Macro Monthly

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

UBS Asset Management | Economic insights and asset class attractiveness
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Key macro curves confirm more procyclical strength

Highlights

– Procyclical positioning continues to work across markets. As multi-asset investors, we look across the investable universe for confirmation that the broad macro and market backdrop remains supportive.
– Three market-based curves stand out to us as confirming that there is more room to run: a steepening yield curve, backwardated commodities curve, and overly cautious VIX futures curve support our positioning.
– After a slow start, a steeper 'vaccination curve' indicates progress towards normalization accelerating.
– We continue to watch these curves, along with other economic and market indicators, for evidence that the backdrop is shifting or already priced in. As this happens, we plan to shift positioning accordingly.

Our preferred risk-on, procyclical stance is being well rewarded in financial markets so far this year. Along the way, it's become a more widely shared consensus – and perhaps crowded – view. Complacency does not beget consistent success, and so the popularity of the early-cycle playbook demands that we reevaluate whether these positions are fully valued or can continue to outperform.

As multi-asset investors, we scrutinize the investable universe for signals that confirm or challenge our base case. In examining three important market-based curves and another relating to public health outcomes, we believe that we have found ample evidence to support our risk-on, procyclical bias and optimism on the global economic recovery. We will monitor the evolution of these curves to determine if and when the macroeconomic sands are shifting, and are prepared to adjust our positioning accordingly.

Shot in the arm

After a slow start, global vaccinations are picking up steam. In successfully navigating production, distribution, and administration challenges, inoculation campaigns are laying the foundation for a durable, comprehensive economic reopening and broad-based earnings growth.

This is the cornerstone of the reflation thesis. An acceleration in vaccinations bolsters visibility on the timing of the service sector recovery, and lessens the risk of additional economic scarring tied to prolonged mobility restrictions. In the US, the pace of administering vaccination doses roughly tripled in the second month relative to the first.

Progress on vaccinations also varies widely between different countries, which provides a potential catalyst for relative value trades. The UK, in particular, is a standout among major economies in terms of getting shots in arms. This outperformance informs our

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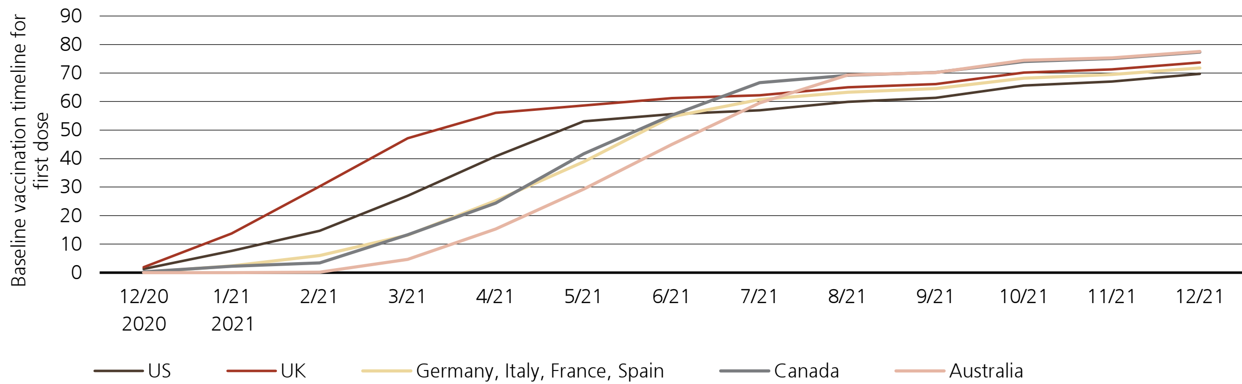
Exhibit 1: Acceleration in vaccinations is laying the foundation for a durable reopening



Source: UBS Asset Management, Goldman Sachs. Data as of 23 February 2021.

constructive view on the British pound and UK equities, among our most preferred in each asset class. We believe that both are relatively undervalued, and should benefit from inflows amid the ebbing of the Brexit uncertainty overhang as well as a more expedient services sector recovery.

We believe this trend steepening of vaccination curves can continue and broaden across advanced economies as production increases and the approvals of additional candidates make doses less scarce. Mutations of the virus are a risk to the outlook, but vaccines appear to be reasonably effective in preventing severe illnesses from these variants. This should alleviate pressure on hospitalizations on a going-forward basis and allow for a loosening of mobility restrictions.

