Macro Monthly

Economic insights and asset class views

UBS Asset Management | October 2023

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

Evan Brown
Head of Multi-Asset Strategy
Investment Solutions

Luke Kawa
Director
Investment Solutions

A little bit softer now

Highlights

- Good news for the US economy has been bad news for the stock market as surging yields have challenged equity valuations.
- In our view, the headwinds from rises in rates, and to a lesser extent oil prices, will not be a major source of incremental downside for stocks.
- Investors have become much more upbeat on the outlook for growth at a time when US activity is poised to moderate and inflation has meaningfully decelerated.
- We remain overweight equities as we expect bond yields to stabilize on a much improved inflation picture and a gentle cooling of US growth.

The story of the third quarter has been that good news for the economy has not been good news for financial assets.

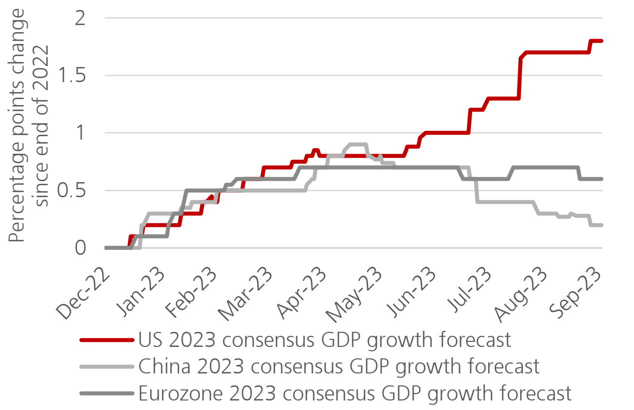
10-year US Treasury yields surged nearly 75 basis points over the course of the quarter to their highest level since 2007. Robust domestic data and policy rate projections from the Federal Reserve are signaling the economy can handle high interest rates, so calls for an imminent recession continue to be premature – in line with our longstanding view.

That is the good news. The bad news is that sharp rises in interest rates can weigh on equity valuations as the yield available on these safer assets creep closer to the earnings growth expected to be delivered by publicly traded corporations. Some non-economic considerations for rising yields, most notably the increase in Treasury bond issuance, added to the pressure on stocks. What's more, the jump in oil prices – primarily attributable to Saudi Arabia's prolonged production cuts – is a negative stagflationary force for financial assets.

Our view is that these two big headwinds for risk assets – rapidly ascending yields and oil prices – should lessen in intensity in the fourth quarter. Risks to the economic expansion are still two-sided, but investors now appear more concerned about the challenges associated with a "no landing" outcome rather than a "hard landing" scenario. This change in the market's assessment of the balance of risks is coming at a time when the US growth rate is likely to moderate from here.

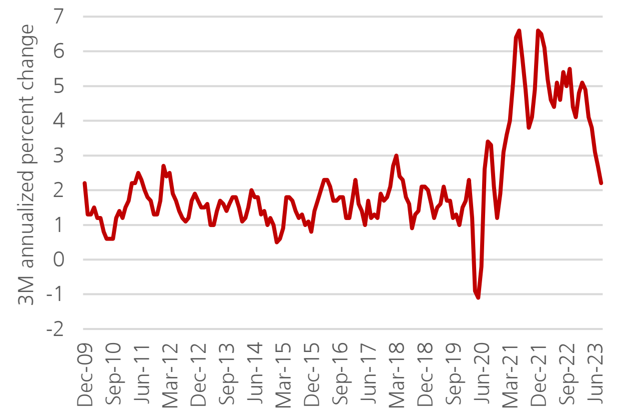
In our view, consolidation in oil prices and bond yields should provide relief for stocks. We remain overweight equities as investors refocus on the significant improvement in core inflation and an economy that becomes a little less hot.

Exhibit 1: Persistent upward revisions to US 2023 GDP growth forecasts



Source: UBS Asset Management, Bloomberg. As of September 2023.

