Macro Monthly

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UBS Asset Management | Economic insights and asset class attractiveness

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Evan Brown
Head of Multi-Asset Strategy
Investment Solutions

Luke Kawa
Director
Investment Solutions

Flash update—Stock valuations have softened, fundamentals haven't

Coming into 2022, we expected that equities would be faced with a tug-of-war between the headwind of multiple compression and the tailwind of strong earnings growth. In January, the derating of stocks has been front-loaded to a large degree as yields, in particular real rates, surged. Yet there is little cause to think the positive profits or economic growth story has deteriorated. In our view, what has transpired so far in 2022 is not a reason to cut risk or transition away from our preferred procyclical relative value equity positions.

The price action has been resoundingly negative in 2022. The underlying backdrop is not. Measures of factory activity have surprised to the upside even amid the rapid spread of the Omicron variant. There is meaningful evidence that China is easing monetary and fiscal policy to stabilize economic activity. Valuations in Europe and Japan are now cheaper than they were before the pandemic. And indicators of investor gloom – like surveys of sentiment and equity put/call ratios – have reached levels at which they provide a powerful contrarian signal and suggest a recovery is in the offing. Global risk assets have become less expensive in January – not worse.

This is not a growth scare

This is a valuation-centric sell-off, not a signal that investors are pricing in a prolonged slide in global growth. 10-year US inflation adjusted yields have risen more than 50 basis points since the start of the year. A move that big, that fast typically causes discomfort for risk assets.

On a regional basis, the S&P 500 and Nasdaq 100 indexes have suffered worse declines than European, UK, and Japanese stocks. We have preferred ex-US developed market equities in part because they are less expensive than US stocks and less susceptible to multiple compression.

Energy, one of our favored equity sectors, has once again proven its worth as a useful hedge from a portfolio construction standpoint during concurrent declines in stocks and bonds. Importantly, the sector is still very attractive on an outright basis. Geopolitical uncertainty surrounding a potential Russian invasion of Ukraine has buoyed the energy complex. However, we believe that the underlying fundamental arguments of tight supply and rising demand are more than sufficient to support resilience in oil and gains in energy equities in the coming months.

It is still early in the US reporting season. But so far, results have been solid. Earnings/sales surprises, as well as rates of growth and corporate guidance are all running far stronger than their long-term averages. As expected, these are not as hot as they have been over the past year. Revisions to calendar year 2022 earnings have also not come under any pressure at the global level.

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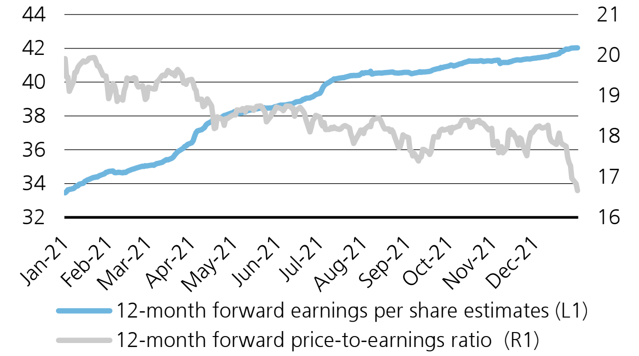
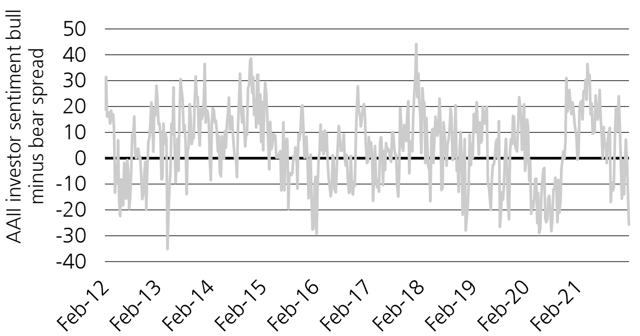
Exhibit 1: Global equities are suffering from a valuation shock, not a growth scare



Source: UBS-AM, Bloomberg. Data as of 21 January 2022.

