Macro Monthly

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UBS Asset Management | Economic insights and asset class attractiveness
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Positioning for a "slow" slowdown

Highlights

- Despite periods of elevated volatility this year, major asset classes remain within the ranges they have been in for months. Most of the action has been under the surface of major indexes.
- This range-bound price action largely reflects the dichotomy of a more robust economy than most expected, facing off against central banks determined to defeat high inflation.
- US stocks are pricing in a soft landing, while bonds are pricing in too much recession risk, in our view. As the economy remains resilient, we see yields drifting higher and the growth-heavy S&P 500 moving lower in the near term.
- Overall, we broadly favor: international equities relative to the US; a weaker US dollar; and emerging market credit.
- The key risk to our economic outlook is a failure of the US government to raise the debt ceiling by the X-date.

The dust is settling after March's episode of banking stress. Early indications suggest to us the outlook for a continued economic expansion is intact. In fact, the backdrop to begin the second quarter is fairly similar to where we started the year. In our view, in that consensus is too pessimistic in expecting a recession around the corner.

Concerns about the health of the financial sector have not triggered a meaningful, immediate deterioration in economic growth. The robust starting point for nominal activity means that growth has room to slow before we need to worry about an imminent economic contraction.

We remain more optimistic than consensus on the near-term outlook for activity, but acknowledge that the range of outcomes remains wide. The outlook for growth and inflation remains uncertain. Major asset classes reflect this uncertainty, in our view, with stocks, bond yields, and the US dollar stuck within ranges year-to-date.

US stocks are pricing in a soft landing, whereas bond markets are pricing in too much recession risk, in our view. We expect this to be resolved with bond yields moving higher and growth-heavy US stock indexes moving lower from the top of their range.

International equities remain attractive relative to US stocks, as we see the growth impulse moving in favor of China and Europe. We believe this turn in relative growth will also cause the US dollar to weaken over time. A not too hot and not too cold global economy also favors the cheaper areas of credit, specifically emerging market debt and European investment grade (IG). The key risk to our view of economic resilience would be a failure of the US government to raise the debt ceiling this summer.

Headwinds to tailwinds

We believe the economy is in for more of a "slow" slowdown than a sudden stop.

Labor markets in the US and Europe are still tight and continue to support improvements in consumer spending. Composite Purchasing Managers' Indexes for both the US and Europe point to a moderate, solid expansion in aggregative activity. European industrial production is bouncing back as concerns over the supply and cost of energy this past winter have faded.

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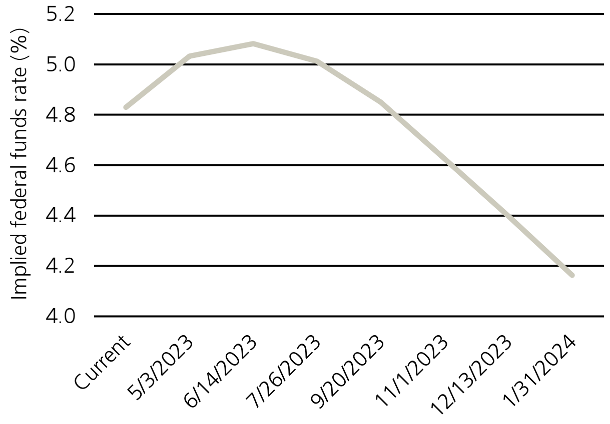
Exhibit 1: Market sees cuts that data doesn't appear to support

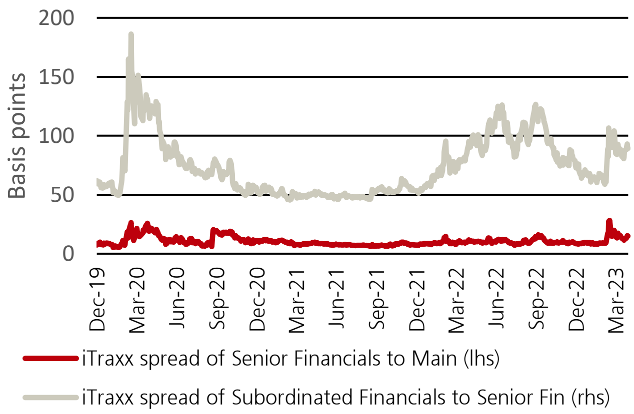


Source: UBS-AM, Bloomberg. Data as of April 27, 2023

Importantly, US real estate looks to be stabilizing, with a solid outlook for construction. In past cycles, housing weakness has been sufficient for a broad-based deterioration in labor market conditions. This cycle, we believe we have already weathered the most severe part of this retrenchment. Given the large structural demand from millennials, recovery in US immigration, and tight inventories, either a different catalyst or substantially higher interest rates are likely needed to bring about labor market pain.