Exhibit 2: Significant deceleration in core inflationary pressures



Source: UBS Asset Management, Bureau of Economic Analysis, Bloomberg. As of August 2023.

Q4 outlook

US inflation outcomes have evolved in a manner increasingly consistent with a soft landing, and we expect that growth data will come off the boil as well.

The three-month annualized rate of core PCE inflation has decelerated to 2.2% as of August, its slowest pace since 2020. Core price pressures will undershoot the Federal Reserve's 2023 target unless core PCE inflation runs well above its year-to-date pace. This is unlikely, in our view, due to the continued scope for shelter disinflation and general slowing in US labor income growth. As such, the recent evolution of core inflation has increased the likelihood that the Federal Reserve's tightening cycle is over.

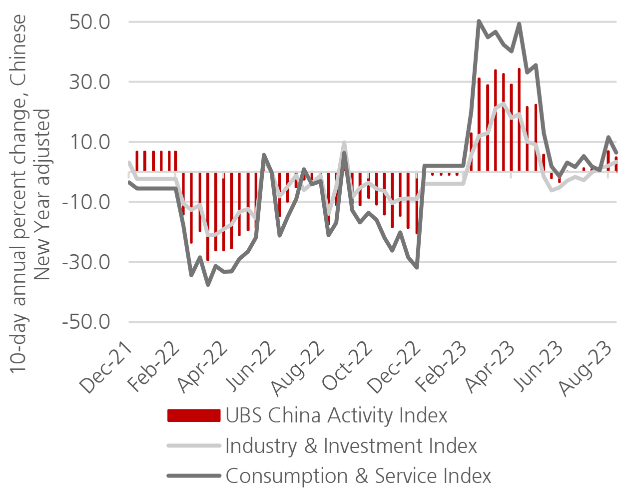
A dominant market theme of the past four months has been US growth accelerating and surprising to the upside, contributing to the rise in bond yields and renewed strength in the US dollar. While US activity may continue to exceed rather depressed economic expectations for the fourth quarter, it is highly likely that the pace of growth will slow.

The United Auto Workers strike and start of student loan repayments are contributing to a loss of momentum as we move into the final three months of the year. Recently passed legislation to fund the US government through mid-November reduces the number of negative catalysts for the economy in Q4, reinforcing our view that this will be a gentle cooling of activity. As activity in the US moderates – largely a function of these temporary factors – we expect other major regions to stabilize, providing some cushion for the step-down in the near-term US outlook.

Chinese economic data broadly exceeded expectations for August, with higher than anticipated credit growth as well as industrial production and retail sales posting a faster pace of annual growth. While risks linked to property sector retrenchment continue to linger, higher frequency macro data for September point to a modest increase in Chinese economic momentum. In September, China's official and private purchasing managers' indexes showed both the manufacturing and non-manufacturing sectors were above 50 (which separates expansion from contraction) for the first time since March. Given depressed sentiment, the measured policy support to date, and likely further incremental steps to support growth, we believe China's economy has more scope to surprise to the upside than the downside in the near term.

There have been few signs of a broad pick-up in global manufacturing activity. This continues to be a more acute drag on European growth than the US, given the former is more levered to factory activity. However, we are seeing some signs of improvement in services purchasing managers' indexes in Europe. The same mechanism supporting US consumption – inflation falling faster than nominal income growth while labor markets stay tight – also applies to the euro area as well. As such, we do not see meaningful downside risk to consumer spending across the continent in spite of the ongoing manufacturing malaise.

Exhibit 3: Signs of improvement in high-frequency Chinese data



Source: UBS Asset Management, UBS IB, CEIC, G7, China ports association, Wind. As of September 2023.

