Macro Monthly

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UBS Asset Management | Economic insights and asset class attractiveness
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Job market resilience could prolong the late-cycle

So far this year, the US Federal Reserve has raised rates over six straight meetings by a total of 375 bps. Assuming the Fed follows through with an expected 50 basis points hike in December, it will have delivered the most cumulative tightening in any calendar year since 1980. The speed and magnitude of rate hikes is, by design, weighing on the US economy in order to bring inflation down.

Amid this backdrop, over 75% of fund managers think a recession is likely over the next 12 months – a level roughly on par with peak pessimism during the global financial crisis in 2009 and the COVID-19 pandemic in 2020.[1]

While a recession is a very real possibility, investors may be surprised by the resilience of the global economy – even with such a sharp tightening in financial conditions. The labor market will certainly cool, but healthy household balance sheets should continue to support spending in the services sector . Moreover, some of the major drags on the world economy emanating from Europe and China are poised to get better, not worse, between now and the end of Q1 2023.

Avoiding a recession would clearly be good news; however, it would not signal an all-clear for risk assets. A more resilient economy may also mean central banks need to do more, not less, in order to get inflation durably back to target. And this raises the risks of a harder landing down the road. But, in our view, it is too early to pre-position for very negative economic outcomes. A longer-lasting late cycle environment can persist for some time, and investors will have to be flexible and discerning in 2023 given these potential dynamics.

The Fed vs. the US labor market

To best understand US economic dynamics, it is necessary to break down the US labor market into lower and higher income cohorts. Lower wage employees, who are disproportionately employed in the service sector, are experiencing very strong wage growth (Exhibit 1). This is happening in large part because higher income workers still have a lot of excess savings, which they are ready and more than willing to spend in the service sector . While high earners have a lower marginal propensity to consume (that is, they spend a smaller percentage of their income compared to lower earners), they also account for the lion's share of total consumption (Exhibit 2).

It is the Fed's job to cool this situation down, and make sure it doesn't turn into a wage-price spiral. The Fed's tightening of financial conditions has meant some progress in

[1]Bank of America Global Research November 2022 Global Fund Manager Survey, Nov. 12, 2022.

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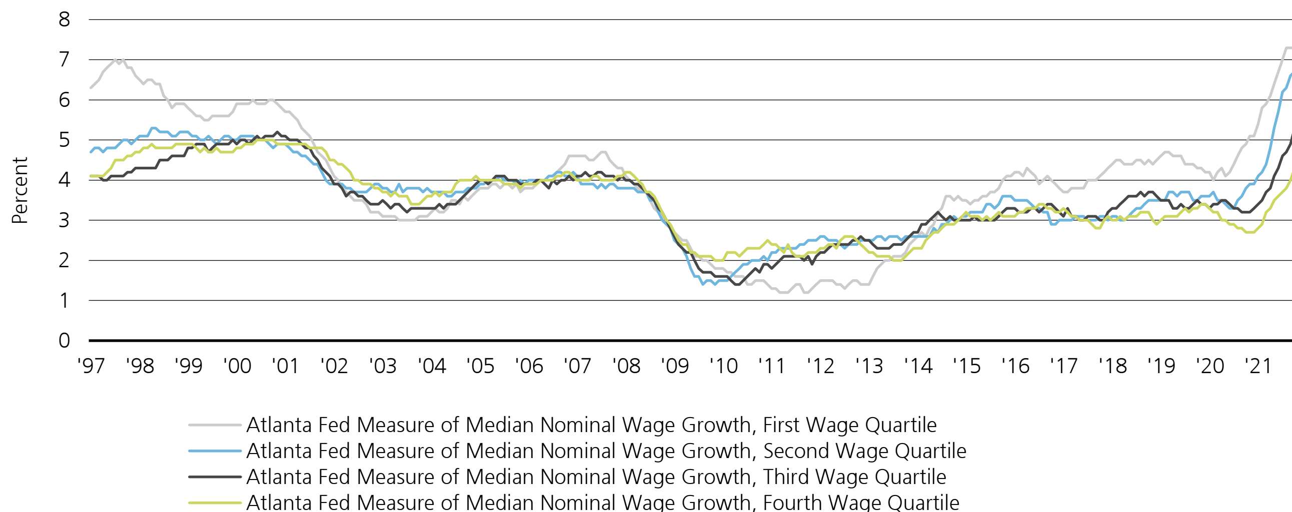
Exhibit 1: Income growth is strongest among the lowest earners



