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Monthly Investment Letter: The test

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339 articles

F. Scott Fitzgerald once said that "the test of a first-rate intelligence is the ability to hold two opposing ideas in mind at the same time and still retain the ability to function." He might also have said that this is the test of a first-rate portfolio.

Investors have faced multiple negative headlines so far in 2022. Inflation has continued to rise, and price pressures are broadening. The Federal Reserve has shifted its focus away from stimulating economic recovery and toward managing prices. A flattening yield curve has heightened fears of recession. Most recently, conflict has broken out between Russia and Ukraine.

All of this speaks in favor of reducing exposure to equities, especially when the recent sell-off in bond markets has increased the appeal of fixed income investments.

But at the same time, growth remains above trend and various economies are lifting COVID-19 restrictions. Supply chain pressures are easing. We are likely close to a peak in inflation in the US. China has started adding more stimulus. Financial conditions are still loose in an absolute sense, and market expectations are for Fed policy rates to peak only at around 2%—this is hardly a “Volcker shock,” when the Fed hiked rates to 20% to subdue inflation. Meanwhile, so far, Russian oil and gas supplies remain mostly unaffected by the conflict.

Markets have also not ignored the risks: They now assume between seven and eight 25-basis-point US interest rate hikes over the next two years. Price-to-earnings ratios for global equities have fallen by 9% in the past two months, and investor sentiment, as measured by the American Association of Individual Investors’ bullish sentiment survey, is close to its worst since 2016.

So how do we continue to build robust portfolios when we face magnified upside and downside risks and the beginning of a new central bank policy regime, and amid geopolitical turmoil?

First, we don't think this is a time to be outright negative on equities—sentiment is already poor, at least some of the risks have been priced in, and a combination of above-trend global growth and falling inflation could quickly make the picture look more favorable for investors.

Second, we think this is a time to consider implementing portfolio hedging strategies: We cannot exclude the possibility of higher inflation expectations forcing the Fed to become outright restrictive in its monetary policy. Nor can we dismiss the chance of a disruption to global energy markets stemming from the Russia-Ukraine situation.

As such, it makes sense to take some steps to prepare portfolios, initially by ensuring they are well diversified geographically and across asset classes to mitigate idiosyncratic risk, and subsequently by considering specific geopolitical hedges, including commodities.

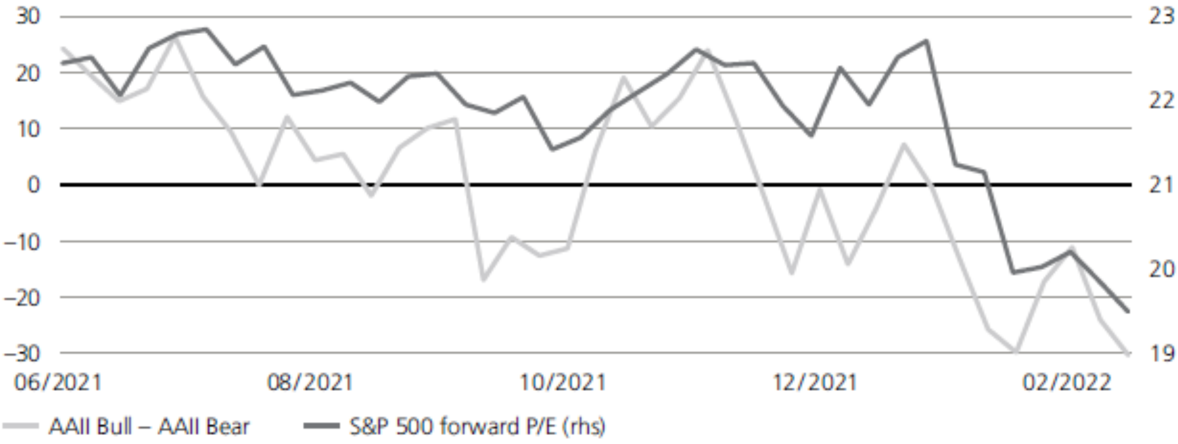
Third, we think this is a time to be more selective about exposure within the market. Oil and energy stocks should perform well in the event of further escalation in geopolitical tensions, but we also expect them to do well if the Ukraine conflict subsides. We also see Chinese equities as attractive relative to other Asian markets, given their exposure to economic recovery and lower valuations. Their relative insulation from rising US interest rates and Western geopolitical risk also means they provide appealing diversification benefits in a portfolio context.

