Macro Monthly

Economic insights and asset class views

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

Evan Brown
Head of Multi-Asset Strategy
Investment Solutions

Luke Kawa
Director
Investment Solutions

Broadening out

Highlights

- We continue to see a high probability of a soft landing and expect a broadening out of equity market performance in early 2024.
- A still healthy nominal growth environment is now being underpinned by an easing of financial conditions. This is supportive of cheaper, cyclical, and smaller companies.
- We anticipate a rebound in the global goods cycle, which should support equites in Europe and EM ex China.
- We think equities can perform without lower bond yields in 2024, consistent with a reduction in the recently high stock-bond correlation.

The core call from our 2024 outlook is that with a soft landing for the global economy well within reach, stocks should have more upside than bonds. We reject the view that positioning should turn more defensive because the expansion is getting longer in the tooth. On the contrary, the economy is supported by solid fundamentals and improving sentiment among households as well as businesses. And, in our view, the outlook for risk assets is bolstered by the nearly $6 trillion in money market funds, some of which may head in search of higher potential returns as central banks begin to lower cash rates.

Importantly, given resilient growth and the potential for a rebound in the goods sector, we believe breadth in the US equity market is poised to broaden beyond megacap tech into more cyclical sectors and indexes, such as midcaps. We also see room for Europe and emerging markets excluding China to perform well in the new year.

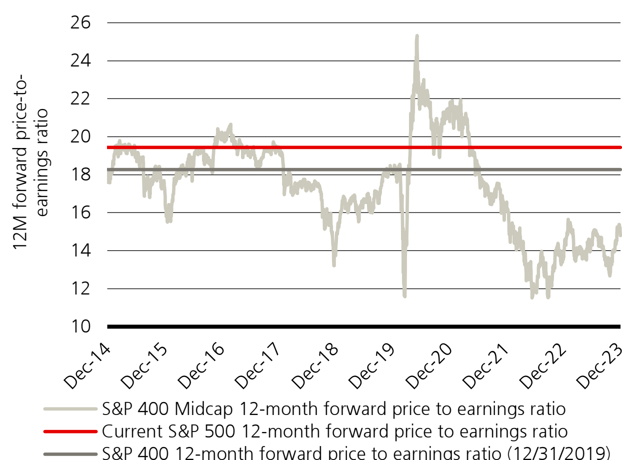
The case for broader US equity performance

The substantial slowdown in the US economy that most prognosticators have been expecting has not happened, and we see little evidence that a sharp weakening is at the doorstep. A simple story has been the most powerful for understanding US economic resilience: the return to positive real income growth has meant healthy consumer spending. Six-month annualized core inflation has slowed from a peak of 6.8% in March 2022 to 1.9%, below the Fed's target. This provides not just support for real incomes, but has allowed the Fed to entertain rate cuts simply due to low inflation as opposed to slower growth. As such, positive real income dynamics are being reinforced by an improvement in financial conditions that should help support business investment and the housing market.

A soft landing means a 'refresh' of the business cycle. This should allow room for more cyclical areas of the market, such as small to medium-sized companies to catch up to the largest ones.

In our view, US mid-cap stocks offer attractive exposure to this enduring expansion. This segment of the market is more cyclical and tends to perform well during periods of solid activity and decelerating inflation. The performance relative to large caps largely lagged the

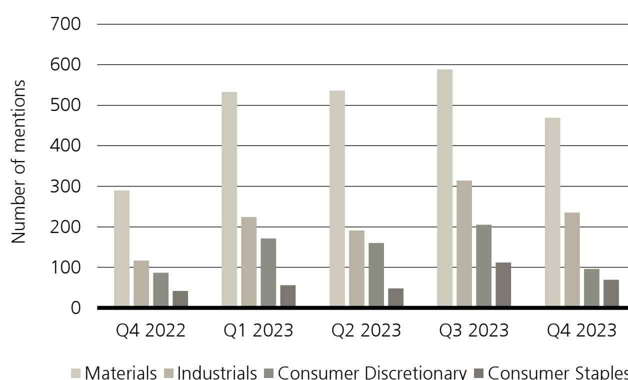
Exhibit 1: Midcaps cheap vs. history and large caps



Source: UBS Asset Management, Bloomberg, Macrobond. As of January 2024.

Exhibit 2: Past the peak of inventory destocking

Mentions of "destocking" on quarterly conference calls in different sectors



Source: UBS Asset Management, Bloomberg. As of Q4 2023.

improvement in real growth that took place during 2023, suggesting there is attractive catch-up potential. Improving earnings breadth among large cap equities should be a positive leading indicator for the S&P Midcap 400, which is a much less concentrated index than the S&P 500.