Source: Macrobond, Atlanta Federal Reserve. Data as of October 31, 2022.

slowing aggregate labor income, cooling the housing market and bringing down goods consumption. But the service spending dynamics mentioned above are unique to this COVID-19-driven cycle and arguably tougher to break. We believe this means the US economy (and earnings) probably don't fall off as sharply as many are projecting, and, however, also the Fed will need to keep rates higher for longer.

In the meantime, China is signaling the relaxation of zero-COVID-19 measures, even in the face of elevated case counts. In our view, this suggests a commitment to such a shift in policy, which should allow for a boost in consumption. The process is unlikely to play out in a straight line, but the direction of travel seems pretty clear, to us. Our confidence that the bottom is in for China is fortified since these adjustments to COVID-19 policy are taking place in tandem with the most comprehensive support for the property sector to date. A rebounding China may provide a needed boost as developed economies slow, but will also likely lead to higher commodity prices. This too may make it difficult for the Fed and other central banks to back off too quickly.

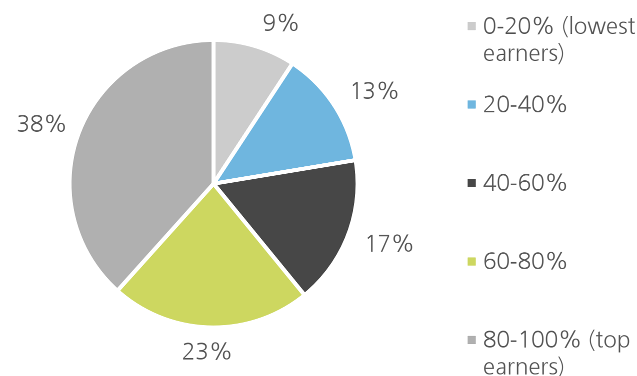
Asset allocation

Macro and cross-asset volatility are unlikely to fade away along with the calendar year. And the distribution of outcomes remains much wider than investors became accustomed to in the previous cycle. Our focus is therefore on positioning over the coming months as opposed to the coming year, and we are ready to pivot as the business cycle evolves.

Going into 2023, we expect global equities at an index level to remain range-bound. They will likely be capped to the upside by the Fed's desire to keep financial conditions from easing too much. However, we expect some cushion on the downside from a resilient economy and rebounding China. The relative value opportunity set across global equities appears fertile. Financials and energy are our preferred sectors. This is because we believe cyclically-oriented positions should perform if what appears to be overstated pessimism on global growth fades in the face of resilient economic data. Activity surprising to the upside and a higher-for-longer rate outlook should benefit value stocks relative to growth, in our view – particularly as profit estimates for inexpensive companies are holding up well relative to their pricier peers. On a regional basis, Japan is buoyed by a rare combination of accommodative monetary and fiscal stimulus.

