

# Macro Monthly

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UBS Asset Management | Economic insights and asset class attractiveness

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## Banking sector stress, not a crisis

### Highlights

- Deposit outflows from some banks in the US/Europe are a catalyst for slower growth, not a systemic financial crisis, in our view.
- The distribution of potential macro outcomes is very wide, and the skew is more negative. But short-term interest rate markets appear to be pricing in an elevated probability of an imminent recession, which we believe is far too pessimistic.
- We continue to prefer Chinese equities and the Japanese yen. Cyclical trades are discounting a lot of near-term economic damage, and have some scope to retrace recent losses, in our view.



**Luke Kawa**  
Director  
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Many investors will have had uncomfortable flashbacks of the Global Financial Crisis (GFC) over the last few weeks. The rush of policymakers and financial institutions to provide stability before Asian markets open does bring back unpleasant memories. However, we would describe the current period of financial turbulence as a period of banking sector stress, not a crisis. There are important differences between what is happening in 2023 versus 2007-08.

We don't want to downplay the current challenges plaguing the banking system, but rather put them in perspective. First, the banking system in both the US and Europe is much better capitalized, and has much less leverage than in the GFC. Second, the issues in the banking sector are largely about liquidity as opposed to solvency. Deposit flight is a confidence problem which is easier for policymakers to deal with than a pile of toxic assets scattered across an opaque web of counterparties. Third, policymakers are more prepared for these kinds of events than they were 15 years ago. And lastly, nominal growth is much higher, so we are entering this period from a starting point of economic strength. For example, the US unemployment rate is near record lows, whereas in 2007 we were already in a recession.

While we view a systemic crisis as highly unlikely, there are negative growth effects that will result from the current banking stress. Credit is the lifeblood of the economy and recent developments will reduce its supply and increase its cost on an aggregate level. And one less helpful difference from 2008 is the problem of high inflation, which will prevent central banks from easing as quickly as they might have in response to this slower growth.

At this point it is difficult to gauge just how much credit standards will tighten and how much they will affect the economy. The range of macroeconomic outcomes has widened and shifted in a negative direction. On the other hand, a sooner pause in Fed tightening is likely, which should provide some cushion for markets and the economy. Given still strong household and corporate balance sheets, we are unconvinced the economy is heading for an imminent recession.

The rates market is now pricing in 75 basis points of easing this year, starting in the summer. To us, this pricing is more consistent with a systemic shock than a gradual slowing of growth, which remains our view. We see room for yields to re-price higher, which would weigh on expensive US growth stocks. We prefer allocating to China, where the stage of the economic cycle and policy bias are more supportive for asset prices.

### **US banks: Contagion limited, but slower lending ahead**

The failures of select US banks provided an urgent catalyst for depositors to move money from regional banks into larger banks they perceived as safer. Or alternatively they prompt switching into products like money market funds that have much higher yields than their checking accounts at the regional banks.

In response, the Federal Reserve swiftly made it easier for banks to meet their depositors' requests with a new liquidity facility that allows securities to be pledged at par in exchange for reserves. This allows banks to avoid incurring severe losses/hits to their capital bases during this period of deposit pressure. We are encouraged by indications from bank management teams, as well as Federal Reserve Chair Jerome Powell, that deposit outflows have largely slowed or stabilized.

One consequence of this deposit pressure, however, is that it is likely that loan growth is going to slow and the cost of accessing financing will rise. This should contribute to slower economic growth going forward. But because nominal growth has been high, and credit concerns relatively subdued, we expect this to be a gradual drying up of liquidity rather than a freeze. Regional banks have a particularly large footprint in commercial real estate, so that segment of the market is likely to be most negatively impacted.

The FDIC, Federal Reserve, and Treasury Department are unable to extend deposit insurance to all banks above \$250,000 unilaterally. For that, an act of Congress would be needed. But, in our view, key officials have provided strong indications that they aim to fully protect depositors on a case-by-case basis should there be further bank failures. This is in line with actions taken to date.

More clarity on what to expect for uninsured deposits and a resolution process for the more obviously stressed financial institutions would likely provide a strong signal to markets that policymakers are acting as proactively as possible. We firmly expect this messaging to prevent stress from spreading into a crisis, but lingering uncertainty will weigh on lending and economic activity over time.