In the rest of this letter, I explain our latest base case view on the key market drivers: inflation, the Fed, and the Russia-Ukraine situation; explain why we are more positive than some of the worst-case scenarios out there; and consider the data that could drive us to change our views in the months ahead.

Figure 1

Markets have not ignored the downside risks

AAII US Investor Sentiment Bullish minus Bearish Readings, S&P 500 forward P/E (rhs)



Source: Bloomberg, UBS, as of February 2022

Russia-Ukraine

Background and our risk case

At the time of writing, sanctions imposed by Western nations have been limited to select financial institutions, issuance of sovereign debt, and a halt to the approval of the Nord Stream 2 pipeline, though we expect more sanctions to materialize in the coming days.

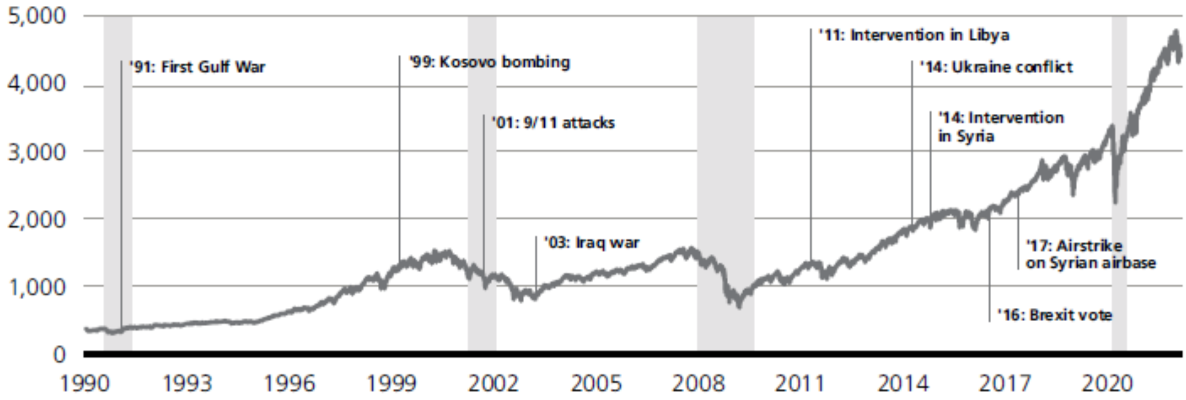
In our view, the limiting factor on President Vladimir Putin will not be Western sanctions themselves but his own assessment of the costs of a wider campaign in terms of resources, Ukrainian resistance, and political support at home in the event of wider conflict.

The risk case is that the crisis remains a source of continued volatility for an extended period until a new point of stalemate is reached. The extreme risk case, which we would define as one that has a lasting and material negative impact on global growth, is that the conflict escalates to a level that pushes Western nations to accept disruption to Russia's energy flow.

Figure 2

The market impact of geopolitics tends to be short-lived

S&P 500 index; shaded areas indicate US recessions



Source: Bloomberg, UBS, as of February 2022

Mutual interests to keep energy flowing

While it is hard to predict the potential limits on the conflict, we think that President Putin has a strong interest in continuing to sell energy and other commodities to Europe, which has a strong interest in continuing to buy them.

Russia's energy sector accounted for close to 20% of Russian GDP and 40% of fiscal revenues in 2019. Europe would suffer profound consequences from a disruption, given its reliance on Russian oil and gas and other commodities for its manufacturing sector. And for the US, the risk of higher energy prices may not sit well against a backdrop of already sliding approval ratings for President Joe Biden in a midterm election year.

As such, in our base case, we think that President Putin continues to destabilize Ukraine and its government through a variety of tactics, but for those tactics to fall short of what might trigger energy sanctions by the West.

More generally, it is also worth noting that risk-off events linked to geopolitical turmoil have historically tended to be short-lived, with the greater risk to investors coming from panic selling or under-diversifying rather than actual events on the ground.

What we are watching

Energy prices will be a key factor to watch as events unfold. In most of our scenarios, we do not expect to see a disruption to energy supplies, but if oil prices were to rise to USD 125/bbl or higher for two quarters, it would result in roughly half a percentage point lower in global GDP growth, and higher inflation affecting consumer spending power.

Should Russia's energy flow be disrupted, higher risk premiums and lower global earnings estimates would likely trigger more long-lasting losses for equity markets.

