

Macro Monthly

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UBS Asset Management | Economic insights and asset class attractiveness

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Evan Brown
Head of Multi-Asset Strategy,
Investment Solutions

Max Luo
Director,
Investment Solutions

Stefan Sabo
Director,
Investment Solutions

Juha Seppala
Director,
Investment Solutions

Benjamin Suess
Director,
Investment Solutions

Joe McDonough
Investment Solutions

US Treasuries: Overvalued but valuable

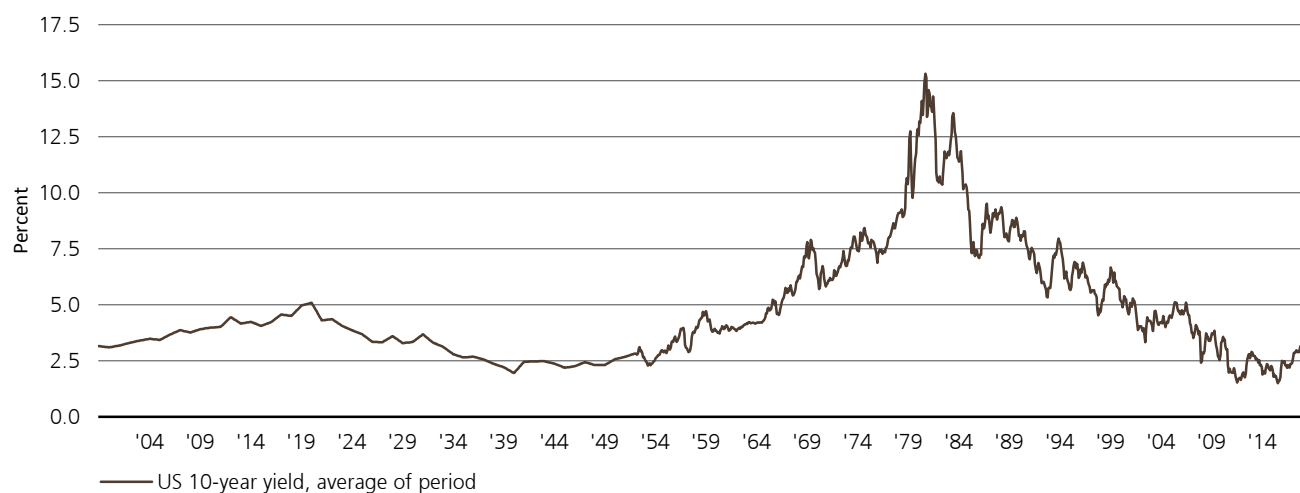
Highlights

- US Treasuries are historically expensive, reflecting low growth, inflation and rate expectations. But a significant driver of low yields is the compression of term premium, reflecting in large part extraordinarily accommodative policy outside the US.
- After the September European Central Bank (ECB) meeting, it is clear that negative yielding debt will be a feature of the market environment for the foreseeable future. And the scarcity of positive yielding, defensive assets is an uncomfortable reality for investors.
- A brighter cyclical backdrop, evidenced by a genuine bottoming in the growth outlook and/or a trade breakthrough can drive some normalization of bond valuations. But a true break in the nearly 40-year downtrend in bond yields will likely require a significant increase in fiscal expansion.
- Even with historically rich valuations, we view US Treasuries as attractive in the context of a multi-asset portfolio. Geopolitical risks have become a core driver of economies and markets, are inherently unpredictable and illustrate the need for downside protection.

A lot can change in a year. In the autumn of 2018, the US 10-year Treasury yield reached just shy of 3.25%; by August 26, 2019 it had fallen to 1.45%. While off their troughs, bond yields remain unquestionably low on a historical basis (see Exhibit 1 on following page). What happened? There are three main catalysts in our view: a significant slowdown in global growth, central banks shifting from tightening to easing and a flight to safety as markets scrambled to price in downside risks of trade conflict. This *Macro Monthly* discusses what low rates are currently signaling, where we go from here and the value of Treasuries in a multi-asset portfolio despite their historical overvaluation.

