

Macro Monthly

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

UBS Asset Management | **Economic insights and asset class attractiveness**
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A healthy pause

Highlights

- Fed policy tightening was a headwind for risk assets in 2018, particularly as broader investor concerns about slowing global growth increased towards the end of the year
- In an important regime shift, the statement and press conference of January's FOMC meeting confirm the Fed is not committed to any further hikes this cycle
- Further hikes are only likely if core inflationary momentum, which remains muted, accelerates sustainably in concert with improving external demand
- In our view, investor concerns that this shift in policy regime is evidence that the Fed has already overtightened are misplaced
- We believe that given this regime change the Fed should not be on investors' list of major concerns for 2019—nor an obstacle for further healing in risk assets over the coming year
- A more accommodative Fed policy is likely negative for the USD, supportive to risk assets and particularly helpful for emerging market debt

In addition to slowing global growth and trade tensions, the US Federal Reserve's (Fed) 100 bps of tightening in 2018 was clearly a headwind for risk assets. The rate hikes pushed real yields on US cash into positive territory again, attracting flows away from longer duration risk assets. Steady rate hikes and reasonably hawkish Fed guidance also raised the discount rate on equities, contributing to a rather sharp derating despite strong earnings growth. Higher rates put upward pressure on the dollar and the cost of credit, tightening financial conditions for corporates. And finally, the steady rise in yields clearly weighed on certain interest-rate sensitive areas of the economy, most notably the housing market.

But now, having witnessed the sharp tightening of financial conditions at the end of last year, the volatility in risk assets, the cooling of global growth and moderation in business and household investment, the Fed is sitting back to evaluate the effects of its prior tightening. In significantly more dovish rhetoric, the recent Federal Reserve statement downgraded its assessment of US economic growth from "strong" to "solid." Critically, in removing its prior reference to "further gradual increases" being required to fulfil its statutory mandate, the Fed strongly implied that it stands just as ready to cut rates as it does to hike them should it prove necessary.

In our view, the drivers of this apparently meaningful policy regime shift have been twofold: waning momentum in core US inflation (Exhibit 1) and increased concerns about the demand environment outside of the US. As such, the Fed is only likely to resume its tightening cycle if core inflation accelerates sustainably in concert with an improving demand environment outside of the US. And with rent and healthcare prices moderating and lower energy prices likely to pass through to core inflation over the coming months, it is unlikely that underlying price pressures in the US are going to accelerate meaningfully, at least in the first half of 2019, despite still tight labor markets.

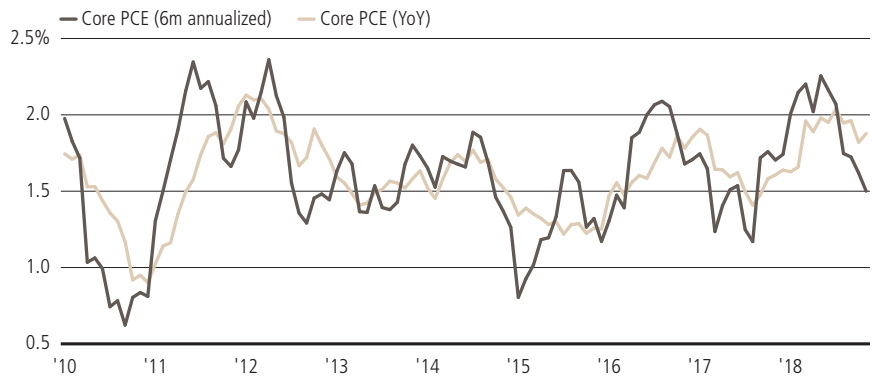
No policy mistake

Nonetheless, some market participants are concerned that the change in Fed rhetoric is an implicit admission that the damage is done; in other words, the Fed has already tightened too much and the US economy is now headed for recession. Monetary policy transmission does indeed work, as Nobel-winning economist Milton Friedman suggested in the early 1960s, over “long and variable lags.”¹ In our view it is therefore entirely sensible for the Fed to take a step back and observe the effects of its prior tightening if it has concerns that external risks to US demand are increasing. But underlying US income growth simply looks too strong relative to the Fed’s current policy stance to worry about recession. Every US recession since the 1970s was preceded by a federal funds rate that surpassed annualized nominal GDP growth, typically with the policy rate closing the gap (Exhibit 2). And while nominal GDP growth is likely to cool from Q3’s 5.5% annualized print, there is still a very healthy spread between growth and the policy rate. The partial US government shutdown may temporarily impact the Q1 GDP print before an expected Q2 bounceback, but we believe that it is unlikely to change the “solid” overall trend.

