Macro Monthly

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UBS Asset Management | Economic insights and asset class attractiveness

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Evan Brown
Head of Multi-Asset Strategy
Investment Solutions

Luke Kawa
Director
Investment Solutions

Answering three key questions for the rest of 2022

Highlights

There are three key questions across the three major economic regions we believe will drive cross-asset performance over the final third of 2022:

- Will the Fed signal any inclination to reverse course on interest rate hikes?
  - Answer: No. The Fed is likely to continue to communicate that rates will stay in restrictive territory to quell inflationary pressures.
- How negative will Europe's winter be, from a growth perspective?
  - Answer: Quite poor – and it's too soon to look through the economic damage.
- Will China's economic slowdown end?
  - Answer: Yes. But stabilization will only be enough to help domestic assets and commodities – not enough for major positive spillovers to the rest of the world.

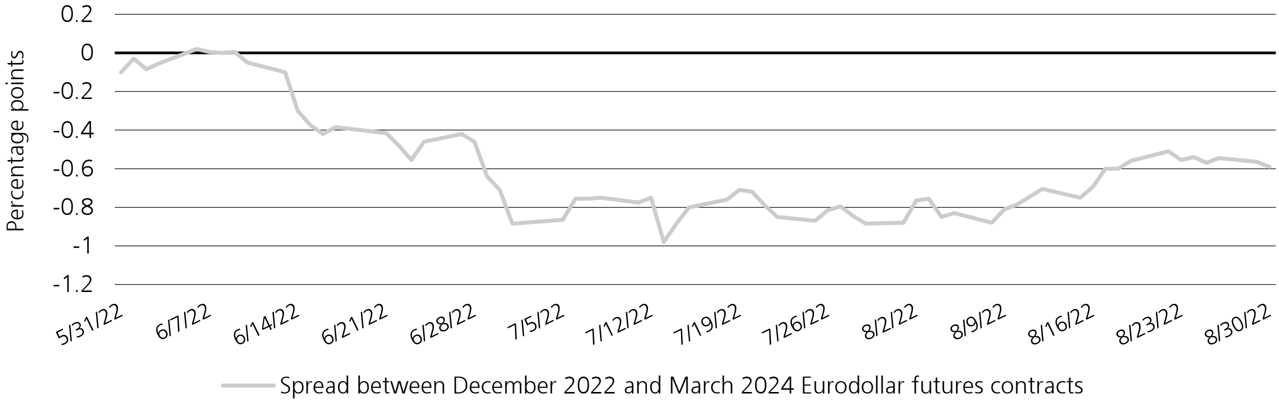
In this update, we will provide a more detailed overview of our base case outcomes across these questions and how this informs our positioning. There is currently an unusually elevated amount of uncertainty surrounding these macroeconomic issues, as much hinges on the geopolitical and policy courses charted by Russia and China. As such, it is particularly important to explore potential deviations from our expectations and manage risk in the current environment.

Will the Federal Reserve pivot?

No. Services inflation, which is relatively sticky, is poised to remain well above target at year end even as core goods and commodities provide some near-term relief in headline inflation. In our view, the level of inflation will simply be too high at year end for monetary policymakers to entertain cuts.

Fed officials are telegraphing that interest rates need to rise to and stay at a level that puts downward pressure on growth in order to quell underlying inflationary pressures. The ongoing shrinkage of the central bank's balance sheet will also be adding incremental monetary tightening. Chair Jerome Powell's recent speech at Jackson Hole reinforced that the campaign to bring rates higher is a sprint, but the process of getting inflation lower is a marathon. Markets are starting to accept this message, but there is still more scope to remove interest rate cut expectations. The amount of easing anticipated by markets between December 2022 to March 2024 has roughly halved from 100 basis points in mid-July to the mid-50s currently.

Exhibit 1: Markets priced out as much as half expected interest rate cuts



Source: UBS-AM, Bloomberg, as of 30 August 2022.

