Macro Quarterly

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

Macroeconomic themes and tactical asset allocation opportunities
3Q2019 | UBS Asset Management

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Bend, don't break

Highlights

- We expect the global economy will ultimately stabilize around its long-term trend rate, but geopolitical risks have clouded the outlook.
- Policy actions taken in the US and China, both in trade and monetary policy, are crucial to the global economy and markets. These actions and resilient labor markets should be able to prevent a hard landing in the global economy, but the risks around this view have risen.
- Position on fundamentals; hedge the politics. We describe how our theme-based approach to investing provides balance and diversification across our strategies.

Theme	Related case study
Global growth to steady around trend	Long EAFE vs US Equities
China finding a cyclical bottom	Long Asia hard currency debt
Central banks to extend the cycle	Long China Agg FX Hedged
Geopolitics and protectionism	Long Japanese yen vs. Korean won
A higher volatility regime	Short Aussie dollar vs. US dollar

Geopolitical developments have always played a part in markets but their impact on economic fundamentals and investment outcomes is only growing. This reality demands an ability to be open-minded about political and economic possibilities that do not have an obvious historical analogue. It also demands a certain humility that we cannot predict the future, and the need to hedge our portfolios where possible against specific outcomes that lie outside of our base case. We have therefore built our investment process around key themes, or hypotheses, that we monitor for confirmation. Themes serve as our 'North Stars'—core views that we build trades around to express them. In each Macro Quarterly we discuss these themes and examples of case studies associated with them. The first three themes capture the macroeconomic and policy outlook which form the basis for our core portfolio positions. The last two themes, focused on geopolitics and volatility, form the views used to diversify and hedge our portfolios to account for the unexpected.

Global growth to steady around trend
We have taken a round trip in global growth over the last three years. Led by China stimulus and an accommodative Fed, global economic growth accelerated from mid-2016 through 2017 only to decelerate sharply in 2018 and to start 2019. Now we are back, with a more dovish Fed and China stimulus again providing support for the economy. The difference between now and back then is the 'muscle' of the stimulus—three years ago China's support for growth was powerful and broad-based and the Fed was still close to its zero bound. Today, US rates are close to neutral and China's

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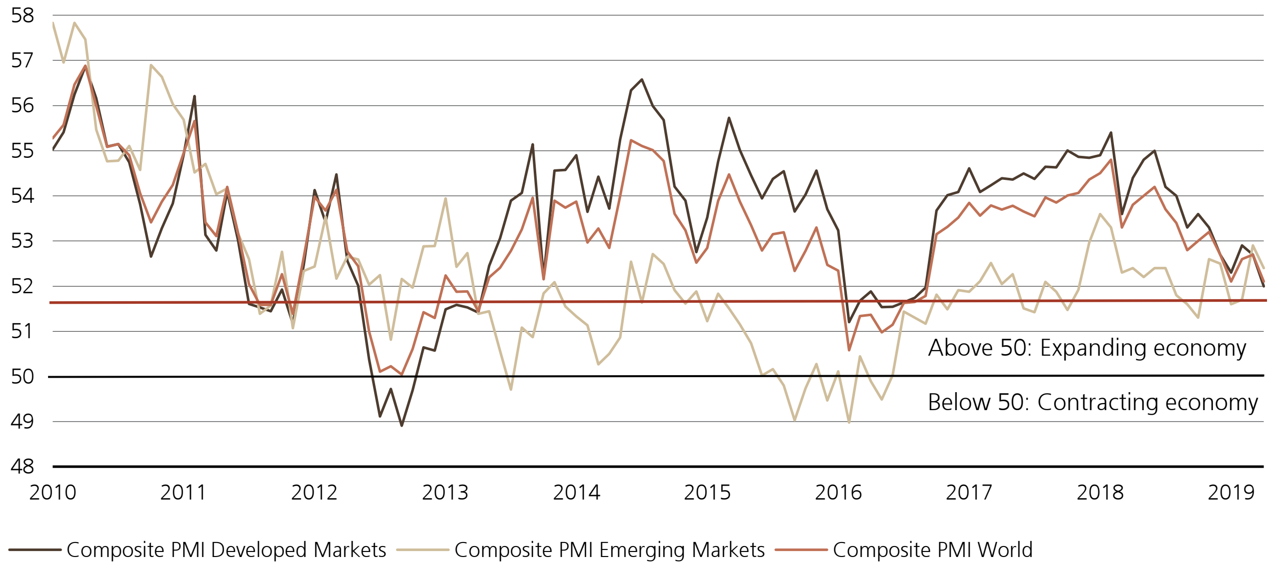
Exhibit 1: Global growth to stabilize around trend