Exhibit 2: Investor sentiment has deteriorated, which often bodes well for forward returns



Source: UBS-AM, Bloomberg. Data as of 20 January 2022.

In the near term, data is poised to weaken due to the Omicron variant, particularly in the services sector. Markets have known this since late November, and largely elected to look through the upcoming soft patch. The judgement, which we share, is that this slowdown would not be severe or long-lasting enough to undermine what is poised to be another strong year of the expansion. The performance of credit and emerging market equities so far this month implies that investors' faith in the growth outlook has not been materially shaken. Of course, we are cognizant that a further 10% decline in global equities would, by itself, be sufficient to raise alarm about the durability of the expansion.

Fed aggressively priced for 2022

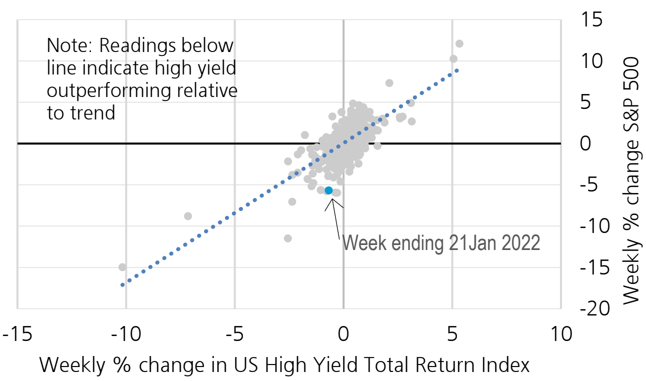
The rise in US real rates linked to Fed balance sheet normalization and expected higher policy rates is the driving force behind the drawdown in risk assets, in our view. Because inflation is stubbornly high, we believe that the Fed will not be quick to pivot despite falling stock prices. This is particularly true given the sell-off has been most painful for highly speculative areas of the market compared to firms most tied to the economic outlook. Our key takeaway from Fed Chair Jerome Powell's press conference is that the central bank has no more tolerance for any additional upside inflation surprises. As such, the market's sensitivity to inflation (CPI, PCE) and inflation-adjacent data (surveys of expectations, wage growth, purchasing managers' prices paid) should be elevated in the weeks to come. This is likely to put a high floor under market volatility, in our view. These inflation data will be significant in determining whether the Federal Reserve elects to signal a much larger withdrawal of monetary stimulus this year. As it stands, there are sizeable two-sided risks to market pricing for 4 to 5 hikes of 25 basis points from the Federal Reserve in 2022. Monetary policymakers want tighter financial conditions as a way of slowing demand growth, and in turn, inflation. Rising rates, widening credit spreads, and the drawdown in stocks have already combined to tighten US financial conditions by an amount consistent with more than two 25-basis point interest rate hikes.

Conclusion

The early year equity turmoil is not prompting us to reduce risk or change preferred styles at this juncture. On the contrary, we have judiciously looked to add risk in some portfolios during this equity downdraft.

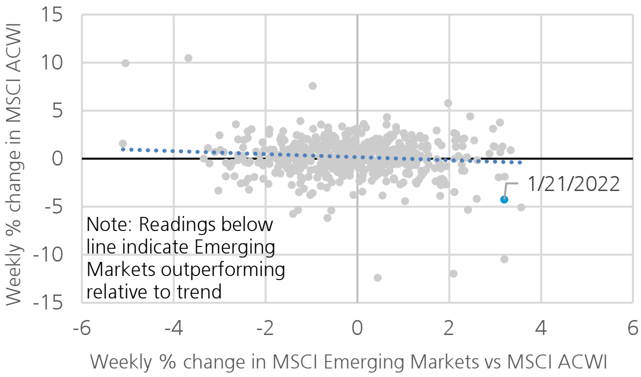
We remain highly confident in our view of above-trend growth for 2022. We also acknowledge a great deal of humility is required when assessing the inflation outlook, which has consistently surprised to the upside. If sustained, elevated price pressures are likely to elicit more aggressive monetary tightening and the continued derating of equities.
It is important to emphasize that the primary risk to stocks at the headline level remains multiple compression, not earnings growth turning to contraction. We are staying positioned accordingly, favoring regions and sectors that will benefit from above-trend activity even as monetary and fiscal stimulus wanes.

