Macro Quarterly

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

Macroeconomic themes and tactical asset allocation opportunities
2Q2022 I UBS Asset Management

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The yield curve: more noise than signal

Highlights

- We believe that the spread between two- and 10-year Treasury bond yields is not a very effective tool for near-term economic forecasting or tactical asset allocation decisions.
- Though growth is decelerating, economic fundamentals remain robust, and recession risk is low, in our view.
- We have closed our short position on government bonds following the sharp rise in yields linked to aggressive tightening from the Federal Reserve.
- On global equities, we are neutral at the index level and favor cyclicals that are overly discounting recession risk or have structural upside, as well as higher-quality and defensive pockets of the market where profit growth should remain resilient.

We believe the inversion of short- and long-term Treasury yields tells us nothing new about the economic outlook and is only of modest utility for tactical investment decisions.

Should the two-year Treasury yield stay above its 10-year counterpart in the coming weeks, as forward rates imply, this does not indicate anything to us beyond what the Federal Reserve has already communicated to markets: The policy rate is poised to be taken swiftly to a neutral setting, and a bit beyond that, over the coming two years. If the policy rate is in restrictive territory, it's very reasonable to expect interest rates to come down over the medium term. But that medium term can be far longer than the 3 to 12 month time horizon for more tactical asset allocation opportunities.

And while rate cuts are often associated with an economic downturn, this is not always the case. As recently as 2019 – and before in 1995, 1984, as well as in the 1960s – a Federal Reserve pivot from increasing to lowering rates helped prevent an economic deceleration from becoming an outright downturn. Furthermore, yield curve inversions have not served as good "sell signals" for stocks and credit in the past. The previous expansion ended due to the exogenous COVID-19 shock – not any economic malaise foretold by the yield curve. Historically, the better time to reduce risk has been when the Federal Reserve is poised to reduce interest rates but, unlike the 2019 episode, is unable to pull off a soft landing.

We often remark that investors must be forward-looking. But when it comes to divining any signals sent by the yield curve, we must also be careful not to be too forward-looking. One day, the US expansion will end. But right now, economic fundamentals – chiefly the labor market, new orders received by manufacturers, and earnings growth – remain robust. This resilience even in the face of headwinds like energy market turbulence in the wake of war and China's COVID-19 flare-up suggest the inflationary boom in the US is not ending any time soon.

Exhibit 1: Forward returns for global equities after five most recent Treasury 2s/10s inversions (Dates indicate first inversion during a Fed tightening cycle.)

Date	Three-month forward returns	12-month forward returns
8/22/2019	7.3%	10.8%
12/27/2005	5.9%	18%
2/3/2000	-0.7	-11.7%
3/24/1998	-1.8%	8.7%
12/14/1988	2.4%	13.2%
Median	2.4%	10.8%
Average	2.6%	7.8%

Source: UBS-AM, Bloomberg. Data as of 29 March 2022.

In our view, the current backdrop warrants a more balanced approach to asset allocation and a focus on relative value within asset classes rather than large tilts on bonds vs. stocks. The surge in long-term global bond yields, driven by changing expectations around US monetary policy, has provided an attractive tactical window to close our short bet against government bonds and neutralize our positioning in duration relative to equities. In risk assets, we are focused on diversifying exposures between what we see as inexpensive pockets of the market with structural upside, cyclicals which embed too much pessimism on the growth outlook, and higher-quality as well as defensive sectors that should benefit if perceived recession risk rises.

Long end, low signal

There are many reasons to believe that longer-term bonds, on a standalone basis, don't provide much information about the short-term environment. Liability-driven, price-insensitive buyers can dilute any economic signal coming from this part of the bond market. Even if inflation continues to surprise to the upside, which is not our base case, we do not anticipate that market participants will price in a sustained stagflationary environment that includes much higher longer-term yields. It is more likely that traders instead price in even more front-loaded monetary tightening that would weigh on price pressures and economic activity, effectively capping the downside in long-term debt.

