Macro Monthly

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UBS Asset Management | Economic insights and asset class attractiveness
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Answering three more key questions for the rest of 2022

An environment of unusually elevated market and macroeconomic volatility means that some of the headline issues one month can be supplanted by even more pressing problems in the next.

In our last update, we outlined three key questions that would inform cross-asset performance for the rest of 2022. Conditions have evolved largely in line with our expectations: the Federal Reserve's September meeting showed the central bank was more hawkish than markets expected, effectively committing to keeping rates high enough for long enough to engender an economic downturn to get inflation back near target. Europe's outlook this winter remains murky, with Russia escalating its aggression in Ukraine as well as on energy policy. And Chinese policy support is proving an insufficient salve for what ails the global economy.

These issues and their ultimate outcomes are still highly relevant. But in light of recent events and price action, an additional three questions have emerged and warrant urgent attention from asset allocators, in our view:

- Does bond market intervention in the UK have broader implications?
    - Yes – a reminder that central banks protect financial stability, which suggests that the UK and Europe may cap bond market volatility and improve the risk/reward in global fixed income.
- Can the US dollar continue to run higher?
    - Yes. Negative catalysts for the dollar are unlikely to emerge in the near term.
- What is the outlook for earnings?
    - Increasingly negative, with little reason to expect a rebound.

Does bond market intervention in the UK have broader implications?
Yes. Global policymakers are increasingly wary of the financial stability effects of the sharp rise in yields. The risks to government bonds are becoming more balanced.

In the UK, government bond yields jumped higher after a larger-than-anticipated fiscal package in the UK, and sparked a self-reinforcing spiral of domestic debt selling by pension funds. The Bank of England (BoE) made an about-face from imminent asset sales to net purchases of government bonds to put a floor under the gilt market and protect pension funds from potentially crippling losses.

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In China, Japan, the European Union, South Korea, and India (among others), the central bank or fiscal authorities are intervening in foreign exchange or bond markets (or have prepared tools to do so). Central banks are prepared to push back against price action judged to be excessive or counterproductive to their goals.

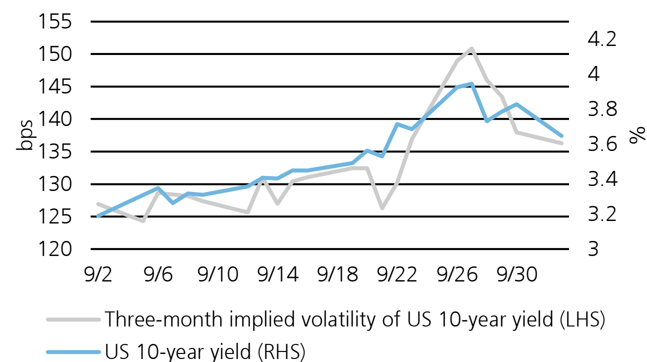
The BoE's return to bond-buying reinforces that while inflation fighting is still the top priority for monetary policymakers, other considerations are important enough to elicit action. Central banks want financial conditions to tighten to help slow activity and contribute to lower inflationary pressures. But when threats to financial stability emerge and perceived 'safe' assets behave in a fragile fashion, central banks may take steps to curb left-tail risks. Right now, there is no perceived trade-off between bringing inflation lower and addressing financial stability concerns. However, though it is not our base case, it is not difficult to countenance a future in which central banks are forced to abandon and fully reverse course on their tightening campaigns should perceived systemic financial risks arise, driven by fiscal demands or other factors. The potential for detours on the path to bringing inflation back to target may contribute to a lingering term premium in longer-term bonds until realized price pressures are sufficiently subdued.

In our view, the European Central Bank is the mostly likely to follow a similar course as the BoE. Both are in regions in which fiscal policy has incrementally eased to cushion against the energy price shock. Widening spreads between core European nations and the periphery as the ECB continues with hiking into the teeth of economic weakness is a likely catalyst for action.

The reduction in how much "gap risk" can persist in long-term government bond yields contributes to a more constructive outlook for sovereign debt, especially relative to stocks. Growth and inflation are decelerating, and we believe that this macroeconomic slowing is likely to dominate price action for a tactical period even if we have entered an environment of structurally higher inflation. Market-based measures of inflation expectations are broadly in line with central bank targets, indicating a degree of confidence that central banks will be successful in their quests to rein in inflation. And yet, long-term government bond yields are also above levels of estimates for where central bank policy rates should generally settle over time. This implies investors are earning extra compensation from holding these securities.

However, the potential for calmer bond markets in the UK and Europe must be balanced against the continued resilience of the US job market. Higher rates for longer in the US to induce a softening in labor market conditions may limit how well government bonds can perform in the near term. In our view, waiting for evidence of some US labor market softening is necessary before adding to long-term sovereign debt.

