Macro Monthly

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

UBS Asset Management | Economic insights and asset class attractiveness
June 2022

Evan Brown
Head of Multi-Asset Strategy
Investment Solutions

Luke Kawa
Director
Investment Solutions

Time to trade the growth slowdown

Highlights

- We are optimistic that the US economy is strong enough to weather headwinds and avoid a recession in the next 12 months.
- However, market pricing of recession risk is likely to increase over the next few months.
- Equity valuations are still expensive relative to bonds. Moreover, we believe that signs of a durable bottom in economic growth or a Fed pivot to a less hawkish stance are unlikely in the near term.
- Should global economic momentum accelerate against our expectations, we feel that Chinese equities are an attractive way to express this view.

A key debate about the stock market concerns the likelihood and proximity of a US recession. Equity bears think an end to the expansion is imminent. Bulls expect a substantial rebound in the stock market so long as the economy avoids such a negative scenario. We disagree with both camps.

In our view, it is unlikely the US enters a recession within the next year – but even so, we continue to find equities unattractive at the index level. We believe market pricing of recession risk is more likely to increase rather than decrease from here, and still-expensive valuations do not provide adequate compensation for the downside risks to activity and earnings. For asset allocation purposes, this sequencing is critical: Before we can position for economic resilience, we believe it is first appropriate to position for a growth scare.

Over the next twelve months, economic strengths trump vulnerabilities

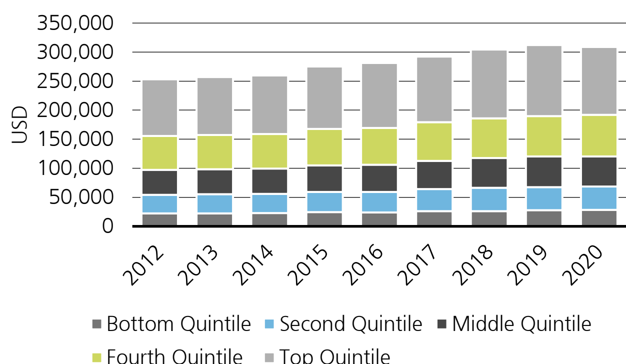
As we've said, this cycle is different, characterized by a higher nominal growth environment. Private balance sheets remain strong, consumer spending is rotating, not shrinking, and core inflationary pressures are likely to cool, in our view. Over a twelve-month period, these positive factors are likely to outweigh the vulnerabilities caused by tighter financial conditions, aggressive Federal Reserve rate hikes, softening in the goods sector, and elevated inflation.

The overall private sector – households and businesses combined – has accumulated a significant financial surplus, the flip side of the massive fiscal deficits since the pandemic. For businesses, this net saving increases their ability to weather shocks to demand without facing financial stress. Even more importantly, for households these funds provide a cushion to maintain spending. Of the seven US recessions in the past five decades, all but one included a contraction in real consumption. Lower-income households have already begun to draw down on savings in the face of high inflation, and elevated energy costs may add more of a drag on discretionary consumption. But critically, the top 40% of US households by income account for 60% of US spending – and this is where the excess savings are concentrated at present.

UBS

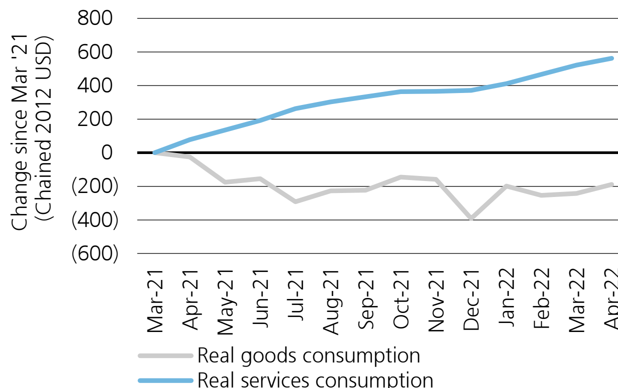
Exhibit 1: Higher-earning quintiles account for the majority of US consumption

Average annual expenditure by income quintile



Source: UBS-AM, Macrobond. Data as of 2020.