In our view, after the year-to-date sell-off, government bonds are now in a position to benefit if the market's assessment of near-term Federal Reserve tightening goes up or down. If fewer hikes are priced should inflation begin to decelerate, there is scope for lower yields across the curve. But if traders expect even more front-loaded Fed action to bring the policy rate above neutral, they will also likely ascribe higher odds to an easing of monetary policy and a potential economic downturn thereafter. This is because such a large magnitude of tightening in a short period of time would be expected to weigh on inflation and activity, with a lag.

It is possible for neutral rate expectations and long-term yields to durably rise from here. But for that, investors will likely need to see evidence that activity is holding up well following aggressive Fed tightening and also, perhaps, that the European Central Bank is able to exit negative interest rates even in the face of material risks to growth linked to Russia's invasion of Ukraine.

We do not anticipate that the Federal Reserve's quantitative tightening campaign will be a meaningful catalyst for fixed income. The net impact on duration in the market is likely to be limited as the Treasury is poised to issue bills, rather than longer-term debt, to replace maturing securities owned by the central bank. Asset sales from the Federal Reserve could cause more market turbulence, but this is not our base case.

Thinking short term

There are three different scenarios that follow from an inverted yield curve:

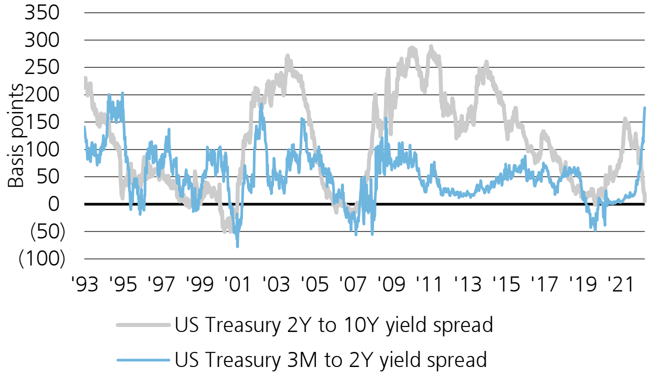
– The central bank overtightens and is slow to pivot; recession ensues (positive for government bonds, negative for equities/credit).
– Monetary policymakers remove stimulus before reversing course in order to avoid an economic downturn (positive for equities and duration).
– The economy proves it can handle meaningfully higher interest rates without much deterioration in activity; neutral rates are higher (positive for equities, negative for duration).

Rather than the 2s/10s curve, we believe that looking at short-term yield spreads (such as the three-month Treasury bill vs. the two-year note) is the most appropriate way to determine whether or not the US economy is in imminent need of monetary support. If this is inverted, investors can make a judgement as to whether central banks will successfully adjust course and keep the expansion on track or not, and position accordingly.

The three-month, two-year Treasury spread is historically elevated at present, implying the US central bank will be able to carry out many rate increases. And yet, this hiking cycle is

