Macro Monthly

Economic insights and asset class views

UBS Asset Management | December 2023

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

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Sticking the landing

Highlights

- A soft landing for the global economy is our base case.
- The labor market is cooling, but inflation is cooling faster. Positive real income growth should continue to support consumption.
- Robust private sector balance sheets reduce the likelihood of a sharp pullback.
- A soft landing is priced into the bond market much more than the stock market.
- We expect global equities to surpass all-time highs in 2024, and to outperform government bonds.

The surprising resilience of US growth has been the one constant throughout this unprecedented economic cycle. This time last year we viewed recession risk as low relative to consensus, due to the underappreciated strength of the underlying fundamentals, and have confidence this trend will continue into 2024. A soft landing for the US and global economy is our base case. To us, that means that the Federal Reserve will begin lowering interest rates for a good reason (the progress made in getting inflation lower), rather than a bad reason (a deterioration in growth large enough to require monetary stimulus).

Nominal growth has considerable room to slow from its Q3 pace of 8.9% quarter-on-quarter annualized without triggering recession concerns. In aggregate, the private sector is not overextended – neither households nor businesses are spending beyond their means. Inflation has slowed by enough for markets to price in an easing cycle from central banks, so financial conditions are much more supportive of growth than they were just six weeks ago. Progress on disinflation means real income growth is still positive, while household net worth remains in a strong position, which should allow for continued growth in consumer spending.

We anticipate that stocks will meaningfully outperform bonds if the US economy achieves a soft landing. In our view, pricing in the bond market is already much more consistent with this positive economic outcome than the stock market. In a soft-landing scenario, we believe global equities will comfortably ascend to new all-time highs in 2024 while it is unclear whether longer-term bond yields have much further to fall.

No major excesses

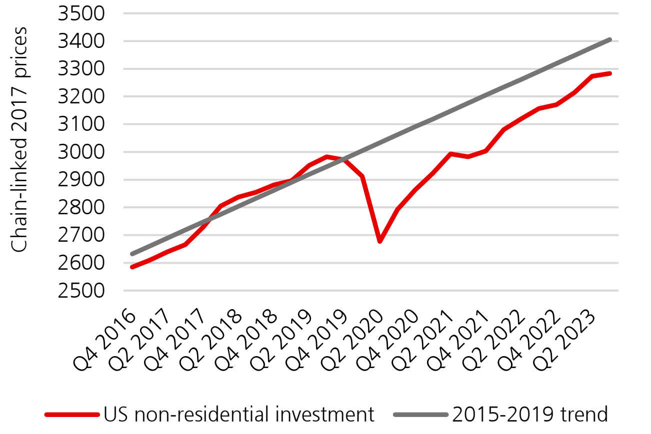
Recessions are typically caused by excesses that develop in the private sector that need to be corrected (mid-2000s real estate bubble or dot-com era capital spending) or major exogenous shocks (the coronavirus pandemic). We judge that there are few obvious imbalances in the household or business sector that need to be curbed.

On the contrary, corporate executives have spent the past 18 months preparing for a recession that has not arrived. There is little scope for further retrenchment. Only recently has their perception of recession risk receded somewhat, and this decrease in pessimism

Exhibit 1: Corporate sentiment is thawing

Source: UBS Asset Management, The Conference Board, The Business Council. As of Q4 2023.

Exhibit 2: Business investment has room to catch up to trend



Source: UBS Asset Management, Bureau of Economic Analysis. As of Q3 2023.

happened before the recent decline in yields, which in our view should further bolster corporate confidence.

We believe the US economy will continue to receive a favorable impulse from past spending incentives for corporations (from the Inflation Reduction Act, CHIPS Act, and infrastructure package) that may help lift business investment. We see scope for upside surprises as firms engage in delayed maintenance capex or expand operations in the face of end-user demand growth which, while slowing, is still positive. Success in achieving a soft landing would provide the potential to shift from the income-driven cycle that has marked the past three-and-a-half years to one where both income and credit are contributing to higher economic activity.