Exhibit 2: The rotation in US consumption is well underway



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

The ongoing mean reversion of above-trend US goods spending is affirmation of the progress made towards retaining pre-pandemic norms – not a harbinger of a domestic recession. Since the March 2021 peak in real US goods spending, services are up by twice as much as goods have decreased. As we think that the aggregate wherewithal to spend remains robust, there is little reason or evidence to suspect this underpinning of US growth over the past year is about to take an abrupt turn for the worse.

If inflationary pressures emanating from goods and the labor market diminish, so too should the threat to the US expansion posed by Federal Reserve tightening. Elevated inventories (ex autos) and moderating shipping rates suggest sharp disinflation, if not outright deflation, in core goods prices may be in the offing. Since these anomalous increases in goods prices have driven above-trend inflation, we believe the downside here will more than offset any upward price pressures from services.

A continued rebound in labor supply would dampen wage growth and bring the job market into more balanced territory, and would provide even more significant evidence that underlying inflation pressures are durably cooling. The aforementioned decline in savings among lower-income households should serve as a push to reintegrate into the labor force. Much of the employment shortfall and elevated job openings relative to pre-pandemic levels are in lower-wage industries – particularly leisure and hospitality. That sector also has also enjoyed by far the highest rate of pay growth since the onset of the pandemic, which could help pull would-be workers back in.

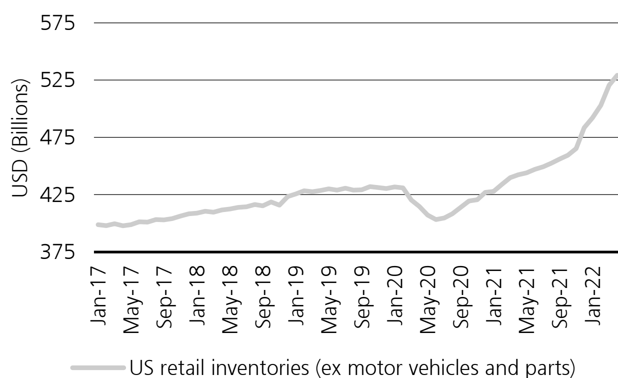
Over the next few months, equity risks outweigh rewards

Our call for US economic resilience over the next 12 months is not yet actionable from a tactical asset allocation perspective.

Stocks are still unattractive on a valuation basis, and need to cheapen further to entice us to add risk absent a material change in the macro backdrop. The equity risk premium is still moderately tight, and markets do not typically bottom when stocks are this expensive relative to bonds.

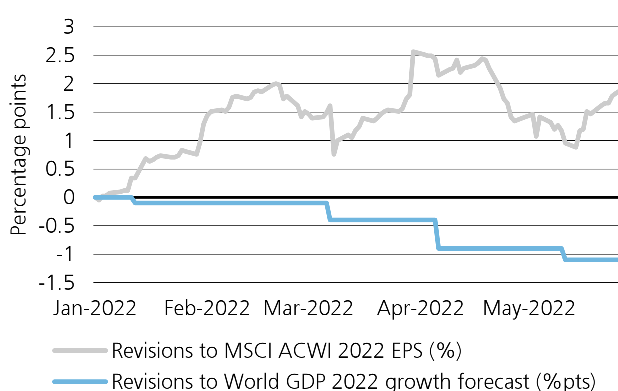
Earnings face downside risks as well. Analysts have revised per share profit estimates for global equities higher by roughly 2% year-to-date even as projected global growth has been trimmed by 1.1 percentage points. Bottom-up estimates suggest the compound annual growth

