Macro Quarterly

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

Macroeconomic themes and tactical asset allocation opportunities
1Q2022 I UBS Asset Management

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2022: The year of pent-up production

Highlights

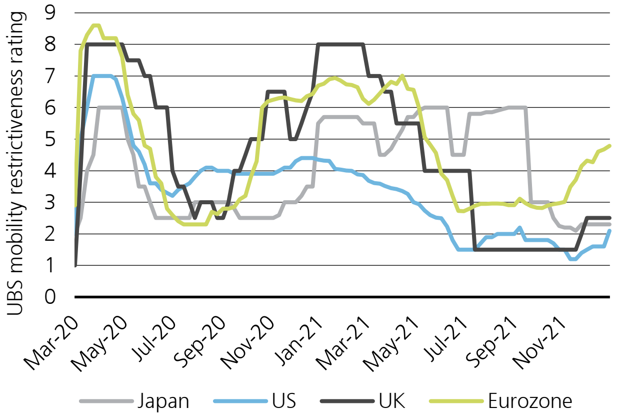
- In our view, a key theme in 2022 will be production catching up to strong demand.
- Global manufacturing surveys suggest conditions for production are improving, while rebounding auto production indicates subsiding shortages.
- Better public health outcomes after Omicron will likely drive more labor market healing.
- Strong growth in output should also allow developed market central banks to reduce monetary stimulus, pushing bond yields higher and weighing on equity valuations.
- However, strong earnings growth means equities should still advance this year, with better performance from cyclically-oriented regions and sectors.

Following each COVID-19 wave, there has been a surge in activity driven by pent-up demand. Strong fiscal support meant that households could afford to boost purchases of goods and services. But lingering effects of the pandemic meant that in many cases, consumers couldn't access them.

In our view, one of the defining characteristics of the year ahead will be a better bridging of this gap between what consumers are able to buy and companies are able to supply. We believe that over the course of this year, supply chain stresses will ease, inventories will be rebuilt, consumption patterns will normalize, labor participation will rise, and productive capacity will increase. As such, 2022 is shaping up to be a year in which growth and inflation moderate – but inflation slows by more than growth, and economies still expand at an above-trend pace.

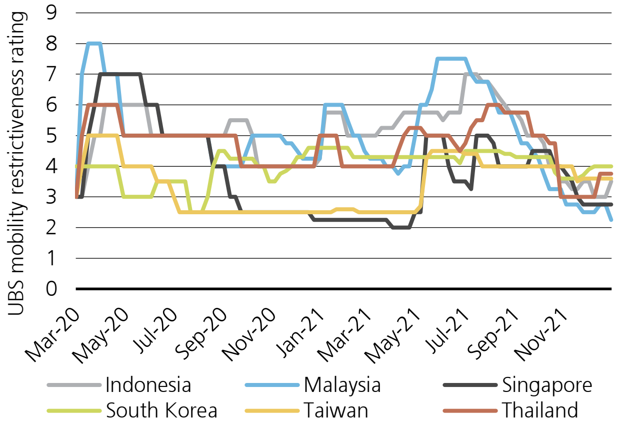
As this pent-up production allows strong demand to be more fully realized, cyclically-oriented sectors and regions of the equity market should outperform. Bond yields, meanwhile, are poised to move higher amid central bank tightening as economic interactions normalize and the expansion matures. Overall, this backdrop should be positive for equities, in our view, because earnings should continue to expand at a healthy pace in an above-trend growth environment. However, valuations will continue to come under pressure as monetary stimulus is withdrawn, which should contribute to more volatility in risk assets than was seen in 2021, on average. Of course, the ongoing pandemic could introduce setbacks that delay some of these optimistic outcomes from coming to pass, but pessimism on this front should not be overstated based on the evidence to date.

Exhibit 1: Reduced appetite for mobility restrictions in developed markets, especially ex-Europe
(Higher numbers indicate more government-imposed mobility restrictions.)



Source: UBS-AM, UBS Investment Bank. Data as of 7 January 2022.