Interpreting the term premium

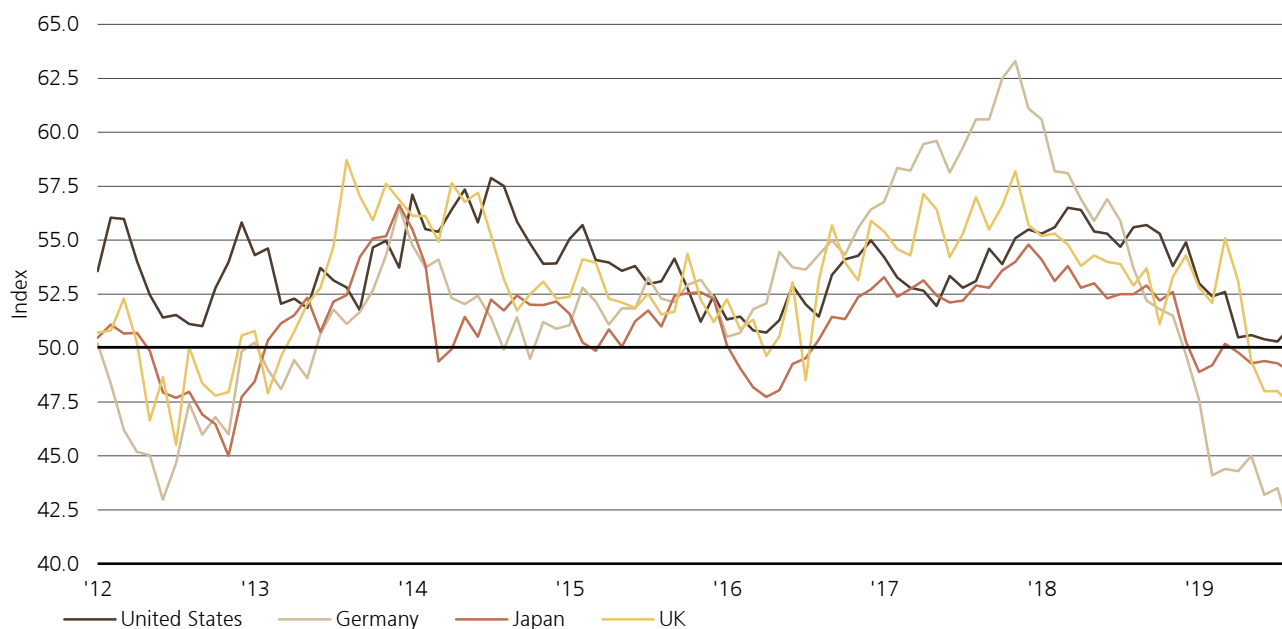
Long-term interest rates can be broken down into two components—rate expectations and term premium, or the compensation investors demand for taking interest rate risk further out the curve. Certainly rate expectations have come down, as the Fed has eased and markets have reassessed the long-term path of Fed policy. But a significant portion of the decline and much of what has driven interest rate volatility of late has been the term premium.

Exhibit 1: US Treasury yields near historical lows

Source: Macrobond, UBS Asset Management. Data as of 26 September 2019.

In our view, the term premium has been driven more by economic and policy developments outside of the US than within it. Global growth has decelerated more in Europe and Japan than in the US. Moreover, central banks like the ECB have driven rates further into negative territory and extended

quantitative easing programs. The ECB's forward guidance has tied negative rates and QE to the inflation outlook—with little evidence that core inflation is moving higher, negative yielding debt is likely to be a feature of global financial markets for the foreseeable future.