Exhibit 3: Inventory destocking likely to be disinflationary



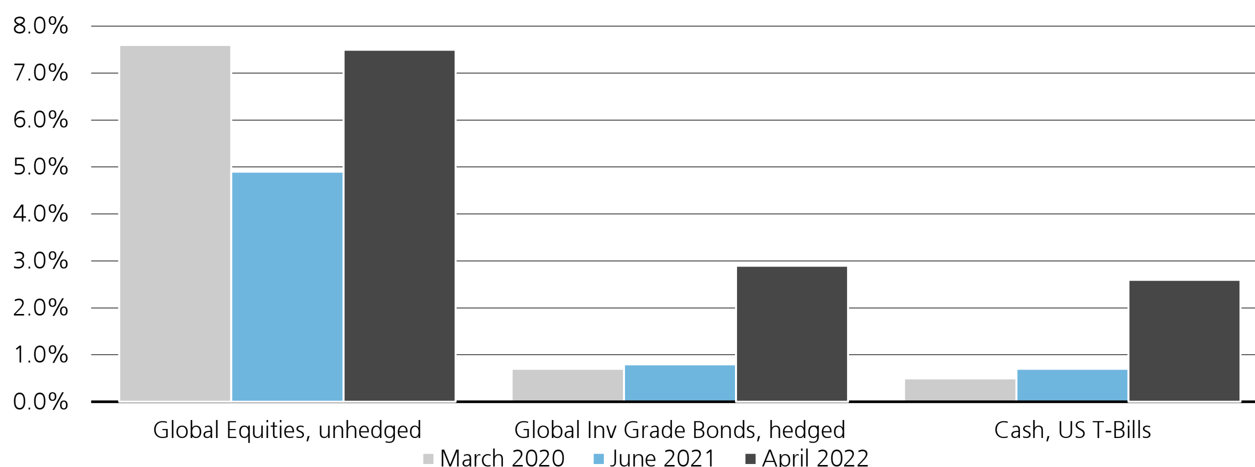
Source: UBS-AM, Macrobond. Data as of April 2022.

Exhibit 4: Downside risks to profit estimates due to slowing growth



Source: UBS-AM, Bloomberg. Data as of 31 May 2022.

Exhibit 5: Expected returns are improving
Five-year geometric projected returns, USD terms



Our baseline process incorporates current valuations, market conditions and key forward-looking inputs to generate our five-year expected returns by asset class and region

Note: March 2020 cash estimate made in April 2020.

Source: UBS Asset Management As of 30 April` 2022.

rate of earnings for the MSCI ACWI from the end of 2021 through 2023 will be over 9%, vs. less than 3% from 2010 through 2019. These estimates are so elevated that we believe that there is room for them to come down in an environment of slowing growth, even without a recession.

Volatility in profit growth has often been linked to the performance of goods-production sectors and the manufacturing PMI cycle. While an inflation peak could provide some relief for equity valuations relative to bonds, a descent of inflation could also reflect margin compression or deteriorating demand that adversely affects operating performance. Already, the breadth of earnings revisions is quite poor. Excluding the commodity-linked energy and materials sectors, earnings per share revisions have stagnated in aggregate for US equities.

Historically, risk assets have not troughed until there is a positive inflection in manufacturing purchasing managers' indexes or there has been a dovish pivot from the Federal Reserve. Neither catalyst is imminent, in our view. The sharp tightening in financial conditions year-to-date is consistent with below trend growth later this calendar year. And even if inflation decelerates, it will likely remain elevated, making it difficult for the Fed to pivot in a less hawkish direction.

Asset allocation implications

This is a challenging environment for asset allocation. In our view, investors are likely to continue to take a glass-half empty view of economic developments in the near term – not distinguishing between deceleration and an outright downturn. It is optimal to trade that path before we trade the destination.

That means staying underweight stocks, where we are more inclined to fade any bear market rallies, and staying positioned relatively cautiously in equities, where health care is our preferred defensive sector.

We also believe in selectively embracing cyclicality, particularly in commodities and energy equities. If consumer demand holds up, oil prices are likely to remain firm. And if energy markets suffer additional negative supply shocks, we believe that spending on other more discretionary items is likely to come under more pressure than fuel – a development already cited by several major retailers on their first-quarter earnings calls.