Exhibit 1: US Bond volatility, yields ease off peaks after BoE bond purchase announcement



Source: UBS-AM, Bloomberg, data as at 3 October 2022

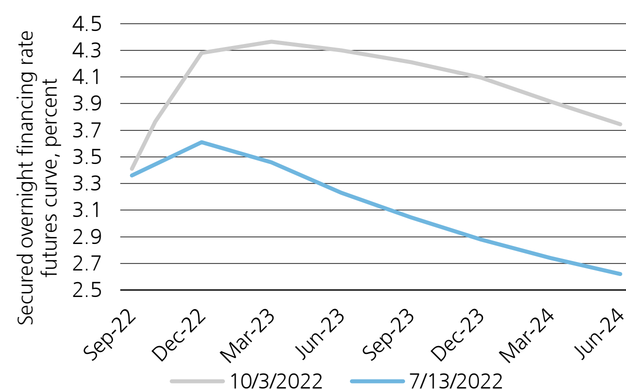
Can the US dollar continue to run higher?

Yes. History shows that the US dollar is expensive on a valuation basis, but also that this condition does not prevent major overshoots.

Federal Reserve policy will continue to buoy the US dollar, in our view, as tightening will likely continue without a pivot to easing until material evidence of labor market weakness emerges or inflation returns much closer to target. Neither of those outcomes is probable in the near term. Central bank tightening will cause a series of dominos to fall across the global economy, and the US labor market is likely to be the last to topple. Globally, the goods sector will come under more stress, and has ample room for continued retrenchment as the share of spending continues to rotate towards services. The US is in a relatively better position to withstand headwinds because a lower share of GDP is linked to goods, Europe is more exposed to the energy price shock, other housing markets are more sensitive to interest rate movements (the 30-year fixed rate mortgage is the dominant US product) and China has been unwilling to durably reopen economic activity.

Exhibit 2: Market embracing "higher for longer" Fed stance

Policy rate expectations are higher across the curve versus mid-July.



Source: UBS-AM, Bloomberg, data as at 3 October 2022. The SOFR futures curve reflects market expectations for where the Fed Funds rate may be at different points in the future.

Not enough of the positive catalysts from outside the US that could spark a reversal – an enduring reopening in China, a ceasefire between Russia and Ukraine, and the Bank of Japan ending yield curve control – appear likely to play out before year end. In particular, we believe the end of China's zero-COVID-19 policy will be more of a process than an event, and one that plays out throughout 2023.

John Connally, the Treasury Secretary to Richard Nixon, famously told his international counterparts that the US dollar is "our currency, but it's your problem." In the near term, we believe that US dollar strength is likely to persist until it is too big of a problem for the US economy to bear.

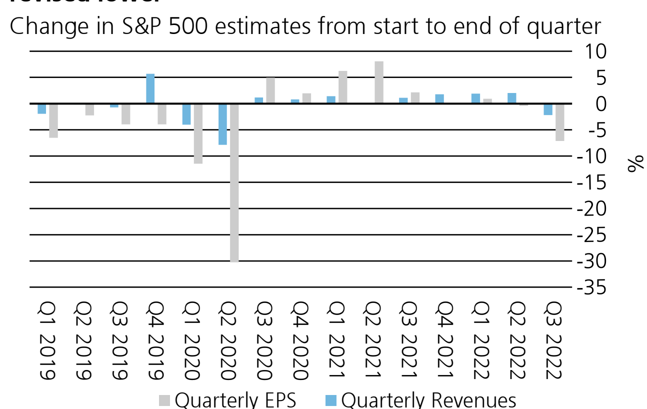
What is the outlook for earnings?

Increasingly negative. July through September 2022 is the first period since Q2 2020 in which both revenue and earnings expectations have been revised to the downside over the course of the quarter. This is symptomatic of a decisive turn to a much slower nominal growth environment. Over the past two years, at least one of growth or inflation has been either accelerating or surprising to the upside, giving an extra boost to revenues and profits. Going forward, it is quite likely that neither growth nor inflation will do so.

As seen in July, downbeat sentiment and relatively low expectations increase the potential for squeezes to the upside in risk assets during earnings season so long as results are not as bad as feared. But over time, the macro conditions will dominate. Falling purchasing managers' indexes, the strong dollar, and waning commodity prices imply profit estimates have further to fall from here. We believe that unless there is a fiscal or geopolitical policy change that provides strong cause to believe that revisions will soon turn, this downward pressure will remain a headwind for risk assets.