Exhibit 3: Credit holding up well despite stress in US equities



Source: UBS-AM, Bloomberg. Data from Feb. 2021 to Jan. 21, 2022.

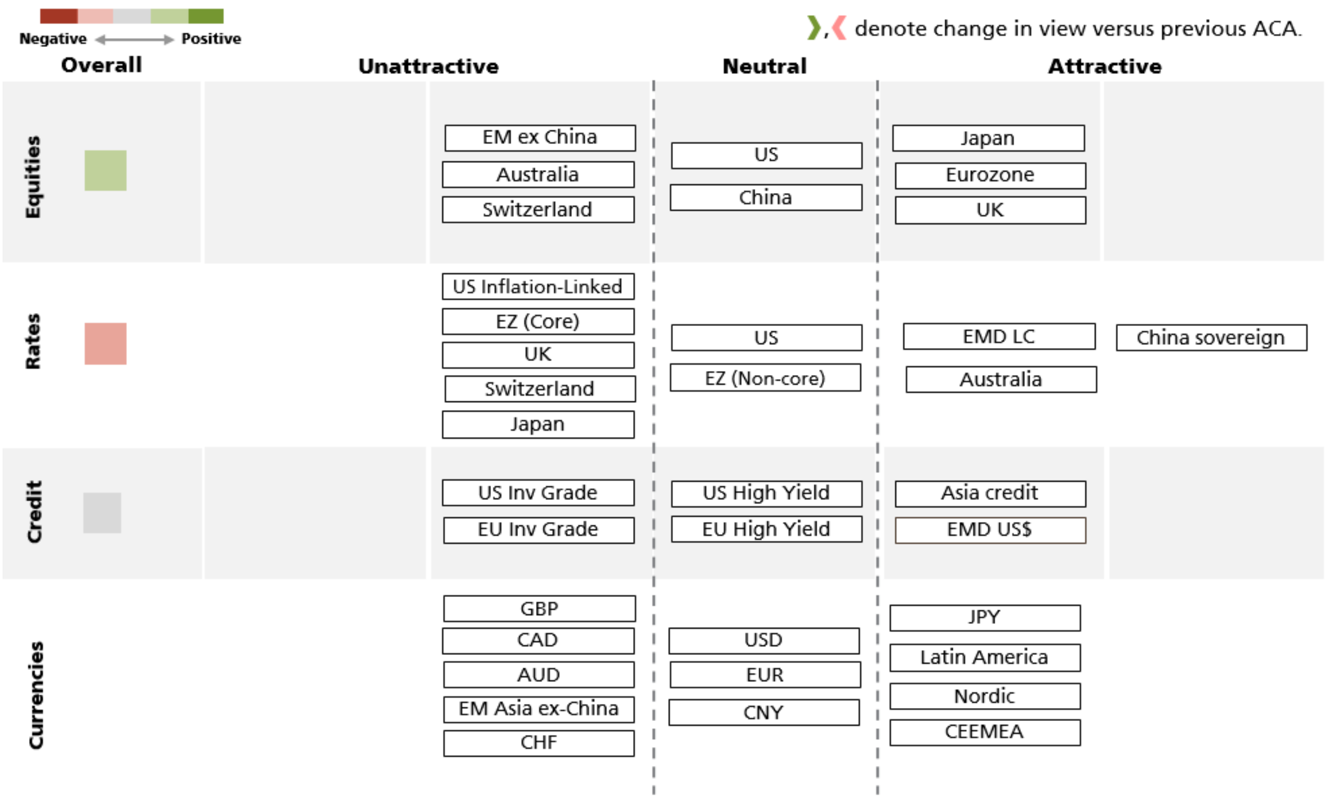
Exhibit 4: Emerging markets holding up well despite stress in global equities



Source: UBS-AM, Bloomberg. Data from Feb. 2021 to Jan. 21, 2022.