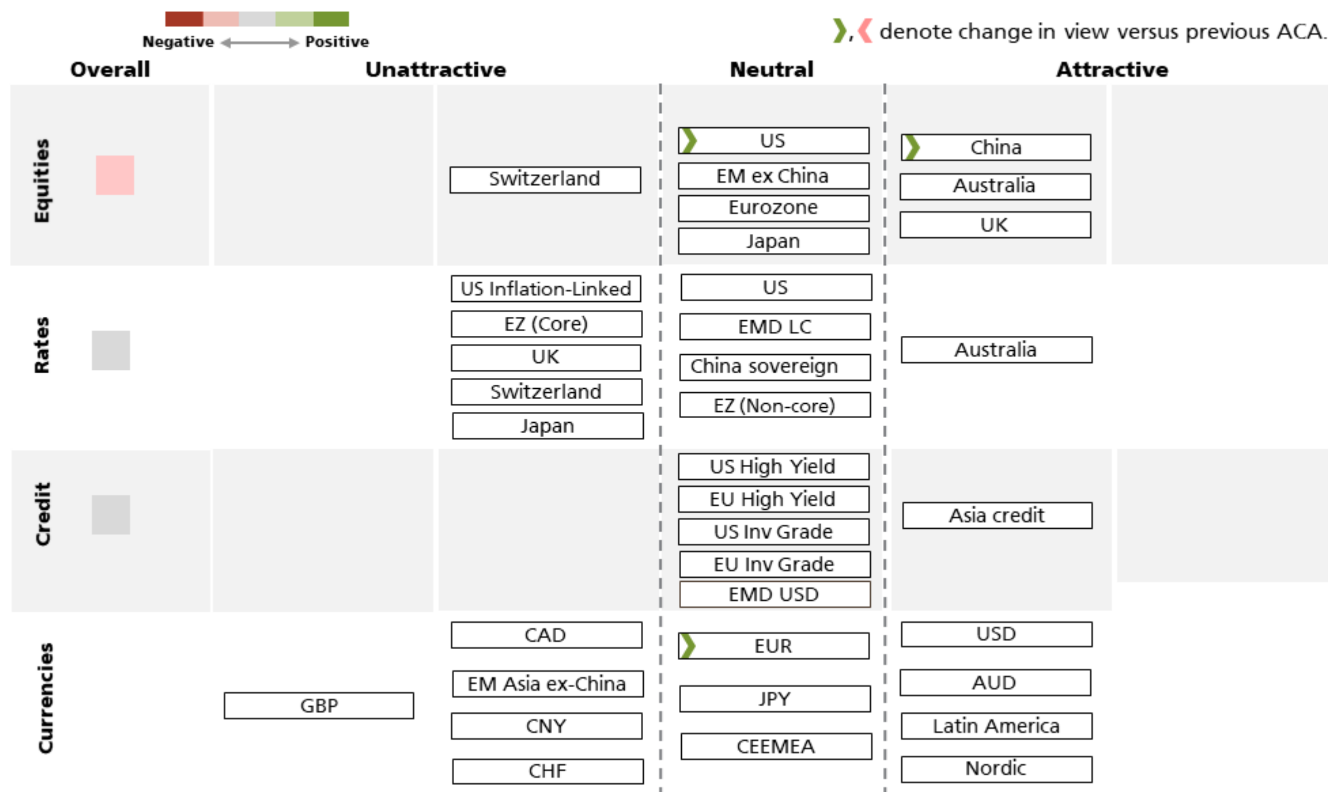
The most attractive investment to play for an unexpected increase in global economic momentum is Chinese risk assets, in our view. Markets are cheap, and unlike other major economies, policy is easing rather than tightening. Of the three largest headwinds we see for markets this year (aggressive Fed tightening, Russian invasion, and Chinese activity), we believe this final one is the most likely to be first to turn into a tailwind.

Given our view that the economic expansion will endure, we are also approaching levels where credit looks more interesting given the all-in move in yields from spread widening and higher government bond yields.

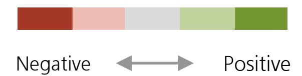
Stepping back, the silver lining of this year-to-date weakness across financial assets is the improvement in expected forward returns as valuations reset and risk-free yield becomes more ample (as noted in Exhibit 5). In our view, exercising a degree of caution on risk assets now leaves us better positioned to be able to capitalize on opportunities as our valuation or macroeconomic milestones are met.

