Macro Monthly

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UBS Asset Management | Economic insights and asset class attractiveness
November 2021

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Thinking long term about surging short term rates

Highlights

- The rates market has priced in earlier and sooner central bank rate hikes, but remains pessimistic on how much central banks will ultimately be able to tighten this cycle.
- This implies pessimism on medium-term growth. We disagree with market pricing and view the backdrop for economic growth this cycle as structurally better than the last one.
- We believe that, into next year, the combination of surging incomes, strong household and corporate balance sheets and robust capital investment will translate into a smooth handoff from public to private sector led growth.
- This backdrop implies an underweight to government bonds and focus on the more cyclical areas of the global equity market, such as regions like Europe and Japan and sectors like energy and financials.

Short-term interest rate markets are sending a clear message: the beginning of global monetary policy tightening is at hand.

The average expected policy rate in one years' time for eight developed market central banks doubled over the past month to roughly one percent, a level above pre-pandemic pricing. (See Exhibit 1.)

In some cases, this surge is contrary to central bank guidance. Investors are leaning into the idea that the stickiness of well above-target inflation will prompt monetary policymakers to act to prevent expectations from becoming unhinged to the upside.
In our view, the more important question for asset allocation right now is not when central banks will tighten policy, but by how much. Despite the sharp rise in expectations for near-term tightening, the market-implied 'terminal rate,' or peak fed funds rate this cycle, is still 50 bps below the peak rate last cycle. Essentially, markets are arguing that with a few hikes, central banks will swiftly quell inflationary pressures and we will return to a world of slow growth and slow inflation. Indeed, long-term inflation-adjusted US yields are near record lows. This combination suggests investors are concerned about the magnitude and persistence of short-term inflationary pressures, but pessimistic about the medium-term growth outlook.

We retain a more positive outlook. In our view, investors are underestimating the sturdiness of economic fundamentals, which portend higher nominal GDP growth in this cycle. Household and corporate balance sheets began the expansion in a position of strength, fiscal drag is not poised to be as fierce of a headwind this cycle, and

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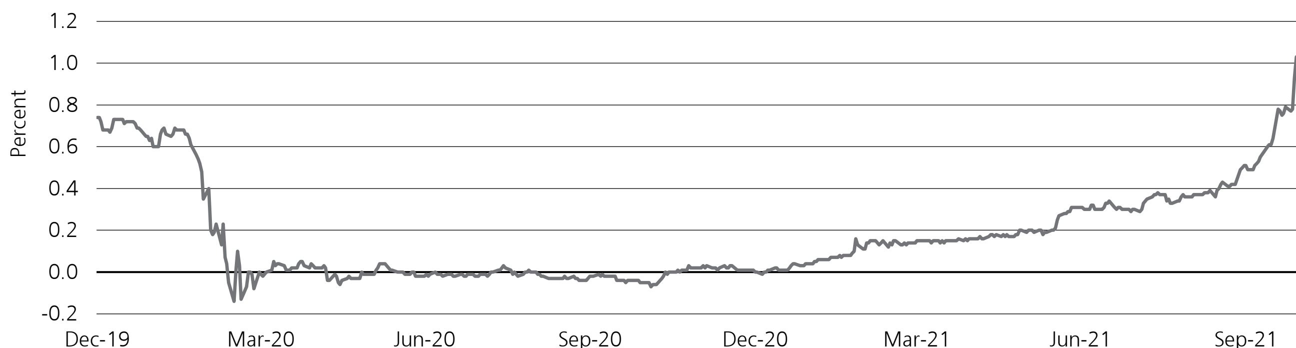
Exhibit 1: Surge in expected central bank policy tightening over next year
Average overnight rate expected in one year's time for US, UK, European Union, Canada, Sweden, Norway, New Zealand, Australia



Source: UBS-AM, Bloomberg. Data as of November 2021.

widespread shortages are boosting incentives for businesses to invest in capex. Indeed, the causes of elevated inflation today are the sources of robust growth in the tomorrows to come.

