Macro Quarterly

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

Macroeconomic themes and tactical asset allocation opportunities
4Q2021 I UBS Asset Management

#

Evan Brown
Head of Multi-Asset Strategy
Investment Solutions

Ryan Primmer
Head of Investment Solutions

Luke Kawa
Director
Investment Solutions

Preparing for another round of pent-up demand

Highlights

- In our view, global activity is poised to reaccelerate in Q4 from Q3, and remain well above trend in 2022.
- Supply chain issues that are contributing to slowing growth and higher inflation will get better, not worse, as vaccinations improve public health outcomes.
- Regions such as Europe and Japan continue to have superior earnings trends and are also relative beneficiaries of rising bond yields as global central banks pare back stimulus.
- However, risks to the procyclical trade, chiefly from more persistently elevated inflation as well as China's real estate sector, have risen in prominence.

With the final quarter of 2021 underway, it's important to refocus on the primary determinant of economic activity and financial market performance over the course of the past two years: the pandemic.

Many factors contributed to the downshift in growth during 2021. There has been a natural deceleration as unprecedented stimulus ebbs. The initial phase of pent-up demand has come and gone. And ongoing public health concerns have exacerbated supply shortages while preventing a durable, comprehensive economic reopening.

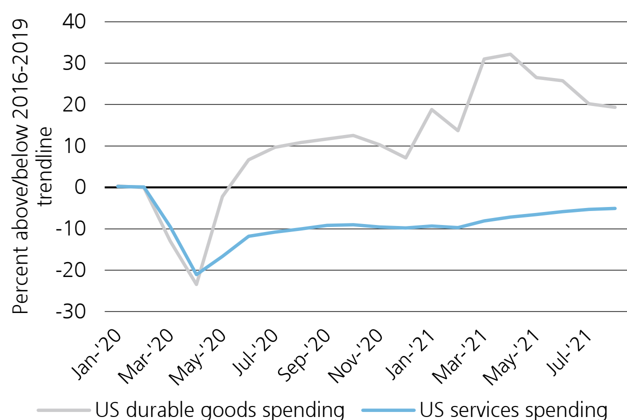
We believe that this final headwind should shift in a persistently positive direction, with material implications for growth and asset market performance. More progress on vaccinations is getting us closer to a broad normalization of activity. This is the future that forward-looking markets should be pricing in, in our view. Our outlook for strong growth is inconsistent with the prevailing narrative that stagflation is on the horizon.

The Delta variant has impeded production and shipping activity, particularly for Asian economies, while also weighing on the service-sector recovery in the developed world. Reduced opportunities for services consumption, in turn, translates to above-trend demand for durable goods, further exacerbating supply constraints. Now, case counts are declining and global vaccinations are moving higher. This allows for the reverse to occur: more production, more labor supply, and more services consumption rather than goods – all of which should prevent supply conditions from worsening.

In our view, these improving public health outcomes mean that the global economy is poised to enjoy a second round of pent-up demand being realized. We expect a reacceleration of activity in Q4 from Q3, with relative performance across financial markets increasingly reflecting the likelihood that 2022 will be another year of above-trend economic activity.

UBS

Exhibit 1: Pandemic-induced shift in spending patterns beginning to normalize



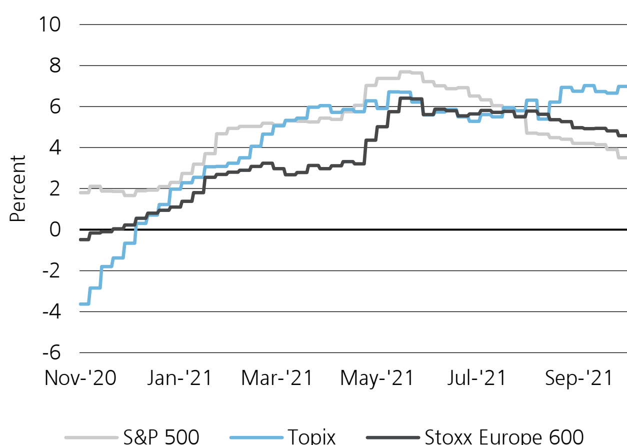
Source: UBS-AM, Bloomberg. Data as of 31 August 2021.

