Increasing risk exposure on greater political clarity

UBS House View - Weekly Global

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Key Messages
1. Phase 1 deal improves outlook for risk assets.

The US and China have announced that they have struck a deal on trade. The US has said it will roll back the tariff rate on USD 120bn of Chinese goods from 15% to 7.5% and will not be adding tariffs to USD 160bn of Chinese goods, as had been scheduled for 15 December. In return, China has agreed to increase its purchases of US goods and services, particularly agricultural products. We think it is significant that for the first time tariffs have been reduced rather than merely delayed. We may have reached the point of “peak tariffs” with regard to the US and China, and this deal could represent the start of a series of phased rollbacks. It is also encouraging that China has made commitments on intellectual property and forced technology transfer, even though details are currently lacking. This could unlock further upside for equity markets, driven by an improvement in business confidence and a recovery in investment. Attractive valuations for stocks relative to high quality bonds should lead to outperformance over a six-to-12 month investment horizon.

Takeaway: We have increased our risk exposure in our global tactical asset allocation, adding an overweight in emerging market equities and closing our FX strategy’s underweight in the Australian dollar versus the US dollar.

2. Pound’s election lift may have further to go.

Investors also gained clarity on another key political risk of 2019. The UK’s Conservative Party won an 80 seat majority in the House of Commons, taking 365 of the 650 seats. The outcome gives Prime Minister Boris Johnson the authority he needs to pass a Brexit Withdrawal Agreement, and push through the UK’s exit from the European Union on 31 January. Attention will then turn to reaching a trade deal during the transition period which runs until the end of 2020. The UK electoral outcome is likely to be a modest positive for global investors as it has reduced the near-term threat of a hard Brexit. But the most immediate impact is likely to be on

Week Ahead
1. What next for the UK? With the UK election out of the way, we can expect further clarity on government policy under the freshly elected Conservative Party, along with rate guidance from the Bank of England and a slew of economic releases – from unemployment data to retail sales to inflation. The main focus for investors over coming months will be whether Prime Minister Johnson displays any flexibility on extending the UK’s transition date out of the EU.

2. Will the trade deal live up to high hopes? The US-China trade deal combines tariff roll-backs with a commitment to agricultural purchases by China and action on intellectual property and technology transfer. Investors now await the full details.

3. Will the Fed’s favorite inflation measure support its standstill? The latest Fed meeting points to no rate moves through 2020. But a sustained move away from the Fed’s 2% target in the Personal Consumption Expenditure index, out this Friday, would bring rate moves back on the agenda. We expect the recent trend of near-target inflation readings to persist.

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sterling. We remain bullish on the pound, which is undervalued against the US dollar. Fading dollar demand and a clear path toward a benign free trade deal with the EU could see GBPUSD rallying to 1.45 by end-2020. Our estimated equilibrium rate three years ahead is 1.54. In the risk case, a failure to extend the transition agreement by 1 July, followed by the UK reverting to trading with the EU on WTO terms, could cause GBPUSD to fall to 1.15.

*Takeaway: Within our FX strategy, we are overweight the pound. For non-sterling investors with a long-term exposure to the UK in their portfolios, we recommend holding these positions on an unhedged basis.*

3. Carry can benefit from Fed standstill.

In its first unanimous vote since May, the Federal Reserve left rates unchanged last week with policymakers also suggesting they are likely to remain on hold through 2020. While recent history has indicated that the Fed is willing to change its plans in response to economic data, we don’t see an immediate trigger for either further cuts or hikes, with inflation close to the target, unemployment low, and growth slightly below trend. The US-China trade deal could reduce the chances of further rate cuts as it reduces the risk to US growth, but appetite for a rate increase also appears limited, with the dot plot of policymaker forecasts suggesting no move up in rates until 2021. Against a backdrop of easy monetary policy and near trend US growth, US dollar-denominated emerging market sovereign bonds offer an attractive carry of more than 3% versus US Treasuries. We expect the growth differential between emerging and developed economies to widen significantly in favor of emerging markets, from 2.6% this year to 3.4% next.

*Takeaway: We overweight US dollar-denominated emerging market sovereign bonds.*
Deeper Dive

Increasing risk exposure on greater political clarity
by Global Chief Investment Officer Mark Haefele

The last week has provided a measure of clarity on two of the key political risks of 2019 – US-China trade and Brexit. Based on the Phase 1 trade agreement reached between the US and China we have increased our risk exposure, while greater certainty on Brexit following the UK election has confirmed our bullish stance on sterling.

- The US and China have announced that they have struck a deal on trade. The US has said it will roll back the tariff rate on USD 120bn of Chinese goods from 15% to 7.5% and will not be adding tariffs to USD 160bn of Chinese goods, a move which had been scheduled to go into effect on 15 December. A 25% tariff rate will remain in place on approximately USD 250bn of Chinese goods. In return, China has agreed to increase its purchases of US goods and services, particularly agricultural products.

We think it is significant that the announcement represents the first time that trade negotiations have led to an actual reduction in tariffs, rather than a mere delay. We may have reached the point of “peak tariffs” and this deal could represent the start of a series of phased rollbacks. It is also encouraging that China has made commitments on intellectual property and forced technology transfer, even though details are currently lacking. This could unlock further upside for equity markets, driven by an improvement in business confidence and a recovery in investment. Attractive valuations for stocks relative to high grade bonds should lead to outperformance over a six-to-12 month investment horizon.

In our Year Ahead publication, we wrote that in a Year of Choices political decisions would drive outcomes. Now, with signs of reconciliation between the US and China reducing downside risks to the global manufacturing sector and consumer sentiment, we are adding risk to our portfolios. We are increasing our risk exposure in our global tactical asset allocation, adding an overweight in emerging market equities and closing our FX strategy’s underweight in the Australian dollar versus the US dollar. We also continue to take risk through carry strategies.

- In the other key development in the past week, the UK’s Conservative Party won an 80 seat majority in the House of Commons, taking 365 of the 650 seats. The outcome gives Prime Minister Boris Johnson the authority he needs to pass a Brexit Withdrawal Agreement, and push through the UK’s exit from the European Union on 31 January.

We remain bullish on sterling, which is undervalued against the dollar. Fading dollar demand and a clear path toward a benign free trade deal with the EU could see GBPUSD rallying to 1.45 by end-2020. Our estimated equilibrium rate three years ahead is 1.54, justifying forgoing currency hedges on UK equities in USD portfolios, in our view. In the risk case, a failure to extend the transition agreement by July, followed by the
UK reverting to trading with the EU on WTO terms, could cause GBPUSD to fall to 1.15.

Greater near term clarity on these issues does not, however, mean the end of political uncertainty. Political decisions will continue to impact markets significantly in 2020. In the near term, volatility could be heightened as the details of what is included in the US-China trade deal becomes known. For this reason we maintain our preference for positions less dependent on specific political outcomes. Within equities, we recommend exposure to markets and sectors that derive a greater proportion of their revenues from domestic rather than global trade, and to favor stocks exposed to consumer spending rather than business investment and trade.

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Appendix

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