Activity normalizing, central banks aren't

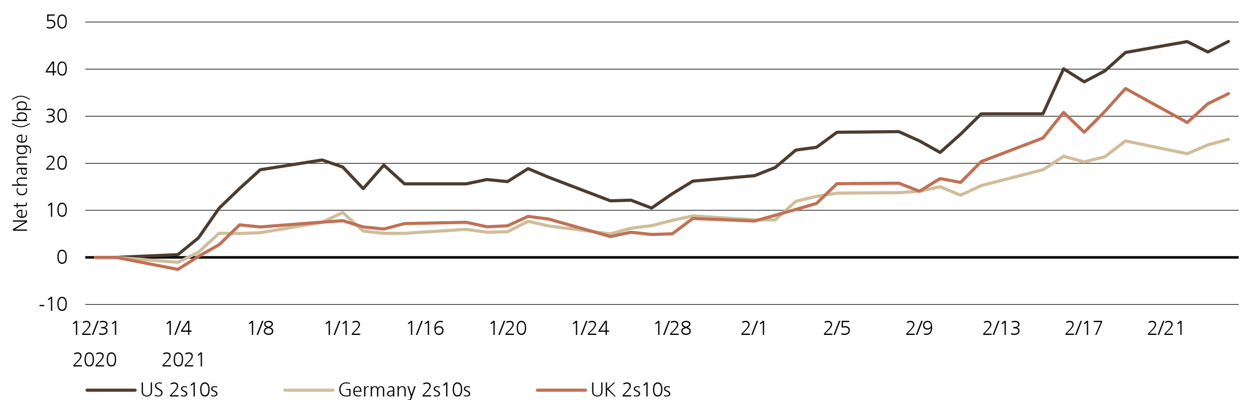
Economic optimism unlocked by the development of effective vaccines and enhanced by the promising outlook for continued US fiscal stimulus is being more fully reflected in global bond markets.

In early 2021, the bond sell-off was most concentrated in US Treasuries, but has more recently become more widely shared across advanced economies. The global backup in yields suggests a common catalyst, which we believe to be an increased conviction in a vigorous synchronized upswing across developed economies in the coming quarters, facilitated by successful vaccination campaigns. That global yield curves are steepening points to an expectation that central banks will remain accommodative for an extended period of time to allow the pandemic-induced economic damage to be repaired. That credit markets are holding up fairly well amid this brisk rise in yields suggests that the bond sell-off is primarily a good-news message about the outlook for activity and inflation.

Fed officials, including Chair Jerome Powell, have yet to push back against the rise in longer-term yields. On the contrary, Powell seemingly welcomed this development as a sign that investors have confidence the US will have a robust, complete recovery. European Central Bank president Christine Lagarde, for her part, has displayed more concern on the potential for this backup in yields to adversely affect the nascent recovery on the continent.

Some of the bond market sell-off in the US relates to pulling forward expectations on Federal Reserve interest rate hikes. An aggressive extension of this trend, and accompanying rise in real yields and US dollar, could serve as a trigger for more disruption in equity markets as well as credit. We have seen some signs of this in the recent performance of high-duration

Exhibit 2: Long term bonds sell off on enhanced conviction in an eventual return to normal



Source: UBS-AM, Bloomberg. Data as of 24 February 2021

growth stocks. Ultimately, we believe the Fed will overpower any overzealousness on the pricing of liftoff that tightens financial conditions or contradicts its forward guidance, as discussed in the February edition of Macro Monthly, *The market will test the Fed. The Fed will win*.

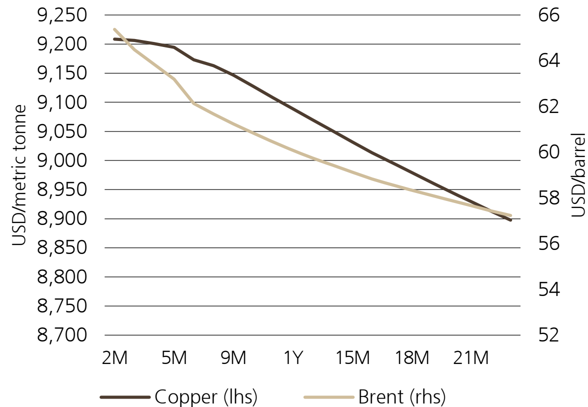
We remain short global duration, expecting further upwards pressure on yields across developed-market sovereign debt. The gap between two- and 10-year Treasury yields should continue to widen, in our view, as the Federal Reserve commits to holding off on rate hikes for the time being while longer-term borrowing costs reflect the discounting of a future in which it will eventually do so after dual mandate goals are achieved. As such, the message sent from the bond market affirms that we are poised to embark upon a period of strong economic growth during which procyclical positions should disproportionately benefit.