Source: UBS Asset Management, Macrobond as of 23 May 2019. Deep red line represents long-term global trend.

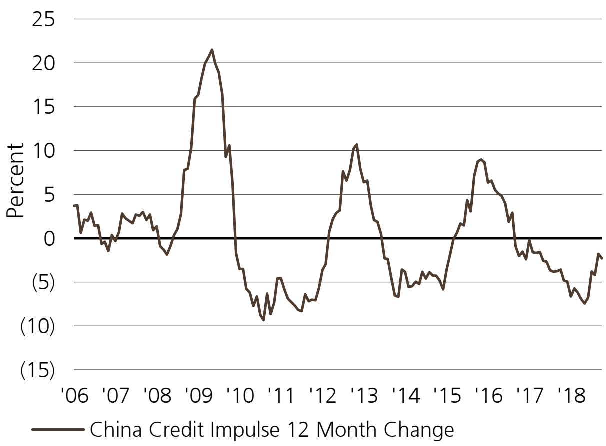
stimulus is more targeted in nature and with less global spillover. Thus we are looking for growth stabilization as opposed to reacceleration, best visualized by the Purchasing Manager Indexes (PMIs). With crucial policy support, we suspect the PMIs will settle around the global economy's average over the period (deep red line) and above the 50 line which separates expansion from contraction. Essentially, this represents a soft landing for the global economy. Our assessment is based on the view that while there has been pronounced weakness in the manufacturing and goods sectors, global services sectors have remained generally resilient. This underlying durability is linked to ongoing strength in developed economy household income growth, supporting consumption. While recent trade escalation between the US and China/Mexico skews the risks towards a move below trend economic growth, incremental policy support will prevent a recession, in our base case.

Case study: Long EAFE vs US Equities
EAFE, or major developed ex-US stock markets, underperformed the US for much of last year. But these markets are pricing a much gloomier outlook than the US, and by some measures relative valuations are near tech bubble extremes. As economic growth in the US moderates but the global economy ultimately achieves a soft landing, these markets have room to outperform.

China finding a cyclical bottom
As the world's second largest economy and the integral anchor in the global supply chain, China's economic health is crucial not only to the overall dynamics of the global economy but to its relative balance with the United States.

An imbalanced global economy, driven primarily by the US, can create destabilizing forces via dollar strength which stress indebted emerging markets and create negative feedback loops. With the US fiscal stimulus fading over the rest of the year and into 2020, China's growth stabilization is critical to

Exhibit 2: China's economy is stabilizing



Source: UBS-AM, Macrobond, Bloomberg. As of 23 May 2019.

provide support and balance to the global economy. We believe that China's easing of monetary, fiscal and regulatory policy is beginning to take hold, although again the results are consistent with stabilization as opposed to a sharp rebound. Credit growth has risen and infrastructure investment is showing signs of life. Moreover, we do not doubt China's willingness and ability to provide additional stimulus should trade tensions or other headwinds create the need.

Case study: Long Asia hard currency debt
An environment with steadying, rather than accelerating or sharply deteriorating Chinese growth, is positive for carry. As we look for higher-yielding assets across the globe, we find Asian hard currency debt quite attractive compared to the low yields on offer in developed markets. Heavily weighted towards China's property sector, we believe that ongoing policy support for the labor market and household income is supportive of this view.