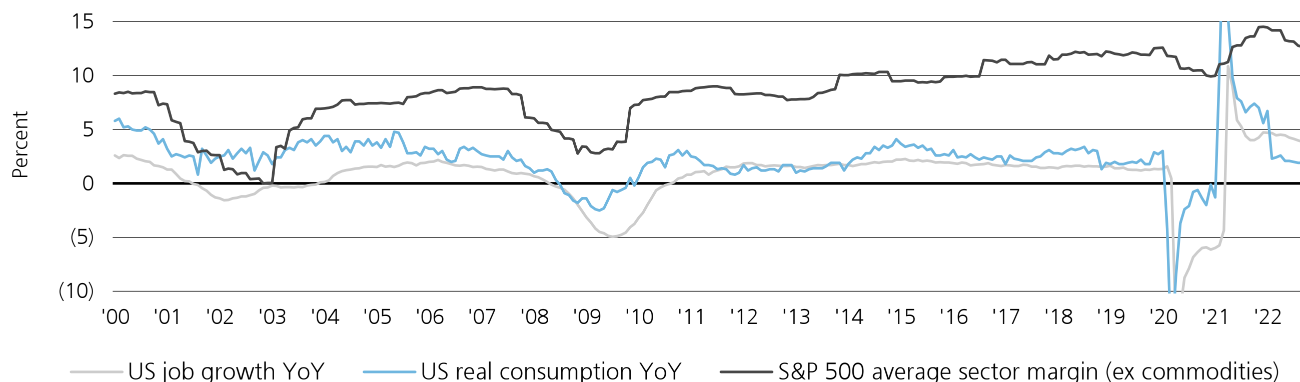
We are neutral on government bonds. The Fed is likely to be slow in ending or reversing its hiking cycle as long as the US labor market bends but does not break, while signs that overall inflation has peaked may reduce the odds of over-tightening. However, price pressures are likely to remain stubbornly high – a side effect of a US labor market that refuses to crack. China's reopening should fuel a pick-up in domestic oil demand, offsetting some of the downward pressure on inflation from goods prices. In credit , US and European investment grade bond yields look increasingly attractive as a balance between a potentially resilient economy and more range-bound government bond yields.

Exhibit 2: Share of US consumption by income quintile, 2021



Source: UBS-AM, Macrobond. Data as of December 31, 2021. US BLS, Consumer Expenditure Survey, Expenditures, Total Average Annual Expenditures, Total, Quintiles of Income Before Taxes, USD.