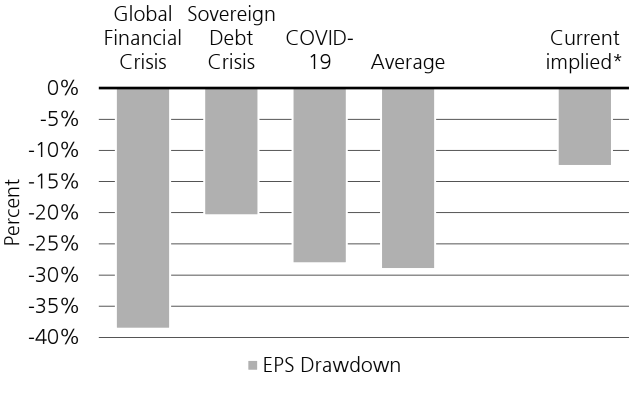
The Fed's goals are not in conflict – unemployment is very low, and inflation is still very high. In our view, evidence of a material slowdown in both inflation and labor demand is needed to convince monetary policymakers that tight monetary policy is no longer appropriate.

Labor market metrics are showing few, if any, signs of cooling. The nascent upward trend in initial and continuing jobless claims appears to be abating. Measures of pay increases the Federal Reserve focuses on (such as the Atlanta Fed wage tracker and the Employment Cost Index) remain hot, at levels that imply the growth in labor income will put a high floor under inflation. And in the near term, US data should be buoyed by the decline in gasoline prices, which frees up funds for more discretionary purchases elsewhere.

There are two ways in which this view could be invalidated: if the US labor market deteriorates rapidly (which would be bearish risk assets and bullish government bonds) or if the Fed signals a higher tolerance for above-target inflation (vice versa). Both of these outcomes are unlikely in our view, particularly the latter, given the central bank's concern with ensuring inflation expectations do not become unhinged to the upside.

Exhibit 2: European equities pricing in a much smaller profit impact than during other recessions

Maximum drawdown in European forward EPS estimates during recessionary periods



Source: UBS-AM, Bloomberg, as of 26 August 2022.

*Note: Current implied EPS drawdown uses average level of forward P/E ratio from 2007-present period to calculate estimate for EPS.

How negative will this winter be for Europe's economy?

Quite poor, with real consumption and industrial production likely to retreat. And while the energy challenges gripping the continent are well-known, they remain difficult to quantify and therefore difficult to appropriately price.

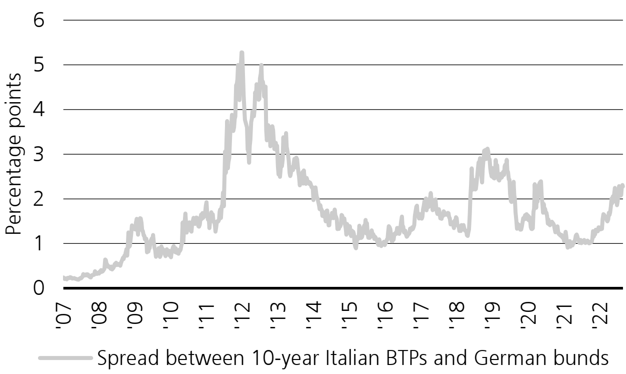
Worst-case economic scenarios may be avoided in light of Europe's success to date in securing alternative sources of natural gas, and also preemptive measures to reduce energy use. However, one implication of companies reducing some operations now in light of high energy prices is that this drag on activity may manifest sooner.

Right now, the quandary for investors looking at European assets is that the range of estimates for how negative this winter will be from an economic and earnings perspective is quite wide. We believe that investors will be able to eventually look through some of this economic damage before it occurs.

But right now, the outlook is a dense fog that is preventing this. We are awaiting a valuation or policy catalyst to become more constructive on European assets.