Exhibit 3: The Fed has failed to sustainably hit its 2% inflation target

Source: UBS-AM, Macrobond, Bloomberg. As of 23 May 2019.

Central banks to extend the cycle

With this US economic expansion now the longest on record, it is unsurprising that investors are increasingly cautious on how long it can possibly go on. But a confluence of developments have materialized that suggest this economic expansion can continue well into 2020 and probably beyond.

Having pivoted amid the sharp tightening in financial conditions late last year, the Fed has now shifted its focus to the stubborn downside inflation misses vs. its 2% target (Exhibit 3). This has led to increasing discussion of the Fed's strategic framework and whether the central bank needs to think about erring on the side of more accommodative policy in order to sustainably bring inflation and inflation expectations to its goal. Moreover, the downside risks to growth related to trade conflict may ultimately drive the Fed into some easing.

Other central banks across the globe have almost uniformly moved in a similar direction, with the European Central Bank and the Bank of Japan pushing out expectations for tightening and the Reserve Bank of Australia shifting towards outright easing. If there is one lesson from the post-crisis period, it is to not bet against central banks finding creative ways to provide the necessary accommodation to cushion economic growth. And the synchronized fall in long-term yields is providing an important automatic stabilizer against trade uncertainty and other headwinds. In the meantime, productivity is genuinely picking up in the United States, suggesting the cycle, despite its length, still has legs.

Case study: Long China Agg FX hedged
We once again stick with China, which continues to offer a rich set of opportunities in the current environment. In short, policymakers are determined to engineer a soft landing. The People's Bank of China (PBOC) is unlikely to raise rates anytime soon, with policymakers committed to keeping policy steady enough to support the economy against external headwinds. We believe that China's sovereign debt offers attractive yields compared to developed economy counterparts on both a nominal and inflation-adjusted basis. And ongoing opening of China's financial markets and index inclusion should encourage inflows and boost liquidity.

Geopolitics and protectionism

The reignition of the US-China trade war, and more recently the administration's potential opening of a new front with Mexico, creates direct global economic headwinds in the form of export disruption, crimped corporate margins and higher consumer prices. But it also has indirect consequences for the global economy, via uncertainty which weighs on business confidence and ultimately investment. Moreover, the trade wars are just part of the story.

Ongoing strategic competition and conflict on technology between the US and China is disrupting supply chains and slowing globalization. Meanwhile, the threat of auto tariffs on Europe and Japan still unresolved Brexit all act as suppressors of global economic confidence and investment.

While these conflicts will blow hot and cold over time, they are just part of an ongoing trend towards deglobalization which acts as a structural headwind to economic dynamism.

Case study: Long JPYKRW
As part of our investment process, we use scenario analysis to identify potential outcomes and their impact on markets. But ultimately there are limitations to predicting geopolitical events, and we prefer to use utility trades which we believe will provide us with an attractive risk-reward in periods of escalation. One such view is long the safe haven and undervalued JPY against the KRW, which has and may be likely to depreciate further if tensions between the US and China continue to deteriorate. Korea plays a crucial role in the Asian technology supply chain and its currency should offer a liquid hedge against further US-China trade disruption.

A higher volatility regime
Geopolitical tension clearly has contributed to market volatility, but there are other factors that are likely to drive volatility structurally higher than average levels in the post-crisis period. While we do see room for this cycle to extend, there is no doubting that the longer an economic cycle goes, the more uncertainty there is about economic and policy outcomes. How stable is the global growth trajectory? Has the Fed tightened too much? Or are markets too complacent that we will never see inflation, just as labor markets hit capacity, output gaps close, and de-globalization boosts consumer prices? These are the questions which markets will debate on and off, and it will likely be reflected in financial assets.

