Macro Monthly

Economic insights and asset class views

UBS Asset Management | November 2023

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

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Stocks or Bonds?

Highlights

– The outlook for stocks and bonds has improved after three consecutive monthly losses.
– We believe stocks have more upside than bonds into year-end given supportive fundamentals, positioning, and seasonal factors.
– In our view, economic activity is poised for a gentle cooling, which suggests that earnings can continue to expand while bond yields stabilize.

We are emerging from a uniquely challenging environment in financial markets: the MSCI World Index and Bloomberg US Treasury Total Return Index have delivered negative results in each of the past three months. This marks the longest time stocks and bonds have declined in concert on a monthly basis since at least 1972.

The silver lining in these pullbacks across stocks and bonds is that expected returns have improved. Over the medium term, there are reasons to expect solid performance from both asset classes. But the most immediate question for tactical asset allocators is which to prefer into year end and early 2024: stocks or bonds?

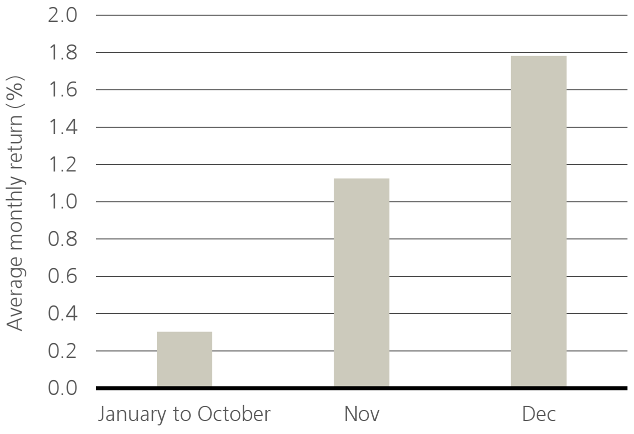
In our view, a combination of fundamental, technical, and seasonal factors suggest the tactical case for stocks is superior to government debt.

The case for stocks

The pullback in global equities over the past three months is tied to the selloff in the bond market. That, in turn, was tied to consistent evidence of US economic strength and larger than expected issuance of US Treasuries, which caused investors to demand more compensation for holding long-term bonds.

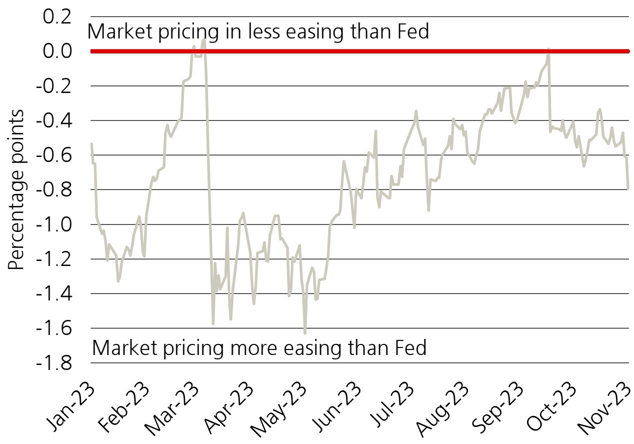
Data released recently, including the October non-farm payrolls report and third-quarter employment cost index, support our thesis that activity is poised to cool (A Little Bit Softer Now). In our view, that means some of the valuation pressure on stocks from rising bond yields should subside, which may bring focus back to what is still a solid backdrop for stocks.

Exhibit 1: Equities tend to perform well in final two months of the calendar year



Source: UBS Asset Management, Bloomberg. Data from January 1989 to December 2022

Exhibit 2: Market pricing vs. Federal Reserve year-end 2024 estimated policy rate



Source: UBS Asset Management, Federal Reserve, Bloomberg. As of November 3, 2023

Twelve-month forward earnings per share estimates are still rising, though we expect the pace of improvement to slow as economic activity moderates. We believe a downshift in growth will help solidify the view that the Federal Reserve's tightening cycle is also likely over. Historically, stocks have tended to rally for a few months once the US central bank stops hiking rates, regardless of whether or not there is a soft or hard landing.

In our view, the stock market does not need lower bond yields in order to rally, but merely a calming of bond market volatility. If activity moderates from the third quarter to the fourth quarter, this would likely signal renewed confidence in a 'soft landing' for the economy as the consensus outcome, rather than a quick pivot in perception from 'overheating' to 'recession.'

We believe recent rhetoric from the Federal Reserve suggests a high bar to additional policy tightening as well as more tolerance for solid growth, so long as it does not foster a reacceleration in inflation. Policy inertia from the US central bank may also help foster lower bond market volatility. Importantly, indicators of positioning and sentiment like the American Association of Individual Investors' bull-bear spread, the ratio of puts traded vs. calls, and the National Association of Active Investment Managers' Exposure Index imply that investors have room to add equity risk from here.

The final two months of the year have also typically been among the most positive for global stocks. From January through October, the MSCI ACWI Index has averaged a monthly return of 0.3% from 1989 through 2022. For the months of November and December, global stocks have averaged gains of 1.1% and 1.8%, respectively, over the same period.

Less upside in bonds

For bonds, the fundamental outlook is not as appealing. Short-term interest rate markets are implying that the Federal Reserve's policy rate will end 2024 roughly 80 basis points lower than what is implied by the most recent 'dot plot' survey of Fed officials' expectations in September. Under a soft landing scenario, which is what we believe consensus will gravitate towards through year end, the amount of easing priced in for next year is already relatively aggressive, given above-target inflation and resilient activity. Economic data, and in particular, labor market and consumption data, would need to show much more deterioration than we think is likely in the near term for more interest rate cuts to become embedded in market expectations.

