The past few months have demonstrated that markets move very fast when narratives change, and it's hard to win when you're not even in the game. (UBS)

Monitoring the ebbs and flows in markets

23 January 2023, 2:04 pm CET, written by UBS Editorial Team

When is bad economic news good news for the markets because it implies easier monetary policy and when is it bad because it means higher recession risk? There's no clear threshold to delineate the two states, and even if there was, it's a thin line between data that's bad enough to trigger a Fed response yet not so bad as to suggest that a recession is inevitable. That makes the "bad news is good news" assessment subjective, and easy for the markets to toggle between the two narratives based on only a few data points.

Such was the case last week, when disappointing retail sales, manufacturing surveys, and industrial production data led to chatter of "bad news is bad news", just as investors were embracing the soft-landing thesis.

It's never wise to overreact to a few new data points, especially when the data has been so noisy, with large month-to-month fluctuations and revisions. It's better to contextualize the data within big picture dynamics. On that basis, we make three observations.

First, US economic growth slowing to below the long-term trend (~2%) isn't surprising, it's the expected outcome of Fed policy. Nor should a few poor data points have much impact on recession expectations. In fact, by some estimates the negative growth impulse from tighter financial conditions will peak this quarter and then fade. That's helped by real incomes now rising because inflation is below wage growth. Moreover, growth data last week was not as bad as the headlines suggest. Unemployment claims fell to four-month lows, while seasonal adjustments to the retail sales data may have overstated the weakness. In short, the US economic outlook isn't any different today than it was a week ago.

Second, investors have become more concerned about slowing US growth at the same time that they've become comfortable, if not complacent, that inflation will fall rapidly. But recent trends in both could be head-fakes. While a mild recession is our base case, growth may stabilize at a positive but below-trend level for this year, and that may keep

inflation at an unacceptably high level for the Fed, especially if labor market strength persists. Thus, a "good news is bad news" narrative could well emerge by 2Q.

Third, diverging growth across regions is becoming more evident, with the US economy likely to keep slowing, while China and Europe should start to improve in 1Q and 2Q, respectively. The boost to China from reopening is obvious, even if it will take a couple of months to show up in the data. Meanwhile, economic surprise indexes and manufacturing surveys (e.g., ZEW in Germany) are surging in Europe and falling in the US.

This thinking informed our latest House View update, in which we gauged the status of inflection points for growth, inflation, and interest rates. The first two observations above allude to the fact that key US inflection points are not imminent, while the third point suggests that they're closer in other major economies. The overall investment outlook has become more balanced, though still warrants cautious portfolio positioning, favoring defensive, value, and income opportunities, while selectively adding cyclical positions. This month we did the latter by adding preferences, consistent with the diverging regional trends, for commodities, EM equities, and EM USD sovereign bonds, and upgrading the EUR up to neutral from least preferred.

Not reflected in preference changes, but an important tactical asset allocation consideration is the economic outlook that's being priced into Treasuries, and the influence of positioning and flows. The fall in Treasury yields this year indicates a market pricing for a recession and benign inflation. Falling yields have also gotten a tailwind from strong inflows into bonds as investors rebalance portfolios and seek carry trades to start the year. This leaves yields vulnerable to backing up once those flows abate and if growth and/or inflation are higher than expected. The implication is that we expect better entry points to add new long Treasury positions.

The bottom line: Investors are eagerly anticipating the key inflection points for central bank policy rates, growth, and inflation. But the paths to those points will likely entail narrative flip-flops between bad data being good versus bad news, and slowing growth versus sticky inflation being the bigger risk. Thus, markets should remain challenging to navigate, with ebbs and flows reminiscent of the past nine months, albeit with perhaps smaller amplitudes and shorter durations. Despite that, it's important to stay invested and to selectively add exposure when attractive risk-reward opportunities arise. The past few months have demonstrated that markets move very fast when narratives change, and it's hard to win when you're not even in the game.

Main contributor: Jason Draho, Head of Asset Allocation

This content is a product of the UBS Chief Investment Office.

Original blog - Ebbs and flows, 23 January, 2023.

Important information
As a firm providing wealth management services to clients, UBS Financial Services, Inc is registered with the U.S. Securities and Exchange Commission (SEC) as an investment adviser and a broker-dealer, offering both investment advisory and brokerage services. Advisory services and brokerage services are separate and distinct, differ in material ways and are governed by different laws and separate contracts. It is important that you carefully read the agreements and disclosures UBS provides to you about the products or services offered. For more information, please visit our website at www.ubs.com/workingwithus.
© UBS 2021. All rights reserved. UBS Financial Services Inc. is a subsidiary of UBS AG. Member FINRA/SIPC.
There are two sources of UBS research. Reports from the first source, UBS CIO Global Wealth Management, are designed for individual investors and are produced by UBS Global Wealth Management (which includes UBS Financial Services Inc. and UBS International Inc.). The second research source is UBS Group Research, whose primary business focus is institutional investors. The two sources operate independently and may therefore have different recommendations. The various research content provided does not take into account the unique investment objectives, financial situation or particular needs of any specific individual investor. If you have any questions, please consult your Financial Advisor. UBS Financial Services Inc. is a subsidiary of UBS AG and an affiliate of UBS International Inc.