Exhibit 3: Third-quarter earnings and sales expectations revised lower

Change in S&P 500 estimates from start to end of quarter



Source: UBS-AM, Bloomberg, data as at 30 September 2022

Asset allocation implications

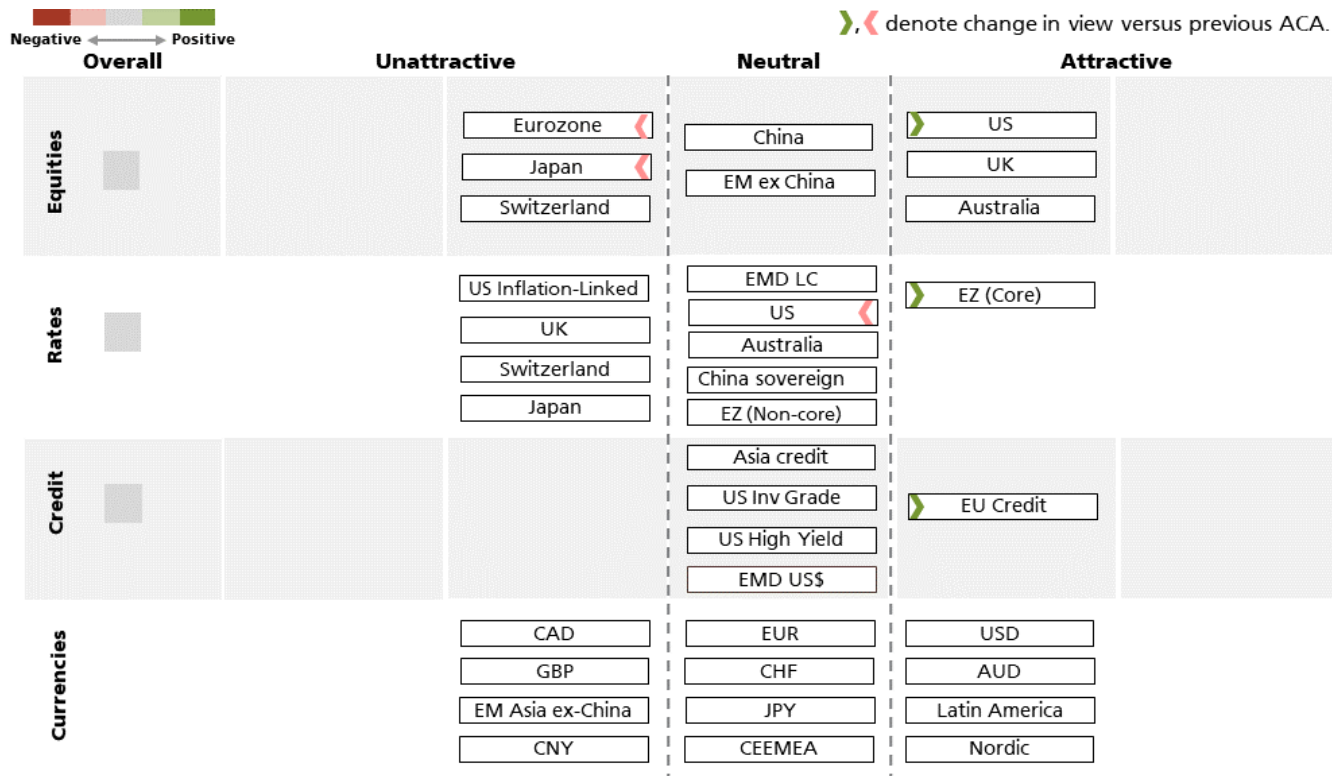
The equity risk premium continues to show stocks are expensive relative to bonds, and more cuts to earnings estimates are likely to come. Meanwhile, central bankers in the UK and Europe are more willing to protect against disorderly spikes in bond yields. The risk/reward of bonds and credit is improving relative to equities.

We remain defensively positioned within equities. Regionally, we now prefer long positions in US stocks versus other developed market stocks on a currency unhedged basis. Global activity is decelerating, and the earnings growth of US-based companies is less cyclical than other regions. US equities may be more vulnerable should real yields continue to trend higher, since they are more expensive and exposed to the growth factor. That is why it is important, in our view, to have a currency unhedged exposure, as the US dollar would also likely strengthen if real yields climb, offsetting some of the potential underperformance on the equities side.

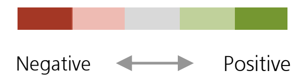
Our conviction in long US dollar positions remains intact. We believe that sufficiently negative domestic-oriented catalysts for the dollar nor positive catalysts outside the US are likely to gain much prominence in the tactical investment horizon.

Asset class attractiveness (ACA)

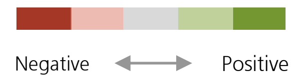
The chart below shows the views of our Asset Allocation team on overall asset class attractiveness as of 3 October 2022. The colored squares on the left provide our overall signal for global equities, rates, and credit. The rest of the ratings pertain to the relative attractiveness of certain regions within the asset classes of equities, rates, credit and currencies. Because the ACA does not include all asset classes, the net overall signal may be somewhat negative or positive.



Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as of 3 October 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/ relative signal	UBS Asset Management's viewpoint
Global Equities		– In our view, equities are likely to remain in a volatile range. Stocks remain expensive versus bonds based on the equity risk premium, and earnings as well as revenue estimates are biased lower from here, in our view. However, sentiment and positioning appear extremely depressed, and the potential that economic conditions have not deteriorated as quickly as feared may be a sufficient catalyst for a squeeze upwards in global equities. – We are staying cautiously positioned within equities given the likelihood that economic activity will continue to decelerate. We prefer sectors like health care and consumer staples and regions such as the US and UK, which have a more defensive/acyclical composition. We also are selectively long cyclicality via energy stocks.
US Equities		– American stocks are more acyclical and tend to outperform when manufacturing purchasing managers' indexes are declining. – US growth is likely to hold up better than other major developed markets. – However, US equities continue to command premium valuations, which may drag on relative performance in the event that expectations for the Federal Reserve's terminal policy rate this cycle increase further. – For this reason, we prefer expressing relative value positions in US equities in currency unhedged terms.
Ex-US Developed market Equities		– Non-US developed market equities are attractively valued but also highly cyclical and tend to underperform in an environment in which manufacturing purchasing managers' indexes continue to decelerate. – Japanese stocks lack catalysts that would help shrink this valuation gap. – European equities are still vulnerable as Russia continues to wage war against Ukraine. The likely hit to earnings from an economic downturn caused by energy shortages has not been fully priced in, in our view.
Emerging Markets (EM) Equities (ex-China)		– We prefer EM markets with the strongest linkages to commodities based on our expectation that the stabilization of growth in China will buoy commodity demand. – EM equities have held up well in the face of challenges in 2022 that include less impressive earnings revisions and higher mobility restrictions relative to DM, rising long-term real rates, and broad US dollar strength.
China Equities		– The Chinese policy stance has turned, both on the monetary and fiscal sides, but there are still questions about whether this support is sufficient given the potential for COVID-19-induced interruptions to activity and lingering weakness in real estate. Any stabilization in activity is unlikely to produce major positive spillovers for real activity elsewhere. – We are closely monitoring geopolitical tensions between US and China, as these carry left-tail risks to both operating performance and valuations.
Global Duration		– Long-term bond yields should be rangebound due to the combination of enduring recession risks, sticky-high inflationary pressures, and US labor market resilience. – Central banks' commitment to tightening should drive even more flattening of yield curves.



Asset Class	Overall/ relative 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 restrictive territory in order to quell inflationary pressures, even if this damages the labor market and puts the expansion in jeopardy. – The enduring strength of the domestic jobs market is the critical US-centric downside risk to Treasuries. The lack of softening across many labor market metrics despite aggressive tightening, high energy prices, and the retrenchment in global factory activity is putting the Federal Reserve on a path to keep interest rates higher for longer.
Ex-US Developed-market Bonds		– Outside the US, the threats of stagflation and recession are more pronounced. The European Central Bank rapidly exited negative interest rate policy by delivering 125 bps in tightening in Q3, and signaled more to come. A new tool – the Transmission Protection Instrument – aims to compress unwarranted widening in periphery spreads relative to the core via asset purchases in order to increase the scope for rate increases. – The Bank of England's intervention in gilt markets mitigates potential left-tail risks. However, these bond purchases are time-limited, for now, and about addressing financial stability risks due to the speed of the move, not an indication that gilt yields should be biased lower from here. – The Bank of Japan's policy of yield curve control undermines the utility of much of this market for now. Maturities beyond the 10-year point may be vulnerable should the persistence of inflation or needed central bank tightening drive even more repricing of global duration.
US Investment Grade (IG) Corporate Debt		– US IG all-in yields have become much more attractive given the year-to-date rise in risk-free rates as well as widening spreads. – However, the typically negatively convex performance of credit as market pricing of recession rises provides some cause for tactical caution.
US HY Corporate Debt		– High yield spreads have widened materially year-to-date. However, spreads are not close to levels that prevailed at the peak of growth scares in 2011 and early 2016. Global recession risks are at least as high now as they were during those periods.
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. – 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 is delivered.
China Sovereign		– The attractiveness of Chinese government bonds has diminished somewhat as nominal rate differentials versus 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 indices. We believe the monetary easing and subdued domestic inflation should prevent any sustained upward pressure on yields during the next 3-12 months.
Currency		– We believe the US dollar is well-positioned to remain elevated, if not strengthen further. Positive catalysts for the rest of the world – most importantly, the end of China's zero-COVID-19 policy – are not due to emerge imminently. It is also unlikely that the US labor market or US inflation weakens enough to spark the Federal Reserve to reverse course on its plans to keep rates in restrictive territory. – In our view some EMFX, like BRL, are poised to outperform cyclical Asian currencies and select G10 commodity exporters given attractive carry.

Source: UBS Asset Management. As of 3 October 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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