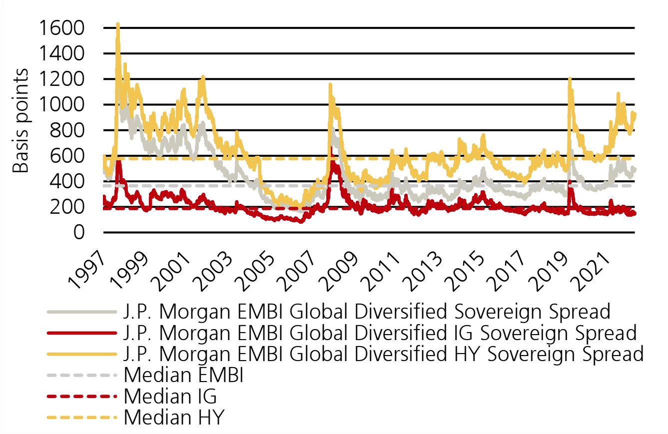
Quarterly reports from US financials also suggest that deposit flight has largely abated or begun to reverse since mid-to-late March, in most cases. This corroborates our view that lingering issues in US regional banks are idiosyncratic and isolated. We simply don't see much evidence that growth is about to fall off a cliff.

Exhibit 2: We see scope for spread compression in European financials as financial concerns fade



Source: UBS-AM, iTraxx, Bloomberg. Data as of April 28, 2023

Exhibit 3: High yield spreads suggest compelling valuation case in EM USD credit



Source: UBS-AM, JPMorgan, Bloomberg. Data as of April 27, 2023

The key risk to this view is if the US government is unable to raise the debt ceiling by the so-called X-date, which will be reached at some point this summer (at the time of writing, there is not much clarity on exact timing). However, the main risk associated with the debt ceiling is not a sovereign default, which would be the basis of a major financial crisis. We believe the risk of a sovereign default is very low, as we are confident the US Treasury would prioritize principal and interest payments on its debt. Such an outcome, however, would still likely entail cuts in spending elsewhere, which could lead to a sharp hit to economic growth, and likely recession. Ironically, Treasuries would likely rally if the US fails to reach a debt ceiling agreement given the expected material hit to growth.

As much as we see upside risk to yields, the lack of a near-term resolution and potential fiscal fallout from debt ceiling negotiations will cap how high US Treasury yields can climb, in our view. This limits some of the downside risk for corporate bonds on an all-in basis. And from a broader market perspective, fiscal policy that contributes to below-trend growth may be part of the solution to the lingering inflation problem.

Opportunity set

2022 was an environment in which major asset classes trended – dollar and yields up, and stocks down. 2023 has been a much choppier environment. This bolsters the relative appeal of credit, as coupons offer some visibility into consistent returns in what has been a directionless market. Corporate bonds may not be the highest-beta option to benefit from economic resilience, but it is an asset class that provides a solid risk-adjusted return in a not too hot and not too cold environment.