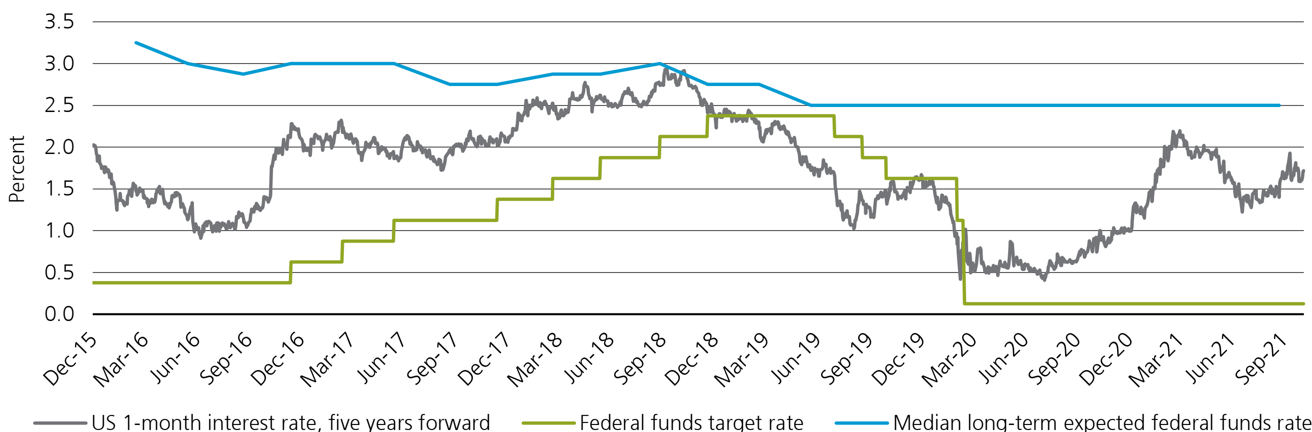
Of course, either view – ours or the market's – could ultimately prove correct. But based on what is being discounted, we believe that being an optimist about the durability of the global expansion is a more attractive risk-reward proposition. We are monitoring a variety of macroeconomic issues to judge whether incoming information corroborates our thesis or supports the status quo. If we are right, investors should still benefit from being overweight equities vs. government bonds, but should outperform when tilted to more cyclical areas of the global equity market and commodities.

Supply chains
The view seemingly embedded in fixed income markets is that supply chain snarls and the price pressures that accompany them will result in demand destroyed, rather than demand delayed. There is also the risk that a certain degree of demand is a mirage – that due to the widespread knowledge of shortages, companies are over-ordering to secure what they can. Monitoring the new orders subindex of manufacturing PMIs should offer insight as to whether the strong demand backdrop persists, or hits an air pocket as supply chain stresses unwind.

Margin pressure would be one key sign that end demand is weaker and companies are unable to pass along higher input costs. The most recent earnings season shows us that this is not the case yet. The consequence is supply chain stresses are fortifying the case for business investment. Companies can borrow at historically low rates to boost capacity and produce more volumes which can be sold at higher prices. Higher capital expenditures both directly increase profitability from an accounting standpoint and contribute to better growth and productivity that are also supportive for earnings on a macro level.

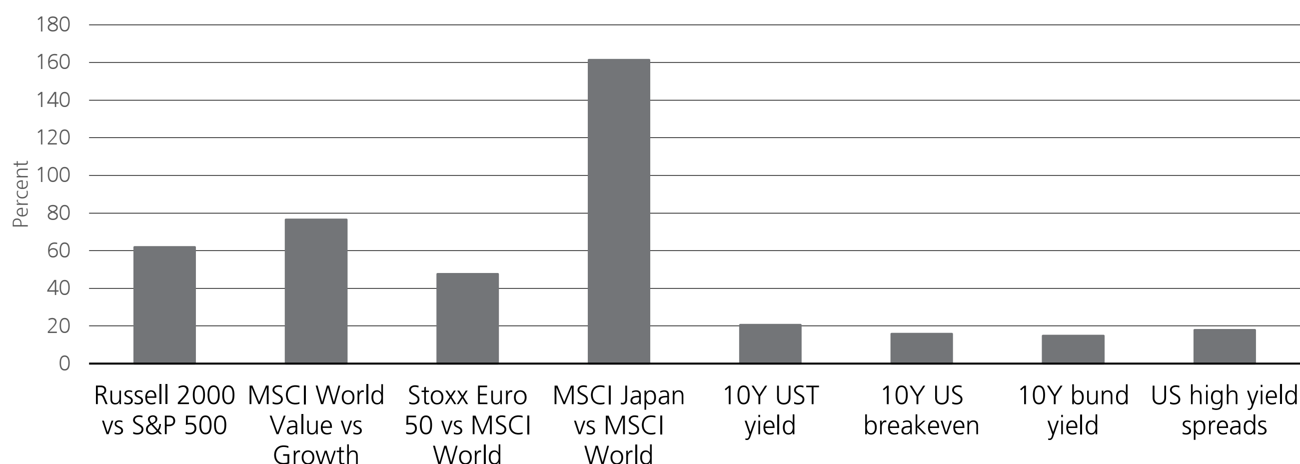
Labor market
Wage growth and labor force participation are two key variables to watch to gauge the urgency for rate increases as well as the ultimate destination for short rates.
Lower participation coupled with the hottest increase in US labor compensation in 20 years would suggest the US economy is closer to maximum employment than the Federal Reserve currently thinks, and that an earlier, and perhaps aggressive, removal of accommodation is warranted.