### **European banks: In better shape**

European banks, meanwhile, are in a better position than their US counterparts. In aggregate, these institutions are more regulated, have a higher capital base, better liquidity coverage ratios, and far less exposure to unrealized losses in their securities portfolios.

We anticipate that bank deposits will be stickier in Europe than the US, in part because of the smaller footprint of alternative options such as money market funds. This should lead to fewer concerns about the liquidity position of European banks, as well as less downward pressure on net interest margins.

In our view, the banking stress in Europe is fairly isolated. We are closely monitoring banks that may be more susceptible to deposit flight to confirm this continues to be the case. There is much less reason for European banks to face liquidity or solvency concerns. But if these arrive, they are better equipped to weather the storm.

As such, we expect a milder impact on lending and growth in Europe compared to the US. And already tight regulations in Europe compared to that covering small- and medium-sized banks in the US means incremental regulatory uncertainty should have a bigger impact stateside. We therefore have more confidence that European banks and equities are likely to reverse more of their recent underperformance compared to US banks.

### **Asset Allocation**

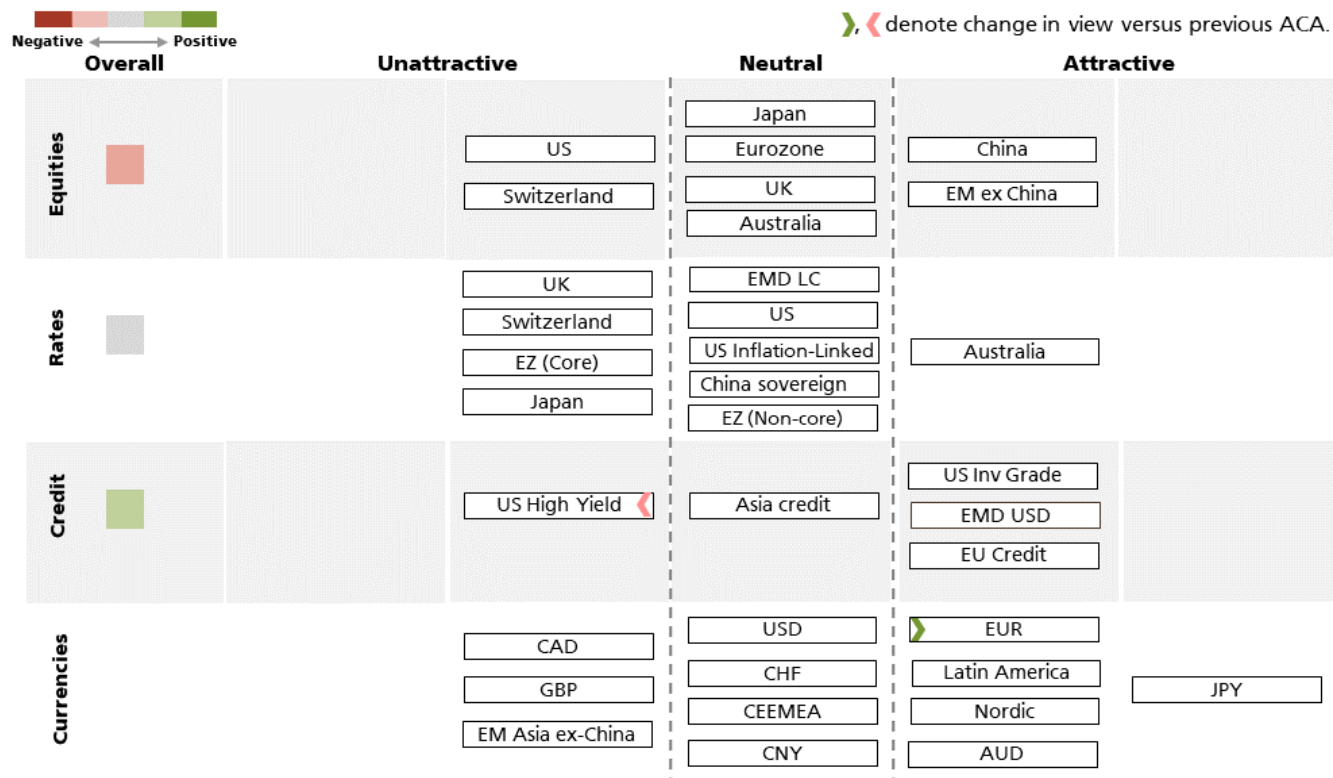
Global nominal growth is high, and US and European corporate and household balance sheets are in a strong position, in aggregate. Last week's PMIs showed global growth actually accelerating into this period of stress while declining oil prices continue to boost disposable income and spending. This provides a substantial cushion for US activity to slow without triggering an outright economic contraction.

