UBS House View

Monthly Letter

17 September 2020
Chief Investment Office GWM
Investment Research

The 'new normal'

Accelerated by the pandemic, central bank action and digital trends have stoked a rally in technology and growth stocks.

Awaiting 'more normal'

To continue sustainably, the rally may need to broaden. The timing of this depends on vaccine and US fiscal developments.

Timing the market

We expect volatility, but investors should stay invested, aligned with their financial plan, and use volatility to build up long-term positions.

Diversify for the next leg

Investors should look to diversify beyond US mega-cap tech, into areas including the UK equity market, US mid-caps, emerging market value, and global industrials.

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We got 'new normal.' What about 'more normal'?

Since the peak of the pandemic, the market narrative has been dominated by the transition to a "new normal," driven by the forces of technological disruption, deficit spending, and further central bank action.

Yet, with recent gains in broad equity indexes concentrated in relatively few stocks, styles, and sectors, all linked to the new normal, we think that for markets to move materially higher in the near term we will need to see less "new normal" and more "more normal." In particular, we think investors want to see a path toward sustainable mobility gains (enabled by vaccine developments) and a reduction in US political uncertainty. We think both factors will happen, but the timing is uncertain.

Figure 1

Record outperformance for growth over value

12-month Russell 1000 Growth vs. 12-month Russell 1000 Value performance

Source: Bloomberg, UBS, as of 16 September 2020

In our base case, we think the combined metaphorical and literal shots in the arm of a successful vaccine, an end to election uncertainty, passage of new US fiscal stimulus, and continued extraordinary global monetary support will enable markets to move higher over the medium term. In our central scenario, we expect the

S&P 500 to trade at 3,700 by the middle of next year. Investors holding cash and waiting for a large correction run the risk of disappointment, particularly given the potential for developments like a vaccine to arrive sooner than expected.

We will likely face a period of volatility in the near term.

Once a vaccine is approved, investors will have a much clearer picture of how quickly we will move to a more normal world. In the interim, however, we will likely face a period of volatility, particularly if no US fiscal stimulus is passed before the election, the Federal Reserve refrains from new policy measures, and rising virus cases dent consumer and business confidence. The series of upcoming event risks related to the US election, US-China relations, and Brexit will also contribute to higher volatility.

What should investors do? Trying to directionally time the market around the daily sequence of vaccine and stimulus announcements that speed up or delay the return to "more normal" is likely beyond human or artificial intelligence. We have much higher conviction around an eventual economic recovery driven by a vaccine as well as global fiscal and monetary stimulus. Based on our view that the longer-term trend is positive, we think the best strategy is to stay invested along the lines of your financial plan. Near-term volatility could, however, be seen as an opportunity to build up positions using, for example, options, structured solutions, or a disciplined phasing-in strategy.

Second, investors need to diversify into those areas most likely to drive the next leg of the rally. In our view, this will involve investing beyond US mega-cap technology stocks, and should include the UK equity market, US mid-caps, emerging market value stocks, and global industrials, as well as other technology stocks like those exposed to 5G and the future of humans—encompassing opportunities in education, healthcare, and consumer preferences as we explore in our eponymously titled new report.

Finally, investors need to consider how to reframe their investment thinking in light of the new normal that will emerge after the pandemic. One such area we are focused on is sustainable investing. In the aftermath of the pandemic, the world's top 50 economies are putting USD 583bn into boosting green efforts. We have made sustainable investing our preferred solution for private clients investing globally.

Markets have embraced the 'new normal'

Technology stocks have driven the market advance.

The rise in broad equity market indexes in recent months has been driven in large part by investors' embrace of a new normal. Supported by lower discount rates and exposure to a less mobile but more connected world, the FAAMNG mega-cap tech stocks—Facebook, Apple, Amazon, Microsoft, Netflix, and Alphabet, Google's parent company—have rallied by an average of 40% this year, and the tech-heavy Nasdaq index is up 24%, outperforming the broader S&P 500 (+6%). For the most part, we see the strong performance from the technology sector as justified, and do not think the sector's price-to-earnings ratio of 25x, with 17% forecast earnings growth, is a bubble.