Exhibit 2: Investors pricing a peak policy rate below last cycle's



Source: UBS-AM, Bloomberg. Data as of 3 November 2021.

Exhibit 3: Attractive risk-reward in procyclical equity trades
Retracement of peak risk-on move since Nov. 6, 2020.



Source: UBS-AM, Bloomberg. Data as of 3 November 2021.

In our view, the current degree of strength in wage growth represents "surge pricing" for labor, which is supply constrained primarily due to the pandemic and will likely moderate over time. Evidence in support of this view includes the slower recovery in participation for women and abnormally low re-entry rates among retired Americans compared to the aftermath of previous recessions. A recovery in labor force participation would imply that the US economy's potential growth is not deteriorating and that there is not any downward pressure on the ultimate terminal policy rate this cycle.

China

The prospects for the world's second largest economy are something of a wild card for the global economic outlook. Investors have been conditioned to expect that Beijing will be reactive in maintaining a high floor for economic activity. However, a focus on the quality rather than the quantity of growth may portend a more prolonged adjustment phase of decelerating activity. In addition, policymakers have been more willing to introduce mobility restrictions to control outbreaks of the pandemic, a short-term negative for activity.

Throughout 2021, China has maintained a substantial current account surplus as credit growth decelerated, capitalizing on the global growth rebound. In our view, the credit impulse is likely to bottom in Q4. That, plus continued resilience in external demand, should be sufficient to stabilize Chinese activity. Trend growth in China is indeed slowing. But in 2022, we have a high degree of conviction that this will be more than offset by the how robust activity is in developed markets.

COVID-19

We believe there is ample evidence that vaccinations are allowing for progress towards pre-pandemic levels of mobility over time, and that successive waves of infections are having smaller impacts on economic activity. Continued public health improvements and innovative adaptations by businesses and consumers should allow this to continue, in our view. If our assumptions are wrong, and the pandemic is a material, persistent drag on activity, we believe that this would support market pricing that central banks have limited scope to raise rates and face an unfavorable growth/inflation mix.

Implications for asset allocation

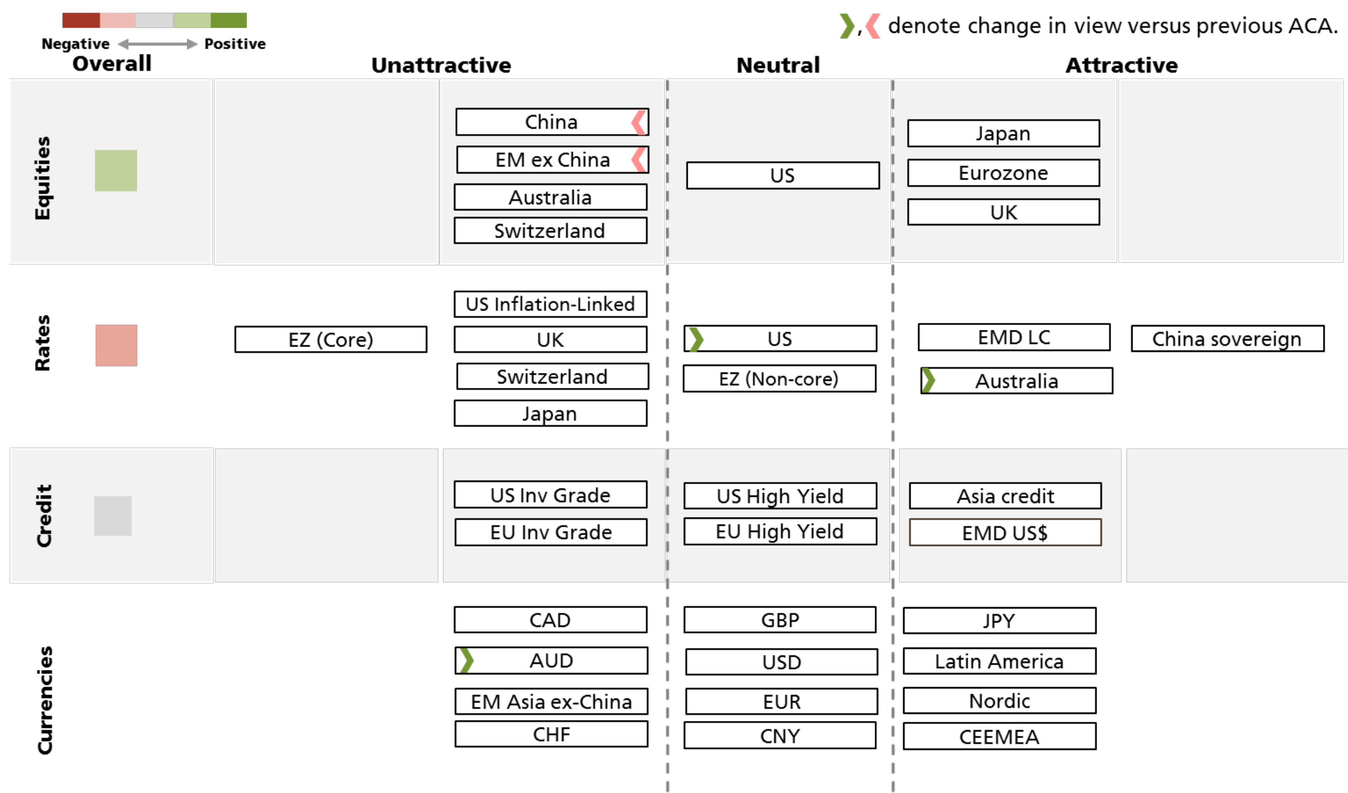
If the market's view of low-for-the-long-term is correct, it would be indicative of a world in which aggregate demand growth cools meaningfully. This backdrop could still be positive for risk assets as long as growth does not slow too much, since lower interest rates help sustain high valuations. Growth stocks and regions like US equities may likely be the biggest beneficiaries, as could traditional 60/40 portfolio structures.