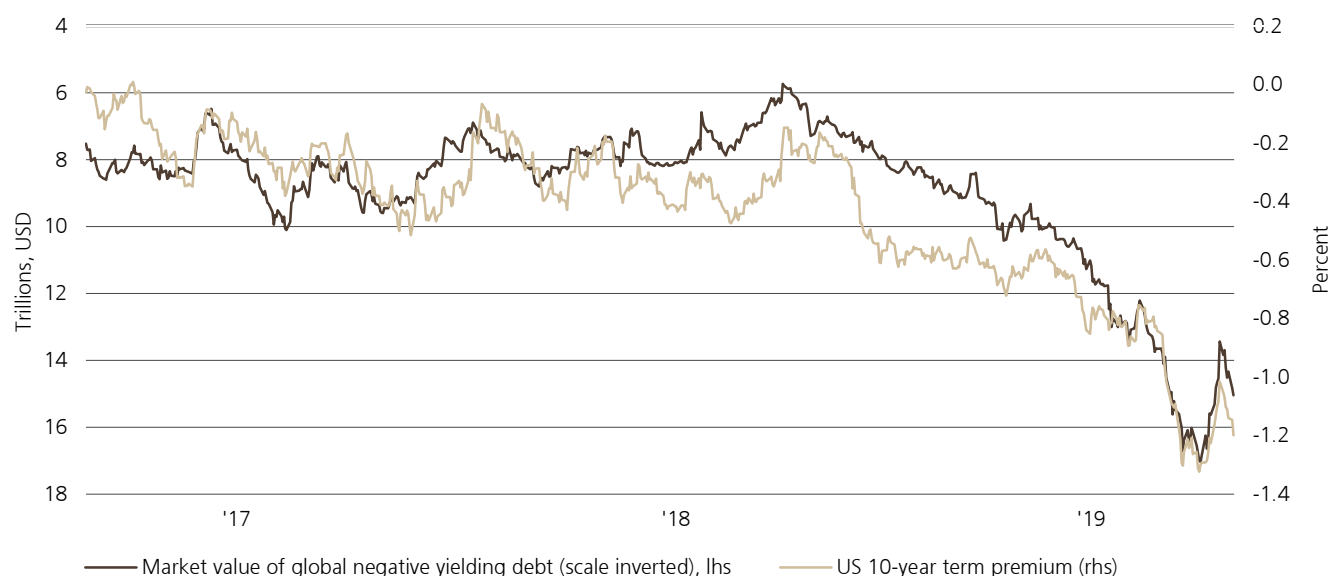
Exhibit 2: Growth concerns are more prominent outside than inside the US

Source: Macrobond, IHS Markit, UBS Asset Management. PMI index value of 50 (heavy black line) separates expansion from contraction. Data as of 26 Sept. 2019.

As global financial markets are integrated, investors facing negative yields are incentivized to look for positive yielding alternatives. There is a scarcity of positive yielding defensive assets in the world, so global capital piles into what's

remaining. Exhibit 3 shows how the term premium on US Treasuries has tracked the sharp rise in negative yielding debt globally.

Exhibit 3: Negative yielding bonds and term premium moving in tandem



Source: Bloomberg LLC, Macrobond, UBS Asset Management. Data as of 26 Sept. 2019.

What can drive yields higher?