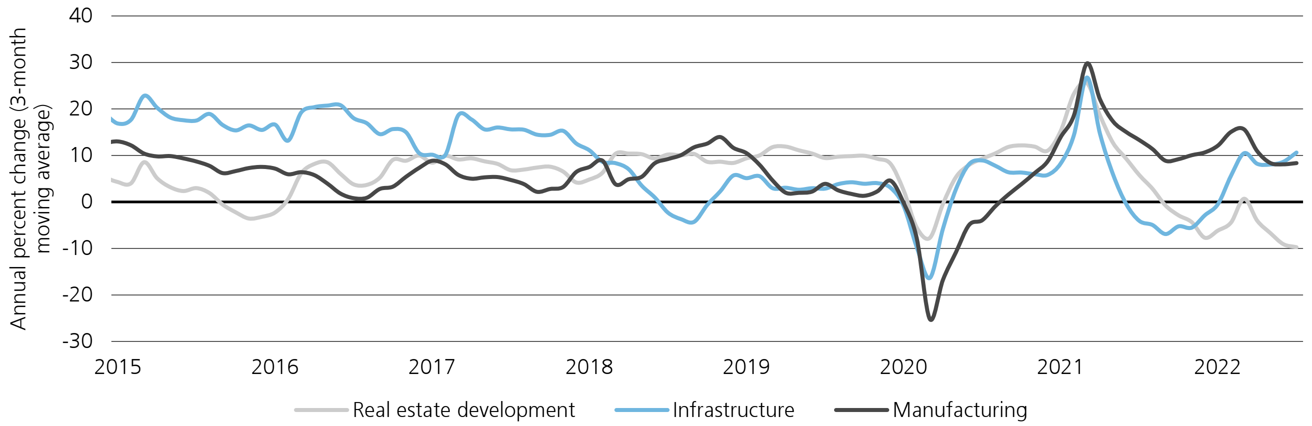
Importantly, we expect strong fiscal support from European governments to ensure that this temporary, seasonal problem does not metastasize into a full-fledged negative credit cycle or prolonged mass unemployment.

Exhibit 3: Markets pricing higher fragmentation risk on aggressive ECB tightening



Source: UBS-AM, Bloomberg, as of 30 August 2022.

Exhibit 4: Chinese property sector a major drag on fixed asset investment



Source: UBS-AM, Bloomberg, as of July 2022

Meanwhile, the European Central Bank (ECB) is on track to continue with aggressive rate increases, in large part due to skyrocketing energy prices but also due in part to this fiscal support, which is likely to have an inflationary cost. Yet this tightening is also increasing the fiscal fragility of more indebted European nations and putting more upward pressure on their borrowing costs compared to perceived safer nations like Germany – which in turn weakens the euro and exacerbates inflationary pressures. This feedback loop may lead to a situation in which the ECB needs to make use of its new transmission protection instrument in a muscular way to ensure financial markets do not effectively deliver too much tightening for the European periphery relative to the core.

Yes, this will certainly be a difficult winter for the European economy. But longer term, we are optimistic that this energy crisis is not a harbinger of another lost decade for Europe after last cycle's sovereign debt crisis – but rather the catalyst for governments to underpin activity in progressing towards energy security and decarbonization.

Will China do enough to reverse its economic slump?

Yes. But this stabilization of activity will not have substantial positive spillovers for the rest of the world, in our view. China's recovery will be fragile and vulnerable to an abrupt retrenchment as long as the zero-COVID-19 policy is intact.

It has been difficult for investors to try to call the bottom in Chinese activity based on policy announcements throughout 2022. The enduring weakness in the property sector has overwhelmed the positive impulses in other areas of the economy, such as infrastructure investment, and also weighed on sentiment. But there has been more urgency in Beijing's provision of stimulus recently. Between elevated youth unemployment and the mortgage payment boycott, social and economic concerns have become intertwined. Importantly, some recent policy measures appear to be more directly aimed at solving the liquidity trap revolving around the real estate sector.