Procyclical positions still preferred

Our positive outlook for global activity informs our preference for procyclical relative value positions – regions like Europe and Japan and sectors like financials and energy. The fundamentals are intact and improving. On a geographic basis, aggregate earnings revisions are stronger in Europe and Japan compared to the US, as is the breadth in profit upgrades vs. downgrades. Valuations, on a relative basis, are also quite compelling to us.

Cyclical assets have performed well since early September even as central banks have grown more hawkish and the outlook for Chinese activity has become more uncertain. When assets, in this case the likes of financials and US equal weight indices (same weighting for each component), fail to react as might be expected to what appears to be bad news, this is often a signal that too much negativity had been priced in.

Exhibit 2: Three-month earnings revisions favor Japan, Europe over US



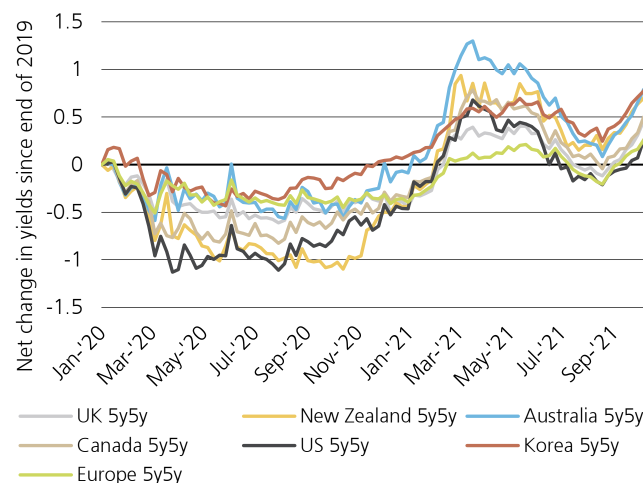
Source: UBS-AM, Bloomberg. Data as of 8 October 2021.

Two of the top three risks for global equities – higher real rates and tax increases in the US – are particular headwinds for US equities. The other risk – continued disappointments on global growth amid uncomfortably high inflation – is why we hedge our favored expressions of non-US developed market equities with a positive view on the US dollar, particularly vs. cyclical Asian currencies.

Some procyclical relative value positions lagged from March to September despite outperforming on earnings. In our view, this is largely attributable to the retracement lower in global bond yields. Therefore, the renewed march higher in rates should allow for a catch-up in which more of this superior growth in earnings is reflected by better relative performance.

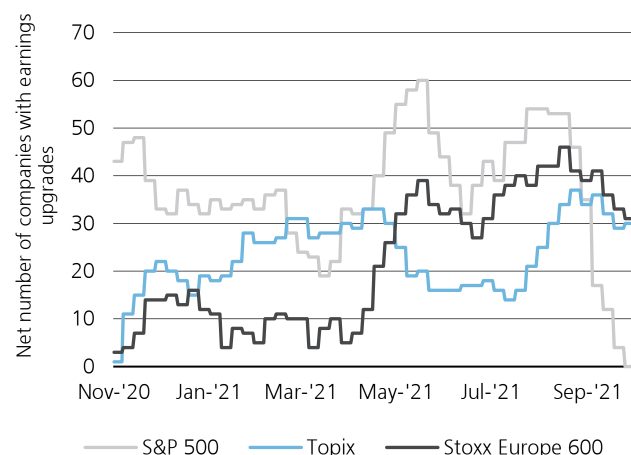
The Federal Reserve will continue to command outsized attention among global central banks, and for good reason.

Exhibit 3: Global cyclical outlook better than before the pandemic



Source: UBS-AM, Bloomberg. Data as of 8 October 2021.

Exhibit 4: EPS revision breadth also favors Europe, Japan



Source: UBS-AM, Bloomberg. Data as of 8 October 2021.

But what is shaping up to be different about this cycle is that US monetary policymakers are not expected to be going alone in withdrawing stimulus, in stark contrast to the 2017-2018 period.