What this suggests to us is that to have a further bounce in bond yields beyond what we saw in the first half of September, there must be some convincing healing in the global economic outlook. The leading economic indicators we track are mixed and at this point show only tentative stabilization in the global economy. A genuine and sustained ceasefire in the US-China trade war would clearly help, and likely be enough to drive US 10-year yields back above 2%.

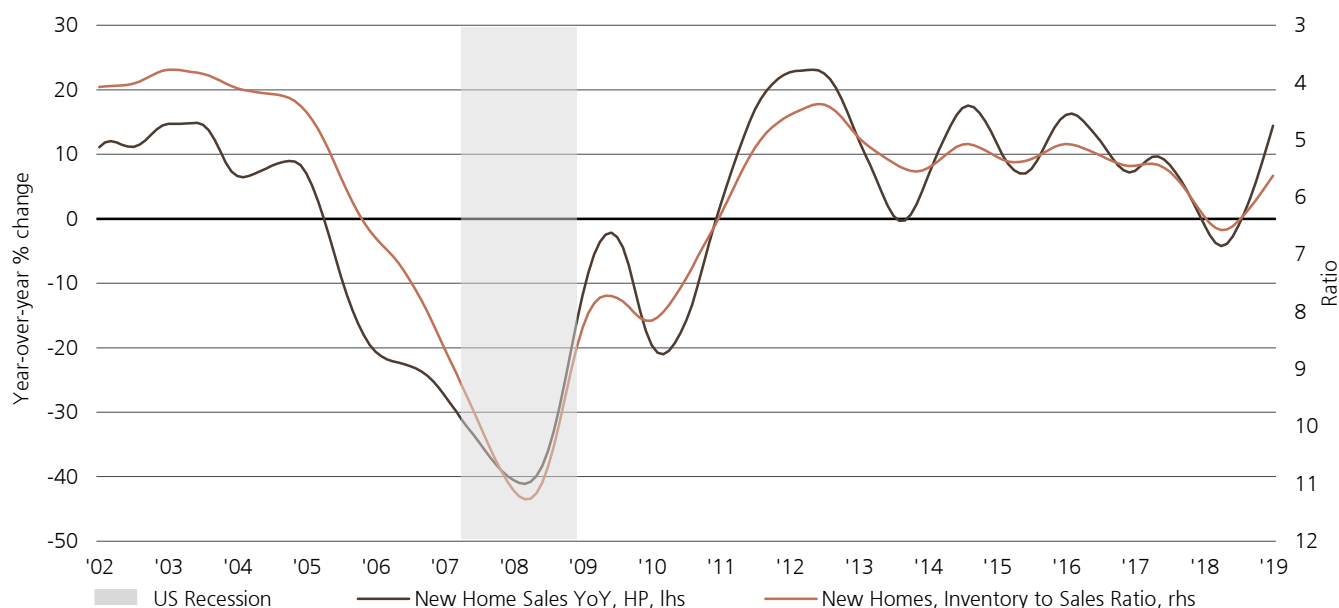
But the forces behind the long-term downward trend in bond yields will not disappear overnight. Slowing demographics, higher desired saving than investment, low inflation and inflation expectations are structural headwinds which can only be countered by a powerful change in the macro-economy. One possibility is a surge in productivity though it is difficult to see this in the near term given the slowdown in investment linked to the trade war. But productivity is notoriously difficult to forecast and we can't rule out a technology-driven game changer.