S&P 500 margins tend to be positive correlated with job, spending growth

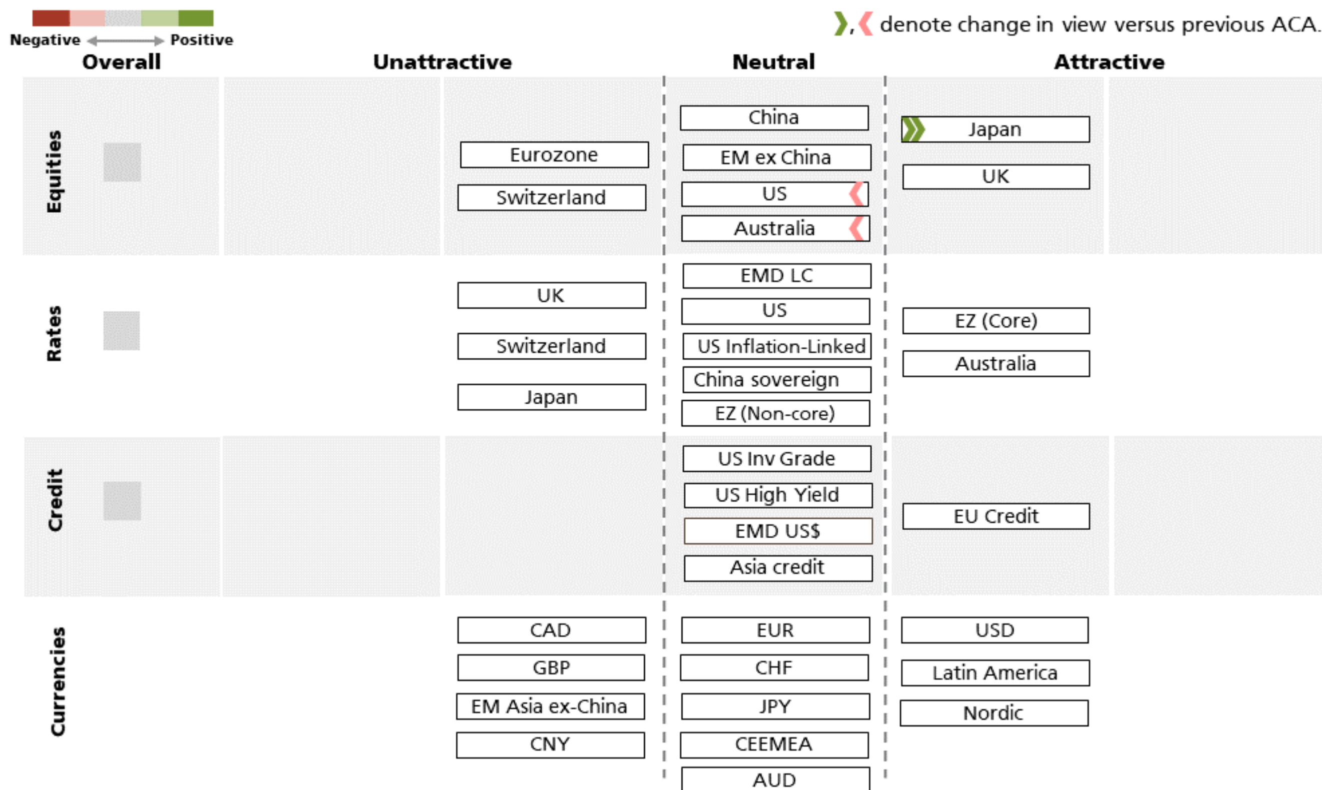


Source: UBS-AM, Macrobond. Data as of October 31, 2022.

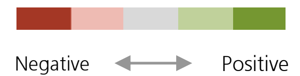
We see commodities as attractive both on an outright basis and for the hedging role they serve in multi-asset portfolios. Already low inventories can continue to shrink in an environment of slowing growth so long as supply remains constrained – as is the case across most key commodity markets. Securing sufficient access to energy is not a problem that will be solved at the end of this winter – and may grow more intense as Chinese demand increases if mobility restrictions are removed. In addition, commodities have a track record of strong performance during months when stocks and bonds suffer meaningful declines.

In currencies, we believe we have moved from a strong, trending US dollar to more of a rangebound trade in USD. Our catalysts for a broad turn in the dollar are for the Fed to stop hiking interest rates, China's zero-COVID-19 policy to end, and energy pressures in Europe stemming from Russia's invasion of Ukraine to subside. None of these have fully happened yet, but all three appear to be getting closer. A more rangebound dollar coupled with a global economy that is still growing, but slowing, could provide a very positive backdrop for high carry, commodity-linked currencies. We prefer the Brazilian real and Mexican peso.

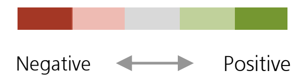
Asset class attractiveness (ACA)
The chart below shows the views of our Asset Allocation team on overall asset class attractiveness as of 29 November 2022. The colored squares on the left provide our overall signal for global equities, rates, and credit. The rest of the ratings pertain to the relative 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 November 29, 2022. Views, 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, equities are likely to remain in a volatile range – and we are closer to the top of that range than the bottom. Stocks remain expensive versus bonds based on the equity risk premium, and earnings as well as revenue estimates are biased lower from here, in our view. – However, sentiment and positioning appear extremely depressed, and the resilience in economic conditions as inflation rolls over with may be a sufficient catalyst for a squeeze upwards in global equities. – We think investors are overly pessimistic in presuming a recession is imminent. As such, we prefer inexpensive, cyclically-oriented regions like Japan and sectors like financials and energy.
US Equities		– American stocks are more acyclical and tend to outperform when global growth is decelerating. – US growth is likely to hold up better than other major developed markets. – However, US equities continue to command premium valuations, which may drag on relative performance if expectations for the Federal Reserve's terminal policy rate this cycle increase further. – Broad US dollar strength has been a material drag on profit expectations for US stocks versus other developed market indexes.
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. – Japanese stocks are buoyed by a relatively rare combination of monetary and fiscal stimulus. – European equities are still vulnerable despite a reduced risk of left-tail outcomes this winter. The likely hit to earnings from an economic downturn caused by energy shortages has not been fully priced in, in our view.
Emerging Markets (EM) Equities (ex-China)		– We prefer EM markets with the strongest linkages to commodities based on our expectation that supply will remain constrained in the near term and that the stabilization of growth in China will buoy commodity demand. – Brazil is our most preferred market in EM. Valuations are attractive, relative performance has room to catch up to the strong appreciation in commodities over the past two years, and the BCB has tightened policy sufficiently to control inflation, which affords them more flexibility to respond to any growth slowdown with interest rate cuts.
China Equities		– China's economic recovery remains constrained by zero-COVID policies and enduring softness in the property market. Importantly, Chinese leadership is turning in a more pro-growth direction on each of these fronts. – Following the National Party Congress, China provided a signal that zero-COVID-19 measures will be relaxed going forward. This process is likely to be bumpy, but the direction of travel – towards pre-pandemic norms – is clear, in our view. – There has also been a more thorough support for the property market, including loan guarantees for developers, funds to complete stalled projects, and a meaningful increase in credit made available by major banks. – In the near term, activity is likely to remain sluggish because of the rapid growth in COVID-19 cases, but on a forward-looking basis the outlook for China is improving materially. However, much of China's rebound will be services-centric, and therefore unlikely to produce large positive spillovers for real activity elsewhere. – We are closely monitoring geopolitical tensions between US and China, as these carry left-tail risks to both operating performance and valuations.
Global Duration		– Long-term bond yields should be rangebound due to the combination of enduring recession risks, sticky-high inflationary pressures, and US labor market resilience. – Central banks' commitment to tightening – albeit at a slower pace – should drive even more flattening of yield curves.