Inflation

Inflation data has surprised to the upside

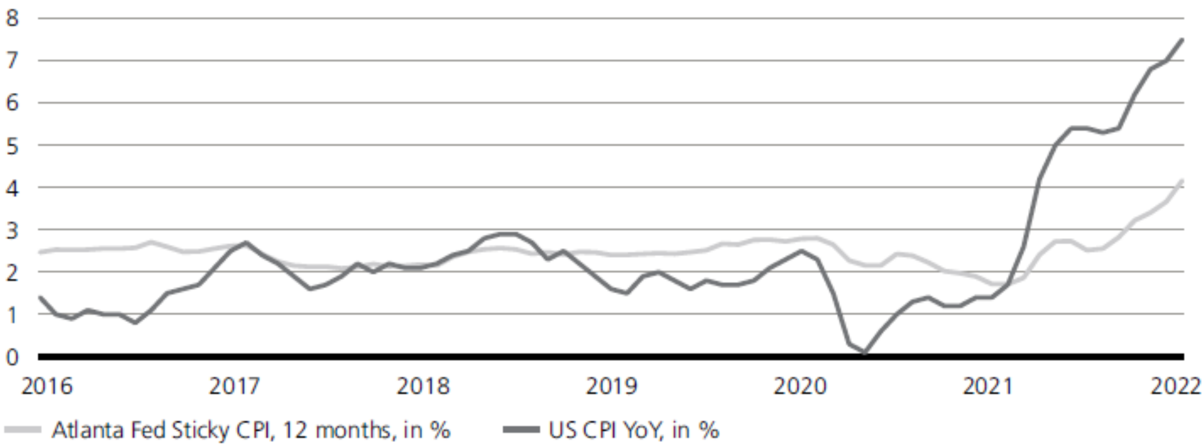
Inflation has continued to hit multiyear highs in the first weeks of 2022: In the 12 months to January, US CPI hit 7.5%, a 40-year high; Eurozone consumer prices touched a record 5.1%; and UK CPI was 5.5%, a three-decade high.

Data also suggests this is not purely a product of pandemic-related factors, and price pressures may be getting more deeply rooted. The Atlanta Fed's Sticky CPI index, which focuses on prices that do not change often, rose to 4.2% year-over-year in January from 3.7% in December. Services inflation, which is not subject to the same pandemic effects as goods inflation, has risen above 4%. And average hourly earnings growth rose to 5.7% in January, from 4.7% in December, potentially suggesting the beginnings of a wage-price spiral.

Figure 3

Sticky prices are rising in the US

Atlanta Fed Sticky CPI, 12 months, US CPI year-over-year, in %



Source: Bloomberg, UBS, as of February 2022

We think inflation will peak soon

While the inflation data released so far in 2022 does point to a heightened risk of stagflation, we still think it is most likely that headline inflation will peak within the next one or two months.

First, past-year comparisons should support a reduction in headline inflation rates. In particular, the rate of increase in used car, fuel, and gas prices should all begin to slow or reverse. It’s also worth noting that, generally, the items that have experienced the highest rates of inflation over the past year are also the same items that have tended to experience less “persistence” in their price movements over the past two decades.

Second, the widespread lifting of COVID-19-related restrictions should ease supply chain backlogs. Data is already showing that semiconductor shipments, auto production, and shipping volumes are increasing; PMI surveys suggest that inventories are growing; and supplier delay times are decreasing. As well as being positive for growth, this should reduce upward pressure on prices.

Third, a shift in consumption patterns away from goods and toward services should help reduce inflation. Although services inflation, driven by tight labor markets, is a cause for concern, this could also be eased if a combination of looser COVID-19 restrictions, renewed immigration, and reduced wealth effects (due to flat stock markets and less stimulus) boost the size of the labor force.

Overall, in our base case, we expect to see inflation peak within the next two months, before falling gradually back toward 2–3% by the end of 2022. We think this should be sufficient for market concerns about inflation to gradually ebb.

What could lead us to become more cautious

Some of the most critical data to watch to confirm or challenge our view include wage growth, services inflation, and the cost of shelter. If these indicators stay elevated, or accelerate further, it could suggest that inflation is proving more persistent than our base case expectations.

To the extent that an improvement in supply chain issues is a driver of lower inflation, we will also need to monitor COVID-19 policy in East Asia. China's zero-tolerance policy continues to create the risk of sudden closures to factories or ports in key exporting regions for the global economy.