Note as well that Fed policy is still below its own and most independent estimates of the real neutral rate (R*), a measure of where policy is neither accommodative nor restrictive. While there is always uncertainty about what the true neutral rate is, it is difficult to argue policy is meaningfully tight relative to current estimates. In all Fed tightening cycles since 1990, the policy rate has surpassed the Fed’s estimate of neutral by 150 to 200 bps before causing a recession (Exhibit 3). Positing that the Fed has already made a policy mistake seems a stretch on these metrics.

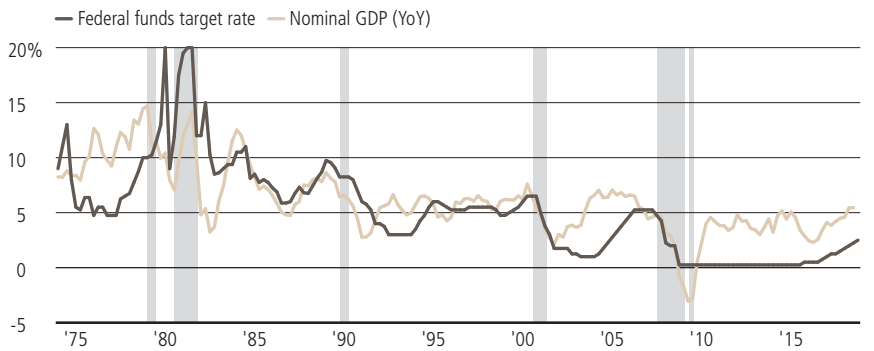
¹ “The Lag in Effect of Monetary Policy,” 1961, Journal of Political Economy, University of Chicago Press, vol. 69, pages 447-447.

Exhibit 1: Core PCE inflation has lost momentum and remains below the Fed’s 2% objective



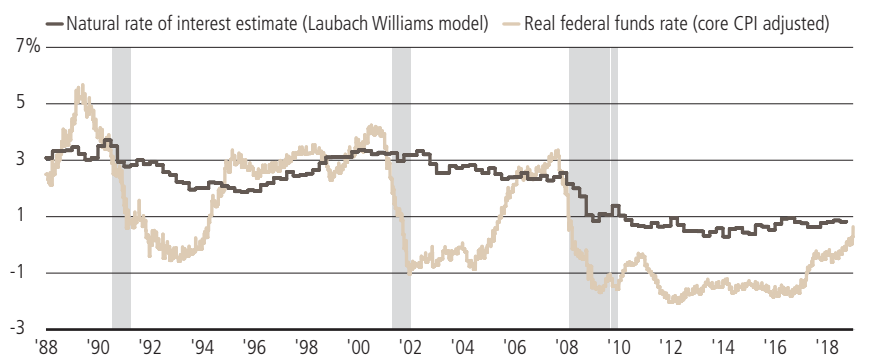
Source: UBS Asset Management, Macrobond as of January 2019.

Exhibit 2: There is a healthy gap between nominal GDP growth and the federal funds rate



Source: UBS Asset Management, Macrobond as of January 2019.

Exhibit 3: Real policy rates typically go well above estimates of R*; today they are below



Source: UBS Asset Management, Macrobond as of January 2019.

The balance sheet controversy

Of course, market concerns about Fed policy haven't focused solely on the policy rate. The Fed's gradual roll off of its balance sheet is commonly referred to as quantitative tightening (QT), an unwind of the Fed's quantitative easing (QE) program of buying longer duration Treasuries and mortgage backed securities. One of the stated goals of the Fed's QE program was to encourage portfolio rebalancing—as duration was removed from the private sector it would encourage diversification into riskier assets and a broader easing of financial conditions for the economy. As such it is reasonable to suppose that the unwinding of these policies would have the opposite effect and weigh on risky assets.

