

Macro Monthly

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For marketing purposes.

UBS Asset Management | Economic insights and asset class attractiveness

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No painless pivot for risk assets

Highlights

- In our view, the recent advance in global equities is a bear market rally, not the start of a new bull run.
- Earnings expectations do not reflect the retrenchment of goods-sector activity or reduction in household spending power.
- We believe the Federal Reserve will not shift from tightening to easing without substantial economic pain.
- Valuations are still on the expensive side, and recession risks are above-average.
- We are staying underweight stocks and using selloffs in bonds as an opportunity to increase exposure to sovereign fixed income.

Global stocks staged a major rebound in July, buoyed by resilient corporate profits and hopes that the point of maximum stress from central banks, elevated fuel prices, and higher mortgage rates has passed.

In our view, conditions getting less bad is enough to spark a relief rally, but not an enduring turn in the economic and risk cycle. We stay underweight global equities, expecting further negative revisions to earnings, a continuation of central bank tightening campaigns, and a lack of valuation support.

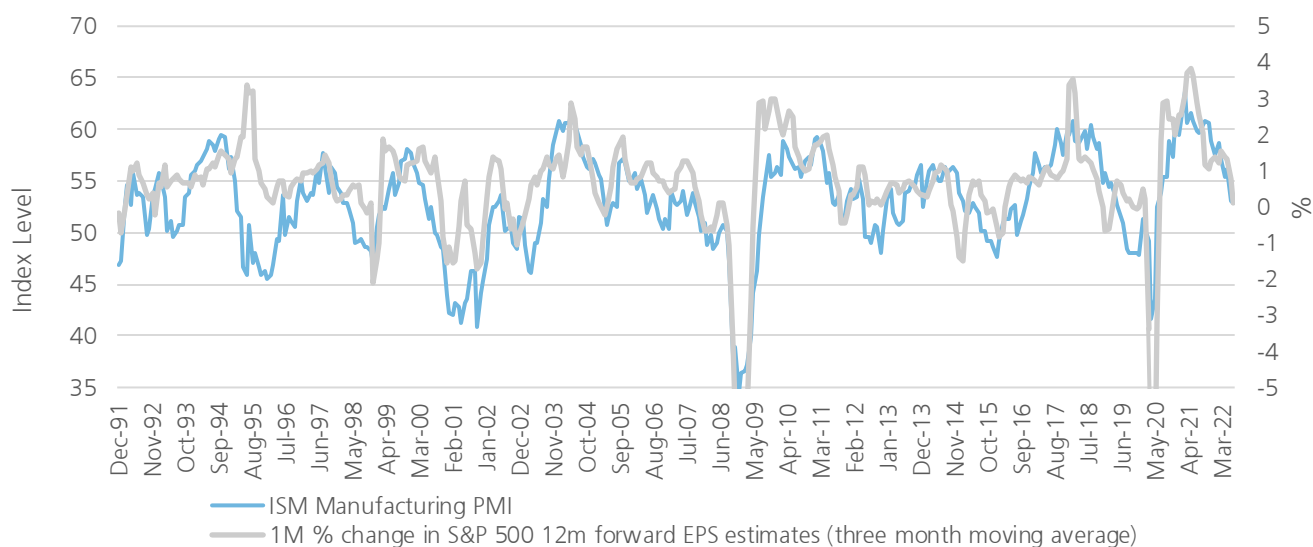
More pressure on profits

Earnings face downside risk even if the US economy avoids a recession. A downturn in the global goods sector is underway, and equities are much more levered to goods than overall economic activity, which is more services-oriented.

A retrenchment in manufacturing activity as part of a goods-to-services rotation was a high-probability event for 2022. But this rotation is being hampered by significant negative supply shocks that have weighed on real incomes and elicited aggressive monetary tightening to further slow demand. Slowing spending growth, an increase in inventories, wider spreads, and higher risk-free rates also point to weaker investment going forward.