We also see the pricing of imminent rate cuts as overdone given the robust economic starting point and continued high inflation. While there is uncertainty, we think the speed at which tighter lending standards weaken the economy will be slower than bond markets seem to indicate. A repricing of yields higher would likely coincide with a rotation from growth back into value.

We continue to prefer Chinese equities and view the policy-induced economic rebound there as most insulated from banking stress in the West. In credit, we prefer emerging market debt to US high yield, which is relatively more expensive and exposed if the US growth outlook turns out weaker than our expectations. We continue to expect US dollar weakness as the Fed approaches the end of its tightening cycle and China rebounds, enabling some rebalancing of global growth away from the US to the rest of the world.

### Asset class attractiveness (ACA)

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness as of March 24, 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.



Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as of March 24, 2023. 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
<b>Global Equities</b>	■	<ul style="list-style-type: none"> <li>– In our view, the risk-reward proposition for global equities at an index level is not particularly attractive. Stocks remain expensive, and we believe earnings estimates are biased lower from here, especially as credit conditions tighten.</li> <li>– Importantly, US stocks still account for nearly 60% of global equities, and are particularly richly valued.</li> <li>– Risks to global activity are high amid ongoing banking stress, and the distribution of possible outcomes has widened. We prefer Chinese equities, which are more sheltered from the risk of a credit slowdown in advanced economies, and benefit from the tailwinds of accommodative monetary and fiscal policy.</li> </ul>
<b>US Equities</b>	■	<ul style="list-style-type: none"> <li>– US stocks have been relatively expensive for a long time, but this valuation premium was justified by superior profit growth.</li> <li>– Recent earnings revisions are modestly weaker for US stocks than for global equities. US stocks are particularly vulnerable to a de-rating vs. global equities should this catalyst of earnings outperformance shift decisively to underperformance.</li> <li>– US equities are also more acyclical and would likely outperform if there is a sharp deterioration in global activity, contrary to our expectations.</li> </ul>
<b>Ex-US Developed market Equities</b>	■	<ul style="list-style-type: none"> <li>– Non-US developed market equities are attractively valued but also highly cyclical. There is a lot of variation between DM equity markets based on differing domestic policy stances and degrees of vulnerability to external headwinds.</li> <li>– We have high conviction that the yen will appreciate, which diminishes the attractiveness of Japanese stocks in local currency terms. Equities are buoyed by strong domestic fiscal support, which may be reinforced by surprising strength in real activity globally if our optimistic economic view comes to pass.</li> <li>– Success in securing natural gas and a mild winter reduced left-tail outcomes for European equities. However, the ECB is committed to bringing policy rates well into restrictive territory despite an increase in financial stability concerns, which should limit how much valuations can improve or how strongly Europe's economy can rebound.</li> </ul>
<b>Emerging Markets (EM) Equities (ex-China)</b>	■	<ul style="list-style-type: none"> <li>– While China's reopening is primarily a story of recovering domestic consumption, we believe it will still produce positive, but measured, spillovers for its trading partners as well as commodities.</li> <li>– Broadly speaking, EM equities have both de-rated and have seen a larger total drawdown in earnings estimates than DM equities. This limits the scope for relative underperformance versus global equities going forward, in our view.</li> </ul>
<b>China Equities</b>	■	<ul style="list-style-type: none"> <li>– Chinese policy has moved in a pro-growth direction with the abandonment of zero-COVID-19 measures, more support for the property sector, and the end of the regulatory campaign against internet platform companies. These shifts bolster our conviction that economic activity and earnings will improve meaningfully from 2022 to 2023.</li> <li>– Traffic and travel metrics suggest a durable, comprehensive opening is well underway. Markets have frequently underestimated the strength of a country's economic rebound once mobility restrictions are removed.</li> <li>– We are closely monitoring geopolitical tensions between the US and China, particularly related to the latter's relationship with Russia, as these carry left-tail risks to both operating performance and valuations.</li> </ul>
<b>Global Duration</b>	■	<ul style="list-style-type: none"> <li>– Long-term bond yields should be volatile and rangebound as robust labor market data and resilient economies square up against the fact that central bank tightening cycles are well advanced and that the risk of a recession is rising amid signs of stress in the financial sector.</li> <li>– Central banks' commitment to keeping policy in restrictive territory and reluctance to reverse course should keep yield curves relatively flat until a contraction in economic activity is at hand.</li> </ul>