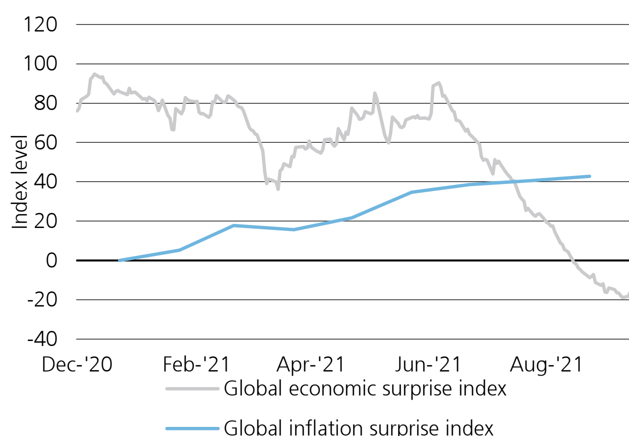
A couple of developed market central banks, like Norway and New Zealand, are already raising rates. And importantly, the expected five-year yield in five years' time for many advanced economies is above where it was prior to the onset of the pandemic. We believe that this is an indication that markets are beginning to tentatively acknowledge the cyclical strength in this expansion will be larger in magnitude and longer-lasting.

Growing risks to the outlook

While we have conviction in our procyclical view, we do acknowledge that the risks surrounding it have risen. The biggest threat is that the current state of affairs persists, contrary to our expectations. A sustained combination of inflation surprising to the upside, growth underwhelming, and stressed supply chains preventing end-demand from being realized would be broadly negative for financial assets – both stocks and bonds. In our view, the Q3 earnings season may mark a peak in the impact of these supply chain concerns on operating performance and guidance.

However, the onset of winter and accompanying heightened risk of COVID-19 spread in the Western world could push back the timing of a comprehensive economic reopening and enhance price pressures. Central banks' patience with inflation could wear thin, with a pivot to more aggressive policy tightening. And even a gradual withdrawal of central bank accommodation would challenge equity valuations, particularly for expensive, growth-oriented segments of the market, and may cap the upside in stocks to the still-strong rate of earnings growth. An appreciation for the wide-ranging ramifications of an extension of this slowing activity, rising inflation backdrop is a key reason why we are running what we believe are judicious levels of risk at the portfolio level and maintain a long US dollar bias.

Exhibit 5: Growth surprises should improve as inflation surprises roll over



Source: UBS-AM, Bloomberg. Data as of 12 October 2021.

China's regulatory campaign and prioritization of the quality and nature of economic growth, rather than the quantity, is a known but difficult to quantify source of downside risk. Markets are conditioned to expect meaningful Chinese policy offsets when the domestic outlook worsened. Investors may be overconfident and wrong-footed in case China's policymakers are willing to endure greater short-term economic pain in the pursuit of long-term goals. A protracted Chinese slowdown, whether linked to a prolonged regulatory crackdown or a severe retrenchment in real estate, would be negative for both domestic risk exposures and have adverse spillovers for global procyclical positions. One mitigating factor to this risk is that China has not been as big of a driver of cyclical upside or commodity demand recently compared to the pre-pandemic early economic expansion, due to a stronger fiscal-led rebound in developed economies.

