Macro Monthly

Economic insights and asset class attractiveness

UBS Asset Management | June 2023

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

Evan Brown
Head of Multi-Asset Strategy
Investment Solutions

Luke Kawa
Director
Investment Solutions

Navigating the US debt drama

Highlights

- Negotiations are likely to conclude with a last-minute deal to raise the debt ceiling that increases fiscal drag starting in October, in our view.
- We believe a US government default on Treasury debt obligations is very unlikely even in the event that Congress fails to raise the debt ceiling; these payments would likely be prioritized.
- Market volatility is poised to rise in the near term as we approach the June 1 'X-date.'
- Given earnings and economic resilience, global stocks may become more attractive if left-tail risks on the debt ceiling fail to materialize.

As negotiations over raising the US debt ceiling twist and turn, we have three core convictions on their evolution and endgame. The risk of a default on US Treasury obligations is extremely low. A compromise agreement by early June is more likely than not. But volatility is poised to increase in the near term, as markets are likely to price in some risk of a disruptive outcome between now and then.

Discussions had taken a positive turn in mid-May as US President Joe Biden expressed a willingness for deficit reduction via spending cuts and the group of negotiators slimmed to key Republicans and the White House. However, both sides are incentivized to drag out talks to make a deal appear difficult to demonstrate to their respective camps that they negotiated for the best outcome possible. The situation will remain fluid, but we expect more negative headlines than positive ones until such time that a resolution is at hand.

Once left-tail risks linked to a failure to raise the debt ceiling are behind us, we will be back to a world in which economic activity and earnings are likely to remain more resilient than many expect.

Down to the wire

In our view, a deal is unlikely to be reached until just before or shortly after the June 1 'X-date' (when the US government is in danger of completely running out of money) as identified by Treasury Secretary Janet Yellen. It has become more likely that, before the government receives tax payments on June 15, the US federal government will be unable to meet all of its spending commitments within roughly a week of the X-date. It is also possible that Congress passes a short-term extension to raise the debt limit and provide more time to negotiate, and we find ourselves replaying this situation in several weeks.

UBS

We believe there is a basic framework for a deal taking shape. The most important component is likely to be a multi-year cap on the level and/or growth rate of federal government discretionary spending beginning this October in exchange for lifting the debt ceiling through the 2024 US elections. Reclaiming unspent COVID-19 relief funds from states and energy infrastructure permitting reforms are also likely to be part of any deal.

Reductions in spending relative to the prior baseline will amount to a drag on growth, but one that is surmountable for an economy that is still displaying nominal strength. Any fiscal drag is likely to be less negative for economic activity compared to the fiscal consolidation that resulted from the 2011 debt ceiling agreement.

What happens past the X-date?

Should Democrats and Republicans fail to reach an agreement past the X-date, there are larger downside risks to growth. The US government would immediately need to limit spending to its revenue-generating capabilities. Conscious that a default on Treasury obligations would risk a financial calamity, we strongly expect the Treasury would prioritize making principal and interest payments on the debt over other obligations. Indeed, Federal Open Market Committee (FOMC) conference call transcripts from prior debt ceiling episodes in 2011 and 2013 state that this was the gameplan.

A prioritization of debt payments means that other obligations would not be met. The ensuing drop-off in spending and substantial hit to consumer confidence would be an increasingly negative drag on economic activity the longer the standoff lasts. In our view, any potential period in which the US government is unable to meet all of its obligations is likely to be short-lived. Whether due to market angst or public outcry, lawmakers would feel pressure to reach a compromise.

A failure to raise the debt ceiling, even without a sovereign default, would be negative for risk assets and positive for longer-term US government bonds given the hit to economic growth. The impact on the US dollar would likely be bifurcated, with weakness against traditional safe havens like the Japanese yen, but stronger against growth sensitive currencies.

What if there is a default on Treasuries?