Asset allocation

In our view, a stabilization in bond yields is all that is needed for the stock market to better reflect the steady improvement in fundamentals and decrease in inflation risk. Twelve-month forward earnings per share estimates for the S&P 500 are up more than 3% since the stock market peaked at the end of July, and we anticipate continued increases given our view that recession risk is low. However, we acknowledge that the range of outcomes has widened given the magnitude of the rise in yields, the solid economic backdrop, still-elevated inflation, and relatively expensive valuations in some pockets of the equity market as well as high yield.

In Q4 we will be more selective in our equity exposures in light of the market's enhanced faith in the durability of the US expansion, which has left cyclically-oriented expressions more vulnerable in the event that recession fears reemerge. However, there is a lot of scope for US activity to cool without raising risks of a growth scare, in our view. Labor markets remain tight, with initial jobless claims near historical lows, and positive inflation-adjusted income growth should allow for increases in real consumer spending.

We retain a neutral stance on government bonds. Sovereign debt has become more attractive on a fundamental basis following the surge in yields, as we have seen meaningful progress on inflation cooling and anticipate US activity data to come off the boil. However, there is a wide range of outcomes on bonds due to the immense uncertainty as to how much the term premium (that is, the extra compensation investors demand for taking on duration risk) ought to rise in a world in which yield curves are still quite inverted and the issuance of Treasuries is moving higher. We would likely need to see the substantial negative momentum in fixed income stabilize before becoming more constructive on bonds.

We remain neutral credit and prefer shifting up in quality as this 'long late cycle' progresses. As of now there is insufficient evidence to suggest growth is set to deteriorate sharply, but we are keeping a close eye on bank balance sheets, consumer delinquencies and small business health to gauge if downside risks are growing. We retain exposure to the US dollar, which has been a useful hedge during periods in which stocks and bonds sell off in tandem.

Asset Class Views

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness as of 1 October 2023. 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.

Asset Class		Opportunity Set	UW		N		OW	
Main Asset Classes		Global Equities				■		Headwinds from rates/oil to lessen going forward. Profits growing, disinflation may support multiples.
		Global Gov			■			Disinflation offset somewhat by solid growth, unfavorable technicals. Useful hedge for recession risk.
		Global Credit			■			Attractive all-in yields amid decent growth and disinflation. But limited room for spread compression.
		Commodities			■			Resilient demand, positive supply surprises may have run their course. Requires stronger China for more upside.
Preference by Asset Class	Equities	US				■		More attractive after recent pullback, with room to advance as profits grow and rates shock fades.
		Europe		■				Funding US equity exposure out of Europe on soft manufacturing, stubborn inflation, and China softness.
		Japan				■		Still cheap after recent gains, solid earnings, corporate reform ongoing, Prefer to express in FX unhedged terms.
		EM			■			EM outperformance requires more evidence of China strength. Asia ex China supported by tech goods rebound.
	Duration	US Treasuries			■			Rates have repriced to reflect US economic strength, higher term premia. Now look more balanced.
		Bunds		■				Strong labor market and sticky inflation mean cuts unlikely to come as soon as currently priced
		Gilts				■		More progress on inflation, and difficult for BOE to keep policy rate as high for as long as currently priced.
	Credit	Investment Grade Credit			■			Narrow spreads means risk-reward confined to carry.
		High Yield Credit			■			Slight preference for IG versus HY. Moving up in quality in context of broader risk-on positioning.
		EMD Hard Currency			■			EMD attractive on expected decline in rate vol, high local rates. Big divergence between EM IG and EM HY.
	FX	USD			■			Resilient US growth but disinflation offset to a broadly neutral USD. Bearish against high carry EMFX.
		EUR			■			Little sign of a bottom in manufacturing activity. Sticky high inflation keeps us neutral.
		JPY				■		JPY is cheap vs USD and the BoJ is beginning to tighten. Safe haven JPY a good hedge against recession.
		EM FX				■		Not too hot, not too cold economy is good for carry. Prefer MXN & BRL.

Negative ⟷ Positive

Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as of October 1, 2023. Views are 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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