Bullish backwardation

Many commodity futures curves, such as crude oil and copper, are in a downward-sloping term structure known as backwardation.

Near-term contracts being priced higher than longer-dated futures is indicative of a market in which demand is outstripping supply. Accordingly, both crude and copper have posted robust gains in 2021. The advance in oil is attributable to both continued supply discipline from OPEC+ and an anticipated resurgence in demand. The crude curve thus reinforces the message from the vaccination curve – mobility will improve, and so too will demand for gasoline and, with a lag, jet fuel. The copper curve suggests that markets share our belief that any pullback in Chinese stimulus will not be abrupt, and that goods sectors will continue to perform well amid a rotation to services-led growth as vaccinations allow for progress towards pre-pandemic norms.

Exhibit 3: Term structure of commodity futures suggests physical market tightening



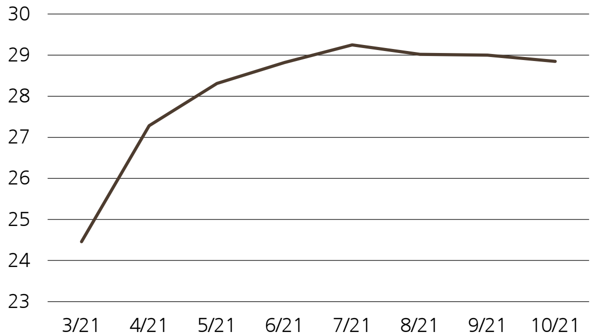
Source: UBS-AM, Bloomberg. Data as of 23 February 2021.

Tightening physical commodity markets are generally positive signals for cyclicals over defensives, emerging market currencies against the dollar, and negative for sovereign bonds. Backwardation also means that long commodity positions can generate positive roll yield over time, which can help increase the attractiveness of commodities as an asset class.

Future fears are your friend

Mix together high hedge fund equity exposure, retail exuberance, expensive valuations, and a near universally positive outlook for economic activity, and investors can reasonably wonder whether the biggest thing to fear about the equity market is the lack of fear itself. However, futures tied to the VIX Index – a gauge of the implied volatility for the S&P 500 Index based on out-of-the-money options prices that's often called Wall Street's "fear gauge" – paint a more nuanced picture on this front.

Exhibit 4: VIX futures curve suggests elevated concern on the outlook for equities



Source: UBS-AM, Bloomberg. Data as of 23 February 2021.

The VIX curve is generally in an upward-sloping structure called contango (the opposite of backwardation) for two reasons: Uncertainty about the outlook increases as a function of time, and US stocks are not typically in the kind of sharp drawdown that would have short-term measures of implied volatility trading above their longer-term counterparts.

At this time, the front of the VIX futures curve is an especially steep contango, ranging from 1 to 2.5 standard deviations above the 10-year mean throughout the first three weeks of February[1]. This suggests the curve is pricing a pronounced pick-up in market volatility in the not-too-distant future. In addition, longer-dated contracts trade at a significant premium to their historical averages. This is in part due to a continued imbalance in volatility markets, where supply continues to be constrained following the intense 2020 bear market.

This term structure sends a strong signal that complacency does not reign in US equities. We do not believe this persistent medium-term skittishness is warranted given the

[1] Based on 10Y weekly VIX front versus second month futures spread, 2011 through Feb 28, 2021.

fundamentals. Elevated levels of market volatility are unlikely to prevail for an extended period if our anticipated backdrop of a broad acceleration in economic activity and colossal earnings growth comes to pass. A compression in this fear premium could provide an additional tailwind for stocks in the months ahead.

Conclusion

Vaccinations are the necessary prerequisite for a sustainable economic recovery. The commodities rally, and shape of those futures curves, point to the substantial rebound in demand and expectations for more to come. The steepening of yield curves speaks to the combined monetary-fiscal support that is underwriting the nascent expansion until it reaches a much more mature phase. And the term structure of VIX futures suggest additional risk premium lingers in equity markets which could dissipate over time and buoy equities in the process.