More likely is a global surge in the use of fiscal policy to support the economy, such as a sharp increase in infrastructure spending. Such policy should drive bond yields higher via the growth channel and increased bond issuance. This, ultimately, is how we'd expect policymakers to lift their economies out of the next recession, especially given less room to ease monetary policy than in prior cycles. But policymakers seem hesitant to deliver proactive as opposed to reactive stimulus, as evidenced by modest changes in policy in Germany and China's hesitance to launch all-out stimulus. We remain on watch for political dynamics to change on this front, such as a large shift towards progressives in the US, but for now it seems the sequencing is recession first, aggressive fiscal stimulus second.

The plus side

The good news for now is that, at least in the US, the low bond yields we've discussed look enough to cushion the economy from a major downturn, in our view. Amid much lower mortgage rates, the US housing market is staging a healthy rebound. It is not easy for the household-driven US economy to fall into recession with the housing market itself in an upcycle.

Exhibit 4: Lower rates are helping to boost the housing market



Source: Macrobond, UBS Asset Management. Data as of 26 September 2019

So where do we stand? We still hold the base case view that the global economy will be able to stabilize around its trend rate, as prior monetary stimulus gains traction in the economy. This suggests some modest upside to yields. Nevertheless,

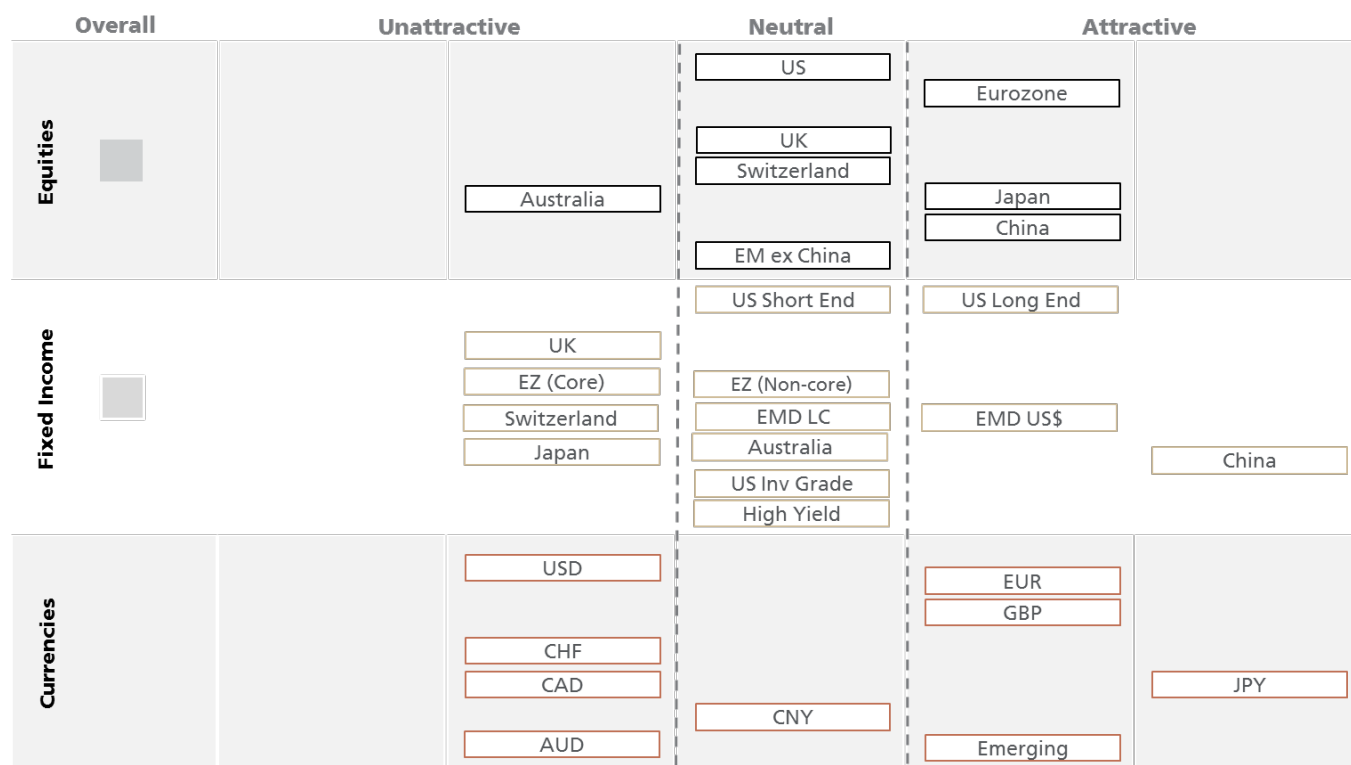
downside risks associated with trade conflicts remain and the scarcity of positive yielding safe assets make US Treasuries important diversifiers in a multi-asset context, even if the yields on offer are less attractive than historically.

The bottom line: Asset allocation

Within fixed income we find US Treasuries attractive, especially relative to negative yielding debt abroad. In a low rate, low (but not recessionary) growth world we also like emerging market debt, including relatively high yielding Chinese bonds. The still tentative state of the global economy and ongoing trade conflicts keep us broadly neutral on equities, though we continue to see value in Japanese stocks, which are finally gaining recognition for improved corporate governance and reform. While overvalued, the dollar remains stubbornly strong and should require clear economic stabilization outside of the US before moving convincingly lower.







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 30 September 2019.



Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as at 30 September 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.