We think there are very low odds that the US government defaults on one of its debt obligations. In the very unlikely event that were to arise, risks to the financial system would be significant. The most severe financial distress occurs not when assets that are known to be risky suffer, but rather when assets that are widely believed to be safe fail. It is very likely that the negative ramifications are not possible to fully identify ex ante, but may include ratings downgrades of the United States, forced selling of US Treasuries, faults in funding markets and broader systemic stress.

In our view, it is more likely that President Biden acts unilaterally to continue paying the US's debt obligations (citing the 14th Amendment, which states "the validity of the public debt … shall not be questioned") than it is that the Treasury ceases making principal or interest payments. This maneuver would be drastic and legally dubious, but put Republicans in the optically unfavorable position of trying to get the courts to enforce a US default.

In a worst-case scenario, we are operating under the principle that the Federal Reserve is prepared to act decisively to maintain market functioning should the creditworthiness of Treasuries be thrust into question. Financial stability considerations will be paramount, even though monetary policymakers do not want to be seen as shielding Congress from the consequences of failing to raise the debt ceiling.

The transcript of the 2013 Federal Reserve meeting on the debt ceiling, indicates that then Governor, now Chair Jerome Powell is willing to accept "loathsome" options such as buying defaulted US Treasury securities or swapping unblemished Treasury securities on the Fed's balance sheet for defaulted ones, if necessary.

Asset allocation

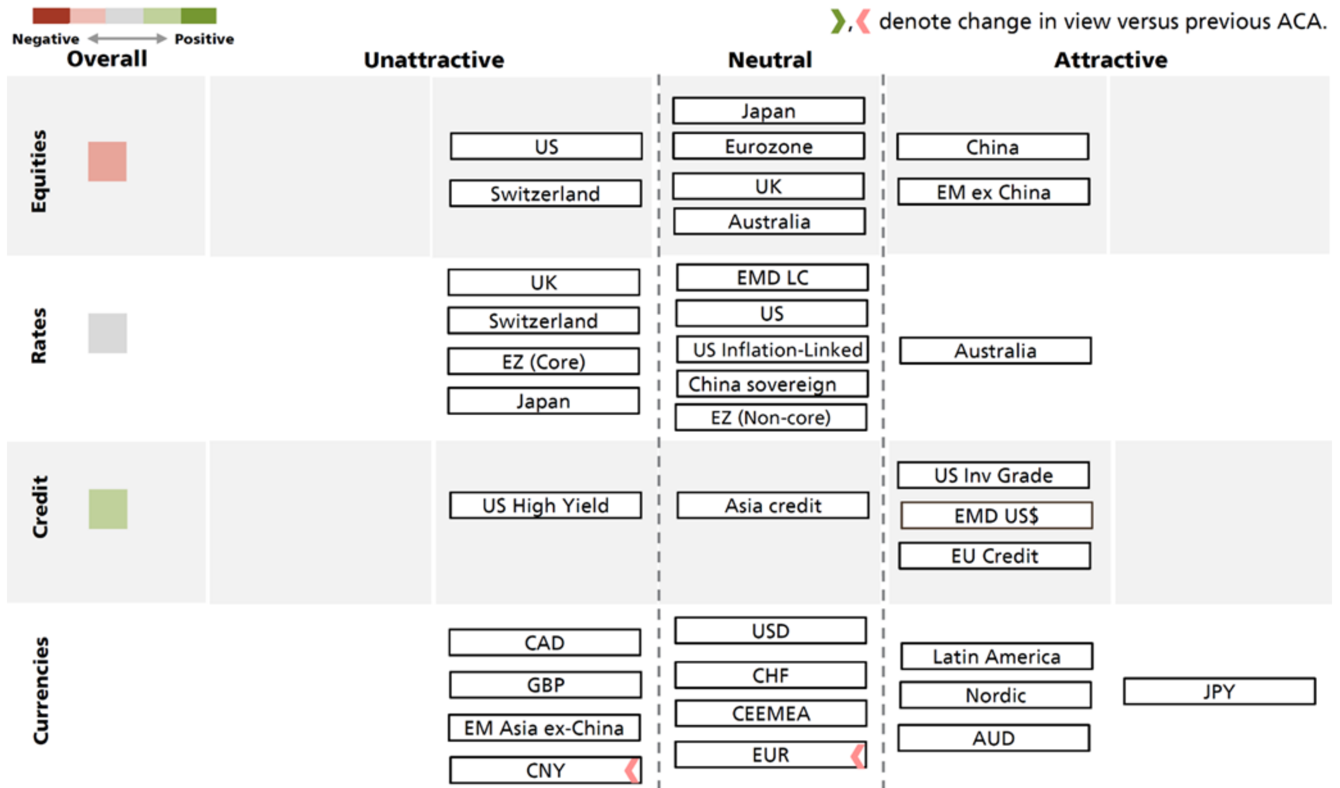
We believe the macroeconomic landscape will become more supportive of risk once this large potential headwind is behind us, and believe a deal will be struck by early June. Any meaningful pullbacks in the stock market linked to concerns about whether a debt ceiling agreement will be reached or if the US government will not service its debt obligations may be an attractive point to increase equity exposure, in our view.