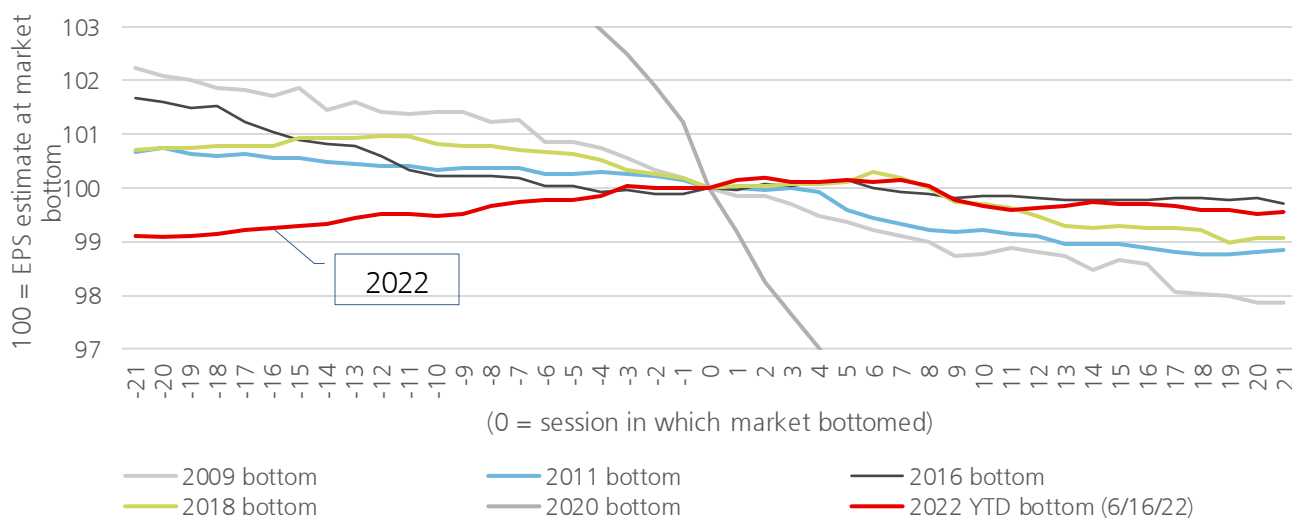
Given this backdrop, analyst expectations for profit growth of 6.6% in 2023 for global equities on the heels of nearly double-digit growth this year are overly optimistic, in our view. Downward revisions in earnings are usually a prerequisite for stocks to be able to find a bottom. It would therefore be unusual for the June low to mark the trough of this bear market, as the process of cuts to aggregate earnings estimates had not yet begun.

Exhibit 1: Manufacturing weakness implies more downside for profit expectations



Source: UBS-AM, Bloomberg, as at 31 July 2022

Exhibit 2: How S&P 500 earnings estimates behave a month before/after recent major equity market bottoms



Source: UBS-AM, Bloomberg, Macrobond, as at 16 June 2022

The rebound in equities over the past month, in our view, is not a signal of increased confidence in the economic outlook. Rather, the price action has the hallmarks of a short-covering rally and trend reversal, with market leaders turning to laggards (and vice versa). The best-performing factors within the US equity market have been growth, earnings variability, and volatility. The two worst-performing have been value and momentum. These violent reversals are a danger in bear market rallies, particularly when sentiment and positioning are depressed.

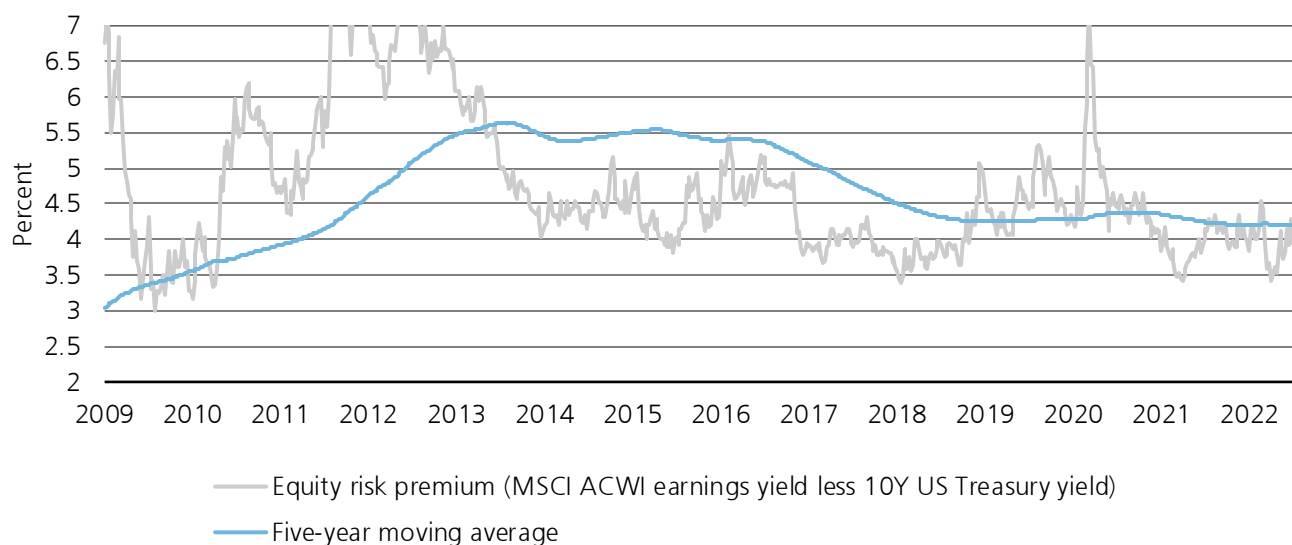
No painless pivot

Throughout 2022, an increasingly hawkish Federal Reserve has been a potent negative catalyst for risk assets. So when Chair Powell suggested that the pace of tightening would slow at some point in the future, risk assets surged. We would caution

extrapolating somewhat less Fed hawkishness to mean Fed dovishness.