Asset class attractiveness (ACA)

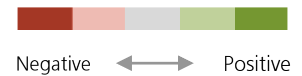
The chart below shows the views of our Asset Allocation team on asset class attractiveness as of 1 June 2022. The colored squares on the left provide our overall signal for global equities, rates, and credit. The rest of the ratings pertain to the relative attractiveness of certain regions within the 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 1 June 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		– In our view, global equities are tactically unattractive. The equity risk premium implies stocks are still expensive relative to bonds. Equities are likely to face valuation pressures from central bank tightening, while slowing growth also raises downside risks to earnings estimates. – We prefer relative value opportunities within equities, and are staying cautiously positioned with a preference for sectors like health care and regions such as the UK, which has a more defensive composition. We also are selectively long cyclicality via commodity-linked stocks. – Our view is that the economic expansion is likely to endure despite the headwinds of tightening financial conditions, aggressive rate hikes, a moderation in goods spending, and elevated inflation. Private sector balance sheets remain strong, spending is rotating rather than shrinking, and core inflationary pressures are likely to cool. However, it is too soon to trade that view: Market pricing of recession risk is likely to increase from here.
US Equities		– 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. – Within US equities, we continue to prefer US equal weight to market cap indexes. – 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, in our view. – Despite recent economic resilience European equities are still vulnerable as Russia continues to wage war against Ukraine. However, this is already partially priced in.
Emerging Markets (EM) Equities (ex-China)		– Concerns about the stabilization of growth in China is a major source of uncertainty 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. As such we prefer EM markets with the strongest linkages to commodities. – EM equities have held up impressively well in the face of challenges early 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. The People's Bank of China (PBOC) has cut rates, the peak in credit tightening has passed, in our view, and 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 the prospective economic rebound. – The relative valuation of Chinese internet companies compared to their US peers suggests too much embedded pessimism about their longer-term earnings prospects, and we believe the intensity of the regulatory crackdown is diminishing. – From a seasonality perspective, Chinese equities have tended to outperform ahead of the China Party Congress.
Global Duration		– We believe the risks to long-term bond yields are well-balanced as traders have priced in aggressive central bank tightening over the coming year. – We expect real rates to rise as inflation peaks and the Federal Reserve tightens policy even more in the coming months, but for this to be offset by decreases in market-based measures of inflation compensation. – Sovereign fixed income continues to play an important diversifying role in portfolio construction and remains particularly effective in hedging downside in procyclical positions.



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 Federal Reserve is likely to take rates to a neutral setting as quickly as possible, while trying not to jeopardize the expansion, and then move to restrictive territory in order to quell inflationary pressures. Quantitative tightening is not a very potent negative or positive catalyst for fixed income, in our view. – Market pricing for the Federal Reserve's terminal rate this cycle has adjusted meaningfully to the upside, and parts of the yield curve already imply interest rate cuts by 2024. The Fed has set a high bar for inflation to surprise to the upside this year, leaving room for rates to come down across the curve by pricing out some of the expected hikes. Even more front-loaded tightening could also increase perceived recession risk and provide a bid for the long end.
Ex-US Developed-market Bonds		– We continue to see developed-market sovereign yields outside the US as unattractive. The European Central Bank accelerated its timetable for tapering even in the face of downside risks to growth tied to Russia's invasion and has outlined a plan to exit negative policy rates by the end of the third quarter. – The Bank of Japan's domination of the market and strategy of yield curve control diminishes the use of much of the asset class outside of relative value positions. Maturities beyond the 10-year point may be more vulnerable should the global repricing of duration resume.
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 near-term caution.
US High Yield Bonds		– We expect carry, rather than spread compression, to drive total returns in HY going forward. The coupons available should continue to attract buyers in a low-yield environment.
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. – Asian credit is enticingly valued and we believe poised to perform well in environments in which highly adverse economic outcomes fail to materialize. – in our view 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 gets priced in.
China Sovereign		– 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 indexes. 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		– The US dollar is well-positioned to remain elevated, if not strengthen further, in our view. Real growth differentials vs. other major economies are likely to remain substantial due to the Chinese authorities' response to the persistence of the pandemic and the negative supply shock to energy prices, which more adversely affects Europe. Elevated geopolitical risks and the prospect of a broad-based growth scare should also put a sturdy floor under the dollar. – Some EMFX, like COP and BRL, may outperform cyclical Asian currencies and select G10 commodity exporters given attractive carry.

