Macro Monthly

Economic insights and asset class attractiveness

UBS Asset Management | July 2023

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

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The widening path to a soft landing

Highlights

- We expect inflation to fall faster than incomes during the second half, supporting real spending and increasing the probability of a soft landing.
- The rebounding housing market is a catalyst for and a signal of US economic resilience.
- We are overweight equities via the US equal-weight index and mid-caps, which remain cheap and are geared to a US economy that should continue to surprise downbeat expectations.

The first half of 2023 was marked by volatility in narratives on the economy, as markets lurched from pricing in benign economic outcomes, to overheating, to the possibility of severe financial distress. We believe that in the second half of 2023, the regime will be more consistent. The path to a soft landing for the US economy has widened and is poised to get wider in the coming months. Inflationary pressures are decelerating, and the labor market is resilient. As such, we expect real income growth will continue to support an ongoing expansion in US consumer spending. Further bolstering the US growth outlook is the rebound underway in real residential investment after a multi-year retrenchment.

Investors are warming to our view that the US expansion is likely to prove much more durable than consensus wisdom anticipated at the start of the year. As such, there are still segments of the market that have ample catch-up potential as recession risk is priced out.

We favor equities as sturdy growth and decelerating inflation reduce the risks to both earnings and valuations. In particular, we prefer the US equal-weight index and US mid-cap stocks, which are more levered to domestic activity than the large-cap, market-weight S&P 500 Index.

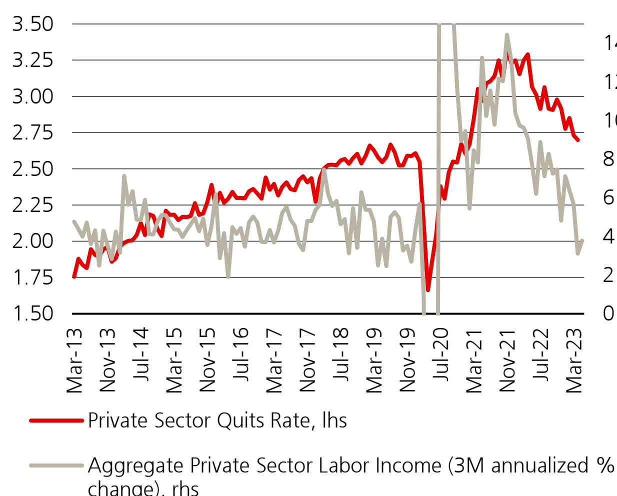
We remain vigilant in keeping track of threats to the expansion, including signs of deterioration in the labor market or an unexpected degree of stickiness in inflation.

Inflation cooling

We have conviction that in the third quarter, core inflationary pressures will downshift meaningfully – both in terms of the annual rate of change as well as on shorter time horizons.

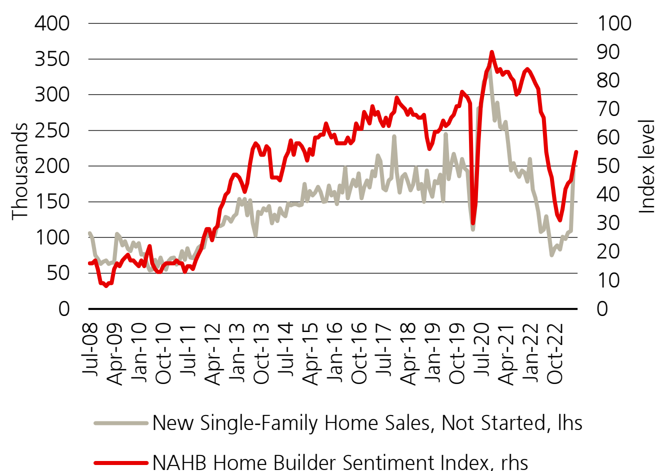
For core CPI in particular, we have turned a corner on shelter inflation, which is slated to make a smaller and smaller contribution to price pressures through at least year-end. There are also tentative signs of slowing in some of the 'stickier' measures of inflation most tied to the labor market, namely core services ex housing and healthcare. While it is too soon to call this a trend, it is encouraging to see progress. Aggregate labor income growth and the private sector quits rate have both reverted to near pre-pandemic levels. As such, we have confidence that price pressures linked to a strong job market and services spending are poised to decelerate.