Asset Class	Overall/ relative signal	UBS Asset Management's viewpoint
<b>US Bonds</b>	■	<ul style="list-style-type: none"> <li>– US Treasuries remain the world's preeminent safe haven asset. The Federal Reserve has essentially reached a sufficiently restrictive policy stance, and plans to keep policy quite tight until services sector inflation, which is linked to the labor market, decelerates meaningfully.</li> <li>– Stress in the financial sector means we have probably seen the peak in terminal rate expectations for this cycle. The enduring strength of the domestic jobs market is the critical US-centric upside risk to yields. The lack of softening across many labor market metrics despite aggressive tightening may keep the Fed on track to keep interest rates higher for longer.</li> </ul>
<b>Ex-US Developed-market Bonds</b>	■	<ul style="list-style-type: none"> <li>– The European Central Bank is drawing a distinction between tools it can use to bring inflation lower (rate hikes) versus other tools that can be employed to safeguard the financial system, if necessary. Monetary policymakers have moved into a fully data-dependent stance due to the particularly high level of uncertainty that currently prevails.</li> <li>– The Bank of England's apparent reluctance to deliver too much more policy tightening despite high wage growth and inflation is raising the probability that inflation expectations will move structurally higher.</li> <li>– The Bank of Japan's expansion of its yield curve control range is a meaningful step towards a monetary tightening campaign, in our view. We believe the new governor is likely to adjust policy further in light of strong wage growth.</li> </ul>
<b>US Investment Grade (IG) Corporate Debt</b>	■	<ul style="list-style-type: none"> <li>– We believe shorter-maturity IG debt is particularly attractive given the flat corporate curve and substantial income opportunity. This is consistent with our view that while risks to growth have risen, the economy will remain resilient in the near term.</li> </ul>
<b>US HY Corporate Debt</b>	■	<ul style="list-style-type: none"> <li>– High yield spreads have widened materially from their mid-2021 lows, but not enough to compensate for increased recession risks in light of the stress on the banking sector. The end of the Fed tightening cycle, which appears to be within view, typically coincides with widening credit spreads.</li> </ul>
<b>Emerging Markets Debt</b>		<ul style="list-style-type: none"> <li>– We have a positive view on emerging market dollar-denominated bonds due to the carry opportunity, falling interest rate volatility, and low default rates.</li> </ul>
US dollar	■	<ul style="list-style-type: none"> <li>– A more positive carry backdrop for EM local bonds following rate hikes delivered well before developed-market central banks has increased the resilience of this asset class even in the face of aggressive global tightening.</li> <li>– Asian credit is not particularly appealing as valuations are roughly fair, and risks related to China's property market are still elevated.</li> </ul>
Local currency	■	
<b>China Sovereign</b>	■	<ul style="list-style-type: none"> <li>– Chinese bonds have been moving from a high yielder among major economies to a low yielder, diminishing the attractiveness of these government bonds somewhat.</li> <li>– 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.</li> </ul>
<b>Currency</b>		<ul style="list-style-type: none"> <li>– We have transitioned to an environment in which the USD is rangebound to lower, in our view. As the Fed approaches the end of its tightening cycle and China's growth rebounds, the overvalued dollar should depreciate. The main threat to short US dollar positioning is a global recession stemming from banking market stress, which is not our base case. The Japanese yen is our most preferred currency given cheap valuations, BoJ tightening, and hedging properties. Some EMFX, like the Mexican peso, are poised to outperform select G10 FX like the British pound given attractive carry.</li> </ul>

Source: UBS Asset Management. As of March 24, 2023. 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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**Americas**

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