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UBS Asset Management | Economic insights and asset class attractiveness
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Managing risk in a time of war

Highlights

- As Russia's invasion into Ukraine deepens, the distribution of economic and market outcomes widens, and the skew becomes more negative.
- Ultimately, we see the negative economic impacts as manageable. The global economy is on strong footing, with robust private sector balance sheets and China's stimulus supporting growth.
- In response to elevated geopolitical risks, we are keeping space available to add exposure if markets overshoot to the downside, maintaining or adding to hedges, and rotating capital into opportunities where we see a more attractive risk-reward, like Chinese equities.

Russia's unprovoked war on Ukraine is aggressive and expansive in scope, adding another vector of volatility to financial markets. This is a broad invasion, not a limited incursion. Russia's goals appear to be the demilitarization of Ukraine as well as the removal and replacement of its governing class. The breadth of these ambitions means that the potential consequences are also significant. Meaningful global sanctions have been levied against Russia – hitting its central bank, companies, and some powerful citizens and politicians. These moves are aimed at bringing Russian President Vladimir Putin to heel – but also raise the risk of a disorderly economic retaliation or military escalation. This war is widening the distribution of economic and market outcomes, and the skew has become more negative.

The war and the economy

It is important to remember the economic fundamentals before this invasion: the US labor market was adding jobs at a rapid clip, even during the worst of the Omicron outbreak. European service-sector activity was also bouncing back in February as the public health situation improved. And Chinese monetary and fiscal stimulus were poised to start showing more signs of stabilizing the domestic economy, in our view. We believe this foundation remains largely intact.

The primary channel through which this war will drag on economic growth is through higher energy prices. According to UBS Investment Bank, a USD 10/barrel rise in oil prices sustained over six to 12 months would be expected to weigh on consumption and crimp global growth by 0.1 percentage points. If oil prices were to rise to USD 110/barrel and stay there, this would be a roughly 0.3 percentage point drag on activity relative to the start of the year. All else equal, that would still leave real global growth on track for its second-best year out of the past decade (trailing 2021).

In our view, an even larger spike in oil and/or natural gas prices would not kick off a sustained inflationary spiral. It is more likely that this would result in lower growth, and in turn lower inflation, before too long. Either spending more on energy would cause consumers to cut back in other areas, or central banks would aggressively tighten policy and crush the expansion – and by extension, inflation. In any event, this constitutes a downside scenario, not our base case.

Whether central banks are more preoccupied with downside risks to growth or upside risks to inflation will be an important influence on markets. We do not think monetary policymakers will abandon plans to reduce stimulus, but on the margin, they are likely to proceed more cautiously on tightening.

Different central banks will likely have different reaction functions. For instance, we believe the European Central Bank will be more reluctant to withdraw too much monetary stimulus in the near term, while the Federal Reserve's tightening plans will be less affected by this ongoing crisis. This informs our more optimistic view on the US dollar.

We are also monitoring for how much this invasion reduces consumer and business confidence, particularly in Europe. Prior episodes of rising geopolitical concerns tend to be accompanied by concurrent slumps in corporate investment. But the potential economic negatives are already partially priced into financial markets. And there is the potential for governments to use subsidies to blunt the pain of higher energy prices for consumers.

These geopolitical-induced headwinds are coming to the fore at the same time as another material drag on activity – the spread of the Omicron variant – fades. A recession is highly unlikely, in our view. What is more likely is another year of above-trend growth given the strong economic foundation in place at the start of the year.

In our view, the key is to manage risk in these turbulent times. Typically, geopolitical strife tends to serve as a source of short-term downside for risk assets that, over time, is overcome by positive underlying fundamentals. The internals of equity markets and sharp drop in long-term bond yields suggest investors are too pessimistic on how big and prolonged the drag on growth will be, in our view. We are much more optimistic on relative value opportunities than beta, where the outlook has become less attractive because of the likely scale of central bank tightening.

There is likely to be considerable volatility across financial markets – in both directions – over the coming weeks as investors react to incoming information regarding the status of this war and actions the international community is taking to either aid Ukraine or punish Russia economically.