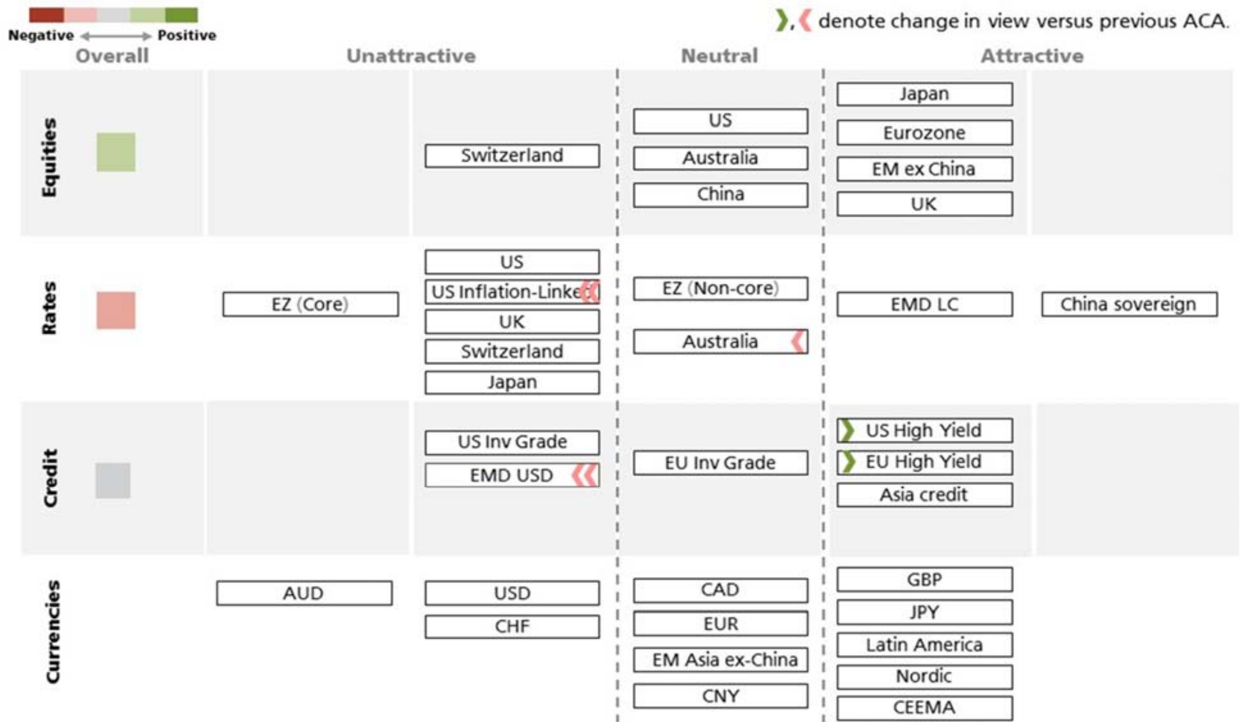
These key macro curves are all pointing in the right direction. While these fortify our stance that there is more upside in global equities, we are even more enthusiastic about the relative value positions beneath the surface in stocks. For procyclical trades that are performing well lately – value stocks vs. growth, US equal weight relative to market cap indexes, and international equities vs. the US – there is considerably more room to run.

But we are cognizant that this bright, early-cycle backdrop will not persist in perpetuity. We will closely monitor shifts in these curves, along with other economic and market indicators, to judge whether the macroeconomic environment is changing or the procyclical rebound is fully priced into different asset classes.

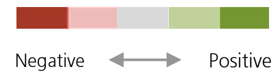
At present, the widespread cross-asset corroboration for our constructive stance on global equities and negative view on sovereign bonds bolsters our confidence in sticking with what is working.

Asset class attractiveness (ACA)

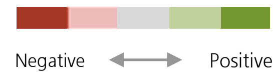
The chart below shows the views of our Asset Allocation team on overall asset class attractiveness, as well as the relative attractiveness within equities, fixed income and currencies, as of 25 February 2021.



Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as at 25 February 2021. 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 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 this year on the back of additional global fiscal stimulus, still accommodative financial conditions, and progress on the broad administration of effective COVID-19 vaccines. We believe there is even more upside to the strong earnings growth expected in 2021. – The global economic recovery to date has been stronger than expected, which we believe is not fully reflected in the performance of more economically-sensitive segments of the equity market. Given the magnitude of the equity rally in recent months, we see more upside in relative value opportunities that offer attractively priced exposure to the turn in global growth compared to beta exposures.
US Equities		– US equities continue to command premium valuations. The sectoral composition drives this dynamic, with a higher weighting towards non-cyclical defensive technology than other bourses. This characteristic may not prove a boon in the event that investors aim to boost cyclical exposure. Accordingly, we prefer US equal weight to market cap indexes. – Nonetheless, continued strong earnings, robust balance sheets, and unprecedented support from the Federal Reserve should continue to support US equities.
Ex-US Developed market Equities		– Non-US developed market equities are attractively valued and have significant exposure to the global economic recovery. – Negative COVID19 developments in Europe are well reflected in asset prices. National budget plans point to solid, sustained fiscal support in 2021, with disbursements from the recovery fund also enhancing the outlook for activity on the continent. – Japanese stocks are attractively valued and have improving corporate fundamentals, with the domestic economy buoyed by substantial fiscal stimulus. – The new US administration's policy priorities should remove some of the lingering US protectionism discount embedded in international risk assets and boost the global growth outlook.
Emerging Markets (EM) Equities (ex-China)		– Robust growth in China even as stimulus ebbs, one of our macroeconomic themes, is a positive for the asset class, particularly for countries with the tightest economic and financial linkages. The strong rally in industrial metals is another leading indicator that points to a solid foundation for real activity. – EMs show a less negative trend in earnings expectations, trade at reasonable valuations, and may also benefit from an ebbing of protectionism by the new administration.
China Equities		– China's superior fiscal and monetary capacity to respond to shocks along with its first-in, first-out status on the global pandemic allowed domestic equities to perform well in 2020. – We expect continued gains so long as there is no abrupt withdrawal of accommodation, but with the recovery in a more mature phase we prefer ex-Chinese emerging market equities. – The new US administration will be more predictable in its relations with China, while continuing the process of economic decoupling in areas of strategic importance.
Global Duration		– The long end of sovereign curves is serving as a release valve for any signs of economic optimism as central bank commitments to keep policy rates low remain credible. We expect both increases in real rates and market based measures of inflation compensation to contribute to further increases in yields. – Nonetheless, sovereign fixed income continues to play an important diversifying role in portfolio construction.



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. We expect a continued steepening in the yield curve as the global recovery gains traction, while flexible average inflation targeting increases the potential risk to the long end of the curve over time. Scope for sustained divergence of US yields from their global peers appears to be limited. The Federal Reserve's immense quantitative easing is an important countervailing force against even more dramatic issuance. Tweaks to the central bank's asset purchase program or explicit messaging would likely be deployed to push back against any increase in yields deemed detrimental to the burgeoning recovery or premature pricing of interest rate increases.
Ex-US Developed-market Bonds		– We continue to see developed-market sovereign yields outside the US 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 potential for European fiscal integration and solid commitment to supporting economies during the pandemic 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 if threats to expansions arise serve as material two-sided risks that weigh on total return expectations.
US High Yield Bonds		– We expect carry, rather than spread compression, to drive total returns in HY going forward. The coupons will continue to attract buyers in a low-yield environment. – More attractively valued and has less sensitivity to rising interest rates than IG bonds.
Emerging Markets Debt US dollar Local currency		– Emerging market dollar-denominated bonds are no longer preferred due to stretched positioning, relatively elevated duration, and reduced capacity for domestic stimulus. – Asian credit is enticingly valued and poised to perform well if growth expectations improve or plateau, so long as highly adverse economic outcomes fail to materialize. – From the perspective of USD-based investors, we expect total returns in EM local bonds will be enhanced by exchange rate movement.
Chinese Bonds		– Chinese government bonds have the highest nominal yields among the 10 largest fixed income markets globally and have delivered the highest risk-adjusted returns of this group over the last 5 and 10 years. The nation's sovereign debt has defensive properties that are not shared by most of the emerging-market universe. We believe that cooling domestic economic growth and inclusions to global bond market indices should put downward pressure on yields during the next 3-12 months.
Currency		– We have high conviction that the shrinking US yield premium, global turn in activity, and lessening protectionism risk premia herald a sustained turn in what is a still overvalued US dollar. We expect higher-beta EM currencies will outperform against the dollar on global progress towards a return to pre-pandemic norms. – Expected US economic outperformance amid substantial fiscal stimulus may limit the breadth and magnitude of any downside in the dollar on a more short term, tactical basis.

Source: UBS Asset Management. As of 25 February 2021. 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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