Midcaps also trade at a lower valuation vs. their pre-pandemic 12-month forward price-to-earnings ratio, and at an even larger discount relative to large-cap US stocks. Historically, they have tended to trade at more expensive multiples than their bigger peers.

Manufacturing rebound

While we expect another year of US economic resilience, we are also optimistic on the prospect of a goods sector recovery that may help other more cyclically-oriented regions.

Commentary from corporate earnings calls suggest the worst of the drag from inventory destocking is behind us. In addition, the US ISM Manufacturing PMI has been below 50 (the level that divides expansion from contraction) for 14 consecutive months. This is the longest such streak since the bursting of the Technology-Media-Telecom bubble at the dawn of the new millennium. As real incomes and real spending continue to rise, we would expect this to catalyze a positive inflection for global factory activity.

The European economy, which is more levered to manufacturing, would be a key beneficiary. Sentiment indexes on the outlook for economic growth are turning up, which tends to be a leading indicator of higher earnings per share estimates for European corporates. The improvement in sentiment is being matched by some underlying components of manufacturing purchasing managers' indexes. In particular, the difference between the new orders subcomponent and the inventories subcomponent has increased (Exhibit 3), which should bode well for future production. And like US midcaps, European stocks generally are inexpensive vs. history and US large caps.

Separately, leading indicators in EM ex China are pointing to an improving outlook for corporate earnings. Korean exports jumped to a 17-month high in December, amid rising demand for semiconductors and higher selling prices.

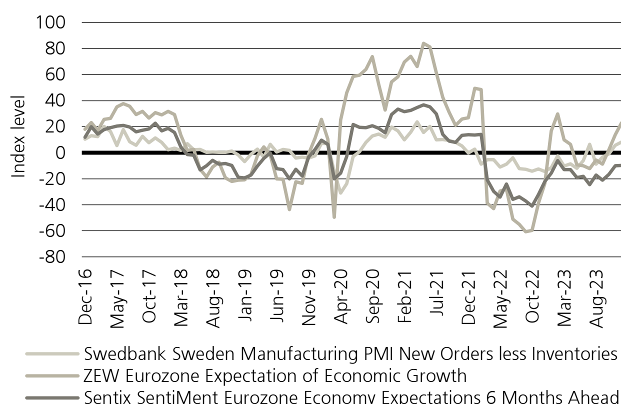
Asset allocation

As discussed in our 2024 outlook, we see solid nominal activity, bolstered further by the recent easing of financial conditions, as supportive for earnings and equities. This resilience in underlying economic growth suggests not as much central bank easing as the market is currently pricing is necessary for further equity gains.

Cross-asset performance over the last two years has been defined by highly positive stock-bond correlation. This high correlation is typical in an environment of high inflation and inflation volatility. Historically, when inflation starts to settle below 3%, as we believe it is now doing, the stock-bond correlation becomes much less positive. This reinforces our call that stocks can perform well without needing support from lower bond yields. Rather, yields can stay range-bound to higher, while economic optimism should be sufficient to support more equity breadth.

For much of last year, we maintained overweights to US large cap equities and Japan. We continue to maintain those positions, but have broadened our overweight to include midcaps, Europe and EM ex China as we believe investors are set to embrace a refreshed cycle.

Exhibit 3: European leading indicators are turning up



Source: UBS Asset Management, Swedbank, ZEW, Sentix, Macrobond, Bloomberg. As of December 2023.

We retain a neutral view on Chinese equities. Geopolitical uncertainty and a still substantial economic drag from the property sector may limit how much both valuations and profits can improve. It is also unclear whether the nature of some of the stimulus – targeted towards strategically important industries – will translate efficiently into profit growth rather than creating excess capacity and low margins. Earnings revisions continue to be underwhelming relative to other regions.

Regional equities that serve as our underweights include Australia and Switzerland. These two markets tend to behave more defensively, and have historically underperformed during periods when leading indicators are rebounding after a contraction and moving into expansion territory.

Asset class views

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness as of 1 January 2024. 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 rate volatility calms; expect more broadening out beyond megacap tech.
Europe				● →		Cheap valuations and leading indicators beginning to turn up.
Japan				●		Still inexpensive after recent gains, with solid earnings and ongoing corporate reform. Prefer to express in FX unhedged terms.
Emerging Markets			●			EM ex China to perform on better global manufacturing. Property sector and geopolitics still weigh on China.
Global Government Bonds			●			Disinflation offset somewhat by decent growth. A lot of easing already priced in.
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			●			"Muddle through" economy 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 given low geopolitical risk premia currently in price.

Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as of 1 January 2024. 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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