The Fed

Markets have repriced the path for rates

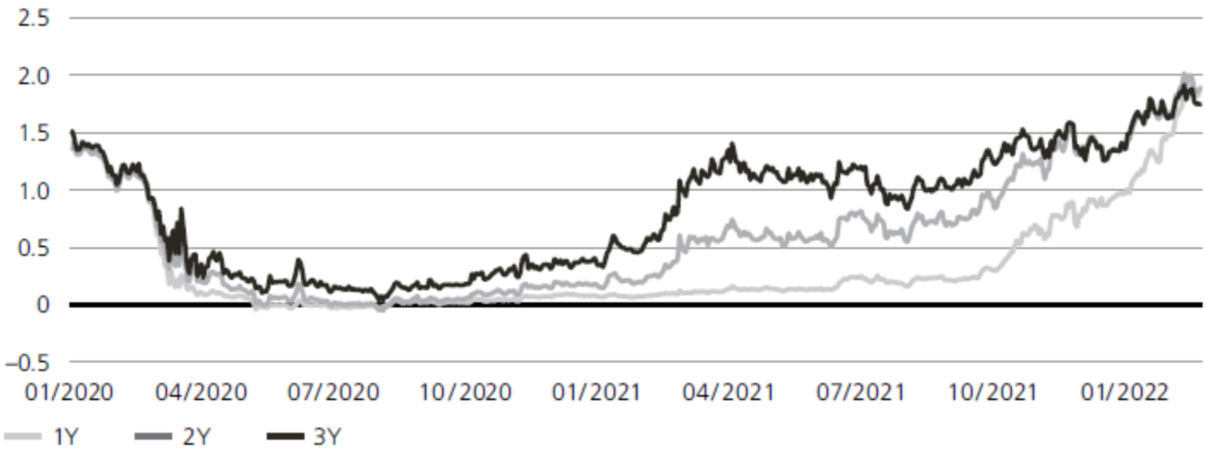
Just two months ago, the market expected that US interest rates would increase by 63bps in 2022 and a further 70bps in 2023, before eventually reaching a terminal rate of 1.9% five years later.

But fears about inflation have led the Fed to make a significant shift in its expected policy path. Now, markets are pricing 1.5% of hikes in 2022 and 0.5% in 2023—a significantly faster path to a market-priced terminal rate of 2%. (Fed projections for the longer-term federal funds rate remain higher at 2.5%.) Meanwhile, the latest FOMC minutes suggest that "a significant reduction in the size of the balance sheet" may also be necessary.

Figure 4

Markets believe Fed hikes will be done within 12 months

US cash rate expectations, one, two, three years from now, in %



Source: Bloomberg, UBS, as of February 2022

Tighter Fed policy concerns equity market investors for at least three reasons:

1. **First,** the Fed's shift in focus away from supporting growth and toward managing prices likely also implies that the US central bank will be less sensitive to a weaker economic outlook or heightened financial market volatility. This "lower strike on the Fed put" increases the inherent risk in equities.

2. **Second,** investors fear that the Fed might drive the economy into recession as it tries to meet its inflation goal—a worry reflected in an increasingly flat yield curve. An inverted yield curve (in which short-term interest rates rise above the yield on long-term bonds, typically measured by two-year versus 10-year maturities) has preceded all recessions since 1976.

3. **Third,** higher interest rates on cash and high-grade bonds increase their appeal and could drive an equity-to-bond rotation if they become sufficiently attractive.

Concerns about higher rates may be overstated

History tells us that Fed tightening often eventually leads to a recession. But history also tells us that markets often continue to rally after the Fed starts tightening. Since 1983, in the six months following the first Fed rate hike of a cycle, the S&P 500 on average has gained 5.3%.

In addition, we have reason to believe that, while higher interest rates do typically have a negative impact on economic growth, it may not hold as true this time around. Higher interest rates usually harm growth by constraining demand. But in this cycle, demand is already constrained by supply issues and residual pandemic-related restrictions. So, while higher interest rates may affect potential demand, if supply challenges ease, economic activity could continue to rise regardless.

Furthermore, this Fed under Jerome Powell is hardly a Volcker Fed. Despite headlines of inflation spiraling out of control, markets expect longer-term inflation to stay low even with a relatively modest peak in interest rates. Markets are currently projecting that a peak interest rate of 2% in the middle of next year is consistent with inflation averaging just 2.5% over the medium to long term (based on five-year, five-year forward inflation expectations). With a real interest rate of -0.5%, this would still be quite accommodative policy in an absolute sense.

And on valuations, with bond yields rising, equities have indeed gotten less attractive in relative terms. Yet the yield gap—the inverse of the P/E ratio minus the 10-year bond yield—is still above its long-term average, at 3.6% versus 3.3%. So is the global equity risk premium based on a dividend discount model, at 5.6% versus 4.4%. This suggests that equities will likely outperform bonds.

