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UBS Asset Management | Economic insights and asset class attractiveness
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Evidence of reacceleration

Highlights

- Financial assets have performed strongly to start the year, reflecting fading investor pessimism on the likelihood of a recession as decelerating inflation means central bank tightening cycles are winding down.
- We believe evidence of economic reacceleration from the US, China, and Europe is a more powerful catalyst for markets going forward.
- Cyclical areas of the equity market have more room to run to reflect this better-than-expected growth backdrop, in our view.
- Growth resilience raises the odds that inflation will remain sticky and elevated relative to the pre-pandemic cycle, which may challenge valuations for more expensive segments within global equities, like the US.

Financial markets have started the year with an 'everything rally' as fears over the potential for an imminent recession – concerns we argued were misplaced – have receded.

There are two key drivers of the price action, in our view. One is the deceleration of inflation, which has given investors more confidence that central banks' tightening campaigns are winding down. Segments of the market like unprofitable, early-stage growth stocks and long-term government bonds have been among the biggest beneficiaries of this shift in views. Secondly, there is evidence of a reacceleration in economic activity. We believe this development is a more important market catalyst as we progress further into 2023.

We continue to favor emerging market equities relative to US stocks, as they have superior earnings revision momentum on the back of China's reopening and are attractively valued on a relative basis. We are also positive on cyclical segments of the stock market, such as the energy and financial sectors, US small caps vs. large caps, and value vs. growth factor. We find the ample carry available in emerging market hard currency debt to be attractive and believe spreads have scope to compress.

US dollar weakness should continue to be in the offing, in our view, as the Federal Reserve's tightening campaign nears its conclusion, China's economic rebound lifts global growth, and the stress on Europe from high energy prices subsides.

There is a limit to how low longer-term US government bond yields can go given this resilient growth backdrop, and we believe this level has been reached. In addition, this sturdier-than-appreciated growth backdrop is not necessarily a good-news story for equities at the index level. Growth resilience raises the odds of inflation aftershocks and, in our view, is likely to contribute to a higher-for-longer interest rate environment. Solid nominal growth coupled with expensive valuations for global equities (driven in large part by a handful of US companies) informs our view that commodities should outperform global equities going forward.

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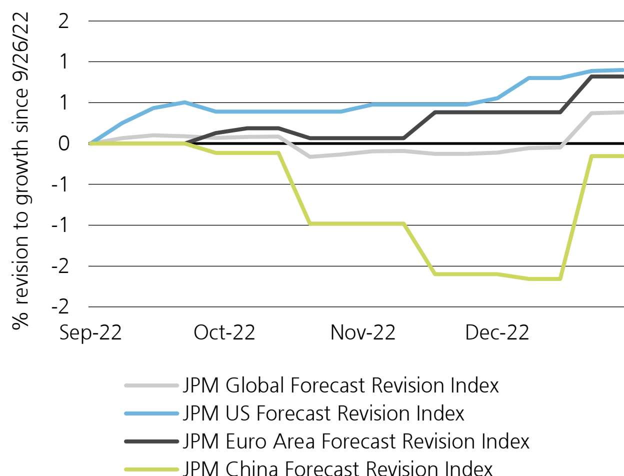
Exhibit 1: Global growth revisions are turning up



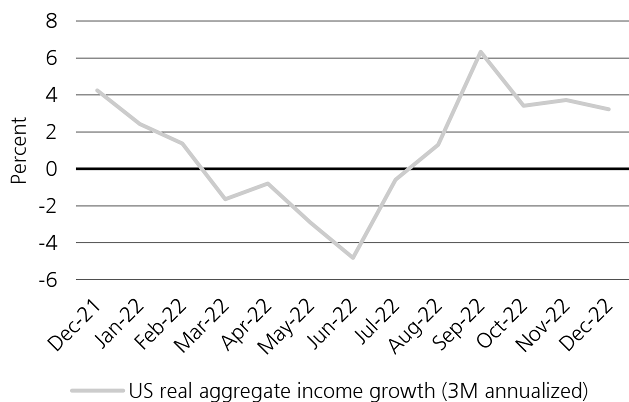
Source: UBS-AM, JPMorgan. Data as of January 23, 2023.

Note: JPMorgan Forecast revision index tracks cumulative change to forecasts for prior quarter, current quarter, and each of the two upcoming quarters.