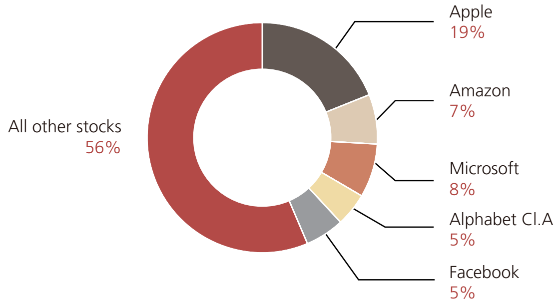
To continue sustainably, the rally will need to broaden to include cyclical and value stocks.

However, this embrace of the "new normal" has contributed to a relatively narrow advance. In August, just five stocks were responsible for almost half the gains in the S&P 500 (Fig. 2). Over the last year, only 32% of S&P 500 stocks are beating the benchmark. Growth's valuation relative to value is at its highest level since 2000, and 34% above the long-term average excluding the tech bubble. For equity indexes to move meaningfully higher over the medium term, the rally will need to broaden to also include value and cyclical stocks, in our view.

Figure 2

The August rally was driven by relatively few stocks

% contribution to S&P 500 performance, August 2020



Source: Bloomberg, UBS, as of 16 September 2020

The timing of a sector rotation depends on when conditions get "more normal."

Some of the potential beneficiaries of this transition are US mid-caps, UK equities, industrials in Europe and the US, and emerging market value stocks. We think investors should already begin to diversify into these areas. However, the timing of the rotation toward these market segments remains uncertain, and before fully embracing the rotation, investors are likely to want to see greater evidence that economic conditions are getting more normal.

Now we just need a bit 'more normal'

By the middle of 2021, we expect a return to normal economic functioning.

With China's recovery currently on track, global investors are focused on the pace of growth in Europe and the United States. Over the medium term, we are confident that we will see economic conditions get more normal and the equity market rally broaden out into cyclical and value stocks. By the middle of 2021, we expect a vaccine to be in the process of being rolled out, new US fiscal stimulus to have passed, and monetary policy to remain very accommodative. With the US election in the past, policy uncertainty will likely also be lower than today.

The timing of a return to "more normal" depends on vaccine and US fiscal stimulus developments.

The timing of this return to "more normal" could be accelerated if, for example, we see encouraging news on a vaccine or the passage of US fiscal stimulus sooner than expected. However, while investors shouldn't exclude the possibility of positive surprises, the near-term constellation of event risks suggests we could face a period of higher volatility:

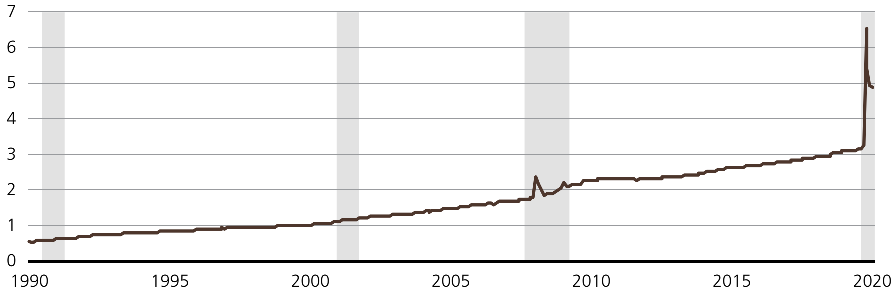
– **Vaccine trials.** Our base case is that a vaccine will be widely available by the second quarter of next year, helping facilitate a return to economic normality. Positive Phase 1 data from a broad range of candidates, large-scale Phase 3 trials underway at Moderna, BioNTech/Pfizer, and AstraZeneca, and strong government incentives to expedite approvals all speak in favor of successful vaccine development in the medium term. That said, like with all biotech development, we should not expect the path to be smooth. And with Pfizer's CEO stoking optimism that a vaccine could be available for delivery by the end of 2020, setbacks may disappoint. In an example of the potential risks faced in vaccine development, AstraZeneca was recently forced to pause its trial after a UK Phase 2/3 volunteer contracted transverse myelitis. Trials have since been resumed.