Exhibit 1: Inflation linked to labor market poised to cool



Source: UBS-AM, Bureau of Labor Statistics

Exhibit 2: US housing market a positive impulse for growth



Source: US Census Bureau, National Association of Home Builders

The Federal Reserve raised its 2023 core PCE inflation forecast from 3.6% in March to 3.9% in May. We believe the risks to this higher bar are tilted to the downside. Additional US monetary tightening, in our view, will be primarily a good news story about the strength of domestic activity, not a panicked, belated response to drive inflation below the Fed's forecast.

Economy solid

Since the start of 2022, the economy has had a series of "rolling recessions" with weakness isolated to certain parts of the economy, such as technology and housing. More recently, global manufacturing outside the US has struggled. Overall US consumption has been able to cover up those weak points because of the long-lived stimulus provided by income support programs, strong balance sheets, and an increasingly robust labor market.

The US economy continues to produce impressive job growth. However, the slowing in income growth and shrinking excess savings imply that consumption growth should moderate. Importantly, we expect inflation to fall faster than nominal incomes, which should keep real incomes and spending solid into year end. And even as services slow, other pockets of strength in the US economy should be sufficient to keep recession risk low.

Since Q1 2022, real residential investment has fallen by 22% -- a contraction similar to what was experienced during the early-90s recession in the US. The sharp recovery in homebuilder sentiment, high number of new homes under construction, and strong pipeline of new single-family home sales where construction has not yet started, suggest that this headwind is turning into a tailwind.

It is remarkable that there are elements associated with an early-cycle economic backdrop – particularly, US consumer confidence and the housing market inflecting higher –in what is a more mature economic expansion and on the heels of 500 basis points in Federal Reserve rate hikes. This reinforces our view that this is a very unique economic cycle, and we are in the midst of a slow slowdown in growth that makes for a more prolonged late-cycle environment.

Even in areas of the US economy where there is perceived weakness, such as manufacturing, there is surprising resilience as well, with new orders for durable goods rising to a fresh cycle high in May.

Risks

Of course, we will closely monitor incoming economic data, earnings, and policy changes to assess potential challenges to our optimistic view on the US economy and risk assets.

The lagged impact of previous monetary tightening and March's episode of financial system stress could turn what we expect will be a mild default cycle into something more concerning or imminent, and jeopardize the strong labor market.

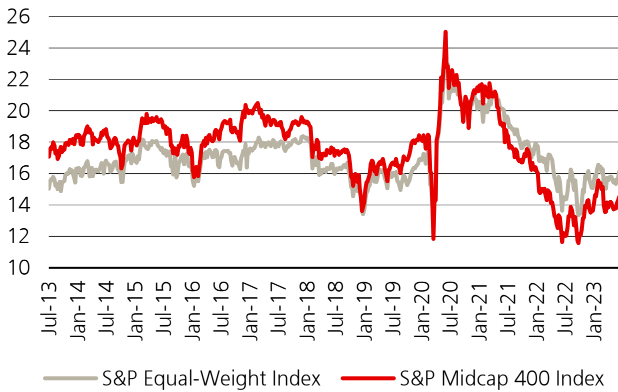
There is also the possibility that progress on inflation, particularly in services ex-shelter components, proves short-lived and limited amid resilience in the labor market and economic activity. Seasonal factors and an upturn in medical costs may also arrest the downward trend in CPI inflation during the fourth quarter.

In the near term, we believe the more likely risk involves the debate over the state of the US economy shifting from "recession or soft landing?" to "soft landing or no landing?" as labor markets and activity remain solid. The 'no landing' scenario is one in which inflation remains sticky high, forcing the Fed to hike to 6% or beyond. The rise in yields and resultant strength in the US dollar could also challenge risk assets.

