Macro Monthly

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UBS Asset Management | Economic insights and asset class attractiveness
March 2023

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Time for Chinese growth to drive global markets

Highlights

- China's reopening is on track, and this remains a key tailwind for the global economy in 2023.
- Recent geopolitical tensions alongside strength in US activity, labor market, and inflation data early in 2023 have sparked a rally in the US dollar and weighed on China-sensitive assets.
- In our view, the next leg of the mini reacceleration in global activity will be driven by China.
- We prefer positions that are linked to China's rebounding economy, such as emerging market equities over developed market stocks, cyclical sectors like energy, and value stocks over growth.

The most important new tailwind for global growth in 2023 – a durable, comprehensive economic reopening in China – has been undermined in February amid a reemergence of geopolitical strife and a counter-trend rally in the US dollar. In our view, the pullback across many China-sensitive areas of financial markets marks consolidation on the heels of strong gains and is an opportunity to position for a renewed push higher.

Our belief is that President Xi Jinping will largely be able to achieve the policy goals he sets. Over the past few years, this meant maintaining zero-COVID-19 policies and addressing perceived excesses in the real estate and technology/internet platform sectors. Now, it means reestablishing a solid foundation for Chinese growth.

Our portfolios are positioned to benefit from a strong rebound in Chinese activity and resilience in developed market growth. We prefer emerging market equities – in particular, China – to US stocks; cyclical sectors, especially energy, vs. more defensive or acyclical segments of the market; and value stocks over growth.

Recovery on track

China's pro-growth policy changes are bearing fruit. High-profile official economic data are likely to take some time to testify to the robustness of China's recovery, because of the lags involved. But more timely high-frequency data already suggest that a durable economic reopening is well underway.

Road traffic, as measured by congestion levels in China's 15 largest cities, is running at levels not seen since September 2021. Other measures of travel intensity within Chinese cities tell a similar story of enhanced mobility. The strength in demand has been

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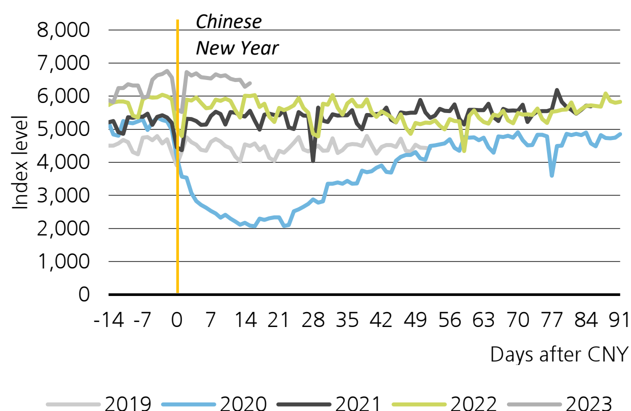
Exhibit 1: Chinese mobility off to a strong start in 2023

Travel intensity within a city (local movement intensity index)



Source: UBS-AM, UBS Evidence Lab, UBS IB estimates. Data as of February 6, 2023.

sufficient for Saudi Arabia to raise selling prices to Asia. In addition, Chinese refiners are also on pace to source about twice as much crude this March from the US Gulf Coast compared to the past few years. Refinery utilization rates, particularly for state-owned firms, have been picking up steam to meet this increased appetite. We believe it is only a matter of time until this sequential improvement in demand from both China and developed markets heading into the spring and summer produces more upside in oil prices as the seasonal slow period passes.

Chinese new home prices were steady in January, arresting a 16-month streak of monthly declines. The suite of policy measures designed to improve the supply side, and to a lesser extent, bolster demand, suggest that this important sector should find more stability in 2023 vs. 2022.

One lesson from developed market economies in 2021 is that markets may consistently underestimate the momentum generated by the reopening process. We think that mistake is

Exhibit 3: Earnings, multiples for Chinese equities have room to run higher

Source: UBS-AM, JPMorgan. Data as of February 27, 2023.

Exhibit 2: Chinese economic data exceeding expectations by more than US, world

Source: UBS-AM, Citi, Macrobond, Bloomberg. Data as of February 27, 2023.

being made again with regards to China. 12-month forward earnings estimates for Chinese stocks are near levels that prevailed at their 2020 lows. So too are forward price-to-earnings ratios. We believe there is ample scope for Chinese equities to both post surprisingly strong earnings and to re-rate higher in line with emerging market stocks more broadly. In addition, multiples on very expensive US stocks should narrow towards EM equity valuations, amid high rates and earnings headed in the other direction.

