Macro Monthly

Economic insights and asset class views

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

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What if the Fed doesn't cut?

Highlights

- The acceleration in bond yields has contributed to weakness in global equities, with markets questioning whether or not the Federal Reserve will lower its policy rate this year.
- The rates market is currently in a discovery process of the appropriate level of yields for what is a very different cycle than the post-GFC one. This is a healthy process, but one that can generate volatility when moving at speed.
- Beyond periodic volatility, a more significant threat to risk assets would be if the market starts to price its next move as a hike as opposed to a cut. We view this as unlikely.
- In our view, the pricing out of rate cuts is more a function of strong growth than stubbornly hot inflation. We think disinflation, while moving slowly, is still on track.
- We stay overweight global equities and prefer cyclical sectors and regions over defensives, as nominal global growth is poised to remain well above last cycle's average.

Our risk-on positioning has been informed by a simple premise: if central banks are cutting rates into an environment of already healthy backdrop for nominal growth, that would be a uniquely positive backdrop for stocks.

Some central banks have already started down that path or indicated that they are about to do so, but there is one big exception: interest rate cuts by the Federal Reserve in 2024 have become a question of if, not when.

Equity markets were able to digest the pricing out of interest rate cuts for much of this year because higher yields, in large part, reflected improving expectations around the growth outlook. Moreover, the pace of moves was fairly gradual until the end of March. Exhibit 1 shows that the relationship between stocks and bonds becomes negative when there is a two standard deviation monthly rise in yields, which is what we've experienced just in the last few weeks.

If the speed of the bond move continues, one should expect more volatility in risk assets. Our bias, however, is that soon enough the disinflationary process will reassert itself and create some stabilization in rates. Higher yield levels are not a barrier to future equity returns, and healthy nominal GDP should support earnings even in a higher for longer rate environment. Equity and credit markets should hold up well, in our view, even if the Fed does not cut rates – as long as rate hikes are not on the table. We think the bar for further Fed tightening is high.

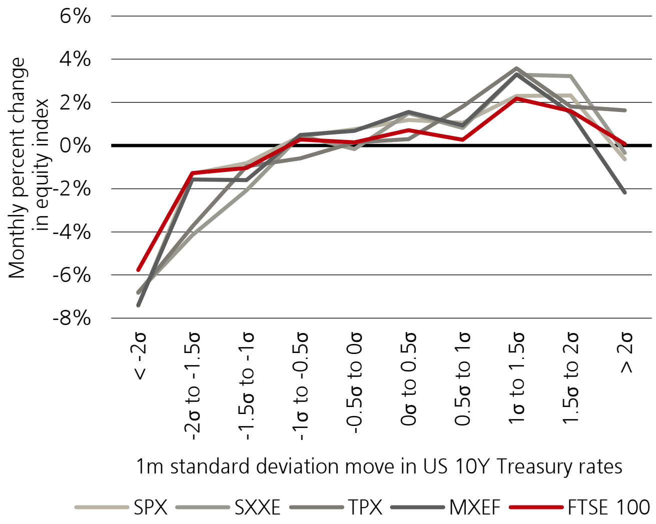
The state of play in the bond market

Bond markets are in a discovery process as traders attempt to ascertain just how much, or whether, the current setting of monetary policy is sufficiently restrictive to bring inflation back to target. It is evident that there are structural features that suggest higher neutral rates than last cycle. These include stronger private sector balance sheets and more expansionary fiscal policy. The present and future of immigration and labor force participation along with potential productivity growth associated with AI or re-shoring also drive uncertainty on the potential growth rate of the economy and ultimately where yields should settle. The reality is that we can only judge whether the Fed is sufficiently restrictive to bring inflation down based on the economic data. With repeated upside surprises in labor markets and inflation so far this year, it's not a surprise that yields have repriced higher as well.

When we decompose the move in US Treasuries since the start of the year, we observe that 10-year real yields have risen roughly 50 basis points, while 10-year measures of inflation compensation have increased by less than half as much.

This, in our view, is a strong signal that higher yields are more about the persistence of strong growth than the short-term reacceleration in inflationary pressures to start the year. Moreover, 10-year breakevens are still consistent with the Federal Reserve achieving its inflation objective over time.

Exhibit 1: Sharp increases in rates tend to weigh on most equity indexes



Source: UBS Asset Management, IBES, Refinitiv. Data from 1998 to present.