However, our view is that optimism should remain tempered because we believe that China will be quite reticent to reverse course on its overarching policy of cooling imbalances in the property market. Stimulus will not be as strong as it was in the expansion following the global financial crisis, in which Chinese policy dictated the cyclical ebbs and flows in economic activity around the world.

The risks to our short-term view are two-sided. We could see more of the same – insufficient policy support – from China, which would support our more positive view on global duration, but undermine portions of our bullish thesis on commodities. On the other hand, this round of stimulus may be perceived as quite potent. In our view, the US dollar, which screens as quite expensive on a valuation basis, would likely come under selling pressure – but on the other hand, commodities would likely perform even better than we anticipate.

Asset allocation implications

The Federal Reserve's commitment to restrictive policy puts a ceiling on the valuation of risk assets, while the resilient US economy is providing a sturdy floor. This leaves us tactically neutral on equities, where we are somewhat cautiously positioned and focused on efficient relative value expressions for different economic regimes.

The Fed is raising interest rates to further reduce economic momentum. By comparison, other central banks, including the ECB, are responding to a backdrop that is more stagflationary in nature. This combination is supportive of more US dollar strength, in our view. It may also support US equities vs. the rest of the world on a currency-hedged basis. This is because the two biggest threats to risk assets, in our view, would be either a global recession or a longer-lasting, more aggressive Fed tightening campaign – and both of these would likely be positive for the US dollar.

We are selectively embracing cyclicality through commodities and energy equities. Oil remains supply-constrained, and the current policy baseline – between the end of releases from the Strategic Petroleum Reserve and scheduled European sanctions on Russia – is baking in another negative supply shock in Q4 and into 2023.

Asset class attractiveness (ACA)

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness as of 29 August 2022. 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.

Negative ⟷ Positive

❯, ❮ denote change in view versus previous ACA.

	Overall	Unattractive	Neutral	Attractive
Equities	❯	Switzerland	China ❮ US EM ex China Eurozone Japan	UK Australia
Rates		US Inflation-Linked UK Switzerland Japan	EMD LC Australia China sovereign EZ (Core) EZ (Non-core)	US
Credit			Asia credit EU Credit US Inv Grade US High Yield EMD US$	
Currencies		CAD GBP EM Asia ex-China CNY	EUR CHF JPY CEEMEA	USD AUD Latin America Nordic

Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as of 29 August 2022. 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.

Negative ⟷ Positive

Asset Class	Overall/ relative signal	UBS Asset Management's viewpoint
Global Equities		– In our view, there is no strong tactical case to be either overweight or underweight global equities. Stocks remain expensive versus bonds based on the equity risk premium, and earnings estimates have started to come under mild pressure. However, sentiment and positioning appear extremely depressed, and the prospect of peak inflation in the US may be a sufficient catalyst for a further squeeze upwards in global equities. – We are staying cautiously positioned within equities given the likelihood that economic activity will continue to decelerate. We prefer sectors like health care as well as technology and regions such as the UK, which have a more defensive/acyclical composition. We also are selectively long cyclicality via commodity-linked stocks.
US Equities		– American stocks are more acyclical and tend to outperform when manufacturing purchasing managers' indexes are declining. – US growth is likely to hold up better than other major developed markets. – However, US equities continue to command premium valuations, which may drag relative performance in the event that expectations for the Federal Reserve's terminal policy rate this cycle increase further or geopolitical risks recede.
Ex-US Developed market Equities		– Non-US developed market equities are attractively valued but also highly cyclical and tend to underperform in an environment in which manufacturing purchasing managers' indexes continue to decelerate. – Japanese stocks lack catalysts that would help shrink this valuation gap. – European equities are still vulnerable as Russia continues to wage war against Ukraine. The likely hit to earnings from a short-term but severe recession caused by energy shortages has not been fully priced in, in our view.
Emerging Markets (EM) Equities (ex-China)		– We prefer EM markets with the strongest linkages to commodities based on our expectation that the stabilization of growth in China will buoy commodity demand. – EM equities have held up well in the face of challenges in 2022 that include less impressive earnings revisions and higher mobility restrictions relative to DM, rising long-term real rates, and US dollar strength versus DM FX.
China Equities		– The Chinese policy stance has turned, both on the monetary and fiscal sides, but there are still questions about whether this support is sufficient given the potential for COVID-induced interruptions to activity and lingering weakness in real estate. Any stabilization in activity is unlikely to produce major positive spillovers for real activity elsewhere. – From a seasonality perspective, Chinese equities have tended to outperform ahead of the China Party Congress. – We are closely monitoring geopolitical tensions between US and China, as these carry left-tail risks to both operating performance and valuations.
Global Duration		– Long-term bond yields should be biased lower due to enduring recession risks and ebbing inflationary pressures. Central banks' commitment to tightening should lead to flatter curves and prompt investors to price in easing, down the road, to counter the ensuing economic weakness. – Sovereign fixed income continues to play a diversifying role in portfolio construction by hedging downside in cyclical positions..