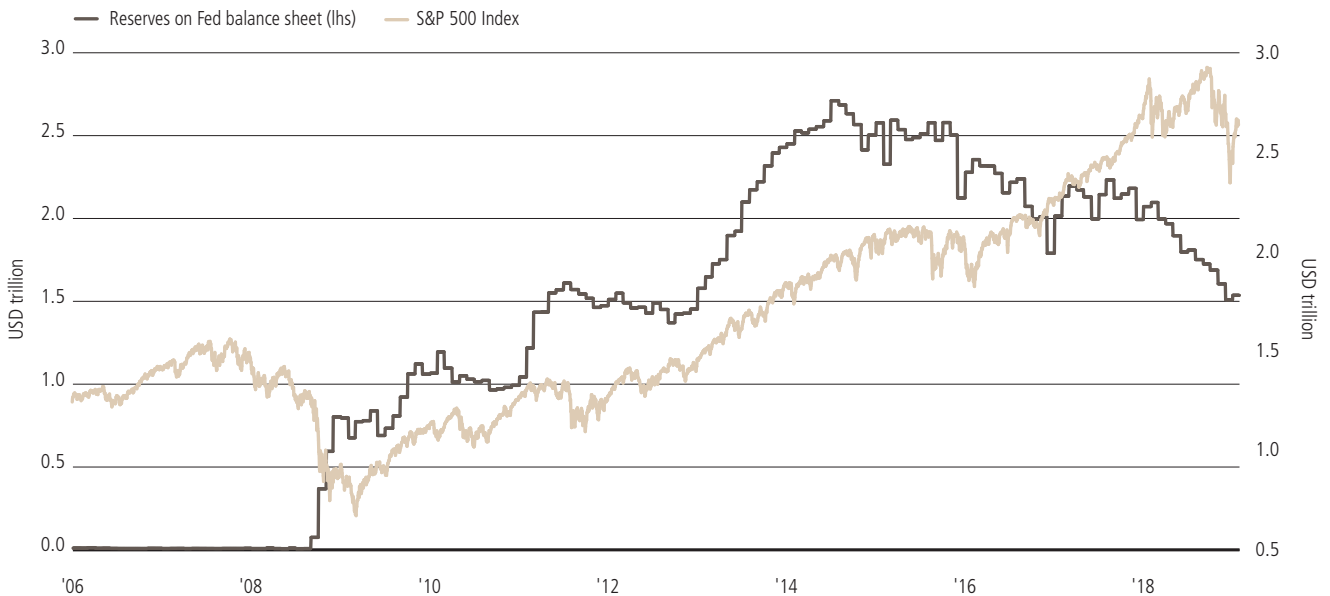
While we acknowledge this logic, irrefutable evidence that the Fed's balance sheet is directly causing distress

in financial markets and the economy is thin on the ground. First, it is important to note that the speed of the unwinding of the Fed's balance sheet is much slower than the pace in which assets were accumulated. Securities are rolling off the Fed's balance sheet at an average pace of USD 26bn per month compared to additions of USD 105bn per month in QE1 and USD 66bn per month in QE2 and QE3. This partly reflects that the Fed's residual balance sheet when it finishes QT will be somewhere between three and four times its size prior to the financial crisis. Much of the discussion of QT also refers to 'liquidity' leaving the system. But as the federal funds system is essentially closed, a decline in excess reserves on private bank balance sheets does not result in a mechanical fall in all measures of external liquidity. The direct causal relationship between the level of reserves on bank balance sheets and

the money available for purchasing risky assets is similarly ambiguous. Note that excess reserves peaked in 2014 and stocks had no trouble performing quite well over recent years (Exhibit 4).

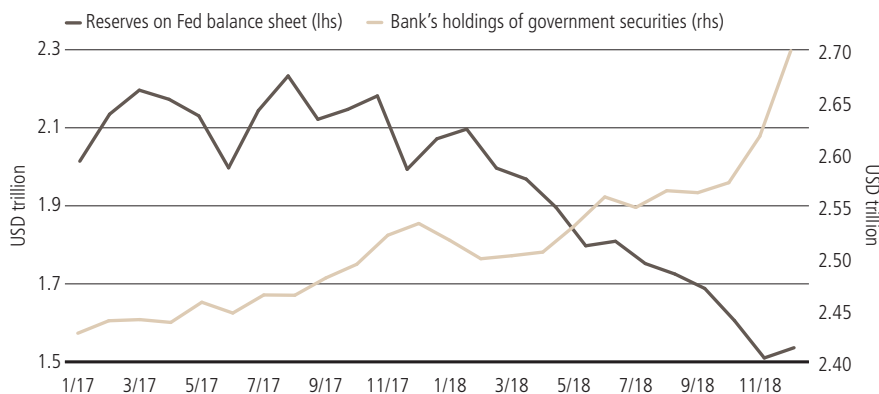
While policy rates are clearly on hold, the Fed's recent statement confirms that the roll off continues. Nonetheless, any concerns that this represents a meaningful tightening of financial conditions are, in our view, misplaced. To ensure such concerns do not become a self-fulfilling prophecy, the Fed additionally clarified that it "is prepared to adjust any of the details for completing balance sheet normalization in light of economic and financial developments" and that the Fed stands prepared to resume asset purchases "if future economic conditions were to warrant a more accommodative monetary policy".