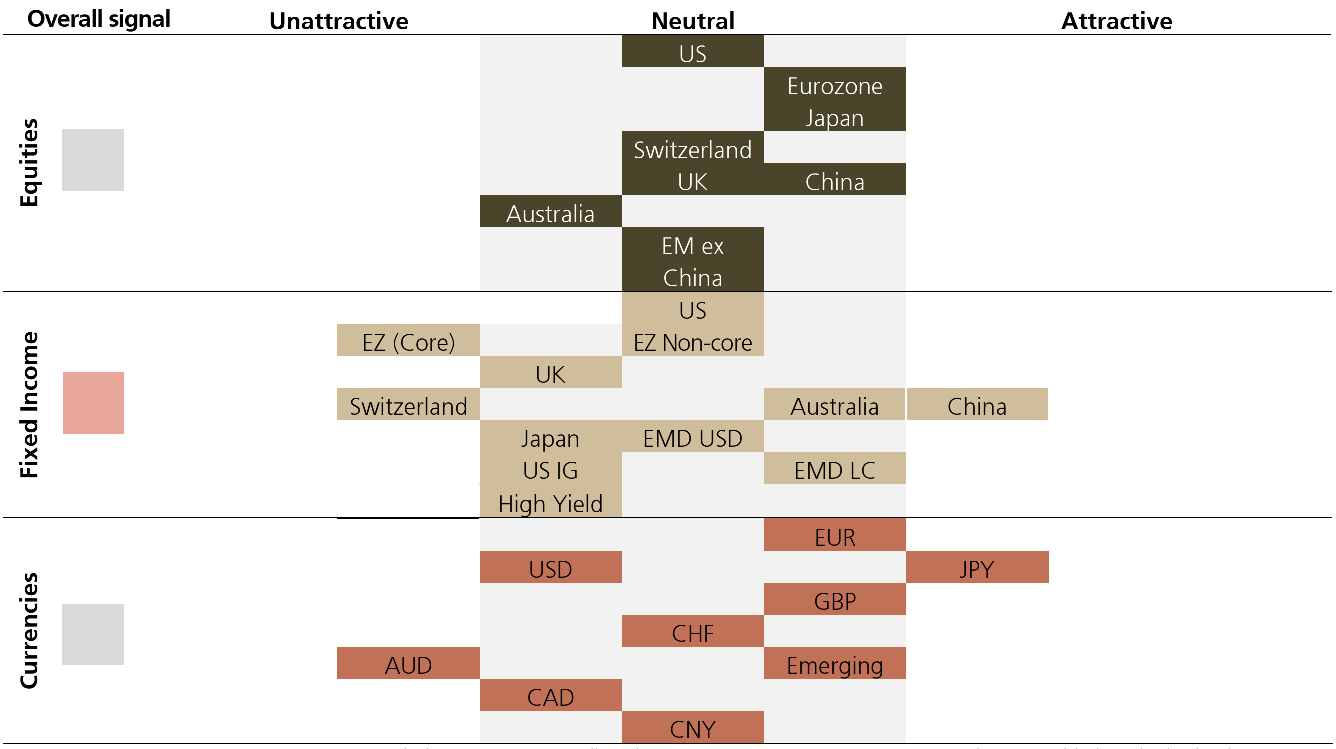
Case study: Short AUDUSD
Short AUDUSD is a view that may benefit from a number of volatility-inducing developments. If global growth deteriorates, due to trade tension or otherwise, the high beta AUD will likely suffer. But Australia also has a net external liability, and if US rates were to suddenly pick up from suppressed levels, AUDUSD would likely also weaken. We believe that this along with ongoing domestic uncertainties on the housing market and a dovish central bank makes the currency an attractive short against USD.

The bottom line: Asset allocation
Position on fundamentals; hedge on geopolitics. That is the approach we strive to take across strategies in Investment Solutions. The second half of the year is likely to be eventful for markets, as tensions between an OK economic environment, a supportive policy cushion but a cloudy geopolitical outlook all combine to push and pull investors in different directions. Still, we suspect this economic expansion will bend and not break, creating opportunities for adding additional risk when the smoke clears. We continue to use our theme-based approach and rigorous monitoring of the macro outlook as our anchor as we manage through the volatility to come.