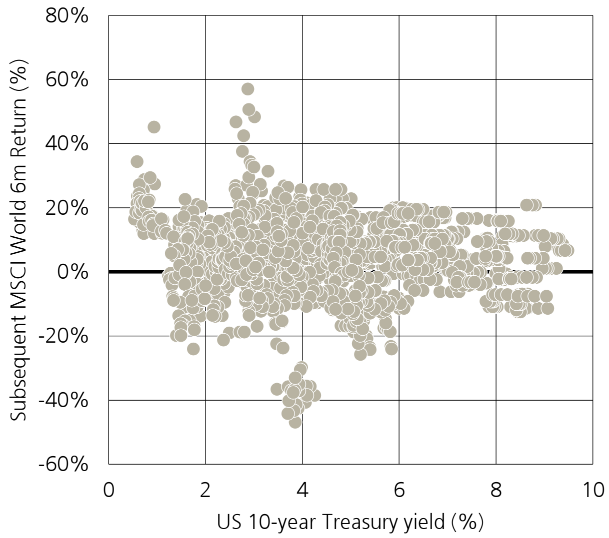
Setting the range

We anticipate that 10-year Treasury yields will broadly track growth and inflation outcomes over the medium term. From the early 1990s through 2019, US 10-year yields tended to run roughly 40 basis points below the year-on-year nominal growth rate of the economy. This helps to map out a loose range for the 10-year US Treasury – with the caveat that even outside of recessions, the yield was up to 250 basis points above and below nominal growth rates on certain occasions.

In our view, barring a negative economic shock, the rate of nominal growth this cycle will settle into a range that is closer to the 2001-2007 US expansion (5%-5.5%) than its roughly 4% pace from mid-2009 until the pandemic. As such, we expect the 10-year US Treasury yield to roughly oscillate within its 2001-2007 range of 3.15% and 5.5%. Given solid economic fundamentals at present, it's not an unreasonable starting point to see the 10-year trade around the mid-point of that range (~4.3%) during this cycle.

In our view, nominal growth will cool over the course of the year, driven by both a deceleration in real growth and inflation. This may allow for roughly 50 basis points of easing from the Federal Reserve in the second half of the year, and also a renewed calming in bond volatility.

Exhibit 2: Little connection between the level of rates and forward returns for stocks

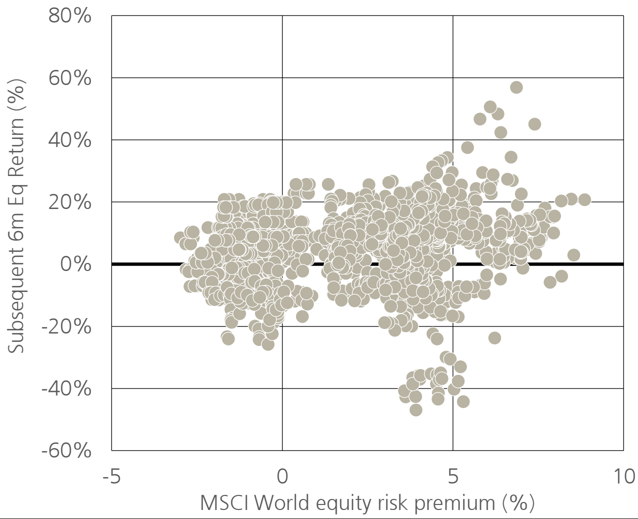


Source: UBS Asset Management, IBES, Refinitiv. Data from 1989 to present.

For stocks, growth > yields

Risk assets can still perform well if only a couple – or even zero – rate cuts are delivered this year, in our view. There is plenty of chatter about higher yields and a lower equity risk premium prompting a large scale rotation of flows out of stocks into bonds. However, we find no historical relationship between the level of yields or equity risk premium and forward looking returns for equities (see Exhibits 2 and 3).

Exhibit 3: No strong relationship between the equity risk premium and future performance either



Source: UBS Asset Management, IBES, Refinitiv. Data from 1989 to present.

The key focus should be on what the Federal Reserve's reaction function implies about the forward growth outlook.

The reason the pricing of significant rate cuts helped fuel a rebound in cyclical assets starting in the fourth quarter of 2023 was because this was a transition away from the campaign of incrementally tightening policy to restrain growth, and in turn inflation. This policy shift reduced recession risk premia embedded in equities.

