

Macro Monthly

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

UBS Asset Management | Economic insights and asset class attractiveness
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Q&A on recent market developments

Highlights

- The most recent step-up in trade tensions heightens the risk of a non-linear escalation and we remain cautious on global equities
- That said, we are not concerned about China's authorities allowing the yuan to depreciate past 7, nor the US's largely symbolic decision to label China a currency manipulator
- At this point, the state of trade talks can improve just as quickly as it can deteriorate. We expect markets to remain volatile through the rest of the summer
- We are of the view there should be more risk premium reflected in the US dollar, given the change in US foreign exchange policy and intervention risks

Global markets remain fluid amid the US-China trade war escalation, the depreciation of the Yuan past 7 per dollar, and the US labeling of China as a currency manipulator. There are a lot of moving parts, so we deliver this *Macro Monthly* in a Q&A format to efficiently share our thoughts on recent developments and what it means for asset allocation.

Why did risk assets sell off so aggressively after President Trump's August 1st tweets on US-China trade?

In our view the severity of the market reaction has less to do with the direct economic effects of a possible 10% tariff on the remaining USD 300 bn in Chinese imports, which is likely to take a few tenths off US, China and global GDP. Rather, we believe that markets are disturbed by the risk of non-linear outcomes of further escalation in both trade and technology. From the US side this includes a full 25% tariff on all Chinese imports (which could potentially be the last straw for a vulnerable global economy) or restricting sales of semiconductors to a wide range of Chinese companies. From China's side, limitations on the sale of rare earths to US companies or prevention of particular US companies to operate or sell in China (known as the unreliable entities list) would also create significant disruption. All of these next potential moves risk major disruption to the trade and technology relationships of the world's two largest economies, with ripples across global supply chains.

The severity of the next moves in the trade war rings of 'mutually assured destruction.' In other words, any of the above steps would probably inflict meaningful pain not just on the receiving party but on the acting party itself. As such we view such escalations as

unlikely, while acknowledging that markets must place some risk premium that they do happen. Domestic political pressures not to back down are present on both sides, as are risks of miscalculation. Our base case is that cooler minds prevail—now that the stakes have risen so high, the economic and political costs of further escalation on both sides are significantly larger than the benefits.

What is the significance of the Yuan's depreciation past 7 per dollar?

The 7 level in USD/CNY was viewed as a symbolic line in the sand. The onshore exchange rate had not traded beyond 7 since March 2008 and Chinese authorities have generally guided the market not to breach that level. Following President Trump's latest tariff threat, Chinese authorities allowed the currency to surpass 7, sparking concerns that they would permit a sharper depreciation catalyzing broad FX weakness (and USD strength) that would lead to a sharp tightening of financial conditions for the US and emerging markets. However, we believe that China's decision to not set the CNY 'fix' weaker than market expectations in the following Asia morning signals that authorities are not looking to use the currency as an active weapon going forward, at least not at this point.

The reality is that despite the benefits of currency weakening to offset the effects of tariffs on companies, there are costs as well. China's authorities do not want to spark a sharp pick up in local outflows, which could disrupt financial stability. Moreover, China is still prioritizing opening up its markets to international investors, both official and private, and would not want to send a message of instability. Finally, a sharp CNY depreciation would make goods more expensive for Chinese consumers. For these reasons we see China's recent allowance of a weaker currency as a warning shot to the US administration, as opposed to the start of a devaluation campaign.

What is the significance of the U.S. labeling China a currency manipulator?

On the day China allowed USD/CNY to slide past 7, Treasury Secretary Mnuchin officially labeled China a currency manipulator (the first time Treasury had taken that step in 25 years). The timing of this move is somewhat ironic in that China had for months and years been taking steps to prevent its currency from weakening and the move beyond 7 was actually in line with market forces after the tariff threat. While

the Treasury Department's step was unexpected and unlikely to be taken well by Chinese authorities, it is more symbolic than anything. The Treasury Department will engage in dialogue with the IMF and China over an entire year on steps that should be taken to alleviate trade imbalances. After that year, the President has some authority to impose penalties on China, but the scale of current and proposed tariffs on Chinese imports make those actions look minor in comparison.

What is happening with US dollar policy?