In addition, we expect that three- and six-month annualized measures of inflation will show less downwards momentum as we move from Q3 to Q4. This lack of progress may limit how much yields can fall absent a more pronounced slide in growth.

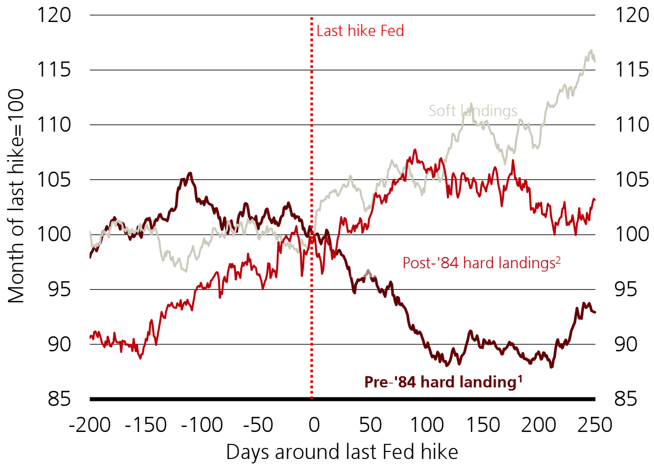
Risks to our view

We anticipate that bonds will perform well both if growth is positive, but decelerating as well as in much more negative economic outcomes. If economic data show a prolonged trend of deterioration, rather than stabilizing and plateauing at a reasonable trend, the next big, convex move higher will be in bonds, not stocks.

And we acknowledge that it is difficult to get overly optimistic on the amount of upside available in stocks as economic growth is losing momentum. To that end, we are closely monitoring revisions to earnings, which have turned negative for the fourth quarter of 2023 as results from the recent reporting period have been released.

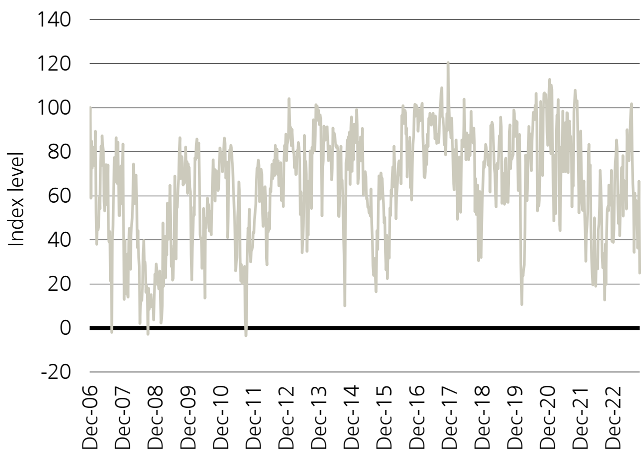
Exhibit 3: The S&P 500 tends to rally when Fed tightening campaigns end

S&P500 around last Fed rate hike



Source: UBS Asset Management, Minack Advisors. As of 2018.
1 Cycles since 1953. Excludes 1980.
2 Excludes 2019. Day zero is first day of the month that the Fed last tightened.

Exhibit 4: Positioning indicators suggest investors' exposure to stocks is low vs. history



Source: UBS-AM, National Association of Active Investment Managers, Macrobond. As of October 2023.

Asset allocation

We believe the conditions are in place for a year-end rally in stocks: relatively low positioning, a decent outlook for earnings as recession does not appear to be imminent, and an end to the valuation pressure brought about by surging bond yields. We prefer US, Japanese, and UK stocks.

In our view, government bonds warrant a neutral weighting, particularly given the sharp drop in yields in early November. However, sovereign debt remains an important part of balanced portfolios. For one, the income-generating properties of bonds have improved dramatically, with US 10-year Treasury yields near the high end of their 20-year range even after the recent leg lower. In addition, we do think it is more likely that the next major market shock involves concerns about growth deteriorating rather than inflation accelerating. Bonds are likely to provide portfolio ballast in such a scenario, though that is not our base case for the near term.

Asset class views

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness as of 2 November 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. Positioning relatively low.
US				●		More attractive after recent pullback, with room to advance as earnings grow and rates shock fades.
Europe			⇨			Cheap valuations balanced against lack of earnings, 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 strength. Asia ex China supported by tech goods rebound.
Global Government Bonds			●			Disinflation offset somewhat by decent growth, unfavorable technicals. Useful hedge for recession risk.
US Treasuries			●			Growth is slowing, but downward trend in inflation may stall as well. Expect volatility to calm.
Bunds			⇨			Deterioration in economic data and slowing inflation reduces need for incremental tightening.
Gilts				●		More progress on inflation; difficult for BOE to keep policy rate as high for as long as currently priced.
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				●		EMD attractive on expected decline in rate vol, high local rates. Big divergence between EM IG and EM HY.
FX						
USD			●			Strong carry, resilient growth limits scope for weakness vs G10 FX. Bearish against higher carry EMFX.
EUR		⇦				Little sign of a bottom in manufacturing activity, and core inflation slowing quickly. Expect ECB to cut before Fed.
JPY				●		JPY is cheap vs USD and the BoJ is moving towards tightening. Safe haven JPY a good hedge against recession.
EM FX				●		Not too hot, not too cold economy 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 November 1, 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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