The persistent strength in US economic activity even at the current level of policy rates is sending the same signal. Policy rates above five percent are not having that much of a cooling impact on growth, which points to lower risk of an economic downturn in the near term and in our view, provides more cause for confidence in continued earnings growth.

Our base case is that US stocks preserve margins near pre-pandemic peaks and get to enjoy the benefits of nominal growth better than the pre-pandemic cycle – a positive environment for risk.

The main risk

Core to this view is the ability of the Fed to maintain its current reaction function. Fed Chair Jerome Powell recently outlined this as the Fed having the ability to keep rates at current levels if higher inflation persists, and room to cut rates if inflation shows signs of durably cooling. Of note, he did not raise the specter of tightening further.

As we've seen in recent years, economic data can foil a central banker's best laid plans. However, we have conviction that even though inflation may take longer to get to the Fed's two percent target, it is unlikely to accelerate on a sustained basis. The labor market is loosening, as evidenced by cooling wage growth and fall in the quits rate. Leading indicators for rents and used car prices, some of the largest contributors to upside in inflation, are clearly pointing downward. These indicators reflect stickier inflation for longer, but not reacceleration.

We believe the Federal Reserve would need to see a resurgence in wage growth to be convinced that the strength in these components of inflation had staying power and that additional tightening would be needed to offset a demand-driven wave of price pressures. This outcome is certainly within the distribution, but we have yet to see evidence pointing in that direction.

Asset allocation

The retreat in equities from all-time highs as bond yields and volatility rise is a reset of valuations, not, in our view, a signal of concern about their ability to post profit growth. We remain overweight global equities and prefer cyclicals sectors and regions relative to defensives.

The risk-reward proposition in sovereign bonds has improved, but we are staying neutral on duration. The range of outcomes is still wide, and we have not seen material evidence of a moderation in US growth and inflation in recent months. In addition, global purchasing managers' indexes and commodity prices have generally been trending higher, raising upside risks to inflation and bond yields. Ultimately, any downside in yields or calming in bond volatility would result in more upside for stocks than bonds, in our view.

All-in yields on credit remain attractive, but most of this comes from the risk-free component as there is limited room for spread compression at current levels.

In our view, the best portfolio hedge to protect against surprisingly hot US growth and inflation driving cross-asset volatility is long positions in the US dollar vs. G10 currencies.

Asset class views

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness as of 23 April 2024. The colored circles 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, bonds, credit and currencies. Because the Asset Class Views table does not include all asset classes, the net overall signal may be somewhat negative or positive.

	Underweight			Overweight		
Global Equities				●		Profits growing, breadth improving, global PMI accelerating, and inflation likely to slow over time.
US				●		Room to advance as earnings grow and rates volatility calms.
Europe				●		Cheap valuations and leading indicators turning up.
Japan				●		Earnings outperforming, ongoing corporate reform, and still cheap after recent gains.
Emerging Markets			●			EM outperformance requires USD weakness, more signs of China strength. Asia ex China supported by tech goods rebound.
Global Government Bonds			●			Limited scope for cuts in US given solid growth. Bonds = recession hedge.
US Treasuries			●			Growth is slowing but solid, inflation roughly in line with Fed expectations. Expect volatility to calm.
Bunds			●			Inflation is cooling, but labor market is tight and wage growth remains elevated.
Gilts			●			Inflation to follow global trend lower; growth not as bad as BOE has feared.
Global Credit			●			Attractive all-in yields amid solid growth and disinflation, but limited room for spread compression.
Investment Grade Credit			●			Carry-driven returns. Investor demand to lock in attractive yields before rate cuts pushed spreads down.
High Yield Credit			●			Spreads are tight for the right reasons as defaults stay low. But negative convexity in adverse scenarios.
EMD Hard Currency			●			Good restructuring news has been largely priced in. US credit offers more favorable yield / duration mix.
FX						
USD				●		Bullish against G10 as US economy remains relative outperformer.
EUR		●				Core inflation slowing, with growth still relatively sluggish. Expect rate differentials to stay in USD's favor.
JPY			●			BOJ's move towards tightening is slow, methodical. Better currencies to be long.
EM FX			●			Bullish high carry LatAm FX, cautious AXJ on China, geopolitical risks.
Commodities			●			Supply constraints, speculative buying driving gains in oil, copper; less support from China limits upside.

Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as of 23 April 2024. Views are 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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