However, we see strong evidence that growth and inflation will run hotter this cycle than is currently being priced, particularly for longer-term real rates. We believe that this more robust expansion should support the outperformance of cyclical-oriented sectors, such as Financials and Energy, and regions like Europe and Japan.

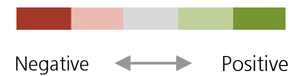
Over the last 18 months, investors learned about the power of fiscal stimulus to fill even unprecedented holes in demand. In our view, the lesson learned in 2022 will be an appreciation of the ability of the private sector to drive above-trend growth. The initial conditions for household and corporate balance sheets are extremely favorable, and income growth is providing a runway for continued increases in consumption while supply constraints incentivize investments in productive capacity.

Asset class attractiveness (ACA)

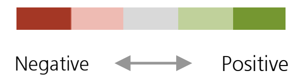
The chart below shows the views of our Asset Allocation team on overall asset class attractiveness, as well as the relative attractiveness within equities, fixed income and currencies, as of 3 November 2021.



Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as at 3 November 2021. 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 signal	UBS Asset Management's viewpoint
Global Equities		– Our outlook for stocks over the next 12 months remains positive. The economic recovery is likely to continue on the back of robust global growth, still accommodative financial conditions, and progress on the broad administration of effective COVID-19 vaccines. – Improving earnings expectations are likely to underpin continued gains in global equities despite elevated valuations. The equity risk premium is near the floor of the previous cycle, which may cap upside as policy risks start to become more two-sided and growth momentum peaks. – We see more upside in relative value opportunities that offer attractively priced exposure to re-accelerating activity in developed markets compared to beta exposures.
US Equities		– US equities continue to command premium valuations. The sectoral composition drives this dynamic, with a higher weighting towards acyclical defensive technology than other markets. This characteristic may not prove a boon in the event that investors aim to boost cyclical exposure. Accordingly, we prefer US equal weight to market cap indexes. – Continued strong earnings, robust balance sheets, and accommodative policy from the Federal Reserve should continue to support US equities, but fiscal/tax policy risks are becoming more two-sided.
Ex-US Developed market Equities		– Non-US developed market equities are attractively valued and have significant exposure to the global economic recovery. – Earnings growth in Europe and Japan is poised to outstrip that of US, and this superior performance is not well reflected by the relative performance of these regions in 2021. – Both earnings and valuations have more room to run in ex-US developed market equities and improving vaccine administration should also bolster investor sentiment. – The recent Japanese election may serve as a catalyst for investors to increase exposure to the region, which is underweight across global portfolios relative to history.
Emerging Markets (EM) Equities (ex-China)		– EM equities continue to face near-term challenges that include a negative turn in forward earnings growth relative to DM, renewed strength in the US dollar, and slower recovery in mobility. – Persistent currency weakness even amid firm commodity prices weighs on total returns from the perspective of international investors. – A stabilization of growth in China amid measured policy support is a positive for the asset class, particularly for countries with the tightest economic and financial linkages. Resilience in industrial metals continues to point to a strong foundation for real activity.
China Equities		– Policy actions designed to limit the power of major internet companies may linger as a headwind for this pocket of the market. – Concern over China's real estate market and uncertainty on the timing and magnitude in policy support, constitute important downside risks to activity and procyclical positions. – Still, the peak in credit tightening has passed, in our view. The upcoming turn in Chinese fiscal support and credit impulse during the fourth quarter should provide support for global cyclical assets. – We prefer international equities where the recoveries are less mature and earnings revisions are more supportive.
Global Duration		– Long-term bond yields have risen well off their year-to-date lows as major central banks begin to signal the withdrawal of policy support. – Inflation risks remain tilted to the upside and global economic activity is poised to remain robust well into 2022. – We expect increases in real rates in particular, as well as measures of inflation compensation, to contribute to this renewed rise in yields. – Global yields have increased even as macroeconomic risks increased, a sign that there was previously too much pessimism priced in. – Sovereign fixed income continues to play an important diversifying role in portfolio construction, and remains particularly effective in hedging downside in procyclical relative value equity positions.



