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.

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A critical window

Highlights

- The US economy is entering a critical window over the next few months, in which the labor market must hold up before the effects of rate cuts and broader easing of financial conditions can provide a cushion for growth.
- We believe that healthy initial economic conditions will bridge growth through this phase, but already optimistic market pricing and the potential for a near-term growth step down warrants dialing back risk tactically.
- This more cautious stance lines up with historical seasonality of equities before presidential elections, as markets tend to wobble amid policy uncertainty in the weeks ahead of voting.
- With less overall beta risk, we prefer to focus on relative value opportunities, favoring a broad set of US stocks vs. ex-US equities, and short positioning in Japanese government bonds and USD/JPY.

It was a memorable August for investors. At the turn of the month, a disappointing jobs report and Bank of Japan tightening kicked off a sharp unwind in popular positions. The VIX spiked to its highest levels since the onset of COVID-19 in 2020, Japanese equities dropped 20% in three days, and the US two-year yield crumbled nearly 40 basis points in short order. At the time, we argued the volatility was more driven by technical than fundamental factors, specifically the unwinding of stretched and leveraged positions amid summer illiquidity.

Since then, the MSCI All Country World Index has more than recouped its losses and set all-time highs, much faster than we anticipated. A string of favorable economic and policy developments catalyzed the rebound. First, while the US employment report for July was disappointing, other labor-related data did not corroborate the weakness suggested by that report. Second, strong retail sales and earnings reports eased concerns about an imminent recession. Lastly, a third consecutive downside surprise in monthly headline inflation allowed Federal Reserve Chair Powell to shift more focus to labor market risks, delivering an unequivocally dovish message at Jackson Hole.

Now what?

While recent developments have undoubtedly been positive, we see the risk-reward for global equities as less favorable at current valuations. A lot of optimism has been priced in, and there is little margin of safety at current valuations in case economic growth deteriorates faster and by more than expected. We are entering a critical window in which investors will have to judge whether easier monetary policy is arriving soon enough to cushion a clearly slowing labor market. Historically, equity performance one-to-two months before a US Presidential election has been poor (on average). Accordingly, we have downgraded equities from overweight to neutral and prefer to focus on relative value opportunities across asset classes.

A less attractive risk-reward

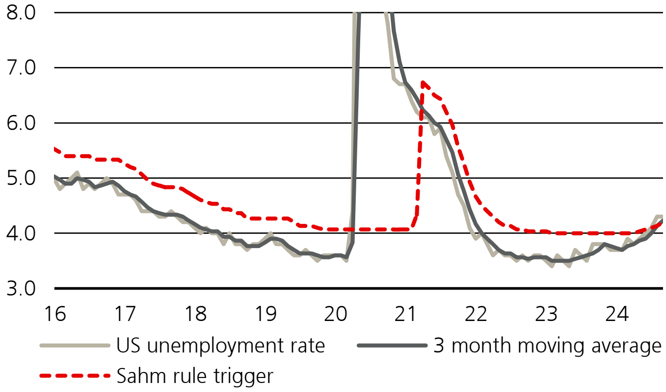
The bull case for equities has been straight forward. The economy is holding up, and central banks are set to cut rates. The challenge now is that this optimism for the outlook looks more than priced. The forward P/E ratio of MSCI World is well above its historical average at near 18x vs. a 30-year average of 15x. Forward earnings expectations still indicate double digit percentage gains at a time when nominal GDP is set to downshift even in a soft landing. And the rates market has now priced in 100bp of Fed cuts to year-end, with terminal rate pricing at a cycle-low of 3%, as indicated by the two year/one year overnight index swap (OIS). Risk assets are unlikely to get further support from lower yields, as further declines will most likely reflect rising concerns on economic growth.

A critical window

The cooling of the labor market has been gentle so far, with a slower pace of job growth and rise in the unemployment rate. But as long as job growth is persistently slowing, there is the risk of hitting a breaking point, where layoffs spike and a negative feedback loop kicks in between employment and consumption. Labor market internals show that cyclical and interest rate-sensitive sectors of the US economy, like housing and manufacturing, have started to weaken. Cyclical employment can lead both initial jobless claims and the unemployment rate.