Exhibit 4: Reserves held at the Fed peaked in 2014 and has not caused issues for equities



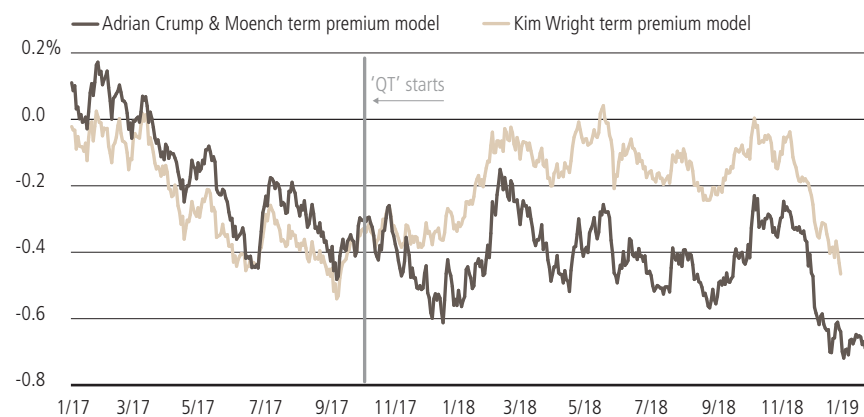
Source: UBS Asset Management, Macrobond, as of January 28, 2019.

Exhibit 5: Regulatory requirements have encouraged banks to pick up where the Fed let off



Source: UBS Asset Management, Macrobond, as of January 2019.

Exhibit 6: Measures of term premia are down since the Fed started 'QT'
10-year premia estimates



Source: UBS Asset Management, Macrobond, as of January 25, 2019.

The bottom line: Asset allocation

Since the Fed now seems likely to tighten only with a sustained pickup in core inflation and an improvement in ex-US demand growth, the probability that US policy will be a major headwind for risk assets in 2019 appears low. Moreover, to the extent markets had priced in a Fed policy mistake, this risk premia should continue to unwind in the wake of the Fed's unequivocally dovish late-January communication. This is not to say there are not key downside risks to risk assets—cooling global growth, peak margins, and geopolitical uncertainty are just a few. But the Fed is unlikely to be one of them, at least not for most of this year. And the Fed pause is raising the probability that this historically long expansion lasts even longer. We remain constructive on global equities and think a patient Fed will contribute to meaningful USD weakness over the medium term. In that context, we are particularly positive on emerging market debt, where we have added exposure of late.

Separately, there are of course concerns that the balance sheet roll off increases the burden on the private sector to absorb those securities and potential crowding out effects to other risk assets. While this is conceptually true, post-crisis regulatory changes have alleviated much of this risk. Specifically, requirements for banks to hold a certain level of high quality liquid assets (HQLA) make them highly incentivized to purchase securities rolling off the Fed's balance sheet. The only fungible replacements of declining reserves are Treasury securities. And banks have shown plenty of demand for the increased supply of Treasuries (Exhibit 5). If Treasury supply were overwhelming the market, then yields and more specifically the term premium (the difference between the yield and average expected policy rate expectations) would have to go higher to entice buyers. But key estimates of term premia are lower than when the Fed's balance sheet program started (Exhibit 6). There is little sign that Treasury supply is outweighing investor demand for U.S. Treasury securities.