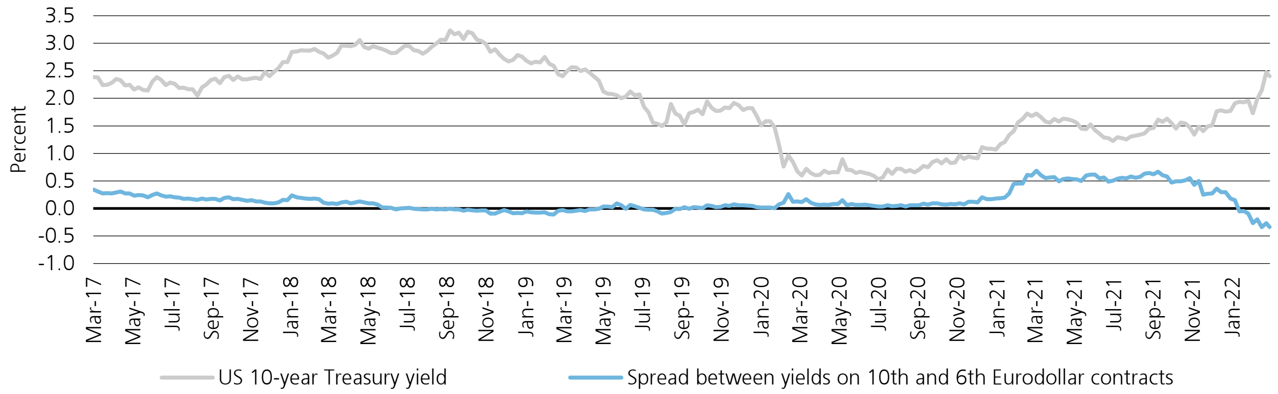
Exhibit 2: A tale of two curves

Three-month vs. two-year curve is a more reliable signal for the economy than 2s/10s



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

Exhibit 3: Outlook for long-term yields more balanced
Fed rate cuts also priced in after mid-2023 based on Eurodollars, a proxy for US policy rate expectations



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

also expected to be short-lived: the two-year portion of the curve also includes a period in which market participants expect the Fed to be reversing some of this tightening.

Beyond tactically adding back some duration, we believe that it is not prudent to adjust positioning too much today based on the potential for interest rate cuts starting in mid-2023. Those cuts might be sufficient to stabilize economic activity – or they may not even be needed if growth remains near-trend despite the monetary tightening delivered by that time.

Asset allocation

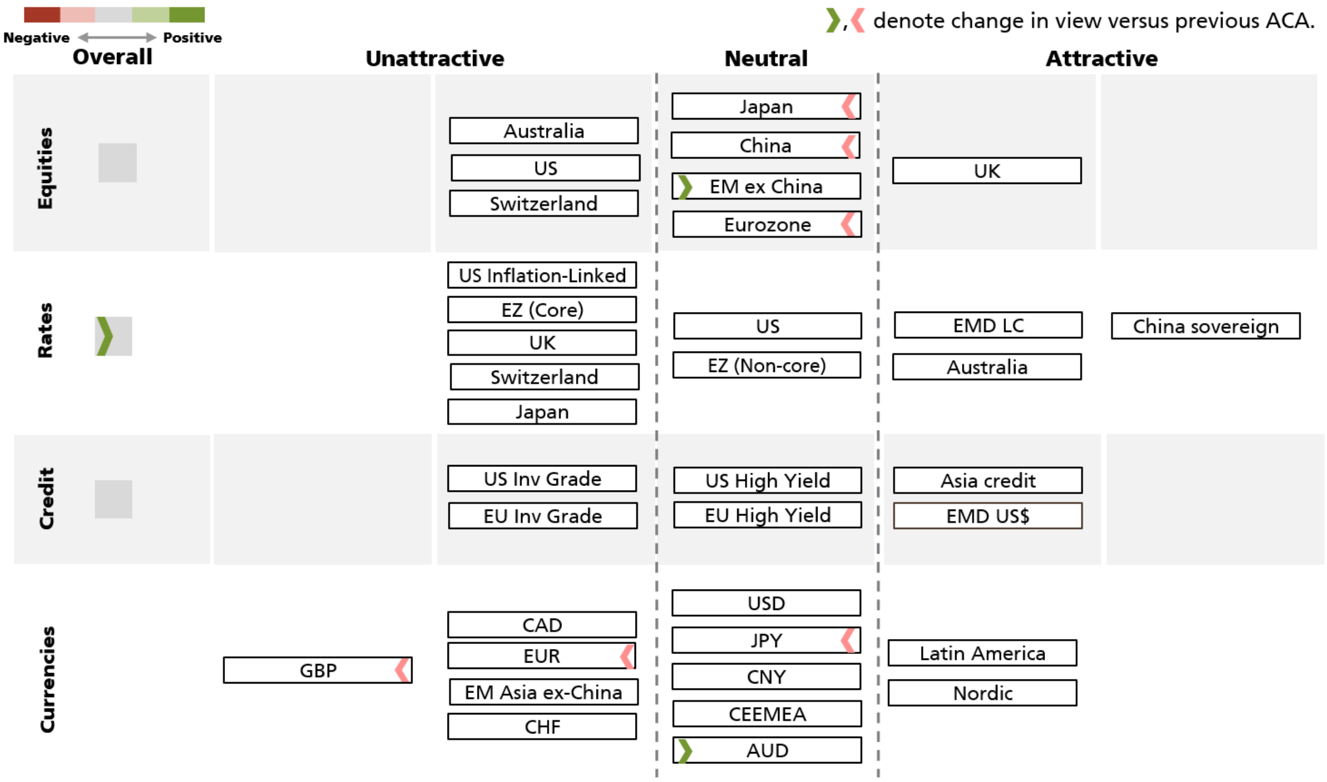
The expansion remains intact, but growth is slowing, while inflation remains uncomfortably high – and not slowing as fast as central bankers anticipated. As investors balance the prospect of increased Fed tightening now to bring price pressures down with a higher probability of easing later as risks to activity rise, this creates a more symmetric risk-reward profile for government bonds in our view.