Fortunately, Fed Chair Powell left little doubt that rate cuts are on the way and the Federal Open Market Committee is prepared to act aggressively to ensure the labor market stabilizes. The question is whether recessionary dynamics have already kicked into gear and it is now too little, too late from the central bank. In fact the Sahm rule, a widely tracked recession indicator, has been triggered.

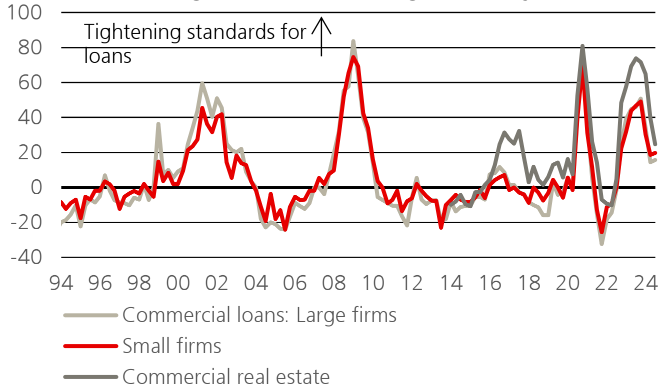
Exhibit 1: The rise in US unemployment has triggered the Sahm rule



Source: Bloomberg, Bureau of Labor Statistics, UBS Asset Management. As of August 2024

Our base case is that it is not too late to avoid recessionary dynamics. Broad financial conditions have eased over the course of the year, well ahead of the actual rate cuts – these should support growth albeit with a lag. Lending standards for commercial and domestic loans have actually tightened by less for several quarters.

Exhibit 2: Lending standards have tightened by less



Source: Bloomberg, Federal Reserve, UBS Asset Management. As of August 2024

Moreover, initial conditions matter, and they portray an economic backdrop that is much healthier than before prior easing cycles that preceded recessions. We see no obvious structural imbalances in the economy and think private sector balance sheets are healthy in aggregate, with debt service ratios at historically low levels. Corporate margins and consumption growth typically slow before a recession; they have been improving.

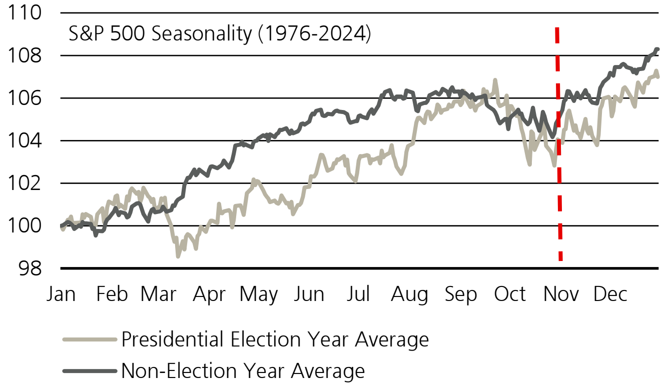
We are entering a critical window through to the end of the year, where the labor market and broader economy will have to 'hang in' before the effects of lower interest rates can take hold. The market is likely to be highly sensitive to labor market indicators and signs that interest-rate sensitive sectors like housing and manufacturing are gaining some traction from lower rates. It would not take much, given the optimism priced in, for the market to experience a 'growth scare' in coming months. Thus, even though we are optimistic there will be an ultimate soft landing, it makes sense to take a few chips off the table in the near term.

Oh, and there's an election

Of course, this critical window for the economy coincides with a critical window in US politics. With just over two months until the US election, current polling and prediction markets suggest a very close race. Historically, markets correct in the one-to-two months leading up to the election, and then rally after it regardless of whether a Republican or Democrat is elected. This likely reflects discomfort with policy uncertainty and then ultimately relief from policy clarity.

And there is plenty of policy uncertainty for investors to stew on within both parties' platforms. Vice President Harris's plans to hike taxes on corporations and high earners, including significant changes to taxation of capital gains, creates clear risks to equity markets, for the US in particular. Meanwhile, former President Trump's market friendly proposals to extend tax cuts and deregulate must be weighed against further deficit expansion and stagflationary policies on immigration and tariffs, the latter of which is a particular concern to markets outside the US.