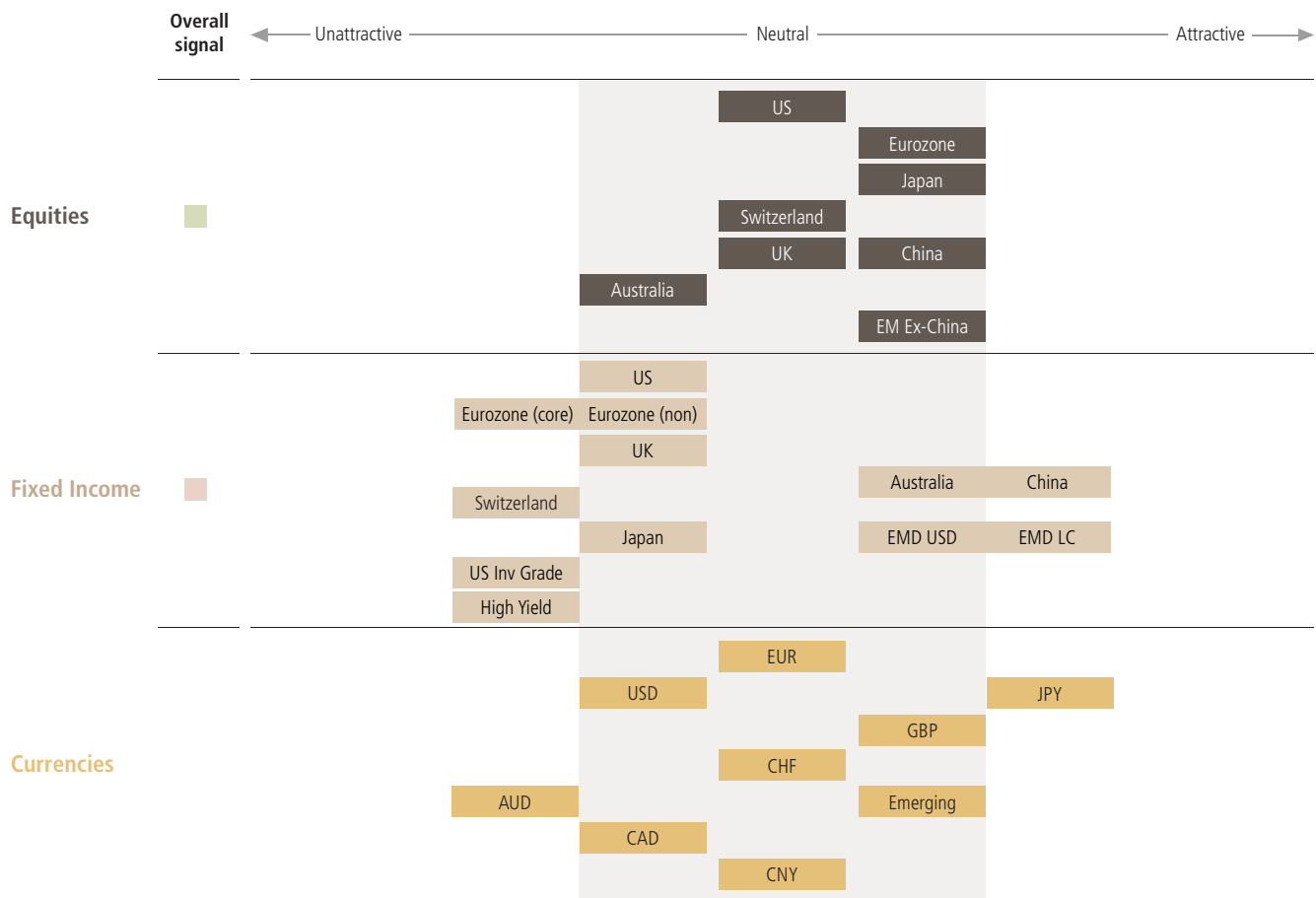
Where the balance sheet roll off matters much more is in technical implications for overnight money market rates. There is plenty of uncertainty about the level of reserves to satisfy bank demand in the post-crisis regulatory regime and higher currency in circulation. Recent spikes in short-term interest rates to the top of the Fed's guided range have raised questions of whether the Fed should end its balance sheet roll off earlier in order to ensure a comfortable level of reserves in the system for managing overnight interest rates.² The communication following the Fed's January meeting certainly suggests that the Fed may begin to taper its balance sheet roll off earlier than previously stated. Ironically, market participants concerned about QT directly impacting risky assets may end up getting what they want (a sooner end to the balance sheet roll off), but for the 'wrong' reasons. In any case, the Fed's balance sheet is unlikely to be a primary source of stress for financial markets from here on out.