Scenarios

We believe the longer the war, the bigger the market and economic impacts. Scenarios in which Ukraine's leaders resign, flee, or cede control to Russia if overmatched from a military perspective would provide visibility into the end of active warfare. So too would substantive peace talks or Russia unilaterally retreating after achieving certain military objectives. Such developments in the near-term would be more consistent with less severe implications for growth and investor sentiment, in our view.

Conversely, there are milestones that would imply a longer period of warfare or deeper hits to markets and the economy. Restrictions on access to Russian oil and gas – imposed by either the West or Russia – would also serve to amplify the negative economic effects of higher energy prices. Also, the establishment of a government by Ukrainian officials in the west of the country would likely entail a longer period of organized military opposition. It would also increase the odds of a tail scenario in which the theater of combat included NATO member countries. We view that outcome as highly unlikely, but think investors would need to increase the odds of such an event if the fighting endures and conditions devolve further.

Asset allocation implications

Three principles are guiding our asset allocation strategies currently. First, we are managing our exposures so that we have the capacity to increase risk should stocks or credit overshoot to the downside.

Second, we are maintaining or adding to hedging positions. We continue to prefer energy equities and commodities. There is a clear risk premium embedded in energy prices that could grow even larger should supplies be disrupted due to the war. Beyond that, the broader picture of constrained production growth and the still-firm expansion of activity is likely to support commodity-linked exposures over time. We have also increased exposure to the US dollar as we believe the outlook for domestic growth and inflation, and in turn the Federal Reserve's tightening plans, will be less negatively affected by this war than other countries.

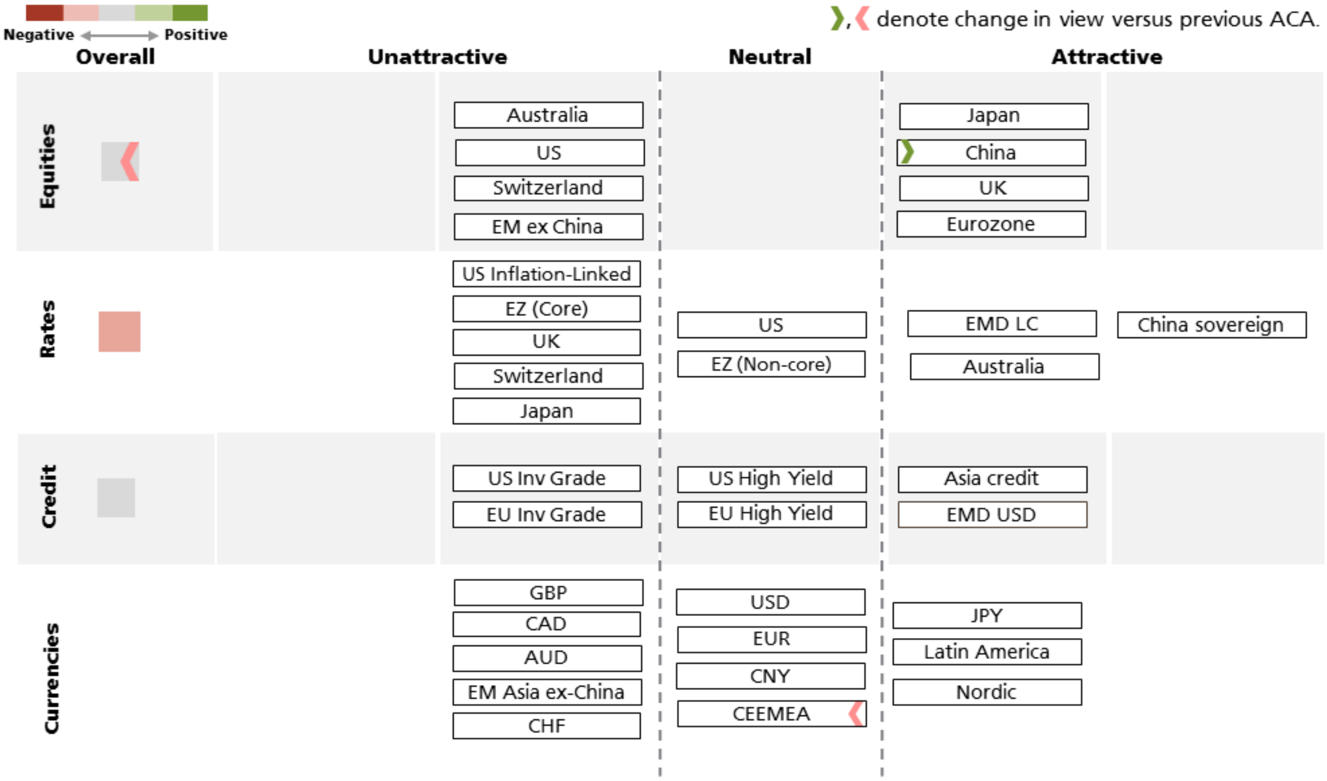
And third, we are rotating into areas of the market where we see a more attractive risk-reward profile in light of recent events. European equities are discounting a scenario in which war is protracted and the economic impacts are more severe than in our base case. However, we are cognizant that risk sentiment towards European assets may remain somewhat impaired even upon a quick resolution to this crisis, and have moderated the size of our overweight position.