– **US stimulus.** The economic logic for replacing the USD 600 a week in emergency unemployment benefits that expired at the end of July is strong. Permanent layoffs are increasing, and the unemployed are more likely to spend rather than save the extra money. The White House and both parties in Congress have said the US needs more fiscal stimulus. But, with less than two months to go before the US election, political calculus will likely take prominence over economic logic. We also doubt the shortfall in fiscal stimulus will be made up for in additional monetary stimulus. Given the lagged effects of monetary policy, the Fed will be reticent to do more than it has if a fiscal package is likely to follow shortly after the election. Overall, this leaves the US economy temporarily short of policy support and facing a period of subpar economic data.

Figure 3

US government stimulus is fading

Personal income transfer payments from the US government to individuals, in USD tr.
Shaded areas indicate US recessions



Source: Bloomberg, UBS, as of 16 September 2020

– **Political event risks.** Various political event risks, ranging from the US election to US-China relations to Brexit, could all also contribute to market volatility. With both the US and China affirming their commitment to the Phase 1 trade deal, we don't expect a return to economically damaging tariff impositions. However, with both Republicans and Democrats wanting to be seen as tough on China ahead of the election, tensions between the US and China are likely to remain high. Elsewhere, the UK government's proposed Internal Market bill, which seeks to override parts of the already-signed Withdrawal Agreement, is stoking renewed conflict with the EU. We believe that political and economic incentives still point to a deal being reached, and we continue to like UK equities, but note that brinkmanship over the coming weeks will mean continued volatility for UK assets.

Scenarios

Central scenario

In our central scenario, we think that an effective vaccine becomes widely available by 2Q21, enabling social activity to normalize, and developed countries' GDP to recover to pre-pandemic levels by 2022. In the interim, we expect central banks to remain accommodative, don't foresee renewed national lockdowns, and, despite toughening political rhetoric, don't anticipate tensions between the US and China to derail growth.

Against this backdrop, we think markets will move higher over the medium term. The equity risk premium is now 390 basis points, slightly higher than the pre-crisis five year average of 380 basis points. As conditions normalize into 2021 we expect rapid earnings growth and some compression in the equity risk premium to drive the S&P 500 to 3,700 by June 2021—our central scenario target for the index.

In this scenario, we think a combination of private markets, commodities, dividend stocks, select credit, and sustainable investments would offer the best risk-return over the period.

Upside scenario

Potential upside could be greater and come more quickly if, for example, a vaccine becomes available or US political uncertainties subside sooner than expected. In our upside scenario, we target the S&P 500 at 3,900 by June 2021, with select value and cyclical stocks performing most strongly. In this scenario, we would also see opportunity for investors to diversify away from US large-cap tech and toward some of the "next tier" growth stocks, including those exposed to 5G, China's new economy, and the future of humans.

Downside scenario

In our downside scenario, the lack of a new vaccine means we do not see a return to "more normal" by the middle of 2021, and growth is damaged by deteriorating US-China tensions or an extended period of political gridlock in the US. Although this scenario would mean meaningful downside for markets, even in this scenario we do not expect to see a return to widespread nationwide lockdowns (which we consider a tail risk) and would expect market declines to be limited by additional action from the Fed. In this scenario, we would expect the S&P 500 to trade at 2,800.

Investment ideas

We retain our view that global equities will move higher over our investment horizon, with a particular preference for the more cyclical and undervalued UK market. Given elevated volatility and skew, we are also seeking opportunities to take on asymmetric exposure in options markets. In credit, we continue to like USD-denominated emerging market sovereign bonds and US investment grade credit relative to high grade bonds. We also retain a positive stance on broad commodity indexes, including gold.