Exhibit 3: S&P Seasonality on election vs. non-election years



Source: Bloomberg, UBS Asset Management. As of August 2024

Post-election, it is likely that actual policy outcomes turn out better than feared. Vice President Harris would require both houses of Congress to enact her tax policies, and the Senate map is difficult for the Democrats. A 50-50 split in the Senate is likely the best they can hope for, with a Vice President Walz being a tie-breaker. Such a narrow majority will make it difficult to enact controversial tax changes. Moderate Democrats stood in the way of major tax hikes even when Democrats held a Senate majority in the first two years of President Biden's term.

And while the sheer scale of former President Trump's tariff threats (60% on imports from China and 10% on imports from all other countries) would be quite damaging domestically and internationally if carried out in full, we suspect much of these would be used as negotiating leverage and ultimately be watered down.

Asset allocation: Focused on relative value

While we are cautious on the overall direction of equities in the near term, we see opportunities in relative value. Within equities, we favor the US over the rest of the world due to its stronger earnings profile and comparatively lower exposure to the weakening manufacturing sector. While this may seem counterintuitive given the aforementioned risks to the US economy, we note that historically US equities tend to outperform during slowdowns, even when the slowdown originates domestically. We focus our US exposure on a broad range of stocks so that it is not overly concentrated in the AI theme.

In fixed income, we are neutral duration and credit. For the former, the market has already priced in a great deal of easing for a soft landing scenario, so exposure to sovereign bonds serves largely as a hedge for risky assets. In credit, spreads are pricing in little default risk in an economic slowdown, but attractive all-in yields keep us neutral.

As with equities, we prefer a relative value approach. We are short Japanese government bonds vs. the US and UK as we believe the market is significantly underpricing further tightening from the Bank of Japan. Rates pricing remains far below even the lowest estimates of Japan's neutral rate, all while Japan's wage growth and consumption point to a structurally higher nominal GDP backdrop than we have seen in decades.

Similarly, within FX, we favor the Japanese yen over most currencies on relative policy dynamics. We also think the Japanese yen would offer protective properties should the more negative economic scenarios outlined above materialize. We are neutral on the US dollar more broadly, with the index caught between dovish Fed policy and the relative outperformance of the US economy and assets. We would turn bearish on the USD on more evidence of a soft-landing scenario accompanied by aggressive Fed cuts.

Asset class views

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness as of 29 August 2024. The colored circles 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, bonds, 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			● ←			Downgraded to neutral as risk-reward less positive as economy, earnings slowing amid high valuations.
US				●		Relatively strong earnings profile and less manufacturing sensitive than global equities. Prefer equal weighted index to AI-concentrated S&P 500.
Europe			●			Disappointing economic and earnings data. Ongoing challenges in global manufacturing is a weight.
Japan			●			Ongoing corporate reform, solid earnings countered by renewed JPY strength.
Emerging Markets			●			Skeptical EM can outperform ahead of US election especially with continued China growth malaise.
Global Government Bonds			●			Disinflation has brought stock-bond correlation negative again, but there is a lot of easing priced.
US Treasuries				● →		Gradual growth and inflation moderation improves hedging properties. Prefer US to Swiss/Japan bonds.
Bunds			●			ECB to ease policy further amidst cooling inflation, middling growth. But well priced into rates market.
Gilts				● →		Expect wages and service sector inflation to slow; gilts are attractively valued.
Global Credit			●			The risk-reward outlook for credit is not particularly attractive, especially in the US, where spreads are close to cycle tights. EUR and Asia HY still offer the best carry opportunities.
Investment Grade Credit			●			Spreads are around usual cycle tights, while corporate fundamentals remain relatively healthy. Returns likely driven by carry.
High Yield Credit			●			Further price upside is limited with spreads around 3% and the return outlook is negatively skewed. But all-in yields remain attractive in parts of the market. Prefer EUR HY over US.
EMD Hard Currency			●			Few pockets of value remain among very weak EM creditors, while higher-rated countries are trading at historically tight spreads by now.
FX						
USD			● ←			Shifted from overweight to neutral amid clear evidence of slowing US inflation and growth.
EUR			● →			Upgraded to neutral as services inflation remains sticky relative to the US.
JPY				● →		BoJ intent on tightening much more than priced as long as global economy holds up.
EM FX			●			Bumpier environment for EMFX carry as volatility rises.
Commodities			●			Global growth gradually slowing and OPEC+ likely dialing back production cuts in the quarters ahead should keep Brent well below USD 90. Gold is structurally supported but has priced in a lot lately.

Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as of 29 August 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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Americas

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