² Source: https://www.wsj.com/articles/fed-officials-weigh-earlier-than-expected-end-to-bond-portfolio-runoff-11548412201?mod=hp_lead_pos6







Overall signal = Positive ← → Negative

Asset class attractiveness







The chart below shows the views of our Asset Allocation team on overall asset class attractiveness, as well as the relative attractiveness within equities, fixed income and currencies, as of January 31, 2019.



Source: UBS Asset Management Investment Solutions Asset Allocation team as at January 31, 2019. 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. For illustrative purposes only.

Asset Class	Overall signal	UBS Asset Management's viewpoint
Global Equities		<ul style="list-style-type: none"> Discordant global growth drivers, a late cycle US economy, the shift from quantitative easing to quantitative tightening, trade wars and corporate leverage have all increased risks to global demand in recent months and raised understandable concerns about an imminent recession. But we see a China-led stabilization of ex-US growth and the likely imminent peak in US monetary policy tightening as key to prolonging global demand momentum, just as they were in early 2016. In particular we view the probability of a recession in the coming year as low given the strength of labor markets and consumption across the developed world. We believe that the global economic growth is slowing, not collapsing.
Global Duration		<ul style="list-style-type: none"> After inconsistent Fed rhetoric prompted fears of a US monetary policy mistake in late 2018, a clearer and growth-supportive Fed narrative is now emerging. While at least one more hike in US policy rates is likely in our view, we believe that the Fed is close to the peak in rates in this cycle and remains data dependent. The recent fall in the oil price plus scant evidence of significant momentum in US core inflation also give the Fed some breathing room. With risk assets already discounting material concerns about the potential impact of a protracted US/China trade war, there is now potential for a positive surprise in the forthcoming negotiations between the two economic behemoths. If only in the short term, the realities of volatile equity market and wider growth concerns are, in our view, likely to encourage a more conciliatory tone on both sides. The ability of China to cushion its slowdown is also likely to be key to the global economy and markets in the remainder of 2019. The Chinese authorities have a broad range of policy tools at their disposal and they appear willing to use the full breadth in achieving a difficult balancing act between derisking a highly leveraged and capital inefficient Chinese economy and softening the slowdown prompted by those deleveraging initiatives. In that context, we view the recent derating of global equities and fall in developed world 10yr nominal government bond yields as overly severe given the fundamental backdrop—leaving equities attractively valued in light of still solid earnings growth prospects. But while we are positive on the outlook for equities in 2019, we believe that the path is likely to be bumpy. In our view, the current higher volatility regime is likely to persist. We retain a negative view overall on developed world duration over the medium term. While wage growth has yet to materially impact core inflation measures, developed world labor markets continue to tighten. We see nominal yields moving gradually higher as explicit monetary policy support fades, output gaps close, wage growth accelerates and as tariffs hit consumer prices.
US Equities		<ul style="list-style-type: none"> US equities remain supported by solid corporate earnings growth and increasing capital returns to shareholders. But the most recent earnings season exposed vulnerabilities in some momentum sectors and illustrates how difficult a return towards more normal growth expectations can be—especially after a period of exceptionally supportive fiscal and monetary policy. We do not expect current headwinds on the IT sector to abate quickly given the present political and regulatory environment. While the recent derating leaves US equity multiples below recent averages, we continue to believe that the case for equities outside of the US is stronger.
Global (Ex-US) Equities		<ul style="list-style-type: none"> In Europe, the deal between the Italian government and the European Commission on the former's budget is a short-term positive, but with the likelihood of an extreme Brexit outcome increasing, significant geopolitical uncertainties persist. Together with the current headwinds on global trade this is likely to hamper the near-term performance of European equities. However, our longer-term base case remains positive, supported by solid domestic demand dynamics, attractive valuations and by a likely stabilization of global economic conditions towards the second half of 2019. We remain constructive on Japanese equities despite the near-term headwinds from weakening global growth. Diminished political uncertainties and ongoing structural reforms are supportive of higher price multiples while a solid domestic economy suggests the outlook for profits growth is stronger than markets are accounting for.
Emerging Markets (EM) Equities including China		<ul style="list-style-type: none"> Emerging market equities have recently outperformed despite a further slowdown in global growth. Part of the outperformance comes from the expectation of a widening EM-DM growth differential. In aggregate fundamental conditions in EM remain relatively robust but we remain wary of the impact of sharply tighter US financial conditions and higher interest rates in several emerging economies. We remain broadly positive on China in the expectation of further measures to cushion the domestic growth slowdown. Any broadening of the current trade standoff with the US is likely to hamper Chinese growth, but a gradual economic slowdown is already priced in and the Chinese authorities have already shown themselves willing to provide monetary, fiscal and regulatory support to help smooth the ongoing economic transition. Chinese equities still trade at a PE discount to other markets and further market liberalization could prompt a rerating as international capital starts to flow into Chinese assets following the inclusion of onshore Chinese equities in MSCI's widely followed EM equity indices.
US Bonds		<ul style="list-style-type: none"> After the recent downward repricing of US rate expectations, 10yr nominal US Treasury yields are close to the low end of the range of our estimate of fair value. Nonetheless, US nominal yields look attractive relative to most other developed government bond markets on an unhedged basis. In the absence of a material pickup in inflation or term premium, yields are likely to remain range bound. Our overall assessment is neutral.