Headwinds to tailwinds

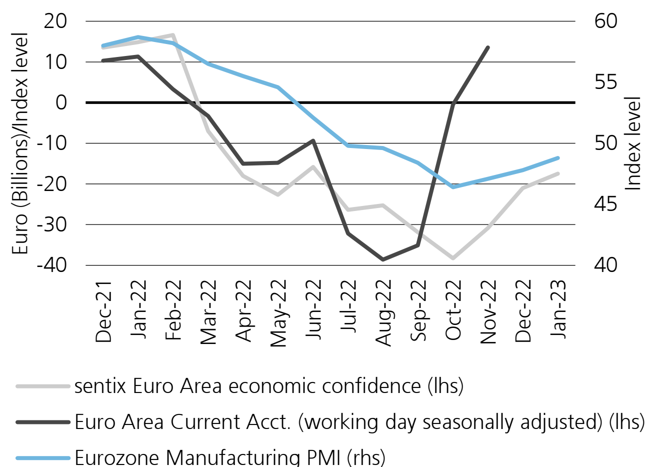
The US labor market continues to be seemingly indomitable, underscored by stunningly high job growth in January. Initial and continuing jobless claims are running at or below levels that prevailed at the end of 2019. While wage growth has moderated, indicators such as the private-sector quits rate imply that this is likely to remain above its pre-pandemic pace. Excess savings have clearly been drawn down, and are no longer putting a sturdy floor under US spending. But, for the US consumer, positive real aggregate income growth is now providing cause to expect continued strength. Since the start of August, US inflation-adjusted spending power has been increasing on a three-month annualized basis as the deceleration in price pressures exceeds that of wage and employment growth. After a concerning dip in December, the ISM Services purchasing managers' index also surged to start the year. This suggests momentum in the most important component of the US economy, services, is intact.

Exhibit 2: Real income growth provides more fuel for consumer spending



Source: UBS-AM, Macrobond supplied data collected from the Bureau of Labor Statistics. Data as of December 2022.

Exhibit 3: European activity is rounding a corner



Source: UBS-AM, Macrobond aggregated data from: Sentix, Euro-Area economic confidence; Markit, PMI; European Central Bank, current account information. Data as of January 2023.

Residential investment, a major negative for US GDP growth over the past three quarters and considered a leading indicator for the economy at large, is also likely to be less of a drag. The near-100 basis point drop in US 30-year fixed mortgage rates off their peak is reinvigorating domestic housing activity, with mortgage applications moving higher since the start of the year.

Meanwhile, China is set to reclaim its role as the engine of global economic growth. The spread of the COVID-19 virus as mobility restrictions were abandoned has been swift. Now, measures such as severe cases and patients in hospitals are now both more than 70% off their peaks. Service-sector spending is likely to receive the biggest boost from a durable, comprehensive economic reopening, but this process should also provide a broad-based lift for growth, in our view. We believe China's manufacturing purchasing managers' indexes will soon rebound into positive territory. If this occurs, history would suggest that this would have positive spillovers for global factory activity.

Investors have also gone from debating the severity of a potential European recession to wondering whether there will be a downturn at all. Fourth-quarter figures showing virtually flat activity (after adjusting for distortions relating to Irish tax policy) reinforces how left-tail outcomes during Europe's winter have been avoided. Forward-looking indicators are evolving in a manner consistent with passing a trough and moving towards recovery. Importantly, the stress brought about by higher energy prices is shaping up to be much less severe than feared. Wholesale energy and natural gas prices are roughly half of what European Central Bank staff predicted for 2023 back in December. This development is an unambiguous positive for European industry as well as consumers.

Asset allocation implications

We believe markets are entering a more nuanced environment that will be less favorable for beta but still surprisingly positive for economic activity relative to consensus.