Fed tightening is designed to slow inflation by bringing about below-trend growth and moderating the rises in aggregate income. This is a feature, not a bug, of policy, and it is on course to continue in light of continued strength in the labor market, especially wages. Our view is that the central bank is willing to tolerate – or even inflict – a substantial amount of economic pain to bring down price pressures before considering any easing. We believe that just as the Fed was behind the curve in removing stimulus amid hot inflation during a rapid expansion, so too will they be behind the curve in responding to economic deterioration.

Exhibit 3: Global equity risk premium implies stocks still expensive relative to bonds



Source: UBS-AM, Bloomberg, Macrobond, as at 25 July 2022

Equity markets appear to have embraced the idea of the Fed cutting rates in 2023 while overlooking the economic damage required to get such an about-face, in our view. We believe there will be no such painless pivot. Consider that the central bank has hiked 150 basis points at its last two meetings, yet financial conditions have eased by an amount roughly consistent with 50 basis points' worth of cuts¹. Financial conditions that are more supportive of growth is something we expect the Fed will actively lean against, as it should not increase their confidence that underlying inflationary pressures will moderate.

The Fed has officially abandoned formal forward guidance and there is a stark divide between the central bank and markets as to the direction of policy rates over the next year. This difference of opinion is a recipe for rates volatility to stay at elevated levels rather than continue to recede, in our view.

No valuation support yet

Despite the earnings and Fed-induced challenges for risk assets, there would still be an argument to be overweight stocks if there was ample evidence that these risks are in the price. But in our view, this is not the case. Global stocks may have sold off year to date, but they are not on sale. The equity risk premium, the expected forward earnings yield for the MSCI All Country World Index less the yield on the US 10-year Treasury note, shows stocks are expensive relative to bonds. This ex

ante extra carry from stocks relative to bonds has been at least 5% at all major market troughs since the 2008 financial crisis. Holding expected earnings and current yields constant, MSCI ACWI would need to be more than 10% lower to meet that valuation criterion.

The ability of lower bond yields to boost the relative attractiveness of stocks is also limited from here, in our view. We believe there would need to be much higher odds of recession – and in turn, even more downside risks to earnings – for bond yields to fall far below the Fed's estimate of the neutral rate (around 2.5%).

Asset allocation implications

In our view, the recent turn in the second derivative – inflation dynamics getting less bad – should not distract from the key feature of the outlook: activity is on a path to weaken from here. Risk assets have not yet priced in the extent of this economic deceleration. Some of the recent positives for stocks, like lower fuel prices, could prove to be a brief respite, and fresh facets of geopolitical risk between the US and China have the potential to roil markets.