Asset Class	Overall 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 Fed's responsiveness to inflation risks has undermined the appeal of curve steepeners (a rise in the spread between long-term and short-term yields) until such a time that price pressures recede and economic activity remains elevated. – The looming peak in global growth, concerns about a potential Fed policy mistake, strong foreign demand, and over-extended short positioning have contributed to a sharp decline in US Treasury yields and flattening of yield curves. – We expect this to reverse going forward, with a combination of strong growth and inflation driving Treasury yields higher across the curve. – The Federal Reserve will likely lay out formal plans to taper its asset purchasing program by year end, and the extent of the deceleration in price pressures during the fourth quarter will play a key role in determining whether the removal of stimulus is expedited or delayed.
Ex-US Developed-market Bonds		– We continue to see developed-market sovereign yields outside the US as unattractive. We believe the Bank of Japan's domination of the Japanese government debt market and success in yield curve control diminishes the use of the asset class outside of relative value positions. The potential for EU fiscal integration and solid commitment to supporting economies during the pandemic are factors that may compress periphery spreads, but perhaps at the expense of rising core borrowing costs, as well.
US Investment Grade (IG) Corporate Debt		– Spreads have fully retraced thanks to policy support and an improving economic outlook, while all-in borrowing costs are well below pre-pandemic levels. US IG is one of the few sources of quality, positive yield available and therefore a likely recipient of ample global savings. However, the duration risk embedded in high-grade debt as the economy recovers as well as the potential for spread widening should threats to the expansion arise serve as material two-sided risks that weigh on total return expectations for this asset class.
US High Yield Bonds		– We expect carry, rather than spread compression, to drive total returns in HY going forward. The coupons available will continue to attract buyers in a low-yield environment. – The asset class is more attractively valued and has less sensitivity to rising interest rates than IG bonds. However, strong relative performance in September as global equities declined makes US high yield less attractive on a tactical basis.
Emerging Markets Debt US dollar Local currency		– We have a positive view on emerging market dollar-denominated bonds due to the balance of carry opportunity and duration risk. – After significant spread widening, Asian credit provides attractive compensation for risks to the asset class and is poised to perform well in environments in which growth expectations improve or plateau, so long as highly adverse economic outcomes fail to materialize. – The more rangebound environment for the US dollar removes one previous tailwind for the outlook for total returns in EM local bonds.
China Sovereign		– Chinese government bonds have the highest nominal yields among the 10 largest fixed income markets globally as well as defensive properties that are not shared by most of the emerging-market universe. We believe that cooling domestic economic growth and inclusions to global bond market indices should put downward pressure on yields during the next 3-12 months.
Currency		– The removal of accommodation by the Federal Reserve puts a higher floor under the dollar and meaningfully reduces the prospect of a retest of its late-May lows in the near term. – EMFX like RUB and BRL, which are supported by continued monetary tightening, are well-positioned to outperform even in a rangebound to upwards USD environment, while cyclical Asian currencies and select G10 commodity exporters are poised to struggle.

Source: UBS Asset Management. As of 3 November 2021. 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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AMT-943 11/21
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