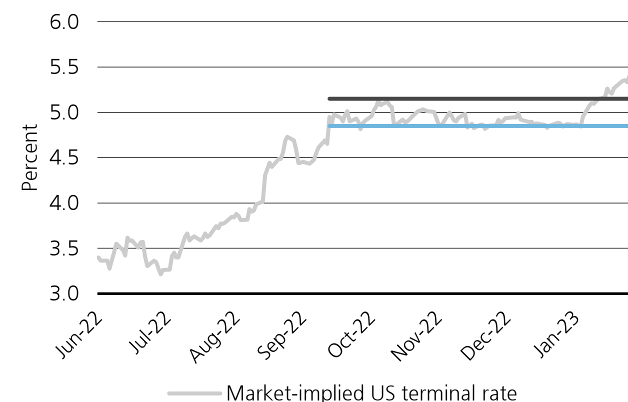
We will continue to closely monitor a number of metrics including Chinese mobility (car, subway, and flight utilization), consumer spending, employment data, and oil imports to confirm that its economic rebound continues to gain traction.

Negative catalysts fading

In our view, the factors that interrupted the outperformance of Chinese equities – a resurgent US dollar and geopolitical concerns – will not have much more staying power.

We came into the year with high conviction that calls for an

Exhibit 4: Higher expectations for the Fed's peak policy rate have helped the US dollar



Source: UBS-AM, Bloomberg, Macrobond, Morgan Stanley. Data as of February 27, 2023.

imminent US recession were far too pessimistic. Indeed, US activity and inflation data have started off the year surprisingly strong relative to consensus. This has caused the market's expectation for the Federal Reserve's terminal policy to break to the upside after being in a narrow four-month range around 5 percent. (See Exhibit 4). A higher expected terminal rate, along with an unwind of short positioning, has sparked a sharp surge in the US dollar in recent weeks. Dollar strength is typically a headwind to cyclical positions, and especially emerging market equities. This episode has been no exception.

However, even some of the more hawkish Federal Reserve officials who would have preferred to raise rates by 50 basis points in February are reluctant to revise their estimate for the eventual end point for the central bank's policy rate upwards as of now. We (and they) believe that the US economy is neither as sluggish as December's data made it out to be, nor in full-blown boom mode as some of the January figures would imply. The truth is probably somewhere in between. It is likely that US economic data still points to a solid expansion in February, but with a step-down in momentum.

Geopolitics have also played a key role in fueling risk aversion for Chinese stocks. The MSCI China Index erased all of its multiple expansion from January after news regarding the entrance of a Chinese spy balloon over US territory. As that issue subsided somewhat, concerns over China's potential military support for Russia emerged.

In our view, some statements made by US officials are more noise than signal, aiming to deter China from providing military aid to Russia and diminish China's attempt to position itself as an independent arbiter of a peace process to resolve the war instigated by its ally. Importantly, dialogue between the US and China remains open, with plans for US President Joe Biden and Xi to speak "in the not too distant future," according to the US National Security Advisor. As mentioned, we have received many signals that Chinese policy has shifted towards prioritizing economic growth. We do not think President Xi plans on compromising that goal by drawing the ire of the US and Europe alike by providing weapons to Russia. Such a course of action would likely see the US and Europe enact crippling sanctions that, in our view, would undo the economic progress China has made to date.

Asset allocation

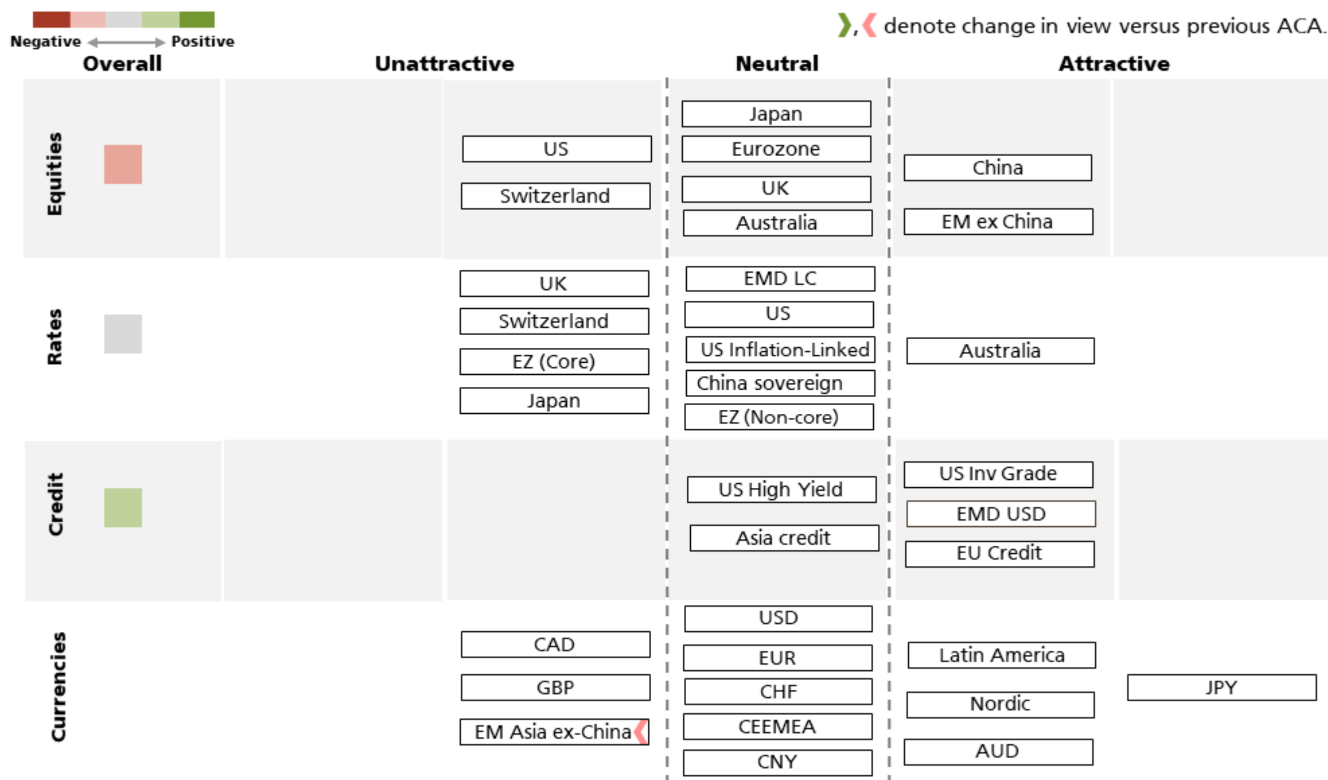
We believe 2023 marks China's return to being a leader rather than laggard in economic growth. This dynamic, in our view, will prove a more potent catalyst for markets than recent geopolitical disputes or the ultimate peak for the Federal Reserve's policy rate.