Source: UBS Asset Management. As of January 31, 2019.

Asset Class	Overall signal	UBS Asset Management's viewpoint
Global (Ex-US) Bonds		<ul style="list-style-type: none"> – In aggregate, we see global sovereign bonds outside of the US as unattractive. The ECB has committed to low rates into 2019, so we see limited opportunity in Europe. Brexit is probably negative for UK gilts in the case of both a hard and soft Brexit. In a hard Brexit scenario, gilt yields are likely to fall first on lower growth expectations before rising on higher inflation risks and a higher credit risk premium. Should the current deal pass through parliament, we would expect UK 10yr yields to rise immediately due to improved growth prospects. – Swiss bonds continue to look very overvalued and in our view they have an increasingly asymmetric risk profile. The Swiss economy is relatively strong and we see Swiss bonds as vulnerable to attempts to normalise monetary policy by a Swiss National Bank increasingly concerned by the strength of the housing market. – Elsewhere we are more positive on Australian duration on a relative basis. We see the Reserve Bank of Australia taking a cautious approach to policy given elevated household leverage and slow inflation.
Investment Grade (IG) Corporate Debt		<ul style="list-style-type: none"> – US IG spreads have been on an upward trend since February 2018. Although we do not believe that a sharp demand slowdown is imminent, we believe that this trend will continue, despite the rally in January. Moreover, we are concerned about increased supply, reduced demand, and potential for a large number of downgrades in BBB, IG's lowest rating, if economic growth slows more significantly than we forecast.
US High Yield Bonds		<ul style="list-style-type: none"> – Current default rates in high yield are very low by historical standards. Given the still relatively positive economic backdrop, we do not expect a material pickup in US defaults in the near term. However, after the significant rally in January, spreads have now tightened to a point where we see the balance of risks skewed towards more widening.
Emerging Markets Debt		<ul style="list-style-type: none"> – Spreads on EM debt relative to US Treasuries widened substantially in 2018 in the face of higher geopolitical risks, a strengthening USD and higher USD funding rates. However, EM local currency bond yields have rallied both in absolute terms and relative to US yields since September while EM hard currency bond yields began a rally in late November. This reflects wider investor expectations for a less aggressive Fed, less aggressive US trade policy, and/or more aggressive China stimulus. We like EM local currency bonds given their attractive valuations.
US dollar		
Local currency		
Chinese Bonds		<ul style="list-style-type: none"> – Chinese bonds have the highest nominal yields among the 10 largest fixed income markets globally and have delivered the highest risk-adjusted returns of this group over the last 5 and 10 years. Slowing economic growth and inclusion to the Bloomberg Barclays Global Aggregate Index next year should continue to push yields down during the next 3-12 months.
Currency		<ul style="list-style-type: none"> – As signs of stimulus from China begin to take hold, we expect ex-US growth to stabilize. Over time, we anticipate capital will flow from the US into earlier-cycle economies and that the USD will weaken, especially as the USD remains somewhat expensive on a real trade-weighted basis. Elsewhere, we continue to see strong valuation support for the JPY and see short AUD as an effective hedge against ongoing China weakness in an economy where domestic household leverage is likely to constrain growth.

Source: UBS Asset Management. As of January 31, 2019.

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