Exhibit 2: Few mobility restrictions in many important Asian manufacturing hubs
(Higher numbers indicate more government-imposed mobility restrictions.)



Source: UBS-AM, UBS Investment Bank. Data as of 7 January 2022.

Internals improving
A high-level look at global manufacturing suggests that conditions for production are getting better. Backlogs of work and new orders remain elevated. The message is there's lots of work to catch up on – and even more to get to after that.

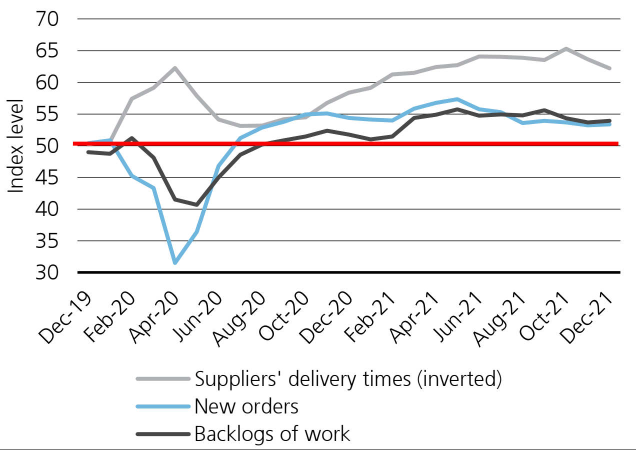
Encouragingly, other PMI details suggest the wherewithal of manufacturers to make good on past and new orders is improving. The supplier delivery times sub-index of the global manufacturing purchasing managers index is off its peak, suggesting some alleviation in the supply chain snarls that have impeded activity. As well, manufacturers' inventory levels for inputs are rising much more than inventories of finished goods are improving. Rising inputs give factories the ability to increase output to both replenish retailers' inventories and meet strong end-user demand.

The spread of the Omicron variant is likely to exacerbate lingering production and shipping challenges in the short term. But at present, a number of critical Asian manufacturing hubs are not seeing the same degree of mobility restrictions as when the Delta wave was in ascension. Many governments in the region have moved away from very strict measures to control the spread of the virus, though this could change should public health outcomes deteriorate materially.

The course of the virus in China could also play an outsized role in how much manufacturing operations are impaired, in aggregate. However, it is important to remember that in 2021, COVID-19 didn't prevent China from posting consistently strong export growth – even around the period when mobility restrictions were the most severe.

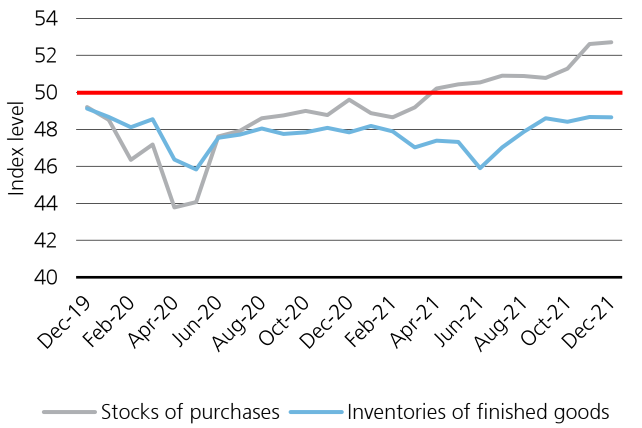
So far, any chain disruptions linked to the Omicron variant appear to be less severe and of a shorter duration than previous iterations of the virus.

Exhibit 3: Global manufacturing orders, backlogs strong as supply stresses lessen



Source: UBS-AM, Macrobond. Data as of 31 December 2021. Note: 50 divides expansion from contraction in PMI series.

Exhibit 4: Global cyclical outlook better than before the pandemic



Source: UBS-AM, Macrobond. Data as of 31 December 2021. Note: 50 divides expansion from contraction in PMI series.

Auto production

Semiconductors have been the poster child of the shortage-stricken global economy. A dearth of chips has widespread negative ripple effects downstream because of the importance of this input. Nowhere has this been more evident than in automobiles. The surge in used car prices is proof that demand is robust – and yet production has not been able to return to pre-pandemic levels.