Negative ⟷ Positive

Asset Class	Overall/ relative signal	UBS Asset Management's viewpoint
US Bonds		– US Treasuries remain the world's preeminent safe haven and top source of risk-free yield. The Fed is poised to take rates to restrictive territory in order to quell inflationary pressures, even if this damages the labor market and puts the expansion in jeopardy. Quantitative tightening is not a very potent catalyst for fixed income, in our view. – However, investors have gotten ahead of themselves in pricing in interest rate cuts in 2023, though these expectations have been reduced recently. Even more front-loaded tightening could increase perceived recession risk and provide a bid for the long end, while signs of economic resilience – particularly in the labor market – could see terminal rate expectations rise once again.
Ex-US Developed-market Bonds		– We see balanced risks to developed-market sovereign yields outside the US, as the threat of stagflation is more pronounced. The European Central Bank exited negative interest rate policy with a 50bp hike and signaled more tightening coming despite the potential for a severe contraction in activity this winter. A new tool – the Transmission Protection Instrument – aims to compress unwarranted widening in periphery spreads relative to the core via asset purchases to increase the scope for rate increases. – The lack of volatility across Japanese government bonds, a product of the Bank of Japan's immense holdings and yield curve control policy, undermines the utility of much of this market from an asset allocation standpoint. Maturities beyond the 10-year point may be vulnerable should concerns about the persistence of inflation drive a renewed repricing of global duration.
US Investment Grade (IG) Corporate Debt		– US IG all-in yields have become much more attractive given the year-to-date rise in risk-free rates as well as widening spreads. – However, the typically negatively convex performance of credit as market pricing of recession rises provides some cause for tactical caution.
US High Yield Corporate Debt		– High yield spreads have widened materially year-to-date. However, spreads are not close to levels that prevailed at the peak of growth scares in 2011 and early 2016.
Emerging Markets Debt US dollar Local currency		– We have a neutral view on emerging market dollar-denominated bonds due to the balance of carry opportunity and duration risk, which are offset by downside risks to growth. – A more positive carry backdrop for EM local bonds following rate hikes delivered over the course of 2021 has increased the resilience of this asset class even as aggressive Fed tightening is delivered.
China Sovereign		– The attractiveness of Chinese government bonds has diminished somewhat as nominal rate differentials versus the rest of the world have compressed. 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. We believe the combination of monetary easing and eventual stabilization of domestic activity should prevent any sustained upward pressure on yields during the next 3-12 months.
Currency		– We believe the US dollar is well-positioned to remain elevated, if not strengthen further. Real growth differentials versus other developed market economies are likely to remain substantial because the US is better sheltered from the negative supply shock in energy. Elevated geopolitical risks and the prospect of a broad-based growth scare also put a sturdy floor under the dollar. There is also scope for interest rate cuts to be priced out of the short-term rate curve. – Some EMFX, like BRL, are poised to outperform cyclical Asian currencies and select G10 commodity exporters given attractive carry.

Source: UBS Asset Management. As of 29 August 2022. 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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