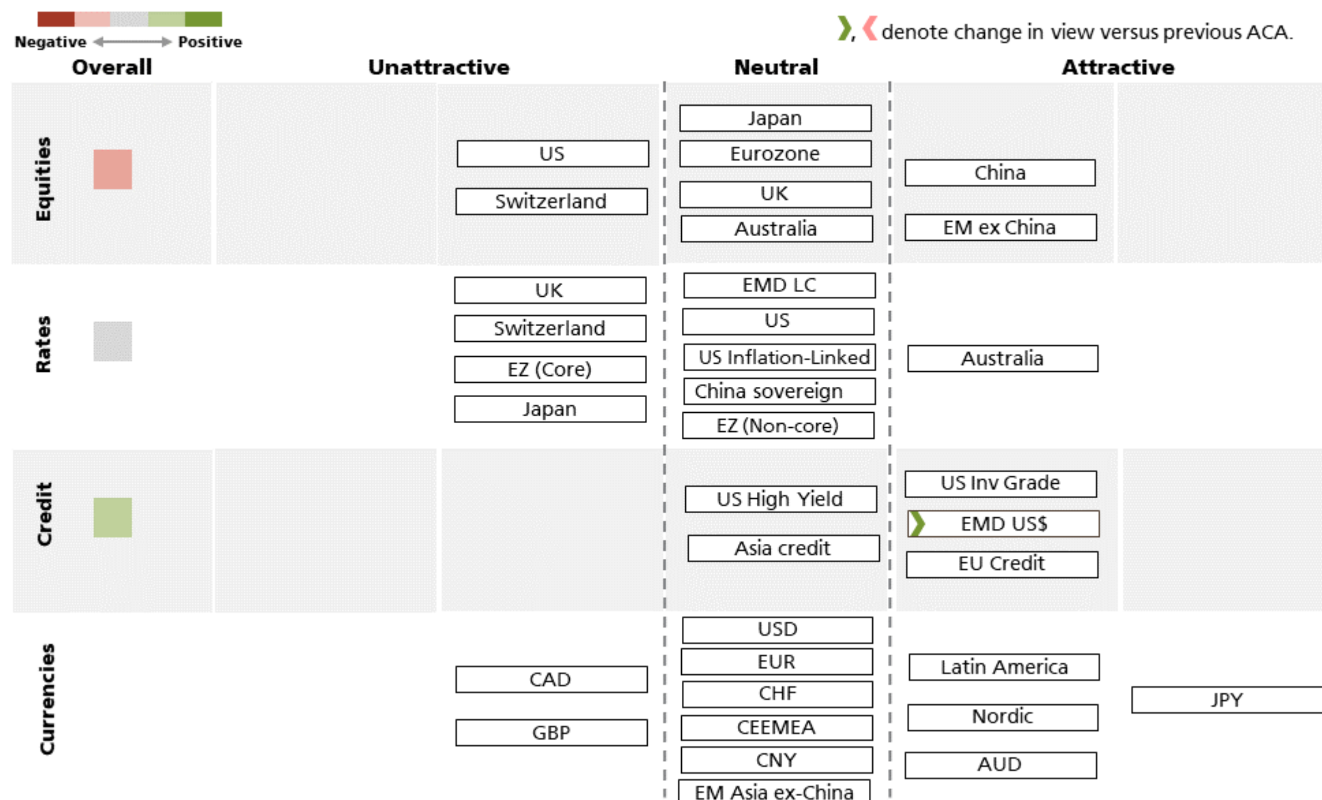
The peak in inflation and central bank hawkishness have fueled a significant rebound in many of the speculative, expensive assets most damaged by tightening campaigns. In our view, there are limits to this "buy what the Fed broke" strategy. Growth resilience means that it will be difficult for central banks to get inflation rates all the way down to their targets. This also suggests that government bond yields have limited room to decline further. Under these conditions, we believe the valuation pressures that plagued more expensive acyclical/growth stocks in 2022 are likely to reemerge.

In our view the most attractive investment opportunities continue to be in cyclically-sensitive areas of the equity market, which are inexpensively valued on a relative basis and are more tightly levered to this re-acceleration in economic activity. Relative growth differentials are likely to move in favor of the rest of the world relative to the US, in our view, which should continue to put downward pressure on the US dollar. The Japanese yen, Mexican peso, and Australian dollar are our preferred currencies amid a sustained depreciation in the US dollar.

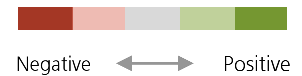
The overall resilience in nominal growth, particularly in China, coupled with tight supply is a recipe for higher commodity prices. Similarly, expensive equity valuations along with limited near-term recession risk makes the carry opportunity in emerging market hard currency debt very attractive on a relative basis.