We do not expect a full resolution of this scarcity of semiconductors in the very near term; demand is high and lead times for new supply are long. But there is still good news: manufacturers say that the severity of semi shortages has peaked, and recent data suggest chips are sufficiently available to believe that global auto production is turning the corner.

In real terms, industrial production of autos and related products has increased in the United States, Germany, and Japan in back-to-back months, as of November. That is the first time all three countries have seen improvements in consecutive months since the initial restart of economic activity in mid-2020 following the COVID-19–induced recession.

Most impressive is the progress in Japan, where the volume of motor vehicle exports jumped by more than 40% month-on-month in November. This helps inform our optimism for Japanese equities, which are heavily weighted towards industrials with very strong earnings revisions that stand to benefit from thawing supply chain stresses, above-trend growth across developed markets, and a stabilization of activity in China.

Strong demand to create labor supply

The recovery in labor supply has meaningfully lagged the recovery in demand, particularly in the US. This contributes to bottlenecks across the global economy, as well as driving underlying inflation via strong wage growth. But our view is that labor supply will continue to pick up, helping to facilitate solid increases in output in both goods and services sectors.

One lesson learned from last cycle was not to underestimate the cyclicality of the labor force participation rate. A strong economy keeps workers in their jobs – or moving to ones with better pay – and raises the rate of immediate job attainment for new entrants.

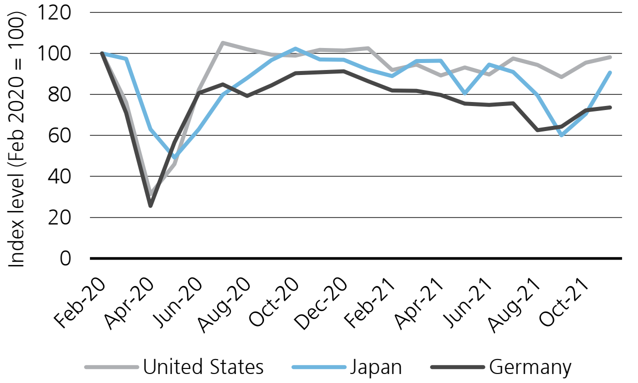
As recent expansions have matured, the labor force participation rate has tended to rise after the unemployment rate fell substantially, offsetting structural downward pressures from an aging population. We would expect this to occur in a normal cycle, but even more so in this one because public health concerns – which we expect to subside – continue to weigh on employment.

In December, 1.1 million Americans said they hadn't been looking for work because of the pandemic. Nearly 1.7 million people reported having a job but not being at work in December because of an illness. As the Omicron wave recedes, the share of the population with some form of immunity from COVID-19 increases, and new anti-virals proliferate, we believe this will be accompanied by a more durable recovery in labor supply.

Different advanced economies are seeing varying levels of labor force attachment and churn, in part linked to the type and generosity of fiscal measures deployed over the past two years. Some research suggests that lower-income US households do not have significant cash buffers after drawing down some excess savings. This may drive a need to re-engage with the labor market.

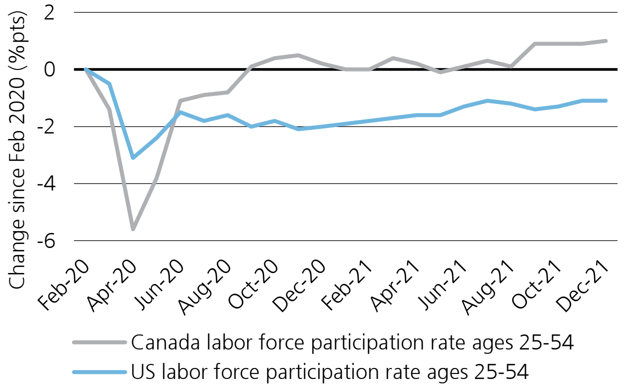
There is a risk of some structural change in labor force participation, but in our view it is more likely that prime-age Americans will re-eclipse the same participation rates that prevailed pre-pandemic, as their neighbors to the north in Canada have already achieved. Jobs in the 24-54 age group would need to be 1.9 million above current level to return to where the US prime-age employment to population ratio was in February 2020.