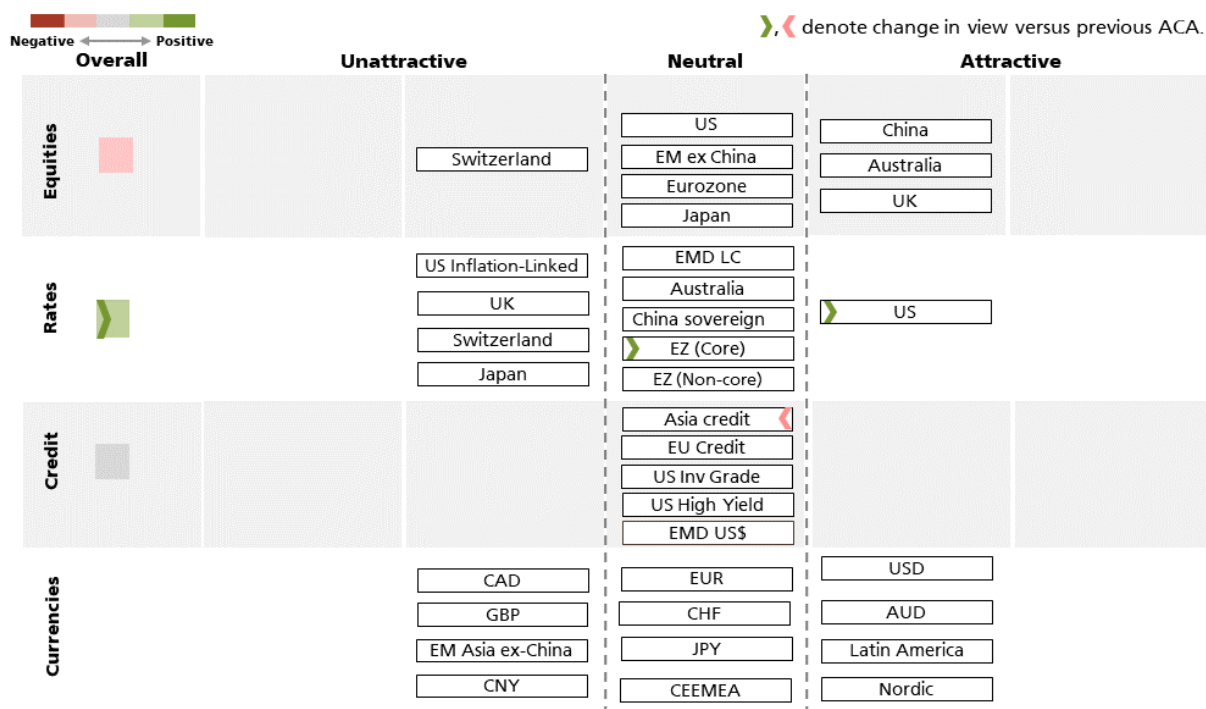
Our positioning has a cautious tilt, as we remain underweight global equities and favor defensive regional, sector, and factor allocations. We are using selloffs in government bonds as opportunities to boost exposure in anticipation of a further economic slowdown. In addition, we are cognizant that equity markets can rally on narrow leadership, even when profit growth falters more broadly. Accordingly, we have boosted exposure to US technology stocks in select portfolios.

¹ Based on change in Goldman Sachs US Financial Conditions Index since June 14, 2022. Changes in the index

are roughly equivalent to market-implied increases/decreases in the federal funds rate.

Asset class attractiveness (ACA)

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness as of 3 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.



Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as of 3 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.



Asset Class	Overall/ relative signal	UBS Asset Management's viewpoint
Global Equities	■	<ul style="list-style-type: none"> – In our view, global equities are tactically unattractive at the index level. The equity risk premium implies stocks are still expensive. Equities are likely to face valuation pressures from central bank tightening, while slowing growth also raises downside risks to earnings estimates. – Our view is that market pricing of recession risk is likely to increase because of tightening financial conditions, aggressive rate hikes, a moderation in goods spending, and elevated inflation. However, private sector balance sheets remain strong, spending is rotating rather than shrinking, and core inflationary pressures are likely to cool. A soft landing for the economy remains possible, but it is too soon to trade that view. – We are staying cautiously positioned within equities and prefer sectors like health care and regions such as the UK, which has a more defensive composition. We also are selectively long cyclical via commodity-linked stocks.
US Equities	■	<ul style="list-style-type: none"> – US equities have become more attractive on a relative basis given our cautious view on global 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	■	<ul style="list-style-type: none"> – 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 and risks to natural gas access and industrial activity. However, this is already partially priced in.
Emerging Markets (EM) Equities (ex-China)	■	<ul style="list-style-type: none"> – 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 vs. DM FX.
China Equities	■	<ul style="list-style-type: none"> – The Chinese policy stance has turned, both on the monetary and fiscal sides. The PBOC has cut rates, the peak in credit tightening has passed, as has the intensity of the tech regulatory crackdown, in our view. Officials are stressing urgency in providing fiscal support. – In our view, investors are discounting too much downside risk associated with China's COVID-19 policies and the real estate market, and not ascribing enough odds to an economic rebound that is already underway. – 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	■	<ul style="list-style-type: none"> – Long-term bond yields should be biased lower in light of rising 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.



Asset Class	Overall/relative signal	UBS Asset Management's viewpoint
US Bonds	■	<ul style="list-style-type: none"> – US Treasuries remain the world's preeminent safe haven and top source of risk-free yield. The Federal Reserve 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. 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	■	<ul style="list-style-type: none"> – 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	■	<ul style="list-style-type: none"> – 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 near-term caution.
US High Yield Corporate Debt	■	<ul style="list-style-type: none"> – High yield spreads have widened significantly and embed more concern about the growth outlook than equities. However, spreads are not yet at levels that prevailed at the peak of growth scares in 2011 and early 2016.
Emerging Markets Debt		<ul style="list-style-type: none"> – 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.
US dollar	■	<ul style="list-style-type: none"> – 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.
Local currency	■	
China Sovereign	■	<ul style="list-style-type: none"> – The attractiveness of Chinese government bonds has diminished somewhat as nominal rate differentials vs. 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		<ul style="list-style-type: none"> – 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 short-term rate curve. – We believe 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 3 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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Americas

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EMEA

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