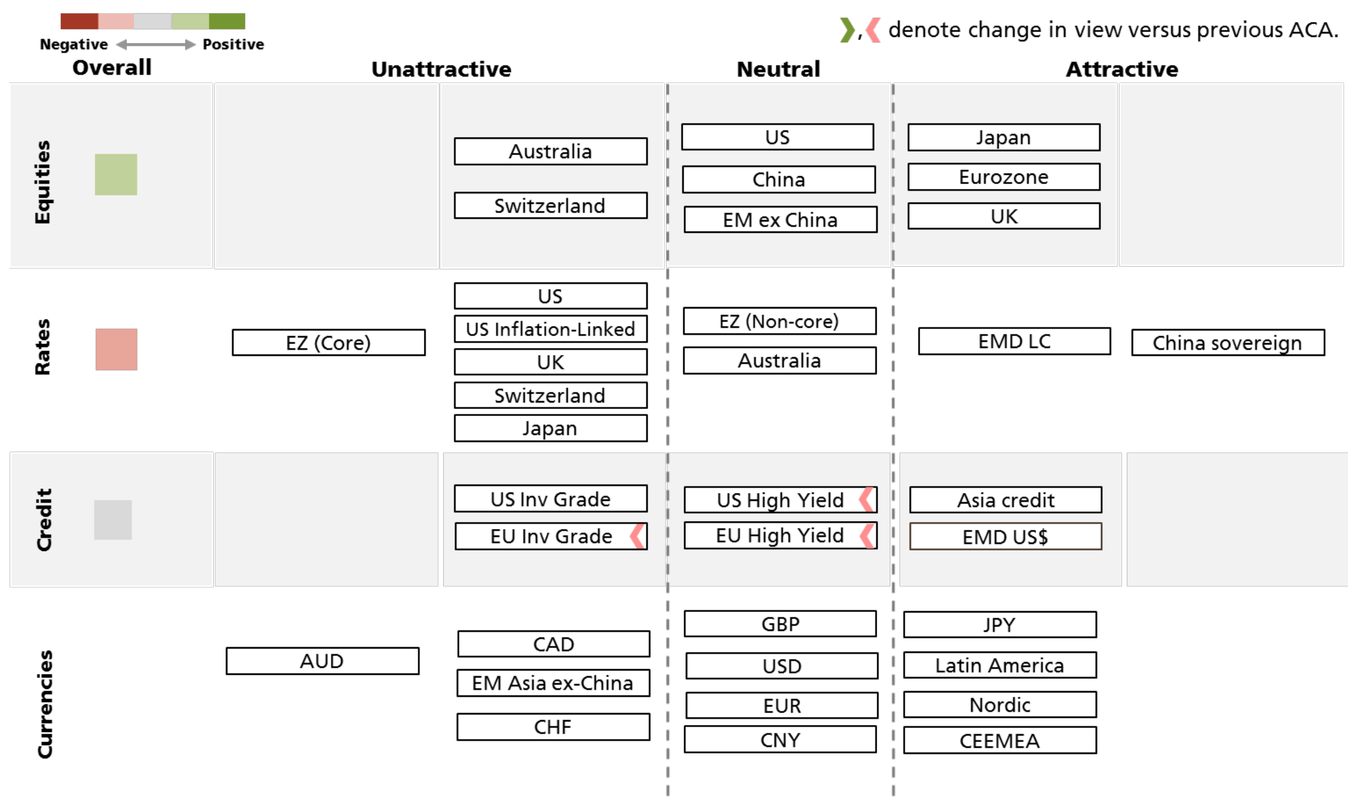
Conclusion

Threats to the outlook – both from monetary tightening and negative side effects from the organization of Chinese economic policy – are introducing downside risks to growth while capping the upside available. But, more importantly, public health outcomes are offering more cause for conviction in the well-being of this nascent expansion. That progress is key to unlocking a healthier nominal growth environment in which both labor and goods shortages dissipate.

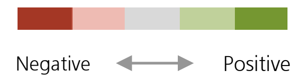
Shifting from a high inflation/slowing growth backdrop to a moderating inflation/robust growth regime should support the outperformance of procyclical positions. We believe that inflation is still likely to remain elevated enough to keep central banks telegraphing the withdrawal of policy accommodation, especially as labor markets continue to heal. This should keep real rates grinding higher while market-based measures of inflation compensation stay relatively lofty, as well. Rising yields, in turn, should prove a boon to cyclical regions like Europe and Japan and sectors like financial and energy. Higher rates may serve as important corroborating evidence as to the likely vigor and duration of the economic expansion – not as a sign of looming stagflation – which should allow the better earnings growth in these areas of the stock market to be more fully reflected in price performance.

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 1 October 2021.

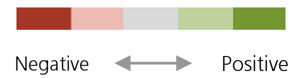


Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as at 1 October 2021. Views, provided on the basis of a 3-12 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change.