Source: UBS Asset Management. As of 1 June 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.

A comprehensive solutions provider

UBS Asset Management Investment Solutions manages USD 170bn as of March 31, 2022. Our 100+ Investment Solutions professionals leverage the depth and breadth of UBS's global investment resources across regions and asset classes to develop solutions that are designed to meet client investment challenges. Investment Solutions' macro-economic and asset allocation views are developed with input from portfolio managers globally and across asset classes.

For more information, contact your UBS Asset Management representative or your financial advisor.

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

This document does not replace portfolio and fund-specific materials. Commentary is at a macro or strategy level and is not with reference to any registered or other mutual fund.

Americas
The views expressed are a general guide to the views of UBS Asset Management as of June 2022. The information contained herein should not be considered a recommendation to purchase or sell securities or any particular strategy or fund. Commentary is at a macro level and is not with reference to any investment strategy, product or fund offered by UBS Asset Management. The information contained herein does not constitute investment research, has not been prepared in line with the requirements of any jurisdiction designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith. All such information and opinions are subject to change without notice. Care has been taken to ensure its accuracy but no responsibility is accepted for any errors or omissions herein. A number of the comments in this document are based on current expectations and are considered "forward-looking statements." Actual future results, however, may prove to be different from expectations. The opinions expressed are a reflection of UBS Asset Management's best judgment at the time this document was compiled, and any obligation to update or alter forward-looking statements as a result of new information, future events or otherwise is disclaimed. Furthermore, these views are not intended to predict or guarantee the future performance of any individual security, asset class or market generally, nor are they intended to predict the future performance of any UBS Asset Management account, portfolio or fund.

EMEA
The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith, but is not guaranteed as being accurate, nor is it a complete statement or summary of the securities, markets or developments referred to in the document. UBS AG and / or other members of the UBS Group may have a position in and may make a purchase and / or sale of any of the securities or other financial instruments mentioned in this document. Before investing in a product please read the latest prospectus carefully and thoroughly. Units of UBS funds mentioned herein may not be eligible for sale in all jurisdictions or to certain categories of investors and may not be offered, sold or delivered in the United States. The information mentioned herein is not intended to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. Past performance is not a reliable indicator of future results. The performance shown does not take account of any commissions and costs charged when subscribing to and redeeming units. Commissions and costs have a negative impact on performance. If the currency of a financial product or financial service is different from your reference currency, the return can increase or decrease as a result of currency fluctuations. This information pays no regard to the specific or future investment objectives, financial or tax situation or particular needs of any specific recipient. The details and opinions contained in this document are provided by UBS without any guarantee or warranty and are for the recipient's personal use and information purposes only. This document may not be reproduced, redistributed or republished for any purpose without the written permission of UBS AG. This document contains statements that constitute "forward-looking statements", including, but not limited to, statements relating to our future business development. While these forward-looking statements represent our judgments and future expectations concerning the development of our business, a number of risks, uncertainties and other important factors could cause actual developments and results to differ materially from our expectations.

UK
Issued in the UK by UBS Asset Management (UK) Ltd. Authorised and regulated by the Financial Conduct Authority.

APAC
This document and its contents have not been reviewed by, delivered to or registered with any regulatory or other relevant authority in APAC. This document is for informational purposes and should not be construed as an offer or invitation to the public, direct or indirect, to buy or sell securities. This document is intended for limited distribution and only to the extent permitted under applicable laws in your jurisdiction. No representations are made with respect to the eligibility of any recipients of this document to acquire interests in securities under the laws of your jurisdiction. Using, copying, redistributing or republishing any part of this document without prior written permission from UBS Asset Management is prohibited. Any statements made regarding investment performance objectives, risk and/or return targets shall not constitute a representation or warranty that such objectives or expectations will be achieved or risks are fully disclosed. The information and opinions contained in this document is based upon information obtained from sources believed to be reliable and in good faith but no responsibility is accepted for any misrepresentation, errors or omissions. All such information and opinions are subject to change without notice. A number of comments in this document are based on current expectations and are considered "forward-looking statements". Actual future results may prove to be different from expectations and any unforeseen risk or event may arise in the future. The opinions expressed are a reflection of UBS Asset Management's judgment at the time this document is compiled and any obligation to update or alter forward-looking statements as a result of new information, future events, or otherwise is disclaimed. You are advised to exercise caution in relation to this document. The information in this document does not constitute advice and does not take into consideration your investment objectives, legal, financial or tax situation or particular needs in any other respect. Investors should be aware that past performance of investment is not necessarily indicative of future performance. Potential for profit is accompanied by possibility of loss. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice.

