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June 2018

The big picture

Global macro-economic and tactical asset allocation outlook

UBS Asset Management

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In recent weeks it has become clear that the rate of acceleration in global economic growth has moderated from the very strong level indicated in late 2017 and in early 2018.

Growth rates by country and region are also more differentiated and less synchronized—with the relative strength of the US amidst this moderation a noteworthy development. Importantly however, while the pace of acceleration may be slowing overall in the global economy, the residual growth rate remains robust and above-trend. With monetary policy in aggregate still accommodative, we do not see the recent moderation as heralding a more meaningful demand downturn or an imminent global recession.

In the US, the current growth cycle is already long by historical standards. As of May, this expansionary phase is the second longest since 1945. Nonetheless, the Tax Cut and Jobs Act passed late in 2017 and the spending bill passed earlier this year are likely to provide a significant boost to the US economy at a time when such demand drivers may otherwise have been slowing more significantly without the fiscal stimulus.

More specifically, tax code reform is helping to support a sharp increase in US corporate capital expenditure. This gives us confidence in longer-term productivity growth and the sustainability of demand growth despite the length of this cycle. Indeed, we believe that US demand growth may reaccelerate later in the year. Consumption growth remains healthy and is likely to be similarly bolstered by the boost to disposable income from the recent tax cuts. While the US economy is not immune to the negative impacts of high oil, the recent spike in energy prices does not represent a material drag on growth prospects due to the growing importance of US oil exports. In fact, energy-related employment and capital investment continues to rise sharply.

Overall US unemployment levels are very low in an historical context and continue to fall. With the number of job openings exceeding the number of unemployed workers for the first time in 17 years, we believe that the US is now at or at least very close to full employment. This is likely to support stronger wage growth in the coming months, albeit from relatively low levels. As the output gap closes, we see inflation continuing to edge higher.

Against this backdrop US monetary policy remains mildly accommodative at current levels. Real policy rates remain around zero. Despite the obvious increase in the Fed's confidence in the growth and inflation backdrop, their overall rhetoric remains neither clearly hawkish nor clearly dovish. According to the minutes of the June FOMC meeting, the "risks to the economic outlook appear roughly balanced." We therefore do not believe that the Federal Reserve will deviate from its current gradual approach to policy normalization unless confronted by a sustained acceleration in inflation data or other evidence that the US economy is overheating. While at some point the Fed will be forced into a restrictive monetary policy stance, neither the data nor rhetoric suggests that this is in any way imminent, not least given that a strengthening USD is already tightening financial conditions for US consumers and corporates.

In a global context the strength of the US is beginning to contrast ever more sharply with the rest of the world, where growth rates appear to be moderating more substantially. Continental Europe has the unwanted distinction of having swiftly evolved from the region where economic data was surprising most consistently to the upside to the region where economic data has been surprising most consistently to the downside. In part we believe that the recent softening of both lead indicators and hard data reflect a number of one-off factors such as unusually high employee illness rates amidst a prolonged cold weather snap, as well as the timing of public holidays. But while the economy continues to grow modestly above-trend, there is no disguising that growth rates in both the services and manufacturing sides of the Eurozone economy are softening in the short term. Higher input costs driven by the oil price are likely to be playing a significant role here. By country, the recent composite PMI data showed the sharpest declines in France and Germany. The most recent announcements from the ECB implicitly recognize this recent softness. In its June statement the ECB announced that its purchasing of assets would stop as expected at the end of 2018. However, the ECB also said that it would continue to reinvest the proceeds of maturing bonds “for as long as necessary to maintain favorable liquidity conditions”. The ECB also pushed back any hike in official policy rates until at least the summer of 2019.

Meanwhile, initial euphoria at the prospect of wide scale Eurozone reform and integration inspired by the election of Emmanuel Macron to the French presidency has dissipated. In Germany, an uneasy coalition has been agreed between Angela Merkel’s Christian Democrats and the Social Democrats. In Italy, the political backdrop is complex and uncertain. Initial attempts by the populist party of the far right, the Northern League, and the anti-establishment 5 Star Movement to form an unlikely coalition government were rebuffed by the Italian president’s veto of the parties’ choice of an anti-euro finance minister. In the face of soaring Italian bond yields, a swift compromise was reached. Nonetheless, the parties’ apparent commitment to lower taxes and higher spending continue to concern investors. The political risk premium in European assets is likely to remain elevated with two non-mainstream parties leading an Italian government that may challenge the Eurozone’s existing fiscal rules. All this comes at a time when the European Union’s negotiations with the UK appear to have stalled on issues including the Irish border.

Elsewhere, recent data suggests that the moderation in Chinese demand growth rates continues as policies aimed at rebalancing the economy and reducing debt kick-in. Clearly any sustained trade war with the US would negatively impact Chinese growth rates. On June 15, President Donald Trump announced new tariffs amounting to USD 50 billion in response to what the US claims has been the systematic theft of intellectual property by China. The Chinese authorities have threatened to respond in kind. Having begun trade negotiations on relatively friendly terms and with the sense that economic pragmatism would ultimately prevail, the most recent rhetoric appears to represent an escalation in tensions and a step closer to a full blown trade war. Meanwhile, the June 1 inclusion of China A shares in MSCI’s widely followed emerging markets index is a small but nonetheless important step in China’s assimilation into the global capital markets system.