Corporations have retained pricing power amid a slowing in economic growth – and nominal activity is still high and has room to decelerate further without triggering recession fears. The aggregate amount that US companies exceeded expectations increased for both the top and bottom lines during the most recent reporting period. The resilience of nominal activity and margins suggest that downside to earnings is limited outside of recession, which we do not believe is imminent. Core inflationary pressures are also poised to decelerate, in our view, and may give scope for the Federal Reserve to not only skip hiking rates at its June meeting, but go on a more extended pause.

Ahead of debt ceiling talks, our relative value positioning in equities and foreign exchange became somewhat more defensive, in line with our belief that there will be some unease in markets along the way to an eventual deal. We are prepared to be nimble to take advantage of opportunities that arise across asset classes if debt ceiling headlines drive market dislocations in the days to come..

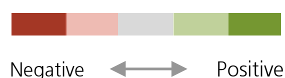
Asset class attractiveness (ACA)

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness as of 28 May 2023. 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 May 23, 2023. Views are 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, the risk-reward proposition for global equities at an index level is not particularly attractive, but is becoming more positive. Stocks remain expensive, but we believe earnings estimates will remain resilient as tight labor markets support consumer spending while profit margins remain relatively elevated. – Importantly, US stocks still account for nearly 60% of global equities, and are particularly richly valued. – Risks to global activity are higher following banking stress in March and the possibility of a disorderly failure to raise the US debt ceiling, and the distribution of possible outcomes has widened. – Our relative value sector positioning has become somewhat more defensive, as we anticipate some market angst over whether or not Congress will raise the debt ceiling in a timely manner.
US Equities		– US stocks have been relatively expensive for a long time, and would likely underperform more cyclical ex-US equities if global activity proves to be more resilient than consensus anticipates, which is our base case. – Earnings estimates for S&P 500 companies are being revised higher once again, and the lower US dollar should help boost profits for multinational corporations.
Ex-US Developed market Equities		– Non-US developed market equities are attractively valued but also highly cyclical. There is a lot of variation between DM equity markets based on differing domestic policy stances and degrees of vulnerability to external headwinds. – Widespread improvements in shareholder return programs have increased the appeal of Japanese equities. However, we have high conviction that the yen will appreciate, which somewhat diminishes the attractiveness of Japanese stocks in local currency terms. – Many forward looking indicators for European equities continue to improve. However, the ECB is committed to bringing policy rates well into restrictive territory, which should limit how much valuations can improve or how strongly Europe's economy can rebound.
Emerging Markets (EM) Equities (ex-China)		– While China's reopening is primarily a story of recovering domestic consumption, we believe it will still produce positive, but measured, spillovers for its trading partners as well as mobility-sensitive commodities. – Broadly speaking, EM equities have both de-rated and have seen a larger total drawdown in earnings estimates than DM equities. This limits the scope for relative underperformance versus global equities going forward, in our view.
China Equities		– Chinese policy has moved in a pro-growth direction with the abandonment of zero-COVID-19 measures, more support for the property sector, and the end of the regulatory campaign against internet platform companies. These shifts bolster our conviction that economic activity and earnings will improve from 2022 to 2023. – However, additional policy support for industrial activity and the housing market may be needed to sustain China's growth momentum, which has recently flagged. – We are closely monitoring geopolitical tensions between the US and China, particularly related to the latter's relationship with Russia, as these carry left-tail risks to both operating performance and valuations.
Global Duration		– Long-term bond yields should be volatile and rangebound as robust labor market data and resilient economies square up against the fact that central bank tightening cycles are well advanced and economic activity is poised to decelerate amid tightening access to credit. – Central banks' commitment to keeping policy in restrictive territory and reluctance to reverse course amid above-target inflation should keep yield curves relatively flat until a contraction in economic activity is at hand.