Negative ⟷ Positive

Asset Class	Overall signal	UBS Asset Management's viewpoint
Global Equities		– Our outlook for stocks over the next 12 months remains positive. The economic recovery is likely to continue this year on the back of robust global growth, still accommodative financial conditions, and progress on the broad administration of effective COVID-19 vaccines. – Improving earnings expectations are likely to underpin continued gains in global equities despite elevated valuations. The equity risk premium is near the floor of the previous cycle, which may cap upside as policy risks start to become more two-sided and growth momentum peaks. – We see more upside in relative value opportunities that offer attractively priced exposure to re-accelerating activity in developed markets compared to beta exposures.
US Equities		– US equities continue to command premium valuations. The sectoral composition drives this dynamic, with a higher weighting towards acyclical defensive technology than other markets. This characteristic 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. – Continued strong earnings, robust balance sheets, and accommodative policy from the Federal Reserve should continue to support US equities, but fiscal/tax policy risks are becoming more two-sided.
Ex-US Developed market Equities		– Non-US developed market equities are attractively valued and have significant exposure to the global economic recovery. – Earnings growth in Europe and Japan is poised to outstrip that of US, and this superior performance is not well reflected by the relative performance of these regions in 2021. – Both earnings and valuations have more room to run in ex-US developed market equities, and improving vaccine administration should also bolster investor sentiment. – The upcoming Japanese election may serve as a catalyst for investors to increase exposure to the region, which is underweight across global portfolios relative to history.
Emerging Markets (EM) Equities (ex-China)		– A stabilization of growth in China amid measured policy support is a positive for the asset class, particularly for countries with the tightest economic and financial linkages. Resilience in industrial metals continues to point to a strong foundation for real activity. – However, EM equities continue to face near-term challenges that include a negative turn in forward earnings growth relative to DM, renewed strength in the US dollar, and slower administration of vaccines.
China Equities		– Policy actions designed to limit the power of major internet companies may linger as a headwind for this pocket of the market. – The peak in credit tightening has passed, in our view. The upcoming turn in Chinese fiscal support and credit impulse during the fourth quarter should provide support for global cyclical assets. – Concern over China's real estate market and uncertainty on the timing and magnitude in policy support, however, constitute important downside risks to activity and procyclical positions. – We prefer international equities where the recoveries are less mature and earnings revisions are more supportive. – 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		– Long-term bond yields have risen well off their year-to-date lows as major central banks begin to signal the withdrawal of policy support. – Inflation risks remain tilted to the upside and global economic activity is poised to remain robust well into 2022. – We expect increases in real rates in particular, as well as measures of inflation compensation, to contribute to this renewed rise in yields. – Global yields have increased even as macroeconomic risks increased, a sign that there was previously too much pessimism priced in. – Sovereign fixed income continues to play an important diversifying role in portfolio construction, and remains particularly effective in hedging downside in procyclical relative value equity positions.



Asset Class	Overall signal	UBS Asset Management's viewpoint
US Bonds		– US Treasuries remain the world's preeminent safe haven and top source of risk-free yield. The Fed's responsiveness to inflation risks has limited the appeal of curve steepeners, but the curtailment of policy accommodation is conducive to higher yields across the curve. – We expect weakness in US bonds to continue as domestic activity picks up from Q3 to Q4, inflation decelerates but remains well above the central bank's target, and global activity remains firm. – The Federal Reserve is poised to reveal its plan to taper its asset purchasing program at the November meeting, with an eye on ending bond buying by mid-year 2022. The persistence of inflationary pressures into 2022 will determine whether this schedule is accelerated or delayed.
Ex-US Developed-market Bonds		– We continue to see developed-market sovereign yields outside the U.S. as unattractive. The Bank of Japan's domination of the Japanese government debt market and success in yield curve control diminishes the use of the asset class outside of relative value positions. The strong outlook for European growth in 2022 may help continue to compress and looming discussions about reducing the European Central Bank's QE program 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 should threats to the expansion arise serve as material two-sided risks that weigh on total return expectations for this asset class.
US High Yield Bonds		– We expect carry, rather than spread compression, to drive total returns in HY going forward. The coupons available will continue to attract buyers in a low-yield environment. – The asset class is more attractively valued and has less sensitivity to rising interest rates than IG bonds. However, strong relative performance in September as global equities declined makes US high yield less attractive on a tactical basis.
Emerging Markets Debt US dollar Local currency		– We have a positive view on emerging market dollar-denominated bonds due to the balance of carry opportunity and duration risk. – Asian credit is enticingly valued and poised to perform well in environments in which growth expectations improve or plateau, so long as highly adverse economic outcomes fail to materialize. – The more rangebound environment for the US dollar removes one previous tailwind for the outlook for total returns in EM local bonds.
China Sovereign		– Chinese government bonds have the highest nominal yields among the 10 largest fixed income markets globally as well as defensive properties that are not shared by most of the emerging-market universe. We believe 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		– The Federal Reserve's telegraphed tapering, along with the meaningful number of Fed officials who signal rate hikes may be warranted as early as next year, puts a higher floor under the dollar and meaningfully reduces the prospect of a retest of its late-May lows in the near term. – EMFX like RUB and BRL, which are supported by continued monetary tightening, are well-positioned to outperform even in a rangebound to upwards USD environment, while cyclical Asian currencies and select G10 commodity exporters are poised to struggle.

Source: UBS Asset Management. As of 1 October 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.

A comprehensive solutions provider
UBS Asset Management Investment Solutions manages USD 167.9 billion (as of 30 June 2021). 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 as of October 2021. 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 2021. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.
AMT-865 10/21
www.ubs.com/am