Negative ⟷ Positive

Asset class attractiveness

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness, as well as the relative attractiveness within equities, fixed income and currencies, as of 31 May 2019.



Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as at 31 May 2019. 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.

Negative ⟷ Positive

Asset Class	Overall signal	UBS Asset Management's viewpoint
Global Equities **Global Duration**	Neutral Slightly negative	– Global growth risks have risen as a result of trade war escalation and we have moved our equity outlook to neutral from overweight. While we still expect the economy to ultimately steady without a hard landing, it is now likely to slip somewhat below trend over coming quarters. Our view that a soft landing is achievable is built on resilience of developed economy labor markets and consumption, along with policy responses from the Fed and China if growth were to deteriorate. After inconsistent Fed rhetoric prompted fears of a US monetary policy mistake in late 2018, a clearer and unequivocally more accommodative Fed narrative has emerged. In our view, the Fed is now likely to remain accommodative in order to rebase inflation expectations and may ease if downside risks to growth become more apparent. With scant evidence of significant momentum in US core inflation, the Fed has considerable breathing room. – The ability of China to cushion its slowdown continues to be key to the global economy and markets. The Chinese authorities have a broad range of policy tools at their disposal and have shown willingness to use the full breadth in achieving a difficult balancing act between derisking a highly leveraged and capital inefficient Chinese economy and softening the slowdown prompted by those deleveraging initiatives. – The key wildcard remains the relationship between the US and China in regards to trade and technology. While in our base case major escalation is avoided, we acknowledge that tensions are likely to simmer and act as a headwind for the global economy and earnings. As such, the risk-reward in equities has turned less positive, even if we are still constructive that the fundamental underpinnings of the economy are sound. The likelihood of further material upside for risk assets in the short term is, in our view, now dependent on no further material escalation of trade tensions. Moreover, the effectiveness of the broad array of ongoing policy initiatives from the Chinese authorities to cushion their growth slowdown remains critical. – We retain a negative view overall on developed world duration over the medium term. While global growth has moderated, the market is now pricing in material easing from the Fed. Some insurance cuts may be delivered, but we believe the cycle is intact and that as global risks dissipate over time, yield curves will steepen The risk to this view is a miscalculation on the geopolitical front which forces a hard landing. Across the Atlantic, we are unconvinced that the ECB will be unable to tighten this cycle. While wage growth has yet to materially impact core inflation measures, developed world labor markets continue to tighten. We see nominal yields moving gradually higher as output gaps close, wage growth accelerates and the global economy stabilizes. However, upside to nominal yields is likely limited by structural factors including fast ageing populations in the developed world and technology-driven price pressures.
US Equities	Neutral	– During the first few months of the year, US equities benefited from a resilient domestic economy and a lower exposure to global growth factors compared to other major indices. However, the risk-reward compared to other markets has deteriorated as growth concerns begin to feed through to the US economy and US equities trade at a premium relative to other markets.