Asset Class	Overall/ relative signal	UBS Asset Management's viewpoint
US Bonds		– US Treasuries remain the world's preeminent safe haven asset. The Federal Reserve has essentially reached a sufficiently restrictive policy stance, and plans to keep policy quite tight until services sector inflation, which is linked to the labor market, decelerates meaningfully. – Stress in the financial sector means we have probably seen the peak in terminal rate expectations for this cycle. The enduring strength of the domestic jobs market is the critical US-centric upside risk to yields. The lack of softening across many labor market metrics despite aggressive tightening may keep the Fed on track to keep interest rates higher for longer, or possibly deliver additional tightening in the months ahead.
Ex-US Developed-market Bonds		– The European Central Bank is drawing a distinction between tools it can use to bring inflation lower (rate hikes) versus other tools that can be employed to safeguard the financial system, if necessary. Elevated inflation, robust wage growth, and improving sentiment and activity data support the case for the monetary tightening campaign to continue in June. – The Bank of England has acknowledged that policy tightening to date is unlikely to meaningfully derail the expansion, and that risks to inflation are to the upside. However, the BOE is still somewhat reluctant to deliver too much more policy tightening despite high wage growth and inflation, which is raising the probability that inflation expectations move structurally higher. – The Bank of Japan's expansion of its yield curve control range is a meaningful step towards a monetary tightening campaign, in our view. We believe the new governor is likely to adjust policy further in light of strong wage growth.
US IG Corporate Debt		– We believe shorter-maturity IG debt is particularly attractive given the flat corporate curve and substantial income opportunity. This is consistent with our view that while risks to growth have risen, the economy will remain resilient in the near term.
US HY Corporate Debt		– High yield spreads have widened materially from their mid-2021 lows, but not enough to compensate for increased recession risks following this episode of banking sector stress. The end of the Fed tightening cycle, which appears to be within view, is typically negative for spreads.
Emerging Markets Debt US dollar Local currency		– We have a positive view on emerging market dollar-denominated bonds due to the carry opportunity, falling interest rate volatility, and low default rates. – A more positive carry backdrop for EM local bonds following rate hikes delivered well before developed-market central banks has increased the resilience of this asset class even in the face of aggressive global tightening. – Asian credit is not particularly appealing as valuations are roughly fair and risks related to China's property market are still elevated.
China Sovereign		– Chinese bonds have been moving from a high yielder among major economies to a low yielder, diminishing the attractiveness of government bonds somewhat. – 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.
Currency		– We have transitioned to an environment in which the USD is rangebound to lower, in our view. As the Fed approaches the end of its tightening cycle and China's growth rebounds, the overvalued dollar should depreciate. The main threat to short US dollar positioning is a global recession stemming from banking market stress or a disorderly debt ceiling outcome, neither of which is our base case. The Japanese yen is our most preferred currency given cheap valuations, BoJ tightening, and hedging properties. Some EMFX, like the Mexican peso, are poised to outperform select G10 FX like the Chinese yuan or New Zealand dollar given attractive carry.

Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as of May 23, 2023. Views are 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

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 May 2023. 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.

ubs.com/am-linkedin

© UBS 2023. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.