UBS

21 August 2023, 07:33AM UTC
Chief Investment Office GWM
Investment Research

Long stem roses

Blog

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July was the month when investor consensus pivoted from recession to soft landing. August is set to be the month when investors' focus pivoted from the short to long term. If you expect the US economy to land softly, you then also have to answer "land softly to what?" That is inherently a question about the long-term outlook for the US economy and the macroeconomic regime it will be in for at least the next few years. The best indication that investors are thinking about the secular regime is the 50bps rise in the 30-year Treasury yield to a 12-year high of 4.38%, *and* the rise in market pricing for the federal funds rate five years out.

The rise in long end rates over the past month stems from technical factors (central banks buying fewer bonds, bigger supply of Treasuries) and investors pricing out Federal Reserve rate cuts in 2024 in response to stronger-than-expected growth. Less noted is that market pricing for the fed funds rate in five years—a proxy for investor beliefs about the long-term neutral fed funds rate—has risen about 50bps during this period to roughly 3.75%. For context, the Fed's current estimate of the neutral rate is 2.5%. This rise in the 30-year yield and market-implied neutral rate has also occurred while market pricing for the terminal fed funds rate in this hiking cycle has barely budged, hovering around 5.42%. The cuts in 2024 that the market has priced out haven't been pushed back to 2025; they've been priced out entirely.

This shift in investor expectations to a higher long-term neutral rate is implicitly an expectation that nominal GDP growth will be sustainably higher than it was during the past 15 years. That's the implicit market answer to the question of what the economy will make a soft landing to. "Higher for longer" has referred to the fed funds rate, but it could now also apply to nominal GDP growth.

The long-term outlook for the US economy is a topic that we've written about for, well, a long time. It started with a rose-colored glasses blog in October 2021 that presented a "roaring '20s" secular bull case scenario of sustained growth above 2%; falling inflation and strong job growth as the decade proceeds; and revolutionary technologies that change the world. The scenario was based on 10 factors that could happen that collectively entailed surging investment in the public and private sectors, enabled by still-ample capital availability and a willingness to take risks and transform businesses that result in faster productivity growth.

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Rose buds in May 2023 was the most recent assessment of this secular bull case. Many of the factors that were conjectures in October 2021 for what could happen the rest of this decade are now coming to fruition. In fact, in the three months since that update, the data on capex spending, manufacturing investment, and AI developments are even more supportive of the secular bull case occurring.

An optimist's interpretation of these developments is that those buds in May are blooming into long stem roses. A more cautious but increasingly plausible secular outcome is sustained higher nominal GDP growth compared to the past 15 years. The bigger uncertainty is over the split of that growth between real GDP and inflation. That will hinge on productivity growth, the magnitude of which is mostly speculation at this point. The more that real growth is responsible for the higher nominal growth, the better the outcome.

That investors are thinking more about the long-term outlook speaks of how much the cyclical economic picture has improved as recession risk over the next 12 months has receded. The latest House View update goes into the details, and explains why this better cyclical outlook was the catalyst for our upgrade of equites to neutral from least preferred. In return terms, we now expect modest upside to US equities (S&P 500) by year-end and more so by next June (about 8% from 4,369 currently to 4,700).

Investors' upgrading of their long-term nominal growth outlook isn't entirely benign because it also reflects concern that the economy and inflation will re-accelerate. The Fed would presumably continue rate hikes were that to happen, or at least not cut for most of 2024, either way raising the risk of a delayed recession. This re-acceleration scenario is unlikely and part of our bear case. Leading indicators for shelter inflation and the labor market imply continued cooling in the economy. It would also defy precedent and logic for an economy to accelerate as monetary policy got more restrictive.

The high likelihood that both growth and inflation will decline over the next 12 months, though still combining for a reasonably healthy level of nominal GDP growth, is why we keep bonds as our most preferred asset class. The technical factors that pushed Treasury yields higher last month should ease, as should these re-acceleration fears. The result is bond yields that drift lower, supporting our recommendation to **invest in quality bonds**. While these bonds offer an attractive risk-reward and are a recession hedge, they are also an implicit bet on the secular bull case. In it, rapid productivity gains support growth while keeping inflation contained, reducing the risk that bond yields rise from current levels.

The bottom line: Receding US recession risk as growth stays at or above trend has directly boosted the cyclical outlook for equities, and indirectly lifted expectations for the secular macro outlook. These positive macro developments offer a relatively benign justification for higher bond yields, further adding to the appeal of quality bonds. In our tactical base case, we continue to recommend **equity laggards** as the best way to position for a softish landing, which would get a further boost if the secular bull case becomes increasingly likely. For the very near term (i.e., the rest of the summer), the markets may remain on edge as investors look for any signs that re-acceleration fears are justified and speculate how the Fed will respond to such news. But through all that market noise, it's important to remember that the US economy smells a lot rosier today than it did a few months.

Appendix

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Version B/2023. CIO82652744

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