In Japan, recent data has been mixed. GDP for calendar Q1 contracted after eight successive quarters of growth—the longest period of uninterrupted expansion since the late 1980s. There are a number of reasons to believe the weakness is temporary. On the income side, profits growth and wage growth are accelerating. Exports also remain strong. Yet there is scant evidence to date of this strength feeding through to inflation despite the relative tightness of the domestic labor market. There are some positives for risk assets from this overall global moderation. Monetary policy outside of the US is likely to stay looser for longer. The unwinding of emergency policy conditions, which we already believed would be gradual, may now take place over an even more extended period. Recent dovish rhetoric from key officials at the European Central Bank and Bank of Japan, both major contributors to global liquidity, and from the Bank of Canada and Sweden’s Riksbank, all support this view.

In our view, it is only the US where there is evidence of any sustained increase in prices. And even here, inflationary pressures are relatively moderate. Nonetheless, with the Fed now alone among major central banks in pursuing a more aggressive tightening regime and the US benefiting from fiscal stimulus while growth elsewhere moderates, we see short-term support for the USD even if our longer-term view remains more negative.

Overall we retain a positive view of global equity markets given above-trend underlying global demand growth and more attractive valuations after recent earnings strength. We do not see rising nominal bond yields as a de facto negative for equities. Historically, equities have struggled when real 10yr yields have exceeded real GDP growth. Even in the US we are still some way from such restrictive financial conditions. Nonetheless we are particularly wary of any structural increase in correlations between equities and government bonds. With the range of potential growth, inflation and interest rate outcomes globally broadening, a moderate and sustained increase in the volatility regime for all major asset classes is likely in comparison to 2017.

Paced by the US in particular, global corporate earnings have also been very strong. The most recent quarterly earnings season for the S&P 500 was the strongest in a decade. We do not see the US or global equities more broadly degrading significantly in the face of such robust corporate profitability. Equities globally remain attractively valued against both government bonds and corporate bonds. Stronger-than-expected corporate earnings growth and increasing capital returns to shareholders are likely to remain key supports in the coming months to US equities in particular.

Emerging market equities have struggled in recent months in the face of a strengthening USD and rising USD rates. Uncertain economic backdrops in Argentina and Turkey in particular have also raised concerns of a return to the volatility of the ‘taper tantrum.’ We remain optimistic. We do not dispute that a stronger USD and higher US yields present headwinds to EM countries with material external funding requirements, nor that within EM's broad universe there remain less favorable political and economic forces. But in aggregate EM demand growth is strong, inflation low, and policy in aggregate still accommodative. We also note the rise in intra-EM trade as an important factor in reducing the potential impact on EM countries (excluding Mexico) of a reduction in US trade. With global growth momentum still positive, we see attractive valuations and rising margins as more than offsetting the potential headwind of tightening financial conditions via a stronger USD and higher US treasury yields.

In Europe, short-term earnings momentum has been negatively impacted by a stronger euro. That strength has now reversed. We believe that the structural earnings recovery story has further to run - supported by the potential for regearing, higher dividend growth and buybacks and operational gearing due to margin expansion. We note that in the short-term, geopolitical concerns may overshadow fundamentals, but over the longer run we still believe that European assets offer good value.

In Japan core inflation remains muted despite the closing of the output gap. This supports a very gradual adjustment of current loose monetary policy. However, after the recent outperformance, we are now slightly less optimistic on Japanese equities as political and overheating risks increase. In addition, any strengthening of the JPY is unlikely to be greeted positively by equity investors given the sensitivity to export volumes.

In the world of fixed income, our view on global duration remains negative. The higher oil price is likely to continue to support higher nominal bond yields. Meanwhile, we see core inflation continuing to tick upwards as higher input costs spill over into consumer pricing, output gaps close and wage growth accelerates across developed countries. Structural deflationary forces including technology and demographics are still likely to limit the overall repricing of inflation risk however. Swiss and German bonds continue to look very overvalued and, in our view, have an increasingly asymmetric risk profile. The Swiss economy is relatively strong and we see Swiss bonds as vulnerable to attempts to normalize monetary policy by a Swiss National Bank increasingly concerned by the strength of the housing market.

Elsewhere we are more positive on Australian and Canadian duration on a relative basis. In our view, both economies are vulnerable to a housing market correction after very strong recent performance.

Within the world of credit, current default rates in high yield are still very low by historical standards. And given the supportive low rates and global growth backdrop we do not expect any material pick-up in US corporate debt defaults in the near-term. However, after the significant spread compression we do not view the risk/reward as attractive. Elsewhere, we see emerging market debt yields as attractive relative to still robust credit fundamentals.

We identify higher-than-expected US inflation, geopolitics and a China hard landing as the three principal risks to global risk assets. In the US, inflation is likely to continue to tick higher but we believe that structural deflationary forces including demographics and technology will continue to limit the scope for price rises. In China, we believe that the authorities have sufficient tools at their disposal to respond quickly if the slowdown accelerates. On geopolitics, our focus is on the uncertainty in Italy and on US and China trade negotiations. While we retain a positive view of global equity markets, geopolitics in general and rising protectionism in particular are therefore perhaps the most immediate threat to risk assets.

The big picture: Global macro-economic and tactical asset allocation outlook from Panorama: Mid-Year 2018.
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