Australia
This document is provided by UBS Asset Management (Australia) Ltd, ABN 31 003 146 290 and AFS License No. 222605.

China
The securities may not be offered or sold directly or indirectly in the People's Republic of China (the "PRC"). Neither this document or information contained or incorporated by reference herein relating to the securities, which have not been and will not be submitted to or approved/verified by or registered with the China Securities Regulatory Commission ("CSRC") or other relevant governmental authorities in the PRC pursuant to relevant laws and regulations, may be supplied to the public in the PRC or used in connection with any offer for the subscription or sale of the Securities in the PRC. The securities may only be offered or sold to the PRC investors that are authorized to engage in the purchase of Securities of the type being offered or sold. PRC investors are responsible for obtaining all relevant government regulatory approvals/licenses, verification and/or registrations themselves, including, but not limited to, any which may be required from the CSRC, the State Administration of Foreign Exchange and/or the China Banking Regulatory Commission, and complying with all relevant PRC regulations, including, but not limited to, all relevant foreign exchange regulations and/or foreign investment regulations.

Hong Kong
This document and its contents have not been reviewed by any regulatory authority in Hong Kong. No person may issue any invitation, advertisement or other document relating to the Interests whether in Hong Kong or elsewhere, which is directed at, or the contents of which are likely to be accessed or read by, the public in Hong Kong (except if permitted to do so under the securities laws of Hong Kong) other than with respect to the Interests which are or are intended to be disposed of only to persons outside Hong Kong or only to "professional investors" within the meaning of the Securities and Futures Ordinance (Cap. 571) and the Securities and Futures (Professional Investor) Rules made thereunder.

Japan
This document is for informational purposes only and is not intended as an offer or a solicitation to buy or sell any specific financial products, or to provide any investment advisory/management services.

Korea
The securities may not be offered, sold and delivered directly or indirectly, or offered or sold to any person for re-offering or resale, directly or indirectly, in Korea or to any resident of Korea except pursuant to the applicable laws and regulations of Korea, including the Capital Market and Financial Investment Business Act and the Foreign Exchange Transaction Law of Korea, the presidential decrees and regulations thereunder and any other applicable laws, regulations or rules of Korea. UBS Asset Management has not been registered with the Financial Services Commission of Korea for a public offering in Korea nor has it been registered with the Financial Services Commission for distribution to non-qualified investors in Korea.

Malaysia
This document is sent to you, at your request, merely for information purposes only. No invitation or offer to subscribe or purchase securities is made by UBS Asset Management as the prior approval of the Securities Commission of Malaysia or other regulatory authorities of Malaysia have not been obtained. No prospectus has or will be filed or registered with the Securities Commission of Malaysia.

Singapore
This document has not been registered with the Monetary Authority of Singapore pursuant to the exemption under Section 304 of the SFA. Accordingly, this document may not be circulated or distributed, nor may the Securities be offered or sold, whether directly or indirectly, to any person in Singapore other than (i) to an institutional investor pursuant to Section 304 of the SFA.

Taiwan
This document and its contents have not been reviewed by, delivered to or registered with any regulatory or other relevant authority in the Republic of China (R.O.C.). This document is for informational purposes and should not be construed as an offer or invitation to the public, direct or indirect, to buy or sell securities. This document is intended for limited distribution and only to the extent permitted under applicable laws in the Republic of China (R.O.C.). No representations are made with respect to the eligibility of any recipients of this document to acquire interests in securities under the laws of the Republic of China (R.O.C.).

Source for all data and charts (if not indicated otherwise): UBS Asset Management.

www.ubs.com/am-linkedin

© UBS 2022. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.
AMT-2254 06/22
www.ubs.com/am