Here are five key actions investors can take to position portfolios for the months ahead:

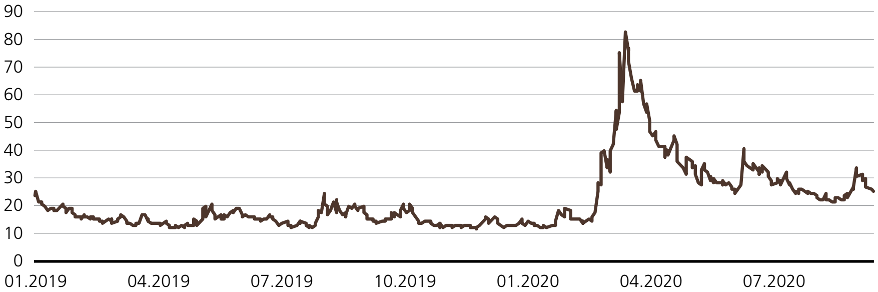
Take advantage of volatility. Amid uncertainty about the timing of vaccine and US fiscal developments, investors could face a period of volatility in the near term. But staying on the sidelines is likely to be costly, in our view. We remain confident on the longer-term trajectory for the economy, and recommend that investors put excess cash to work straight away. For cautious investors, or those with large deposits to invest, we recommend using near-term volatility as an opportunity to build up positions for the long term. This can be done, for example, by embarking on a disciplined phasing-in strategy, or, when appropriate, using options or structured solutions.

Position for the upside in equities. To advance sustainably, the rally will need to broaden beyond growth and US mega-cap tech stocks to also include value and cyclical stocks, in our view. Although the timing of this rotation is uncertain, we think investors should already look to position in select areas of the market that could drive the next leg. These include UK equities, US mid-caps, emerging market value stocks, and global industrials. Within the growth and technology space, we think areas like 5G and the future of humans have among the highest potential promise.

Figure 4

Equity volatility has remained elevated

VIX index since January 2019



Source: Bloomberg, UBS, as of 16 September 2020

Hunt for yield. We expect interest rates to remain at record lows for the foreseeable future, and more central banks have begun to discuss the possibility of negative interest rates. As such, investors will need to continue to work hard to find attractive income-generating assets. While credit spreads have tightened, we still see value in select segments of the market. In particular, we like USD-denominated emerging market sovereign bonds, European crossover bonds, green bonds, and Asia high yield bonds. Investors can also seek opportunities to generate income in high-dividend paying stocks.

Seek opportunities in commodities. We expect broad commodity indexes to rise in the months ahead. Prices of cyclical commodities are likely to go up as the economy returns to “more normal.” Commodity returns tend to be double their 30-year average when looking at periods of accelerating economic growth in advanced economies. Gold also continues to look attractive in a portfolio context in an environment of negative real interest rates and elevated geopolitical uncertainty.

Buy into sustainability. As governments use fiscal stimulus to help economies recover from the pandemic, spending on green initiatives is rising. An analysis by the *Bloomberg New Energy Finance* calculated the world’s top 50 economies were putting USD 583 billion into boosting green efforts. Investors have a variety of ways to gain exposure to sustainable investment opportunities, including replacing traditional asset classes with sustainable ones, investing in multilateral development bank or green bonds, or investing in equity themes aligned with the UN Sustainable Development Goals. We have made sustainable investing our preferred solution for private clients investing globally.

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UBS Investor Forum Insights

At this month's Investor Forum participants discussed the outlook for the global economy and if the rally in risk assets could resume:

- Participants agreed that the swift phase of the recovery had already drawn to a close.
- Several participants argued that the near-term upside is probably limited because a lot had been priced into markets. The next most likely catalyst for a further upside in equities would be progress toward a vaccine.
- The main risks cited stemmed from the US election and US-China relations. But there was agreement that it was unlikely that either risk would be a major impediment for risk assets.
- On inflation, several participants said they expected more reflationary pressures rather than Japan-style deflation. One participant said this view reflected expectations that the US Congress would eventually agree to further stimulus, the Federal Reserve would continue its unprecedented easing, and pent-up savings would fuel a rise in consumption over coming years.

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Version B / 2020. CIO82652744