In turn, we have become more optimistic on Chinese equities. Government policy has pivoted in a way that should allay investors' big concerns over economic deceleration, tech regulation, and the potential for a hard landing in the real estate market. Monetary accommodation has been increased, the credit impulse has troughed, and we expect to see industrial activity accelerate following the Beijing Olympics.

Internet companies, which comprise a substantial share of many Chinese equity indexes, are trading at depressed levels after the regulatory crackdown. Recent communications indicate that the government is aiming to better balance regulation with the development of the platform economy going forward. Investors' expectations on the ability of Chinese companies to grow earnings are too pessimistic, in our view.

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 March 2022.



Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as of 1 March 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	Neutral	– Our outlook for stocks over the next 12 months is neutral. We prefer relative value opportunities with exposure to the still-robust global growth outlook relative to outright beta exposures, which may face persistent valuation pressures from the combination of central bank tightening and geopolitical risks. – 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, particularly for cyclically-oriented sectors and regions. – The direct impacts from Russia's invasion of Ukraine on economic activity are manageable at the macro level, but may keep the equity risk premium relatively elevated.
US Equities	Moderately negative	– 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 or expectations for the terminal policy rate this cycle increase. 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 earnings growth should still hold up well and balance sheets remain strong.
Ex-US Developed market Equities	Moderately positive	– Non-US developed market equities are attractively valued and have significant exposure to the global economic recovery. – Earnings revisions in Europe and Japan continue to be stronger than in the US, and the extent of this superior performance has not been reflected in the relative returns for these regions over the past year. – European equities may be particularly vulnerable following Russia's invasion, as the direct economic impacts are larger and the hit to investor sentiment likely larger than in other regions. However, this is already partially priced in.
Emerging Markets (EM) Equities (ex-China)	Moderately negative	– 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 in the face of challenges early in 2022 that include less impressive earnings revisions relative to DM, higher mobility restrictions relative to DM, and rising long-term real rates.
China Equities	Moderately positive	– 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.
Global Duration	Moderately negative	– On a tactical basis, duration is receiving a bid as part of a flight to quality amid geopolitical-induced de-risking. – However, we expect long-term bond yields to continue trending higher as the above-trend growth outlook stays largely intact, inflationary pressures linger with risks tilted to the upside, and most global central banks withdraw monetary stimulus. – We expect rises in real rates to be the key contributor to higher long term yields. – 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. – We expect domestic activity to reaccelerate after a brief interruption due to the Omicron variant, inflation to remain uncomfortably elevated well above the central bank's target, global activity to remain firm, and weakness in US bonds to continue.
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 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, though downside risks tied to Russia's invasion are likely to delay a more hawkish pivot in the near-term.
US Investment Grade (IG) Corporate Debt		– Spreads are at relatively tight levels amid continued policy support and minimal near-term recession risk. In our view 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 both serve as downside 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. Coupons available will continue to attract buyers in a low-yield environment. – The asset class is more attractively valued with 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 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 credit is attractively valued and we believe 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 2021 has increased the resiliency of the asset class even as 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 drive a renewed bid for US dollar. The country is also likely to less negatively affected economically by the Russian invasion, particularly compared to Europe. We believe 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. – In our view, 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 1 March 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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