Asset class attractiveness (ACA)

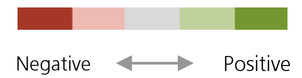
The chart below shows the views of our Asset Allocation team on overall asset class attractiveness as of February 3, 2023. The colored squares on the left provide our overall signal for global equities, rates, and credit. The rest of the ratings pertain to the relative attractiveness of certain regions 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 February 3, 2023. 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, the risk-reward proposition for global equities at an index level is not particularly attractive. Stocks remain expensive vs. bonds based on the equity risk premium, and we believe earnings estimates are biased lower from here. – Importantly, US stocks still account for nearly 60% of global equities, and remain richly valued while also displaying underwhelming earnings revisions. – We are more optimistic on global economic activity than consensus for 2023, but there are better ways to express this view than through equities at the index level. We prefer regions where both monetary and fiscal policy are still highly accommodative, like China, as well as sectors such as financials and energy.
US Equities		– US stocks have been relatively expensive for a long time, but this valuation premium was justified by superior profit growth. – Recent earnings revisions are more negative for US stocks than for global equities. US stocks are particularly vulnerable to a negative re-rating relative to global equities given this catalyst of earnings outperformance shifting to underperformance. – US equities are also more acyclical and would likely fare poorly vs. global equities if global economic activity surprises to the upside as we expect.
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. – We have high conviction that the yen will appreciate, which diminishes the attractiveness of Japanese stocks in local currency terms. Equities are buoyed by strong domestic fiscal support, which may be reinforced by surprising strength in real activity globally if our optimistic economic view comes to pass. – Success in securing natural gas and a milder start to winter have reduced left-tail outcomes for European equities. However, the ECB is committed to bringing policy rates well into restrictive territory amid a soft patch in activity, which should limit how much valuations can improve.
Emerging Markets (EM) Equities (ex-China)		– While China's reopening is primarily a story of recovering domestic consumption, we believe it will still produce positive, but measured, spillovers for its trading partners as well as commodities. – Broadly speaking, EM equities have both re-rated to the downside and have seen a larger total drawdown in earnings estimates than DM equities, which limits the scope for relative underperformance vs. global equities going forward, in our view. On a shorter timeframe, earnings revisions are also favorable for EM equities vs. the US, due in large part to the expected rebound in China.
China Equities		– The swift abandonment of zero-COVID-19 policies is paving the way for China's economic recovery and the outperformance of domestic risk assets. The removal of mobility restrictions is also being accompanied by more thorough support for the property sector, which bolsters our conviction that economic activity and earnings will improve meaningfully from 2022 to 2023. – Investors have been willing to look through some sluggishness in activity as COVID-19 rapidly spread through the population, and a durable, comprehensive reopening of activity is now imminent. – 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 as robust labor market data and resilient economies squares up against the fact that central bank tightening cycles are well advanced and that the risk of an eventual recession has not gone away. – Central banks' commitment to tightening – albeit at a slower pace – and reluctance to reverse course should keep yield curves relatively flat.



Asset Class	Overall/ relative signal	UBS Asset Management's viewpoint
US Bonds		– US Treasuries remain the world's preeminent safe-haven asset. The Federal Reserve is close to getting rates to a sufficiently restrictive territory and plans to keep policy quite tight until services sector inflation, which is linked to the labor market, decelerates meaningfully. – 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 may keep the Fed on track to keep interest rates higher for longer, especially as economic activity is accelerating in the near term.
Ex-US Developed-market Bonds		– The European Central Bank is preparing to start quantitative tightening in Q1 while telegraphing a terminal policy rate above 3%. 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 hikes. – The Bank of England's apparent reluctance to deliver too much more policy tightening despite high wage growth and inflation is raising the probability of a structural rerating higher for inflation risk. The Sunak government has outlined a spending plan that involves some fiscal consolidation, but much of this is back-loaded. – The Bank of Japan's recent expansion of its yield curve control range is a meaningful step towards a monetary tightening campaign in light of more entrenched inflationary pressures, in our view.
US Investment Grade (IG) Corporate Debt		– US IG all-in yields have become much more attractive given the rise in risk-free rates as well as widening spreads. 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 the economy will remain resilient in the near term.
US HY Corporate Debt		– High yield spreads have widened materially from their mid-2021 lows, but are still quite narrow in the context of growth risks. While we are optimistic on the economy, we do not think investors are adequately compensated for downside risks to justify an overweight.
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. – We expect a more positive carry backdrop for EM local bonds following rate hikes delivered well before developed-market central banks, which 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.
Currency		– We believe the US dollar has peaked, and has transitioned to an environment in which the USD is rangebound to lower. The catalysts for sustained USD depreciation (Fed tightening cycle over, fading energy pressures on Europe, and an end to China's zero-COVID policy) are increasingly taking shape. 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 British pound and New Zealand dollar given attractive carry.

Source: UBS Asset Management. As of February 3, 2023. 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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