Negative ⟷ Positive

Asset Class	Overall signal	UBS Asset Management's viewpoint
Global (Ex-US) Equities		– In Europe, growth has decelerated considerably, due to external and domestic factors. Externally, China's slowdown and trade uncertainty negatively affected European exports. Domestically, political upheaval in Italy and France along with disruptive auto emissions regulations weighed on the economy. However, we expect at least some of those headwinds to fade over the coming months. European stocks remain supported by solid domestic demand dynamics, attractive valuations and by a likely stabilization of global economic conditions towards the second half of 2019. – We remain constructive on Japanese equities despite the recent headwinds from weak Chinese imports. We believe that diminished political uncertainties and ongoing structural reforms are supportive of higher price multiples while a solid underlying domestic economy suggests the outlook for profits is stronger than markets are discounting. For Europe and Japan, a lot of bad news is already in the price. Thus the downside relative to the US may be more limited.
Emerging Markets (EM) Equities including China		– Emerging market equities continue to underperform developed market equities driven by an ongoing deterioration in earnings and a re-escalation of US-China trade war worries. While the surge in Chinese social financing bodes well for EM growth eventually, increasing trade war escalation will likely pressure tech heavy Asian firms until resolved. – We remain broadly positive on China in light of further economic stabilization in the second half of the year. Any broadening of the current trade standoff with the US is likely to hamper Chinese growth, but Chinese authorities have shown themselves willing to provide additional monetary, fiscal and regulatory support to help smooth ongoing developments. We believe that Chinese equities still trade at a small PE discount to other markets and further market liberalization could prompt a rerating as international capital starts to flow into Chinese assets following the inclusion of onshore Chinese equities in MSCI's widely followed EM equity indexes.
Currency		– As signs of stimulus from China begin to take hold, we expect ex-US growth to stabilize. Over time, we anticipate capital will flow from the US into earlier-cycle economies and that the USD will weaken, especially as the USD remains somewhat expensive on a real trade-weighted basis. Elsewhere, we continue to see strong valuation support for the JPY and see short AUD as an effective hedge against on-going China weakness in an economy where domestic household leverage is likely to constrain growth.
US Bonds		– After the recent downward repricing of US rate expectations, 10yr nominal US Treasury yields appear reasonably valued given our outlook. Nonetheless, US nominal yields look attractive relative to most other developed government bond markets on an unhedged basis. In the absence of a material pickup in inflation or term premium, yields are likely to be range bound. Our overall assessment is neutral.
Global (Ex-US) Bonds		– In aggregate, we see global sovereign bonds outside of the US as unattractive. The ECB has committed to low rates for some time, limiting attractiveness of core Euro area bonds. We find Italian BTPs attractive on diminishing political risks. Swiss bonds continue to look very overvalued and in our view they have an increasingly asymmetric risk profile. The Swiss economy is relatively strong and we see Swiss bonds as vulnerable to attempts to normalize monetary policy by a Swiss National Bank increasingly concerned by the strength of the housing market. – Elsewhere we are more positive on Australian duration on a relative basis. We see the Reserve Bank of Australia easing given slow inflation along with domestic and external economic risks which are skewed to the downside.

Negative ⟷ Positive

Asset Class	Overall signal	UBS Asset Management's viewpoint
US Investment Grade (IG) Corporate Debt		– Although we do not believe that a sharp demand slowdown is imminent, we believe IG spreads troughed for the cycle in early 2018. Moreover, we are concerned about increased supply, reduced demand, and potentially large number of "fallen angels" when economic growth slows down significantly and downgrades begin. However, given the more accommodative Fed, in the near term we believe the balance of risks is roughly equal both to upside and downside.
US High Yield Bonds		– Current default rates in high yield are very low by historical standards. Given the still decent economic backdrop, we do not expect a material pickup in US defaults in the near term. Moreover, after the escalation of trade tensions the spreads have now widened to a point where we see the balance of risks roughly equal both to upside and downside.
Emerging Markets Debt US dollar Local currency		– Spreads on EM debt, both hard currency and local currency, relative to US Treasuries widened substantially in 2018 in the face of higher geopolitical risks, a strengthening USD and higher USD funding rates. However, this year both hard currency and local currency EM yields have rallied together with Treasuries. Given this big move, the escalating trade tensions, higher tariffs, and slowing global trade volume, we expect that both curves will begin to price in additional credit/term premium. We are neutral until we are closer to the resolution of trade uncertainty.
Chinese Bonds		– Chinese bonds have the highest nominal yields among the 10 largest fixed income markets globally and have delivered the highest risk-adjusted returns of this group over the last 5 and 10 years. We believe that slowing economic growth and inclusion in the Bloomberg Barclays Global Aggregate index next year should continue to push yields down during the next 3-12 months.

Source: UBS Asset Management. As of 31 May 2019.

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