Exhibit 5: Recovery in auto production gaining momentum across different regions



Source: UBS-AM, Macrobond. Data as of 30 November 2021.

Exhibit 6: US prime-age participation rate has room to rise, supporting employment growth



Source: UBS-AM, Statistics Canada, Bloomberg. As of 31 December 2021.

Most developed market central banks, including the Fed, have signaled they will not wait for a full recovery in inflation before raising policy rates. New workers as well as capital deepening should drive growth in the years to come, likely allowing central banks to reach higher terminal rates this cycle than the market is currently pricing in. Over time, the expansion remaining intact as monetary accommodation is removed should put upward pressure on interest rates across the yield curve.

Asset allocation

The continued recovery in labor markets and easing of supply chain disruptions should combine to help foster a healthier nominal growth environment – more production, and less inflation.

Risk assets have endured some volatility at the start of the year. A surge in US real rates is hitting more speculative pockets of the equity market, where valuations are stretched and profits scarce.

Ultimately, we believe that global equities are well-positioned to move higher in 2022 on robust earnings growth. In our view, bond yields should trend higher as the economy continues to expand amid central bank tightening, and inflation remains elevated even after peaking.

To be sure, there are risks to this view. While we have high conviction in the outlook for growth, we also acknowledge high uncertainty in judging when, and by how much, inflation will decelerate. A sufficiently large spike that brings 10-year US real rates above zero could exert enough pressure on equity valuations at the index level to overwhelm the positive effects of earnings growth. This would likely be fueled by uncomfortably high inflation that would elicit more aggressive rate hikes from the Federal Reserve as well as a hawkish pivot from the European Central Bank.

We continue to find the beneficiaries of strong production growth – cyclical sectors like Financials and Energy, as well as regions like Europe and Japan – more attractive than broad equity beta. These sectors have fared quite well in the early weeks of 2022, and though it will not be a straight line, we expect more outperformance in the months to come.

Asset class attractiveness (ACA)

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 12, 2022.

Negative ↔ Positive

❯, ❮ denote change in view versus previous ACA.

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

Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as of January 12, 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 signal	UBS Asset Management's viewpoint
Global Equities		– Our outlook for stocks over the next 12 months remains positive. The economic recovery is likely to continue in 2022 on the back of robust global growth, still accommodative financial conditions, and improving public health outcomes. – Improving earnings expectations are likely to underpin continued gains in global equities despite high valuations, which will continue to come under pressure as monetary stimulus is withdrawn. The equity risk premium is near the floor of the previous cycle, which may cap upside as policy risks start to become more two-sided and growth decelerates. – We see more upside in relative value opportunities that offer attractively priced exposure to above-trend activity in developed markets compared to beta exposures.
US Equities		– US equities continue to command premium valuations. The sectoral composition drives this dynamic, with a higher weighting towards acyclical defensive technology than other markets. This characteristic has been a disadvantage as real rates rise, and may further drag on relative performance in the event that investors aim to boost cyclical exposure. Accordingly, we prefer US small caps and equal weight to market cap indexes. – Continued strong earnings and robust balance sheets should continue to support US equities, but the skew of fiscal and monetary policy risks has turned negative.
Ex-US Developed market Equities		– Non-US developed market equities are attractively valued and have significant exposure to the global economic recovery. – Both earnings and valuations have more room to run in ex-US developed market equities. – Earnings revisions in Europe and Japan continue to be stronger than in the US, and this superior performance has not been sufficiently reflected in the relative performance of these regions. – Historically, rising real rates regimes have typically been particularly positive for Japanese equities.
Emerging Markets (EM) Equities (ex-China)		– A stabilization of growth in China amid measured policy support is a positive for the asset class, particularly for countries with the tightest economic and financial linkages. Resilience in industrial metals continues to point to a strong foundation for real activity. – However, EM equities continue to face near-term challenges that include less impressive earnings revisions relative to DM, rising real rates, and slower administration of vaccines and boosters.
China Equities		– The relative valuation of Chinese internet companies compared to their US peers suggests too much embedded pessimism about their longer-term earnings prospects. – The peak in credit tightening has passed, in our view. Manufacturing and services PMIs have returned to expansionary territory, and more policy support to stabilize activity will have a positive impact on activity going forward. – From a seasonality perspective, Chinese equities have tended to outperform ahead of the China Party Congress. – Concern over China's real estate market constitutes an important downside risk to activity and procyclical positions; some regulatory headwinds may also linger for domestic equities.
Global Duration		– Long-term bond yields are slated to continue trending higher as most global central banks withdraw monetary stimulus.. – Inflation risks remain tilted to the upside and global economic activity is poised to remain robust well into 2022. – We expect real rates to be the key contributor to higher long term yields, even after their recent surge. – Global yields have increased even as risks to activity from Omicron have flared, a sign that central bank policy is a more important driver. – Sovereign fixed income continues to play an important diversifying role in portfolio construction, and remains particularly effective in hedging downside in procyclical relative value equity positions.

