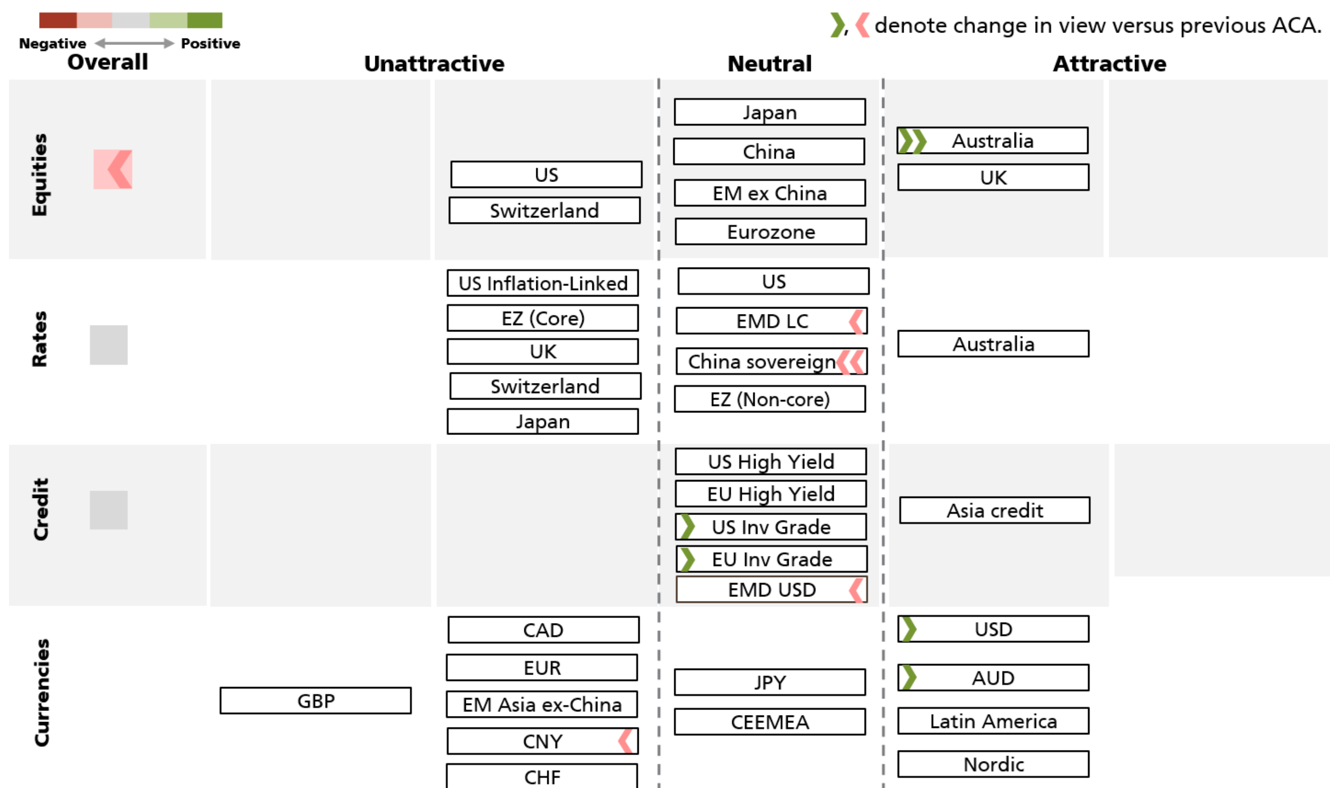
Exhibit 5: Forward earnings yield for MSCI ACWI less the 10-year Treasury yield



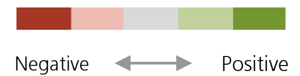
Source: UBS-AM, Bank of America, Bloomberg. Data as of 27 April 2022.

Asset class attractiveness (ACA)

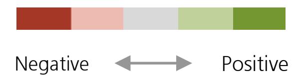
The chart below shows the views of our Asset Allocation team on overall asset class attractiveness, as well as the relative attractiveness within equities, fixed income and currencies, as of 29 April 2022.



Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as of 29 April 2022. 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		– In our view, global equities are tactically unattractive at the index level. The equity risk premium is near its tightest level of the past decade, and stocks are likely to face valuation pressures from central bank tightening and slowing growth. – We prefer relative value opportunities that have strong structural upside, undervalued cyclicals that have priced in too much of a growth deceleration, and higher-quality and defensive segments that should continue to post robust profit growth as activity moderates but remains above trend. – Our view is that the economic recovery is likely to continue in 2022 on the back of strong starting points for consumer and business balance sheets and improving public health outcomes. These should underpin strong earnings growth, but multiples have more room to adjust to the downside in the near term.
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 drag on relative performance in the event that expectations for the Federal Reserve's terminal policy rate this cycle increase further or geopolitical risks recede. Accordingly, we prefer US equal weight to market cap indexes. – The skew of fiscal and monetary policy risks has turned more negative for US equities, though earnings growth should still hold up well and balance sheets remain strong.
Ex-US Developed market Equities		– Non-US developed market equities are attractively valued. Somewhat surprisingly, earnings revisions in Europe continue to be stronger than the US, while the pace of Japanese earnings revisions has converged with that of the S&P 500. – However, Japanese stocks lack catalysts that would help shrink this valuation gap, and European equities may be particularly vulnerable as Russia continues to wage war against Ukraine. However, this is already partially priced in. – Ex-US developed market equities are highly cyclical, and tend to underperform in an environment in which manufacturing purchasing managers' indexes continue to decelerate.
Emerging Markets (EM) Equities (ex-China)		– Concerns about the stabilization of growth in China is a major source of uncertainty for the asset class, particularly for countries with the tightest economic and financial linkages. Resilience in industrial metals continues to point to a strong foundation for real activity. As such we prefer EM markets with the strongest linkages to commodities. – EM equities have held up impressively well in the face of challenges early in 2022 that include less impressive earnings revisions and higher mobility restrictions relative to DM, rising long-term real rates, and US dollar strength vs. DM FX.
China Equities		– The Chinese policy stance has turned, both on the monetary and fiscal fronts. The People's Bank of China (PBOC) has cut rates, the peak in credit tightening has passed, in our view, and officials are stressing an urgency in providing fiscal support. – However, it is unclear whether this policy support will be sufficient to stabilize the economy, particularly in light of ongoing downside risks to activity from COVID-19 and the real estate market, which we believe are a threat to global activity and procyclical positions. – A fresh wave of the pandemic and ensuing mobility restrictions are likely to restrain economic activity in the near term, particularly in services sectors but in goods as well. – From a seasonality perspective, Chinese equities have tended to outperform ahead of the China Party Congress. – The relative valuation of Chinese internet companies compared to their US peers suggests too much embedded pessimism about their longer-term earnings prospects, though the regulatory overhang may constrain the potential upside.
Global Duration		– We believe the risks to long-term bond yields are well-balanced as traders have priced in aggressive central bank tightening over the coming year. – We expect real rates to rise as inflation peaks and the Federal Reserve tightens policy even more in the coming months, but for this to be offset by decreases in market-based measures of inflation compensation. – Sovereign fixed income continues to play an important diversifying role in portfolio construction, and remains particularly effective in hedging downside in procyclical positions.



Negative ⟷ Positive

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 Federal Reserve is poised to take rates to a neutral setting as quickly as possible without jeopardizing the expansion, and then move to restrictive territory in order to quell inflationary pressures. Quantitative tightening is not a very potent catalyst for fixed income, in our view. – Market pricing for the Federal Reserve's terminal rate this cycle has adjusted meaningfully to the upside, and parts of the yield curve already imply interest rate cuts by 2024. The Fed has set a high bar for inflation to surprise to the upside this year, leaving room for rates to come down across the curve by pricing out some of the expected hikes. Even more front-loaded tightening could also increase perceived recession risk and provide a bid for the long end.
Ex-US Developed-market Bonds		– We continue to see developed-market sovereign yields outside the US as unattractive. The European Central Bank accelerated its timetable for tapering even in the face of downside risks to growth tied to Russia's invasion. If these large threats to the expansion do not materialize, the central bank is highly likely to exit negative interest rate policy within the next 12 months. – The Bank of Japan's domination of the market and strategy of yield curve control diminishes the use of much of the asset class outside of relative value positions. Maturities beyond the 10-year point may be more vulnerable should the global repricing of duration continue.
US Investment Grade (IG) Corporate Debt		– Spreads are at relatively tight levels amid continued policy support and below-average near-term recession risk. US IG is one of the few sources of quality, positive yield available and therefore will likely be a recipient of ample global savings. However, the duration risk embedded in high-grade debt has weighed on total returns, and the potential for spread widening should the Fed's tightening cycle call the longevity of the expansion into question serves as another downside risk for this asset class.
US High Yield Bonds		– We expect carry, rather than spread compression, to drive total returns in high yield going forward. The coupons available, however, should continue to attract buyers in a low-yield environment.
Emerging Markets Debt US dollar Local currency		– We have a neutral view on emerging market dollar-denominated bonds due to the balance of carry opportunity and duration risk, which are offset by downside risks to growth. – We believe Asian credit is enticingly valued and poised to perform well in environments in which highly adverse economic outcomes fail to materialize. – A more positive carry backdrop for EM local bonds following rate hikes delivered over the course of 2021 has likely increased the resilience of this asset class even as aggressive Fed tightening gets priced in.
China Sovereign		– The attractiveness of Chinese government bonds has diminished somewhat as nominal rate differentials vs. the rest of the world have compressed. However, the appeal of Chinese government bonds is bolstered by their defensive characteristics, which are not shared by much of the EM universe, as well as their low beta to global bond indexes. We believe the combination of monetary easing and eventual stabilization of domestic activity should prevent any sustained upward pressure on yields during the next 3-12 months.
Currency		– We believe the US dollar is well-positioned to continue its rally. Real growth differentials vs. other major economies are likely to remain substantial due to the Chinese authorities' response to the persistence of the pandemic and the negative supply shock to energy prices, which more adversely affects Europe. Elevated geopolitical risks and the prospect of a broad-based growth scare also put a sturdy floor under the dollar. – Some EM FX, like COP and BRL, are likely well-positioned to outperform cyclical Asian currencies and select G10 commodity exporters given attractive carry.

Source: UBS Asset Management. As of 29 April 2022. 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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