We have a neutral stance on global equities at the index level, and view stocks as closer to the upper end of their range based on expected earnings and bond yields. The equity risk premium is near the floor of this cycle. So long as the repercussions of Russia's invasion could imperil the European expansion and inflation is a threat to the US expansion, it would be imprudent to expect higher valuations to drive equity appreciation.

The economic and market backdrop is far too complex to rely on a one-size-fits-all indicator like the spread between two- and 10-year yields as a guide to investment decisions. But an environment in which perceived recession risks are no longer trivial does prompt us to keep our risk exposures well-diversified and better focus on our procyclical positions. Energy and commodities remain an attractively valued segment of the market buoyed by themes, like changing supply discipline from oil producers and the green transition, that will have staying power, in our view. We believe European banks are overly discounting the extent to which activity will slow. And companies with a high loading to the quality factor or more defensive characteristics should continue to post strong operating results relative to the broader market if the deceleration in economic activity is more abrupt than we anticipate.

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 March 30, 2022.



Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as of March 30, 2022. Views, provided on the basis of a 3-12 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change.

Negative ⟷ Positive

Asset Class	Overall signal	UBS Asset Management's viewpoint
Global Equities		– Our outlook for stocks over the next 12 months is neutral. We prefer relative value opportunities that have strong structural upside, undervalued cyclicals that have priced in too much of a growth deceleration, and higher-quality and defensive segments that we expect to continue to post robust profit growth if activity moderates but remains above-trend. – At the index level, beta exposures may face persistent valuation pressures from the combination of central bank tightening and geopolitical risks. We believe global stocks are closer to the top than the bottom of their near-term range. – The economic recovery is likely to continue in 2022 on the back of strong starting points for consumer and business balance sheets, still accommodative financial conditions, and improving public health outcomes. These should underpin strong earnings growth.
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 drag on relative performance in the event that expectations for the Federal Reserve's terminal policy rate this cycle increase further or geopolitical risks recede. Accordingly, we prefer US equal weight to market cap indexes. – The skew of fiscal and monetary policy risks has turned more negative for US equities, though we expect earnings growth to still hold up well and balance sheets to remain strong.
Ex-US Developed Market Equities		– Non-US developed market equities are attractively valued. Earnings revisions in Europe continue to be stronger than the US, while the pace of Japanese earnings revisions has converged with that of the S&P 500. – However, Japanese stocks lack catalysts that would help shrink this valuation gap, and European equities may be particularly vulnerable as Russia continues to wage war against Ukraine. Some downside risks are already partially priced in. – Ex-US developed market equities are highly cyclical, and tend to underperform in an environment in which manufacturing purchasing managers' indexes are decelerating.
Emerging Markets (EM) Equities (ex-China)		– A stabilization of growth in China amid measured policy support is a tailwind, particularly for countries with the tightest economic and financial linkages. Resilience in industrial metals continues to point to a strong foundation for real activity. – EM equities have held up impressively well in the face of challenges early in 2022 that include less impressive earnings revisions and higher mobility restrictions relative to DM, rising long-term real rates, and US dollar strength versus DM FX.
China Equities		– There is sufficient evidence that the Chinese policy stance has turned, both on the monetary and fiscal sides. The Peoples Bank of China (PBOC) has cut rates, the peak in credit tightening has passed, in our view, and officials are stressing an urgency in providing fiscal support. – A fresh wave of the pandemic and ensuing mobility restrictions are likely to restrain economic activity in the near term, particularly in services sectors. – From a seasonality perspective, Chinese equities have tended to outperform ahead of the China Party Congress. The relative valuation of Chinese internet companies compared to their US peers suggests too much embedded pessimism about their longer-term earnings prospects, though the regulatory overhang may constrain the potential upside. – Concern over China's real estate market constitutes an important downside risk to activity and procyclical positions.
Global Duration		– The risks to long-term bond yields are well-balanced after traders have priced in aggressive central bank tightening over the coming year. – We expect real rates to rise as inflation peaks and the Federal Reserve tightens policy even more in the coming months, but for this to be offset by decreases in market-based measures of inflation compensation. – Sovereign fixed income continues to play an important diversifying role in portfolio construction, and remains particularly effective in hedging downside in procyclical positions.