Asset Class	Overall/ relative signal	UBS Asset Management's viewpoint
US Bonds	▪	– US Treasuries remain the world's preeminent safe haven and top source of risk-free yield. The Federal Reserve is poised to take rates to restrictive territory in order to quell inflationary pressures, even if this damages the labor market and puts the expansion in jeopardy. In our view, the Fed will soon slow down the pace of tightening on signs that core inflation has peaked, but the bar to stop hikes completely will require more slowing of inflation that is broad-based (in both goods and services) and corroborated by a cooling off of the job market. – The enduring strength of the domestic jobs market is the critical US-centric downside risk to Treasuries. The lack of softening across many labor market metrics despite aggressive tightening, relatively elevated energy prices, and the retrenchment in global factory activity is putting the Federal Reserve on a path to keep interest rates higher for longer.
Ex-US Developed-market Bonds	▪	– Outside the US, the threats of stagflation and recession are more pronounced. The European Central Bank rapidly exited negative interest rate policy and is poised to deliver additional hikes through Q1 2023. A new tool – the Transmission Protection Instrument – aims to compress unwarranted widening in periphery spreads relative to the core via asset purchases in order to increase the scope for rate increases. – The Bank of England's intervention in gilt markets, along with a change in political leadership, has meaningfully curbed left-tail risks to UK debt. However, the BOE has already pivoted back to asset sales and is expected to deliver the most tightening over the next year among developed-market central banks. – The Bank of Japan's policy of yield curve control undermines the utility of much of this market for now. Maturities beyond the 10-year point may be vulnerable should the persistence of inflation or needed central bank tightening drive even more repricing of global duration.
US Investment Grade (IG) Corporate Debt	▪	– US IG all-in yields have become much more attractive given the year-to-date rise in risk-free rates as well as widening spreads. However, there are two-sided risks: bond yields could rise further if expectations for the Federal Reserve's terminal rate are too low (a dynamic which could also be accompanied by wider spreads), or if recession is more imminent than we anticipate and substantial spread widening ensues.
US HY Corporate Debt	▪	– High yield spreads have widened materially year-to-date. However, spreads are not close to levels that prevailed at the peak of growth scares in 2011 and early 2016. Global recession risks are as high now as they were during those periods.
Emerging Markets Debt US dollar Local currency	 ▪ ▪	– We have a neutral view on emerging market dollar-denominated bonds due to the balance of carry opportunity and duration risk, which are offset by downside risks to growth. – A more positive carry backdrop for EM local bonds following rate hikes delivered well before developed-market central banks has increased the resilience of this asset class even in the face of aggressive global tightening.
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. We believe monetary easing and subdued domestic inflation should prevent any sustained upward pressure on yields.
Currency		– We have moved from a strong, trending US dollar regime to a more rangebound USD environment. The catalysts for major USD depreciation (Fed tightening cycle over, fading energy pressures on Europe, and China's zero-COVID policy to end) are starting to take shape, though none has fully played out yet. Some EMFX, like BRL, are poised to outperform cyclical Asian currencies and select G10 commodity exporters given attractive carry.

Source: UBS Asset Management. As of November 29, 2022. Views, 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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