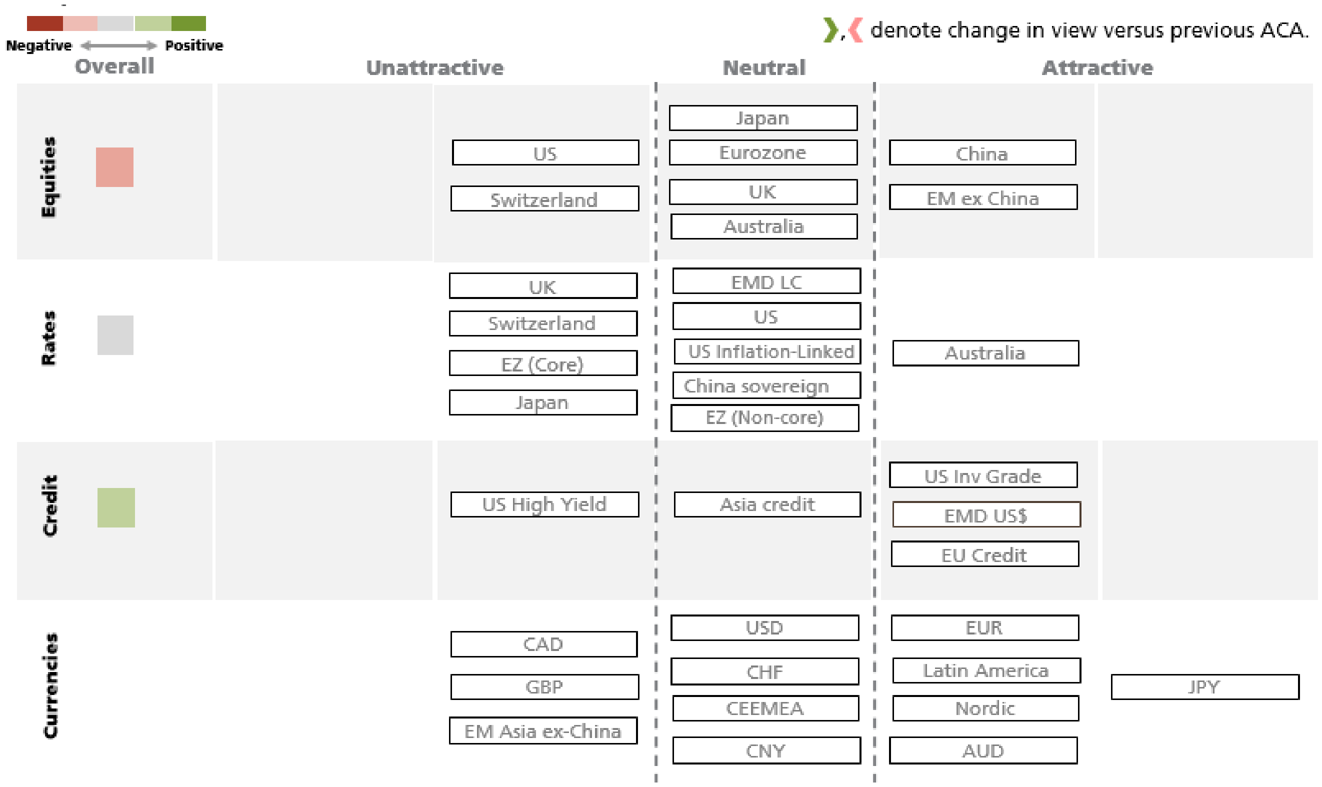
In particular, we prefer European investment grade credit and emerging market dollar denominated bonds. European IG is pricing in excessive economic deceleration even as the macro data in the Eurozone picks up steam. The attractive valuation is driven largely by the widening in the financials sector. Bank stress, in our view, was moderate and short-lived, and spreads have more room to retrace to reflect this reality.

The valuation case is also compelling for emerging market dollar-denominated bonds. Spreads are very elevated on a historical basis, a function of widening in the high yield segment of the market, and in particular the weakest parts of the index. The low-rated portion of the EMBI Global Diversified index is trading at extreme levels with a few countries likely to get IMF support. This should provide positive return asymmetry.

Global equities – particularly US large-caps – are quite expensive, and a deceleration in growth may contribute to downward pressure on future earnings-per-share estimates. However, the market-implied path for the Federal Reserve's policy rate includes much more easing delivered in the second half of 2023 than is consistent with what we believe will be still-strong labor markets and above-target price pressures. As cuts are priced out, this should put upward pressure on US bond yields, which may also cause some de-rating in highly priced US growth stocks. International equities look more attractive to us, as China and Europe show relative economic strength and are cheaper than US markets.

Asset class attractiveness (ACA)

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness as of 28 April 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 April 28, 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

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. Stocks remain expensive, and we believe earnings estimates are biased lower from here as credit conditions tighten. – 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 distribution of possible outcomes has widened. We prefer Chinese equities, which are more sheltered from the risk of a credit slowdown in advanced economies, and benefit from the tailwinds of accommodative monetary and fiscal policy.
US Equities		– US stocks have been relatively expensive for a long time, but this valuation premium was justified by superior profit growth. – US stocks are particularly vulnerable to a de-rating vs. global equities should this catalyst of earnings outperformance shift decisively to underperformance. – US equities are also more acyclical and would likely underperform if global activity proves to be more resilient than consensus anticipates, which is our base case.
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. – We have high conviction that the yen will appreciate, which diminishes the attractiveness of Japanese stocks in local currency terms. Equities are buoyed by strong domestic fiscal support, which may be reinforced by surprising strength in real activity globally if our optimistic economic view comes to pass. – Success in securing natural gas and a mild winter reduced left-tail outcomes for European equities. 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 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 meaningfully from 2022 to 2023. – Traffic and travel metrics suggest a durable, comprehensive opening of China is well underway. Markets have frequently underestimated the strength of a country's economic rebound once mobility restrictions are removed. – 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 should keep yield curves relatively flat until a contraction in economic activity is at hand.

Negative ⟷ Positive

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.
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 additional monetary tightening. – The Bank of England's apparent reluctance to deliver too much more policy tightening despite high wage growth and inflation 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 in our view 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, which is not 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 British pound given attractive carry.

Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as of April 28, 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.

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Americas

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