Negative ⟷ Positive

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 Federal Reserve is poised to take rates to a neutral setting as quickly as possible without jeopardizing the expansion, and then move to restrictive territory in order to quell inflationary pressures. Quantitative tightening is not a very potent catalyst for fixed income, in our view. Market pricing for the Federal Reserve's terminal rate this cycle has adjusted meaningfully to the upside, and parts of the yield curve already imply interest rate cuts by 2024. Additional front-loaded tightening is more likely to contribute to deeper inversions between short- and longer-dated Treasuries than it is to higher long-term yields. The Fed has also set a high bar for inflation to surprise to the upside this year, leaving room for rates to come down across the curve by pricing out some of the expected hikes in 2022.
Ex-US Developed-Market Bonds		– We continue to see developed-market sovereign yields outside the US as unattractive. The European Central Bank accelerated its timetable for tapering even in the face of downside risks to growth tied to Russia's invasion. If these large threats to the expansion do not materialize, the central bank is highly likely to exit negative interest rate policy within the next 12 months. – The Bank of Japan's domination of the Japanese government debt market and continuation of yield curve control diminishes the use of much of the asset class outside of relative value positions.
US Investment Grade (IG) Corporate Debt		– Spreads are at relatively tight levels amid continued policy support and minimal near-term recession risk. 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 has weighed on total returns, and the potential for spread widening should the Fed's tightening cycle call the longevity of the expansion into question serves as another downside risk 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.
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. – A more positive carry backdrop for EM local bonds following rate hikes delivered over the course of 2021 has increased the resilience of this asset class even as aggressive Fed tightening gets priced in.
China Sovereign		– 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 the combination of monetary easing, stabilizing domestic activity, and continued strong foreign inflows should prevent any sustained upward pressure on yields during the next 3-12 months.
Currency		– Elevated geopolitical tensions may contribute to a higher floor for the US dollar in the near term. The country is also likely to be less negatively affected economically by the Russian invasion, particularly compared to Europe. However, real growth differentials relative to many other developed market economies are poised to shrink in 2022, and the Federal Reserve is not the only DM central bank hiking rates. – We believe some EMFX, like COP and BRL, are well-positioned to outperform cyclical Asian currencies and select G10 commodity exporters given attractive carry.

Source: UBS Asset Management. As of March 30, 2022. Views, provided on the basis of a 3-12 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change.

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