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 26 January 2022.



Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as at 26 January 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 remains positive. 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. – A lot of valuation pressure has been front-loaded early in 2022. Improving earnings expectations are likely to underpin continued gains in global equities. The equity risk premium has also edged higher as earnings yields have risen faster than bond yields during the January decline in equities. – We see more upside in relative value opportunities that offer attractively priced exposure to above-trend 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 has been a disadvantage as real rates rise, and may further drag on relative performance in the event that investors aim to boost cyclical exposure. Accordingly, we prefer US equal weight to market cap indexes. – Continued strong earnings and robust balance sheets should continue to support US equities, but the skew of fiscal and monetary policy risks has turned negative.
Ex-US Developed market Equities		– Non-US developed market equities are attractively valued and have significant exposure to the global economic recovery. – Both earnings and valuations have more room to run in ex-US developed market equities. – Earnings revisions in Europe and Japan continue to be stronger than in the US, and this superior performance has not been reflected in the relative performance of these regions. – Historically, rising real rates regimes have typically been particularly positive for Japanese equities.
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 near-term challenges that include less impressive earnings revisions relative to DM, rising real rates, and slower administration of vaccines and boosters.
China Equities		– There is sufficient evidence that the Chinese policy stance has turned, both on the monetary and fiscal sides. The PBOC has cut rates, the peak in credit tightening has passed, in our view, and officials are stressing an urgency in providing fiscal support. – Manufacturing and services PMIs have returned to expansionary territory. – 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. – Concern over China's real estate market constitutes an important downside risk to activity and procyclical positions; some regulatory headwinds may also linger for domestic equities. – We expect 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 are expected to continue trending higher as most global central banks are likely to withdraw monetary stimulus. – Inflation risks remain tilted to the upside and global economic activity is poised to remain robust well into 2022. – We expect real rates to be the key contributor to higher long term yields, even after their recent surge. – Global yields have increased even as risks to activity from Omicron have flared, a sign that central bank policy is a more important driver. – 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.

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 start a tightening cycle in March and has telegraphed that the unwind of its bond purchases will follow soon thereafter, both of which should be conducive to higher yields across the curve. In the near term, however, Fed tightening for 2022 looks to be close to fully priced in. – We expect weakness in US bonds to continue as domestic activity reaccelerates after a brief interruption due to the Omicron variant, inflation remains uncomfortably elevated well above the central bank's target, and global activity remains firm.
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 European Central Bank is likely to have to begin laying out a timetable for rate hikes as inflationary pressures prove more persistent and growth remains strong in 2022.
US Investment Grade (IG) Corporate Debt		– Spreads are at relatively tight levels amid continued policy support and minimal near-term recession risk, with all-in borrowing costs around 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, spread levels that are lower than the forward earnings yield for equities (on a risk-adjusted basis) make this asset class relatively less attractive than stocks.
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 EM 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 less positive environment for the US dollar after its 2021 advance removes one previous headwind 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 the combination of monetary easing, stabilizing domestic activity, and continued strong foreign inflows should put prevent any sustained upward pressure on yields during the next 3-12 months.
Currency		– Positive catalysts for the US dollar have largely been priced in. Real growth differentials to many other developed market economies are poised to shrink in 2022, and the Federal Reserve will not be the only DM central bank hiking rates in 2022. – However, we do not expect to see major downside in the US dollar, which also serves a useful hedging role in portfolios where duration is underweight and procyclical relative equity positions are preferred. – Select EMFX like COP and BRL, are well-positioned to outperform cyclical Asian currencies and select G10 commodity exporters.

Source: UBS Asset Management. As of 26 January 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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