We do not expect US activity and inflation data to be so strong as to provoke a return to 2022 in rates and foreign exchange markets, where expectations for the Fed's policy rate – and the US dollar vs. other currencies – trended persistently higher. The next leg of the mini reacceleration in global activity will be driven by China – and benefit the assets most sensitive to its economic rebound.

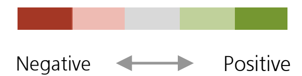
The China growth story, coupled with clear evidence that developed market economies will avoid recession for at least the first half of the year, is key to our preference for cyclical assets, for example: emerging market equities over US stocks, sectors like energy and financials, and value stocks over growth.

Asset class attractiveness (ACA)

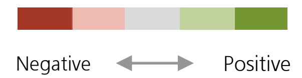
The chart below shows the views of our Asset Allocation team on overall asset class attractiveness as of February 28, 2023. The colored squares on the left provide our overall signal for global equities, rates, and credit. The rest of the ratings pertain to the relative attractiveness of certain regions 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 28, 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 are richly valued while also displaying negative 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 energy and financials.
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 worse for US stocks than for global equities. US stocks are particularly vulnerable to a de-rating vs. 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 mild winter 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 or how strongly Europe's economy can rebound.
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 de-rated and have seen a larger total drawdown in earnings estimates than DM equities. This limits the scope for relative underperformance vs. global equities going forward, in our view.
China Equities		– Chinese policy has moved in a pro-growth direction with the abandonment of zero-COVID-19 measures, more support for the property sector, and the end of the regulatory campaign against internet platform companies. These shifts bolster our conviction that economic activity and earnings will improve meaningfully from 2022 to 2023. – Traffic and travel metrics suggest a durable, comprehensive opening is well underway. Markets have frequently underestimated the strength of a country's economic rebound once mobility restrictions are removed. – We are closely monitoring geopolitical tensions between the US and China, particularly related to the latter's relationship with Russia, 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 square 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 upside risk to yields. The lack of softening across many labor market metrics despite aggressive tightening may keep the Fed on track to keep interest rates higher for longer, especially in light of the recent re-acceleration in economic activity.
Ex-US Developed-market Bonds		– The European Central Bank is preparing to start quantitative tightening in March while telegraphing a terminal policy rate above 3%. Monetary policymakers have signaled that another 50 basis point hike will also be delivered in March, and we suspect they may be more cautious about proceeding with additional tightening thereafter. – The Bank of England's apparent reluctance to deliver too much more policy tightening despite high wage growth and inflation is raising the probability that inflation expectations will move structurally higher. 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. We believe the new governor is likely to adjust policy further
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. – 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.
Currency		– We believe the recent move higher in the US dollar is a countertrend rally, and not a return to its 2022 peak. We have transitioned to an environment in which the USD is rangebound to lower, in our view. The catalysts for sustained USD depreciation (Fed tightening cycle over, fading energy pressures on Europe, and an end to China's zero-COVID-19 policy) are increasingly taking shape, though the first one has been undermined by the strength of US activity and inflation data in early 2023. 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 28, 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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