The Treasury's currency manipulation announcement is just part of a broader evolution in US dollar policy under the Trump administration. The President has verbally criticized China and Europe for competitive devaluations, demanded commitments not to devalue in trade agreements, and recently tasked aides to find ways to weaken the dollar. This is a meaningful departure from the implicit strong dollar policy or at least a laissez faire one that has governed US FX policy for 25 years. The executive branch, via the Treasury Department, owns the right to intervene in foreign exchange markets. It is possible, especially in reaction to further dollar strength, that the President could authorize intervention to sell dollars against the offshore yuan, euro and yen. If the Fed were to act in concert with the Treasury, as it has done historically, the Treasury could sell about USD 200 bn into foreign currency. Such a move would shift the dollar lower in a knee-jerk fashion, and the signal has the potential to carry a more pronounced depreciation.

How does the Fed fit into all of this?

The Fed shifted to an easing stance in May, largely due to growing downside risks associated with slower global growth and trade tensions (along with persistently low inflation). These risks were magnified when the President delivered his tweet, just one day after the Fed had cut rates for the first time since 2008. The President continues to demand easier Fed policy and is likely to get it especially after the tightening in financial conditions that followed the most recent uptick in trade tensions. We suspect the Fed will ease by an additional 50 bps by year end. However, the bet that Fed easing will continue to offset growing economic and financial market damage is a risky one. Fed easing impacts the economy with long and variable lags, while trade risks are a here and now for companies and consumers.

What are we watching?

Markets are likely to remain volatile for the rest of the summer and conditions can improve just as quickly as they can deteriorate. In the very near term, we are focused on whether the US Commerce Department issues some partial waivers to permit American companies to continue shipping products to China's Huawei. This was part of the original deal out of the G20 in Japan, along with China agreeing to step up purchases

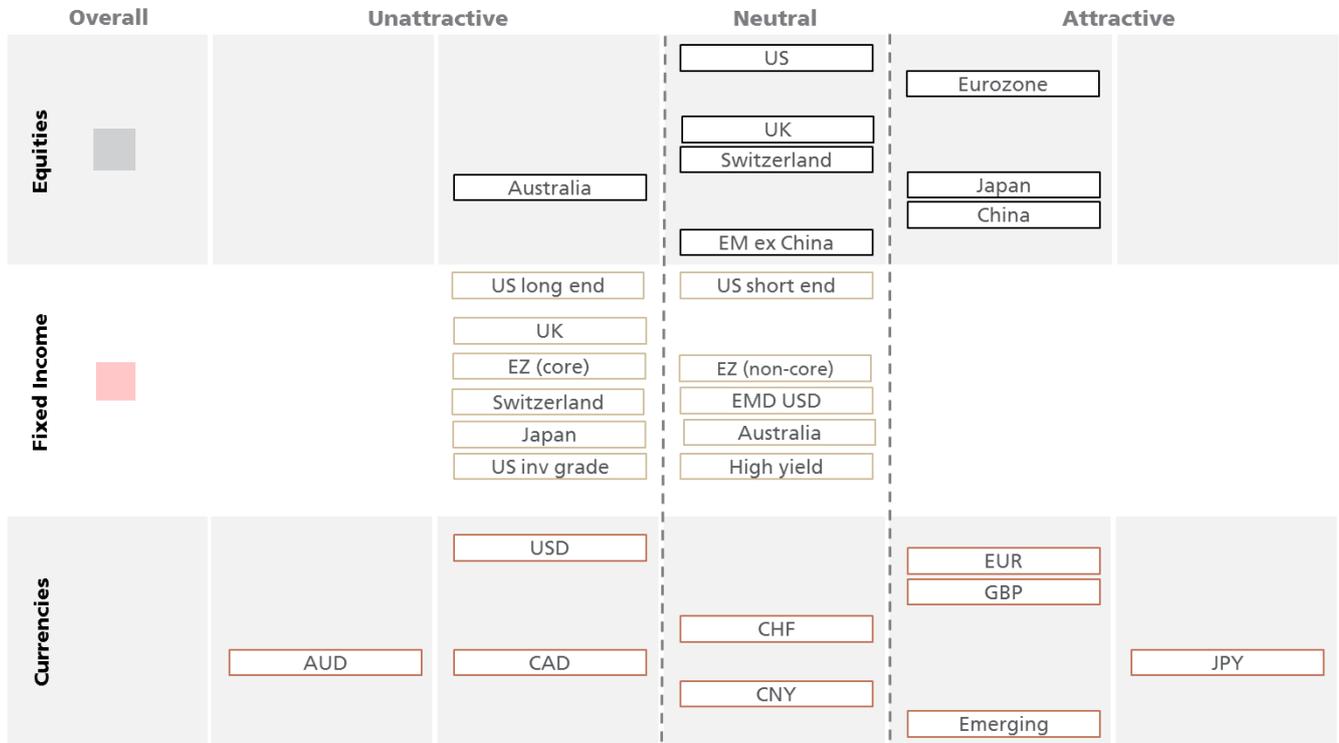
of US agricultural goods. Such a move (and ensuing agricultural purchase) would significantly de-escalate tensions and probably lead President Trump to scrap the plan to increase tariffs on September 1st. Of course, the imposition of tariffs in September would be negative for global growth, risk assets and the path forward for US-China relations.