We've earned it

Financial conditions eased significantly in November as evidence of a cooling in US economic activity and inflation accumulated. The six-month annualized rate of core PCE inflation is running at 2.5% through October. A host of labor market metrics have also moved towards pre-pandemic norms. In the recent past the Fed has needed to push back when financial conditions have eased too much, because inflation was too far from target. There is less need to do so now because the economy has 'earned' the most recent easing of financial conditions.

As such, some of the "long and variable lags" from the Federal Reserve's tightening cycle have now been blunted, in our view. The effective interest rate paid by corporates on the looming "maturity wall" of debt will not rise as much as it otherwise would have. The drag on household disposable income and spending from higher interest rate expense should be less intense, while residential housing resales and mortgage applications are also likely to pick up steam if this interest rate environment is sustained.

The big "if"

Of course, maintaining this level of financial conditions, or seeing them ease further, is contingent on inflation remaining well-behaved or moving closer to central bank targets. A key risk to our view is that relatively sticky price pressures could reverse some of the improvements in financial conditions and push real income growth lower.

To be clear, the Federal Reserve is still likely to deliver some interest rate cuts in 2024 even if price pressures fail to decelerate further from their recent trend – but, in our view, not as much as markets are currently pricing. Substantial uncertainty remains as to whether inflation will allow for the 125 basis points in easing from the Federal Reserve in 2024 currently embedded in short-term interest rate markets.

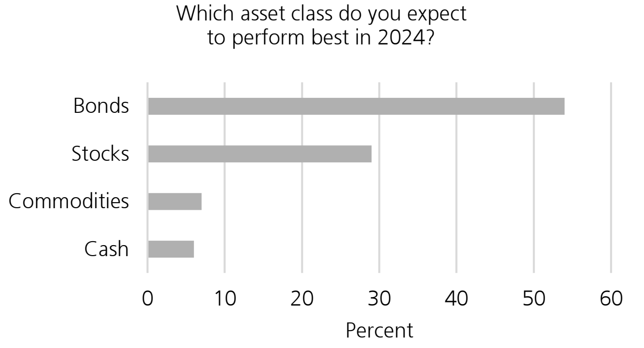
Separately, there is the risk that, as economic data continue to cool, more metrics will occasionally appear to be more consistent with a recession than a soft landing. We have seen in 2023 how quickly economic narratives can change and expect the path to a soft landing to be a bumpy one. In general, we believe there will be opportunities in 2024 to address extremes in valuations by adjusting positioning whenever markets lurch too far towards pricing in either persistently sticky inflation, an imminent recession or a soft landing.

Global disinflation

Importantly, major economic regions outside the US – such as China and the European Union – are relatively sluggish, which is helping to reinforce the broader disinflationary regime. Soft demand in these economies, along with healing supply chains, has helped to drive the deflation in global goods prices. We believe global inflation would be higher and the Federal Reserve's ability to consider interest rate cuts would be lower if Europe and China were firing on all cylinders.

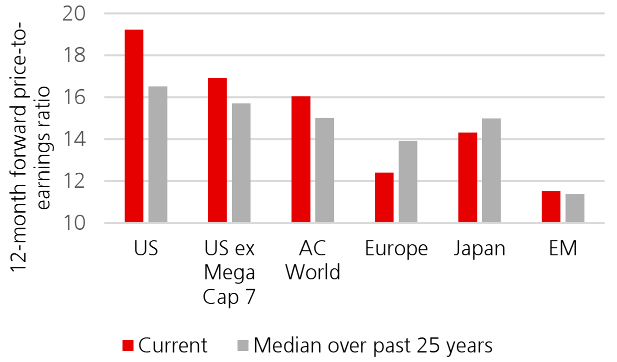
In our view, both economies are poised to 'muddle through' in the near term, in part due to these easier financial conditions. There are some green shoots in European survey data, both for manufacturing and investor sentiment, though few signs of a decisive turn. In China, the data are stabilizing to improving in most areas of the economy – except for the property sector. Incremental policy support has largely been successful in putting a floor under activity, and recent measures to improve conditions in real estate suggest property will be less of a drag on growth in 2024 than in 2023. In both Europe and China, the

Exhibit 3: Fund managers are betting on bonds over stocks



Source: UBS Asset Management, Bank of America Global Fund Manager Survey. As of November 2023.