Asset allocation

In summary, we anticipate a moderation in inflation will support a continuation of this expansion, by supporting real incomes and taking some pressure off of central banks. Even as services spending slows, the housing market should put a floor under US growth. We are overweight equities, and favor US equal-weight and mid-cap exposures. There has been positive breadth in US earnings revisions recently that stands in sharp contrast to the narrowness of the year-to-date equity rally in US stocks. The performance of equal weight relative to market-cap indexes has lagged the upward move in US Treasury yields and US economic surprise indexes, so these positions have room to catch up to these improved fundamentals, in our view. There is also valuation support, as the S&P 500 equal-weight index and S&P Midcap 400's forward price to earnings multiples are in the lowest quintile of their 10-year range.

Exhibit 3: Compelling valuations for S&P 500 equal weight, US mid-cap stocks

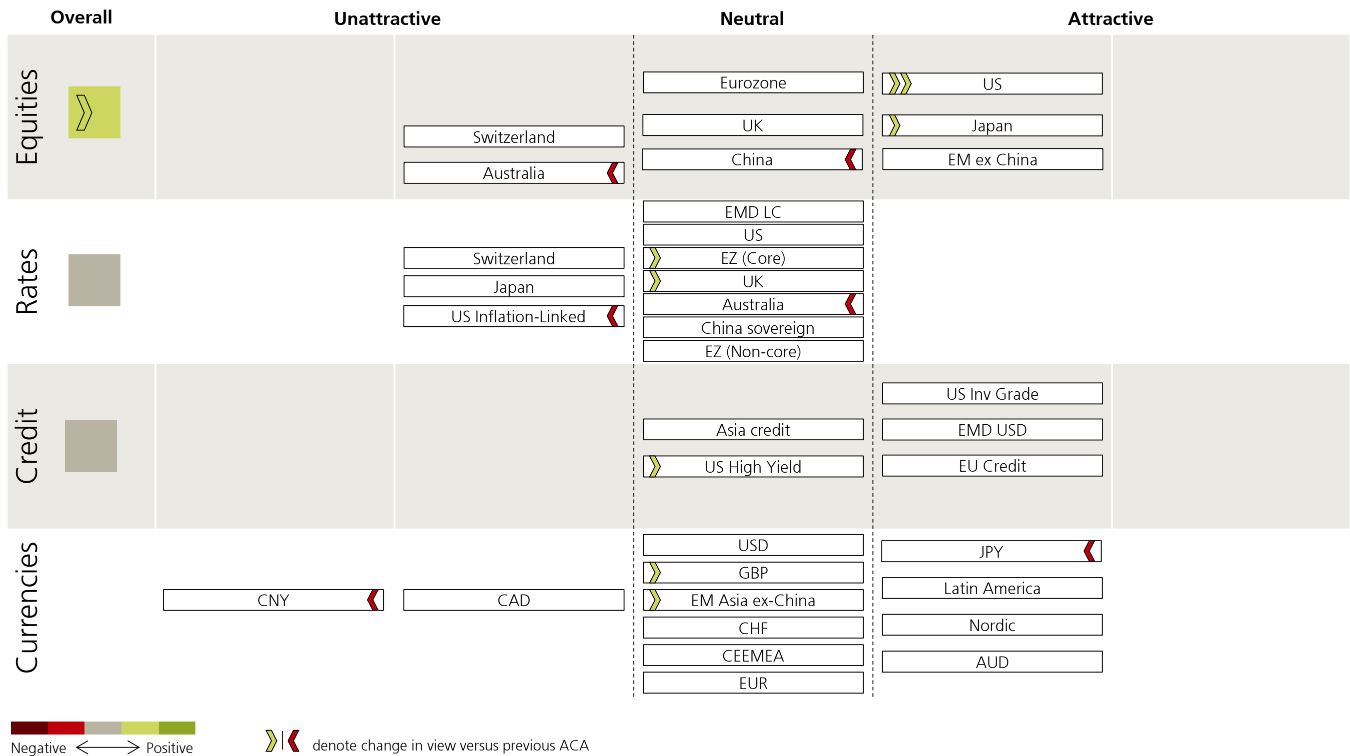


Source: UBS-AM, Bloomberg

Credit should also perform well, in our view, as the expansion extends and interest rate volatility will likely subside with a slowing Fed. We are neutral on long-term government bonds, as downward risks to yields from inflation are offset by the pricing out of recession risk. Of course, duration still plays an important role in well-balanced portfolios to protect against economic downside scenarios. In currencies, long US dollar versus short Chinese yuan is a useful hedge in our view due to the relative shift in growth momentum away from China and towards the US, as well as its typically strong performance in risk-off environments.

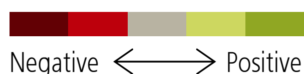
Asset class attractiveness (ACA)

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness as of 30 June 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 ACA does not include all asset classes, the net overall signal may be somewhat negative or positive.



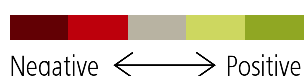
Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as of June 30, 2023. Views are provided on the basis of a 3-12 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change.

Asset Class	Overall/ relative signal	UBS Asset Management's viewpoint
Global Equities		– In our view, the risk-reward proposition for global equities is attractive. The probability of a soft landing for the US economy has increased meaningfully. Decelerating inflation has reduced a chief threat to the expansion and asset valuations, while tight labor markets may continue to support solid growth in consumer spending. – Outside of a small handful of US stocks, valuations for global equities are relatively fair. Importantly, earnings estimates are trending higher, particularly outside of commodity-linked sectors. – Risks to global activity are still present following banking stress and the lagged impact of the significant global monetary tightening delivered since the start of 2022.
