Topics for today's investors
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Outlook

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More good news is priced in: time to lock in some profits

Mark Haefele
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The December equity sell-off showed why it pays not to panic out of investments. Global equities have rallied by 16% since the December low, helped by a shift to more accommodative central bank policy and positive rhetoric surrounding a US-China trade deal.

But a lot of good news is now priced in. The balance of risk-reward has changed at the margin, and we think it's prudent to take some profit after this run-up:

- Markets appear to be pricing in little risk of recession, low inflation and no rate hikes. Global growth expectations have rebounded sharply according to the BAML global fund manager survey, and Fed funds futures are pointing to a rate cut in the next 12 months. That backdrop is positive for global stocks, which have rallied 11% since the start of the year. Bonds have rallied too—the US 10-year Treasury yield has fallen by a further 22 basis points and bond proxies have performed well. For example, the US utilities sector is up 10%. This raises the question of whether a "goldilocks" scenario is priced in for bonds as well as equities.

- The Federal Reserve has delivered another dovish surprise, but markets appear to want more. At last week's Fed meeting the updated "dot plot," which indicates where FOMC participants expect rates to be at the end of

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each calendar year, showed a significant downgrade. Fed members now expect no hikes in 2019, compared with the two hikes shown in December's dot plot. The Fed also confirmed that it would complete the reduction in its balance sheet by September, compared with our estimate at the start of the year that the run-off would end in March 2020. Fed Chair Jerome Powell stated in his press conference that current data does not point to a rate move in either direction, yet markets are pricing in a cut. The sharp fall in the S&P 500 at the end of last week suggests the Fed's dovishness has been insufficient to allay fears about the weakening in growth that lies behind the shift in policy stance.

- A US-China trade deal looks accounted for in market pricing too. Our base case, to which we assign a 60% probability, is that a trade agreement will be signed in the next two to three months. We think any deal would include a commitment to reduce bilateral trade imbalances, and a review of intellectual property protection and forced technology transfer. But this positive outcome appears to be well priced in. Chinese stocks, which are highly sensitive to the result of the talks, have been the best performing market of the year, with the Shanghai Composite up 22%, roughly twice the rise in global stocks. And US industrials, a sector which is also sensitive to trade conditions, have outperformed the S&P 500 by nearly 2 percentage points this year. Also, regardless of whether an agreement is reached, the deep-seated, longer-term nature of the US-China rivalry is likely to continue to be a source of periodic volatility, and should temper any market enthusiasm in the event of a trade deal.

Bottom line

Against this backdrop, we have reduced our equity exposure. We remain risk-on through our overweights in US equities and emerging market USD sovereign bonds. At current levels, we would like to see more confirmation that growth and inflation have stabilized before we increase risk.

As published in UBS House View Weekly, *March 25, 2019.*

Cash ain't trash…but it sure ain't equity, either

Michael Ryan
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I bristle at the dismissive attitude that some have adopted toward cash within portfolios, so the phrase "cash is trash" has always puzzled me. It conjures up images of portfolio managers discarding bundles of greenbacks along with weekold newspapers and empty Amazon boxes. I've almost been tempted to take a few "dumpster dives" into the recycling bins outside of asset management firms. Because if they truly view cash as trash, then I may need to moonlight as a trash collector.

When managed properly, cash can be a critical component within an investment portfolio.

It offers investors the flexibility to take advantage of new opportunities as they present themselves. Cash, and the ability to borrow, also provide portfolio managers with an essential Plan B to avoid liquidating assets at depressed values. Since cash is a non-correlated asset, it can also offer some respite during periods of uncertainty when conviction levels on risk assets are low. So maintaining some "frictional cash" within portfolios makes perfect sense. But to say that cash has an appropriate place within portfolios is not to suggest that it should have a prominent one.

Most investors accept the wisdom that portfolios with heavy exposure to equities provide the best prospects for building wealth over time. For example, USD 100 invested in an all-equity portfolio in 1945 would be worth about USD 205,000 today, compared with USD 4,600 for an all-government bond portfolio or USD 1,700 for cash (T-bills). We generally advise against all-equity portfolios since diversification benefits can reduce risk and improve returns, but this helps to illustrate the importance of having a healthy allocation to stocks.

However, we also recognize that those returns are never uniform either across or within cycles.

Some expansions are stronger than others, so asset-class returns vary between economic cycles. It's also clear that there are divergences in asset class performance at different stages of each cycle. So while portfolios with large equity allocations may be ideal for the long term, they may not fare as well during shorter periods.

With the current economic expansion having now shifted to "late cycle," it is this concern that seems to be driving investors to consider increasing their cash weightings now. But as we have stressed repeatedly in our business cycle work, the late stage of the business cycle should not be confused with the terminal phase (e.g., a recession). Our work shows that equity markets continue to do well in the late stage of the cycle, consistently outperforming both bonds and cash. For example, the median six-month return for equities has been 6.6% during the late stage of the cycle, versus just 2.8% for cash.

For those who believe that things might be different this time around, it's instructive to assess how valuations across each of the major asset classes compare to historical norms. What we find is that while price-to-earnings multiples for stocks are right in line with the historical average for the late stage of the cycle, at about 16.5x, the expected returns for bonds and cash are both significantly lower than in prior cycles (bond yields are 2.7% versus an average of 5.2% in prior cycles, and cash yields are just 2.4% versus 3.4% for a comparable stage in prior cycles).

So while we have entered the late stage of the business cycle, we counsel against reflexively (and prematurely) increasing cash positions. Because while cash clearly ain't trash, it sure ain't equity, either.

As published in UBS House View Weekly, *March 18, 2019.*

Preferred investment views

For more information, please see *UBS House View*, April 2019.

	underweight	neutral	overweight
Total equities			+ ⟵ +
Global		=	
US all-cap			+
US large-cap growth		=	
US large-cap value		=	
US mid-cap		=	
US small-cap		=	
Int'l developed market		=	
Emerging market		= ⟵	+
Total bonds		= ⟶	+
US government	− ⟶ −		
US Treasuries (long)			+
US municipal		=	
US investment-grade corporate		=	
US high-yield		=	
Int'l developed market		=	
Emerging market		=	
EM hard-currency			+

Overweight
Tactical recommendation to hold more of the asset class than specified in the moderate risk strategic asset allocation.

Underweight
Tactical recommendation to hold less of the asset class than specified in the moderate risk strategic asset allocation.

Neutral
Tactical recommendation to hold the asset class in line with its weight in the moderate risk strategic asset allocation.

+ ⟶ + **Month-to-month change**

Please see the monthly *UBS House View: Investment Strategy Guide* for our latest views.

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