At present, market pricing assumes around six interest rate hikes in 2022 and a further one to two in 2023, but it is worth noting that investors and markets have historically tended to overestimate the consistency and durability of rate-hiking cycles—1994 and 2009–10 are clear examples of this.

If the Fed begins hiking rates and inflation starts to come down as we expect, we could still end 2022 with a Cinderella story of a Fed that went from “behind the curve” to “threading the needle” of balancing its mandates of full employment and price stability.

What could lead us to become more cautious?

One key risk to our view is that longer-term inflation expectations begin to rise, which would be a sign that markets are starting to worry that the projected interest rate path could be insufficient to manage inflationary pressures. This could mean the Fed has little choice but to hike rates more aggressively, and the increased risk of a Fed-induced recession would make us demand a higher risk premium from equities.

An alternative risk is that longer-term inflation expectations stay contained, but they only do so because the market fears that the Fed is driving the economy into recession with overly tight policy. We can monitor this risk by focusing on the shape of the yield curve. If we see short-term interest rates rise meaningfully above long-term rates, it could indicate that the market fears recession ahead. The spread between 2-year and 10-year US Treasury yields is currently 40bps, still in positive territory but the narrowest since August 2020.

Our investment scenarios

Considering all the above factors, we have revised our end-2022 targets for various equity markets. Our forecast revisions for our base case are based on the following assumption changes:

- We have raised our estimate for 10-year bond yields. We now expect the 10-year US Treasury yield to end 2022 at 2.3%, from 2.1%. Although estimates of the pace of the Fed's tightening have increased substantially, while longer-term inflation expectations

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to longer-term yields is relatively limited. All else equal, the increase in our yield forecast reduces our estimate of fair P/E valuations for equity markets by 4% based on an earnings yield model.

- We keep our estimates for 2022 and 2023 corporate earnings unchanged, given our expectation that growth will remain above trend this year, inflation will fall back, and geopolitical tensions will subside by year end.

- We maintain our year-end estimate for the equity risk premium. Relative to our last update, we believe that the uncertainty associated with inflation, growth, monetary policy, and geopolitics have all risen, warranting a higher risk premium in the short term. But we believe these factors will recede by the end of 2022, leaving our forecast at 290bps.

Although we revise down our forecasts, we still project double digit percentage returns for the S&P 500 and the Euro Stoxx 50 and 4% upside for the MSCI Emerging Markets index. However, given the degree of uncertainty in the current environment we have lowered our downside scenario price targets more significantly.

At a time of elevated risks and ahead of a potential slowdown in growth later in the year, it can be hard to envisage meaningful market upside. But moderating growth momentum need not present a problem for stocks: Since 1960, when the ISM manufacturing index has been below its previous three-month average, but still above 55, subsequent 12-month returns have averaged 10%.

In addition, when solid business momentum is combined with low investor sentiment, equity gains historically have been strong. Since 1987, when the AAII net bullish sentiment reading has been below

21% and the manufacturing ISM above 55, S&P 500 returns in the next 12 months have averaged more than 20% (compared with an average return of 10% for all periods).

Key scenarios and asset class impact

		Upside	Central	Downside
Scenarios	*Inflation / central banks*	Inflation fears abate. Major central banks gradually reduce accommodation, but less than the market expects.	US inflation to peak in 1H before gradually falling toward 2% by late 2022. Major central banks reduce accommodation, but policy remains accommodative. The Fed finishes taper by March, raises rates in line with market pricing, and starts quantitative tightening in 2022.	Inflation remains high for longer. Energy prices remain elevated at least until mid-2022. The Fed hikes more than the market expects and starts QT at an accelerated pace.
	Growth	Growth stays well above long-term trend.	Growth slows down gradually but remains above trend in 2022.	Global growth slows down-and remains below trend throughout 2022 amid aggressive monetary tightening by major central banks.
	COVID-19	The next COVID-19 variant becomes indistinguishable from the common cold. Developed countries follow the Denmark example and remove all COVID-related restrictions by 2H 2022.	Gradual shift from pandemic to endemic COVID-19 continues, allowing countries to continue reopening their economies.	The next COVID-19 mutation is more severe than omicron. Consumption does not fully recover due to continued public fear.
	China	COVID-related restrictions start to be lifted after the Winter Olympics. Regulatory crackdown and property market issues ease.	Chinese growth stabilizes. Central bank support continues. COVID-related restrictions start to be lifted in 2H.	China fails to contain omicron. Economic reopening is delayed until after the Politburo meeting in November. More broad-based property market crisis or further regulatory tightening further weighs on growth.
	Geopolitics	Quick de-escalation of the Ukraine crisis.	Escalation in Ukraine does not lead to a disruption of Russian energy supply to Europe or a significant and prolonged spike in energy prices.	Further escalation of the Ukraine crisis leads to a disruption of Russia's energy supply to Europe and a sharp spike in energy prices, with Brent holding above USD 125/bbl for at least six months.