Asset Class	Overall signal	UBS Asset Management's viewpoint
Global Equities	■	<ul style="list-style-type: none"> – We maintain an overall neutral stance towards global equities after the sharp rebound in valuations year-to-date. On the positive side, we expect global growth to stabilize around its trend rate and do not anticipate a recession over the next 12 months. Meanwhile, monetary policymakers around the world have shifted to a clearly accommodative stance. Nevertheless, we see a lot of good news as priced in already, leaving the market vulnerable to surprises on trade policy, earnings expectations or less dovish tilts from central banks.
US Equities	■	<ul style="list-style-type: none"> – US equities benefited from a resilient domestic economy, a lower exposure to global growth factors compared to other major indices, and a more accommodative message from the Fed. However, we believe that the risk-reward compared to other markets has deteriorated as growth concerns begin to feed through to the US economy and risks to the technology sector as geopolitical and regulation headwinds grow. US equities trade at a premium relative to other markets, suggesting they may underperform over coming quarters should global growth stabilize.
Ex-US Developed market Equities	■	<ul style="list-style-type: none"> – In Europe, recent economic data and business surveys have been disappointing but we expect the worst to be over and for data to start bottoming over the coming months. We expect European equities to anticipate this development. The European consumer remains resilient and services are holding up much better than in 2012. In September, the ECB delivered a comprehensive stimulus package which is growth supportive and the continued easing of central banks and governments around the world will likely put a bottom under the bleak external demand picture. This should gradually alleviate the main headwind to European and especially German economic downward pressures. Furthermore, geopolitical headwinds have somewhat diminished in the region with Italy agreeing to a new coalition government and UK Parliament passing a law to avoid a hard Brexit on October 31. – We remain constructive on Japanese equities despite the near term headwinds from the VAT hike and an escalating trade conflict with South Korea. Fiscal measures taking effect in the aftermath of the tax hike should soften the spending slowdown and Tokyo business investment is likely going to accelerate as we move closer to the 2020 Summer Olympics.
Emerging Markets (EM) Equities	■	<ul style="list-style-type: none"> – Emerging market equities continue to underperform developed market equities driven by ongoing deterioration in earnings and a lingering of the US-China trade war. While the rise in Chinese social financing bodes well for EM growth eventually, the recently raised tariffs likely prevent regional trade from rebounding convincingly until resolved.
China Equities	■	<ul style="list-style-type: none"> – We remain positive on China as policy measures continue to provide a cushion the economy. Our view is any broadening of the current trade standoff with the US is likely to hamper Chinese growth, but Chinese authorities have shown themselves willing and able to provide additional monetary, fiscal and regulatory support to help cushion domestic growth. Chinese equities still trade at a small PE discount to other markets and further market liberalization could prompt a re-rating. International capital should increasingly flow into Chinese assets following the inclusion of onshore Chinese equities in MSCI's widely followed EM equity indices.
Global Duration	■	<ul style="list-style-type: none"> – Global central banks have almost universally moved in the direction of accommodation this year together contributing to much lower bond yields. Moreover, heightened US-China trade tensions amid a still vulnerable global economy have driven a flight to safety in sovereign bonds. We believe that these heightened risks will continue to weigh on sovereign bond yields, but as long as the economy does not move towards recession, credit and EM should continue to perform.
US Bonds		
Short end	■	<ul style="list-style-type: none"> – We still expect the Fed to deliver some further accommodation although perhaps not as much as is currently priced. Hence, our assessment of the short end of the US curve is neutral. The scarcity of positive yielding safe assets should continue to drive flows into US Treasuries, keeping term premiums significantly negative. The long end of the US has more room to rally than other safe assets.
Long end	■	

Asset Class	Overall signal	UBS Asset Management's viewpoint
Ex-US Developed-market Bonds		<ul style="list-style-type: none"> – In aggregate, we see ex-US developed market sovereign bonds as unattractive. The ECB and BoJ have committed to negative rates for some time, limiting attractiveness of these markets. We find Italian BTPs attractive on diminishing political risks. – Elsewhere we were more positive on Australian duration on a relative basis. However, a 150bp rally in Australian bond yields since November 2018 makes us neutral on the current rates.
US Investment Grade (IG) Corporate Debt		<ul style="list-style-type: none"> – Given the increased fraction of global fixed income markets which now has negative yield, we believe that US IG is more attractive in relative terms. We do not have a recession as our base case and therefore think IG debt will remain supported. – That said, we acknowledge high levels of corporate debt and the potentially large number of "fallen angels" when economic growth slows down significantly and downgrades begin.
US High Yield Bonds		<ul style="list-style-type: none"> – Current default rates in high yield are very low by historical standards. Given the still relatively positive economic backdrop and accommodative Fed, we do not expect a material pickup in US defaults in the near term.
Emerging Markets Debt		
US dollar		
Local currency		<ul style="list-style-type: none"> – 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. The valuation case for EM rates is now much weaker than it was last year particularly for the EM local currency debt. On the other hand, EM hard currency debt spreads have been around 350bp this year while the average since 2010 is 330bp. In the environment of reach for yield this is attractive.
Chinese Bonds		<ul style="list-style-type: none"> – 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 scheduled and planned inclusions to global bond market indices in coming years should continue to push yields down during the next 3-12 months.
Currency		<ul style="list-style-type: none"> – The USD has been stubbornly strong, but we see the next big move as lower. The USD is overvalued on a real trade-weighted basis. Meanwhile, US economic growth is moderating and the Fed is easing. Over time, we anticipate economies outside of the US will stabilize and investment capital will seek out opportunities in those countries, sending the dollar weaker. Elsewhere, we continue to see strong valuation support for the JPY and view short AUD as an effective hedge against ongoing China weakness in an economy where domestic household leverage is likely to constrain growth.

Source: UBS Asset Management. As of 30 September 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.

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Americas

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