Negative ⟷ Positive

Asset Class	Overall 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 Federal Reserve is poised to start a tightening cycle in March and has telegraphed that the unwind of its bond purchases will follow soon thereafter, both of which should be conducive to higher yields across the curve. – We expect weakness in US bonds to continue as domestic activity reaccelerates after a brief interruption due to the Omicron variant, inflation remains uncomfortably elevated well above the central bank's target, and global activity remains firm.
Ex-US Developed-market Bonds		– We continue to see developed-market sovereign yields outside the U.S. as unattractive. The Bank of Japan's domination of the Japanese government debt market and success in yield curve control diminishes the use of the asset class outside of relative value positions. The reduction in asset purchases from the European Central Bank coupled with a strong outlook for growth in 2022 are factors that may compress periphery spreads, but perhaps at the expense of rising core borrowing costs, as well.
US Investment Grade (IG) Corporate Debt		– Spreads have fully retraced thanks to policy support and an improving economic outlook, while all-in borrowing costs are well below pre-pandemic levels. US IG is one of the few sources of quality, positive yield available and therefore a likely recipient of ample global savings. However, the duration risk embedded in high-grade debt as the economy recovers as well as the potential for spread widening should threats to the expansion arise serve as material two-sided risks that weigh on total return expectations for this asset class.
US High Yield Bonds		– We expect carry, rather than spread compression, to drive total returns in HY going forward. The coupons available will continue to attract buyers in a low-yield environment. – The asset class is more attractively valued and has less sensitivity to rising interest rates than IG bonds. However, spread levels that are lower than the forward earnings yield for equities (on a risk-adjusted basis) make this asset class less attractive than stocks.
Emerging Markets Debt US dollar Local currency		– We have a positive view on emerging market dollar-denominated bonds due to the balance of carry opportunity and duration risk. – Asian credit is enticingly valued and poised to perform well in environments in which growth expectations improve or plateau, so long as highly adverse economic outcomes fail to materialize. – A less positive environment for the US dollar after its 2021 advance removes one previous headwind for total returns in EM local bonds.
China Sovereign		– Chinese government bonds have the highest nominal yields among the 10 largest fixed income markets globally as well as defensive properties that are not shared by most of the emerging-market universe. We believe the combination of monetary easing, stabilizing domestic activity, and continued strong foreign inflows should put prevent any sustained upward pressure on yields during the next 3-12 months.
Currency		– Positive catalysts for the US dollar have largely been priced in. Real growth differentials to many other developed market economies are poised to shrink in 2022, and the Federal Reserve will not be the only DM central bank hiking rates in 2022. – However, we do not expect to see major downside in the US dollar, which also serves a useful hedging role in portfolios where duration is underweight and procyclical relative equity positions are preferred. – Select EMFX like RUB and BRL, which are supported by continued monetary tightening, are well-positioned to outperform cyclical Asian currencies and select G10 commodity exporters.

Source: UBS Asset Management. As of January 12, 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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