The bottom line: What does this all mean for asset allocation?

We moved neutral equities in May and in some portfolios went underweight after the July G20. Our view was that a lot of good news was in the price, leaving markets vulnerable to negative surprises on growth, central bank action or trade tensions. We maintain a cautious stance, given that meaningful uncertainties remain in the near term. That said, we do think developed market consumers are fundamentally in good shape and do not anticipate a recession over coming months. With that backdrop, expectations for Fed easing have become a bit too aggressive and we have an underweight stance on duration over the next 12 months. In currencies, we remain underweight the dollar which we think should have greater risk premium attached to it given intervention risks.

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 July 2019.



Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as at 31 July 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 amid recent volatility. On the positive side, we expect global growth to stabilize around its trend rate and view the probabilities of a recession over the next 12 months as relatively low. 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 further negative surprises on trade policy, global growth and earnings.
US Equities	■	<ul style="list-style-type: none"> – During the first half of the year, 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 a result of geopolitics and regulation start to mount. US equities trade at a historically high premium relative to other markets, suggesting they may underperform over coming months.
Ex-US Developed market Equities	■	<ul style="list-style-type: none"> – In Europe, current headwinds on global trade persist with few signs of an imminent recovery in manufacturing activity. The longer the manufacturing weakness persists, the higher is the contagion risk to other sectors of the EZ economy and especially Germany. Moreover, geopolitical uncertainties still linger with the likelihood of new elections in the UK rising after Boris Johnson assumed the PM position. Together, those factors could hamper the near term performance of European equities. However, our medium-term base case remains positive, supported by solid domestic demand dynamics, attractive valuations and by a likely stabilization of global economic conditions in the second half of 2019. – We remain constructive on Japanese equities despite the near term headwinds from an imminent VAT hike and an escalating trade conflict with South Korea. Fiscal measures taking effect in 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 an ongoing deterioration in earnings and a lingering of the US-China trade war. While the surge in Chinese social financing bodes well for EM growth eventually, the recently raised tariffs likely prevent regional trade from rebounding aggressively until resolved.
China Equities	■	<ul style="list-style-type: none"> – We remain 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 and able to provide additional monetary, fiscal and regulatory support to help smooth ongoing developments. Chinese equities still trade at a small P/E 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 sending global yields much lower. However, current aggressive pricing of rate cuts and low term premiums are inconsistent with a global economy which we expect to bottom in coming months. At current yield levels, the bar is low for upside surprises in economic or inflation data to catalyze some normalization of interest rates across yield curves.
US Bonds		
Short end	■	<ul style="list-style-type: none"> – With the Fed's rather abrupt dovish shift towards risk management, nominal US Treasury yields have dropped significantly. We still expect the Fed to deliver some further accommodation and, hence, our assessment of the short-end of the US curve is neutral. However, we do not envision an US recession during the next 12 months and view the long-end of the curve to be at the lower end of the expected future trading range. In other words, we have a steepening bias over coming month.
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 global sovereign bonds as unattractive. The ECB and BoJ have committed to low rates for some time, limiting attractiveness of core euro area bonds. We find Italian BTPs attractive on diminishing political risks. – Elsewhere we were more positive on Australian duration on a relative basis. However, 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"> – Although we do not believe that a sharp demand slowdown is imminent, we think 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.
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		<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 but the current environment of dovish central banks and low volatility should support EMFX and, hence, EM local currency bonds in the coming months.
US dollar	■	
Local currency	■	
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. Slowing economic growth and inclusion to the Bloomberg Barclays Global Aggregate index next year should continue to push yields down during the next 3-12 months.
Currency		<ul style="list-style-type: none"> – As fiscal stimulus in the US fades, 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. Indeed, 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 ongoing China weakness in an economy where domestic household leverage is likely to constrain growth.

Source: UBS Asset Management. As of 31 July 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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