Exhibit 4: Equity valuations not that stretched versus history



Source: UBS Asset Management, Bloomberg. As of November 2023.

bottom-up profit revisions are underwhelming relative to other regions.

A global manufacturing recovery if easier financial conditions lift cyclical sectors could be a potential upside surprise to our global growth outlook, though this would also likely be accompanied by an increase in inflation risk, as well.

Asset allocation

Stocks and bonds are in the midst of a strong run to close out the year, leading to some concerns that a soft landing is fully priced in already. We disagree, mostly in terms of the stock market.

We believe the surprise in markets for 2024 will be an equity rally without much of a decline in bond yields, only a decrease in bond market volatility. Consensus expectations are for the outperformance of bonds vs. stocks. However, we believe 12-month forward earnings revisions still point towards equity upside and stock valuations are not that stretched outside of a handful of megacap US technology firms.

Importantly, there is a record USD 6 trillion in money market funds. As cash rates begin to decline and recession concerns dissipate, we suspect a good portion of these assets will be redeployed in search of higher returns. Return-seeking flows into stocks and credit could catalyze much stronger performance in risk assets than consensus expects.

As growth moderates, there will be times when investors get concerned that the soft landing may turn into a hard landing. For multi-asset portfolios, this has one important consequence: A shift from inflation risk to recession risk implies the positive stock-bond correlation should weaken. This means traditional portfolio structures may see strength in their fixed income holdings offset any episodic weakness in their equity exposures.

In our view, the US dollar is poised to perform well vs. other G10 currencies due to relative growth and rate differentials. The dollar is also a broad-based hedge that offers protection against the risk that inflation and growth are too high for the Federal Reserve to ease policy as much as is priced in, or if global economic conditions deteriorate more sharply than we anticipate.

Asset class views

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness as of 1 December 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 Asset Class Views table does not include all asset classes, the net overall signal may be somewhat negative or positive.

	Underweight			Overweight		
Global Equities				●		Profits growing, lower rate volatility should help support multiples.
US				●		Room to advance as earnings grow and rates volatility calms; more exposure to quality as activity moderates.
Europe			●			Cheap valuations balanced against lack of earnings and economic momentum.
Japan				●		Still inexpensive after recent gains, with solid earnings and ongoing corporate reform. Prefer to express in FX unhedged terms.
Emerging Markets			●			EM outperformance requires more evidence of China's strength. Asia ex China supported by tech goods rebound.
Global Government Bonds			●			Disinflation offset somewhat by decent growth and unfavorable technicals. Cuts priced in are too excessive.
US Treasuries			●			Growth is slowing, but downward trend in inflation may stall as well. Expect volatility to calm. Still the best hedge for recession.
Bunds			●			Deterioration in economic data and slowing inflation lays foundation for easing cycle.
Gilts			●			Bank of England policy rate path meaningfully lower amid more progress on inflation.
Global Credit			●			Attractive all-in yields amid decent growth and disinflation, but limited room for spread compression.
Investment Grade Credit				●		Spreads relatively narrow, so risk-reward confined to carry.
High Yield Credit			●			Slight preference for IG versus HY. Moving up in quality in context of broader risk-on positioning.
EMD Hard Currency			●			Valuations and macro data have become less supportive relative to DM credit.
FX						
USD			●			Strong carry and resilient growth limit scope for weakness vs G10 FX. Bearish against higher carry EMFX.
EUR		●				Core inflation slowing quickly, along with weak growth. Expect ECB to cut before Fed.
JPY				●		JPY is cheap vs. USD and the BoJ is moving towards tightening. Safe haven JPY is a good hedge against recession.
EM FX				●		Soft landing is a good environment for carry. Prefer MXN and BRL.
Commodities			●			Prefer oil to industrial metals on China property weakness, limited rebound in global manufacturing.

Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as of 1 December 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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