US Equities		– We prefer the S&P 500 equal weight index relative to the market cap index, where valuations are in the bottom quintile of their 10-year range. – At the sector level, earnings revisions have displayed solid breadth, which we believe will translate to a continued improvement in breadth in performance within the US equity market. – At the market cap level, US stocks have been relatively expensive for a long time, and would likely underperform if economies outside of the US regain some momentum.
Ex-US Developed market Equities		– Non-US developed market equities are attractively valued but also highly cyclical. There is a lot of variation between DM equity markets based on differing domestic policy stances and degrees of vulnerability to external headwinds. – Widespread improvements in shareholder return programs have increased the appeal of Japanese equities. Macro data in Japan are also more positive than most other regions, and the country is benefitting from companies shifting their supply chains outside of China, particularly in semiconductor manufacturing. – Valuations and earnings are still relatively supportive of European equities. However, Europe is more vulnerable to the global slowdown in manufacturing activity. In addition, the ECB is committed to bringing policy rates well into restrictive territory, which should limit how much multiples can expand and how fast the economy can grow.
Emerging Markets (EM) Equities (ex-China)		– Broadly speaking, EM equities have both de-rated and have seen a larger total drawdown in earnings estimates than DM equities. This limits the scope for relative underperformance versus global equities going forward, in our view. – We expect an improvement in the global manufacturing cycle on the back of rising final demand in developed markets. AI-related spending could support semiconductor exporters in Asia, which are heavily weighted in EM ex China.
China Equities		– The Chinese economic rebound is losing traction. The reopening impulse for consumption is being offset by continued weakness in the property sector, which makes up a substantial part of the economy. – Though Chinese policy turned in a pro-growth direction (the abandonment of zero-COVID-19 measures, more support for the property sector, and the end of the regulatory campaign against internet platform companies), additional policy support for industrial activity, the consumer and the housing market may be needed to improve sentiment and regain growth momentum. – We are closely monitoring geopolitical tensions between the US and China, particularly related to semiconductors as well as the latter's relationship with Russia, as these carry left-tail risks to both operating performance and valuations.
Global Duration		– Long-term bonds play an important role in balanced portfolios in hedging against downside risk to the economic cycle. Yields should be volatile and rangebound as robust labor market data and resilient economies square up against the fact that central bank tightening cycles are well advanced and disinflation is finally beginning to set in. – Central banks' commitment to keeping policy in restrictive territory and reluctance to reverse course amid above-target inflation should keep yield curves relatively flat until a contraction in economic activity is at hand.