Asset class impact (forecasts for December 2022)		Spot*	Upside	Central	Downside
	S&P 500	4,179	5,100	4,800	3,700
	EuroStoxx 50	3,817	4,600	4,300	3,400
	MSCI EM	1,207	1,350	1,250	1,000
	USD IG spread**	94	45bps / +1%	80bps / +1%	150bps / +2%
	USD HY spread**	372	270bps / +6%	350bps / +4%	550bps / –1%
	EMBIG spread**	414	300bps / +6%	370bps / +4%	550bps / –3%
	EURUSD	1.11	1.20	1.13	1.07
	Gold	1,927	USD 1,400–1,500/oz	USD 1,700/oz	USD 1,900–2,000/oz

* Spot prices as of 24 February 2022

** During periods of market stress, credit bid-offer spreads tend to widen and result in larger ranges. Percentage changes refer to expected total return (t.r.) for the indicated spread levels

Note: Asset class targets above refer to the respective macro scenarios. Individual asset prices can be influenced by factors not reflected in the macro scenarios

Source: UBS, as of February 2022

How to invest

As reflected in the above forecasts, we don't think this is a time to be outright negative on equity markets. Particularly for investors with a longer-term perspective, staying invested and focusing on incremental portfolio changes are key.

Overall, we think now is a time for investors to:

- a) be more selective;
- b) consider portfolio hedging; and
- c) seek longer-term opportunity.

Action	Investment idea	
Be selective in equity market exposure	*Buy the winners from global growth*	Against a still-strong growth backdrop, we continue to favor value and cyclical sectors and markets, including energy, financials, and Eurozone stocks, along with broad commodities. Current uncertainties about the effect of Ukraine-Russia tensions on energy supply mean that energy stocks and commodities can also play a key role in portfolios as a geopolitical hedge.
	Seek opportunities in China	We like Chinese equities relative to other markets in Asia. Policy is easing, growth is likely to accelerate into the second half of the year, valuations are relatively attractive, and earnings growth is improving. Furthermore, the market is relatively well insulated from key global risks—geopolitics and rising US interest rates—making it an appealing diversifier in a portfolio context.
Consider portfolio hedging	*Prepare for rising rates*	The financial sector typically benefits as rates rise thanks to higher net interest income. We would also expect value sectors to outperform growth sectors, such as technology, which face the greatest headwinds from rising rates. In fixed income, we see US senior loans as offering some protection from rising rates due to their floating-rate structure.
	Build up some defense	With uncertainty set to remain elevated, investors can consider balancing some of their cyclical exposures with defensive sectors and strategies. Global healthcare is our preferred defensive sector, and we also see dividend strategies, dynamic allocation strategies, and the use of structured solutions as potentially attractive means of improving the risk-return profiles of overall portfolios.
	Position for US dollar strength	The dollar is a "safe-haven" currency that tends to rally in case of heightened geopolitical uncertainty or "risk-off" sentiment in financial markets. In addition, we think that expectations of US interest rate hikes this year are likely to support the dollar in the months ahead. As such, we see the US dollar as an attractive tactical currency position at present.
	Diversify with alternatives	Diversifying beyond stocks and bonds can help reduce overall portfolio volatility. We favor exposure to hedge funds, as well as other alternatives including private markets, global direct real estate, and structured investments.
Seek longer-term opportunity	*Position for the net-zero carbon transition*	Investing in traditional commodities and commodity producers, alongside greentech, clean air, and carbon reduction strategies, is a diversified, realistic way to invest in the major global trend toward net-zero carbon emissions.
	Take advantage of tech volatility	Despite headwinds from rising yields, we believe the overall earnings outlook for the tech sector remains robust. In particular, we see upside for companies exposed to three foundational technologies: artificial intelligence, big data, and cybersecurity, or the "ABCs of tech."

Source: UBS, as of February 2022

Charts and scenarios are for illustrative purposes only. Historical performance and forecasts are no guarantee for future performance.
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