Negative ⟷ Positive

Asset Class	Overall/ relative signal	UBS Asset Management's viewpoint
US Bonds		– The Federal Reserve may be on the verge of a sufficiently restrictive policy stance, and plans to keep policy quite tight until services sector inflation, which is linked to the labor market, decelerates meaningfully. Additional policy tightening is likely to be very incremental, and a function of still-strong activity. The odds of any easing in 2023 are low, in our view. – We are underweight TIPs as inflation falls and the economy remains resilient, putting upward pressure on real yields. – All said, US Treasuries remain the world's preeminent safe haven asset. Should we prove wrong about economic resilience, the Fed has room to ease policy via rate cuts and global investors will naturally gravitate towards Treasuries.
Ex-US Developed-market Bonds		– The European Central Bank is committed to delivering sufficient monetary tightening to bring inflation down to its target even as growth across the continent weakens, including in core economies. The policy rate has further to rise, with ECB officials expecting that strong nominal wage growth coupled with low productivity will keep inflation stubbornly above target for longer. – The Bank of England has acknowledged that policy tightening to date is unlikely to meaningfully derail the expansion, and that risks to inflation are to the upside. The recent increase in the magnitude of rate hikes signals that the BOE is willing to act more forcefully to counter high wage growth and inflation, and as such should help contain inflation expectations. – The Bank of Japan's expansion of its yield curve control range was a meaningful step towards a monetary tightening campaign, in our view. We believe policy is likely to be adjusted further in light of improving wage growth and higher than anticipated inflation.
US IG Corporate Debt		– We believe shorter-maturity IG debt is particularly attractive given the flat corporate curve and substantial income opportunity. This is consistent with our view that while risks to growth have risen, the economy will remain resilient in the near term.
US HY Corporate Debt		– As we believe near-term macro risks are relatively low and technicals remain strong, High Yield provides a healthy all-in return with the index offering 8.5% – With spreads fairly narrow relative to Treasuries and Investment Grade, High Yield is primarily a carry asset as opposed to an opportunity for appreciation. We are keeping a close eye on rising default rates and leading indicators as we manage our positioning.
Emerging Markets Debt US dollar Local currency		– We have a positive view on emerging market dollar-denominated bonds due to the carry opportunity, falling interest rate volatility, and low default rates. – EM local bonds do not have very attractive carry versus US Treasuries relative to their five-year history and while there are some attractive duration opportunities in LatAm, this is not the case for the European and Asian constituents. – Asian credit is not particularly appealing as valuations are roughly fair and risks related to China's property market are still elevated.
China Sovereign		– Chinese bonds have been moving from a high yielder among major economies to a low yielder, diminishing the attractiveness of government bonds somewhat. – However, the appeal of Chinese government bonds is bolstered by their defensive characteristics, which are not shared by much of the EM universe, as well as their low beta to global bond indices.
Currency		– We have transitioned to an environment in which the USD is rangebound, in our view. The downward pressure on an overvalued US dollar as the end of the Fed's tightening cycle approaches will limit upside in the absence of a global recession, which is not our base case. However, any downside in the US dollar may be capped by the relative outperformance of US economic growth versus other major regions and the attractive carry of US dollar positions compared to other G10 FX, in our view. The Japanese yen is our most preferred currency given cheap valuations, BoJ tightening, and hedging properties. Some EMFX, like the Mexican peso, are poised to outperform select G10 FX like the Chinese yuan or New Zealand dollar given attractive carry.



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