

# Global Macro Strategy

## The Pulse of the Reflation Theme

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Global

#### Don't believe the hype.

A few weeks ago the market was convinced that a 30 year bull market for bonds was set to unwind in favour of stocks. The last couple of weeks have seen consensus shift; now questioning the sustainability of "the reflation trade". This is not the first time that the market gets whipped around, driven by powerful narratives. [Our work](#) has shown that, since 2008, both markets and macro data have frequently gone through sudden, violent cycles, which, in the end, fade and ultimately become forgettable (Figure 1).

#### Reflation still in the price, although less than before.

The macro planes for growth and inflation are shifting as our economists have discussed in detail in their [2017 outlook](#). Yet, for every macro shift, there is a "fair" price. Straight after the US election, [we used our macro frameworks to produce](#) ranges within which USTs, SPX and the USD would likely trade on the back of a plausible but large policy package delivering a range of growth outcomes (Figure 2; [link](#)). At the mid-December extremes, our frameworks helped us [argue](#) that too much optimism was in the price for US 10y yields [and for the USD vs the EUR](#). Today, and with the same frameworks in mind, market expectations still look high, yet visibly less than before.

#### Follow the signposts: some good news for "reflation" ...

From here, for the reflation theme to extend we need to see the macro evidence. In [our 2017 Outlook](#) we laid out the conditions for the narrow path to reflation to materialize. Along those lines, "reflation" has seen some wins. Sentiment indicators (PMIs, consumer confidence, small business confidence, etc.) have risen, not just in the US but also around the world. Risky assets have traded resilient despite higher yields and USD strength, which is likely to further boost economic sentiment. Metals, typically sensitive to (China) demand, are nearing new highs. And oil prices have risen at an orderly pace.

#### ...but not unequivocally so.

That said, there have also been some crucial blows to the reflation theme. First and foremost is the hawkish Fed shift in December. Until fiscal policy becomes active and credible, the reflation thesis crucially hinges on a dovish Fed that stays behind the curve (Figure 3). Second, despite stronger wage growth, PCE and CPI continue to lose momentum partly driven by dollar strength. And survey as well as market-based inflation expectations continue to hover at low levels (Figure 4). Third, in line with our [UBS Evidence Lab findings](#), retail sales in the US have failed to gain momentum.

#### What to do with risk aversion starting to approach "complacency territory"?

In **equities**, the SP500 is trading at the upper end of our model ranges. Separately, our risk aversion index is approaching "complacency" territory (Figure 5). And the rotation trade from staples and utilities to financials has outpaced the spike in yields (Figure 6), driven in part by regulatory expectations. As growth gains pace, we continue to expect stocks will benefit, but we would be granular. Our [Top Trades](#) focus on sectors that have lagged due to the rise in yields, yet will likely benefit as growth gains pace. In **bonds**, our broad bias is to be long duration and [we expect convergence in real yields](#) between Europe and US. [Since we introduced the view](#), US yields have declined leaving less space for spot gains; however, relative to forwards, bonds still offer good carry. Moreover, we would use spikes towards 2.60 as opportunities to add. In **FX**, we have recommended long EUR/\$ (as part of a basket) and short vol as part of [our top trades](#).

#### What would raise our ranges for yields, dollar and stocks?

A policy plan involving stimulus above one trillion US\$ and growth enhancing policies would boost our ranges. [Comprehensive tax reform](#) could further boost US stocks and economic sentiment. Paced oil price increases could also support inflation expectations.

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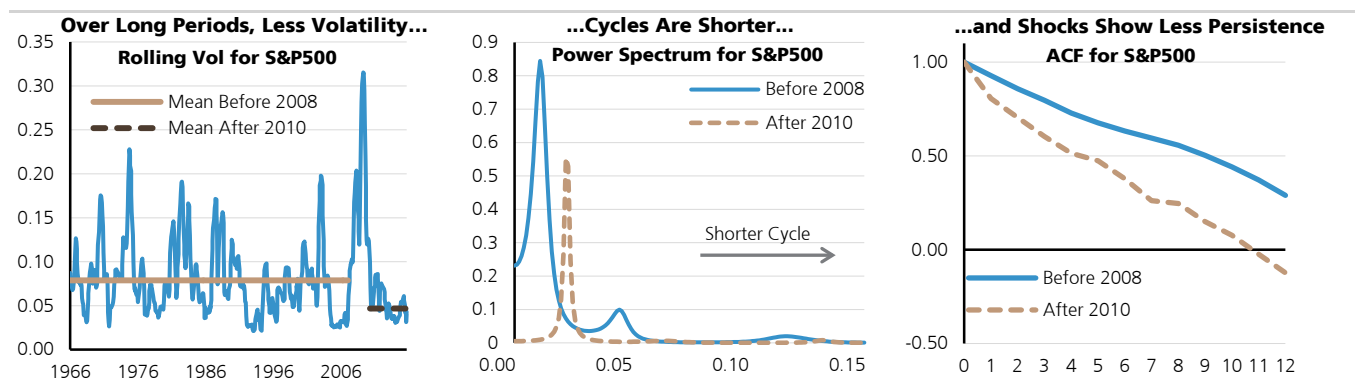
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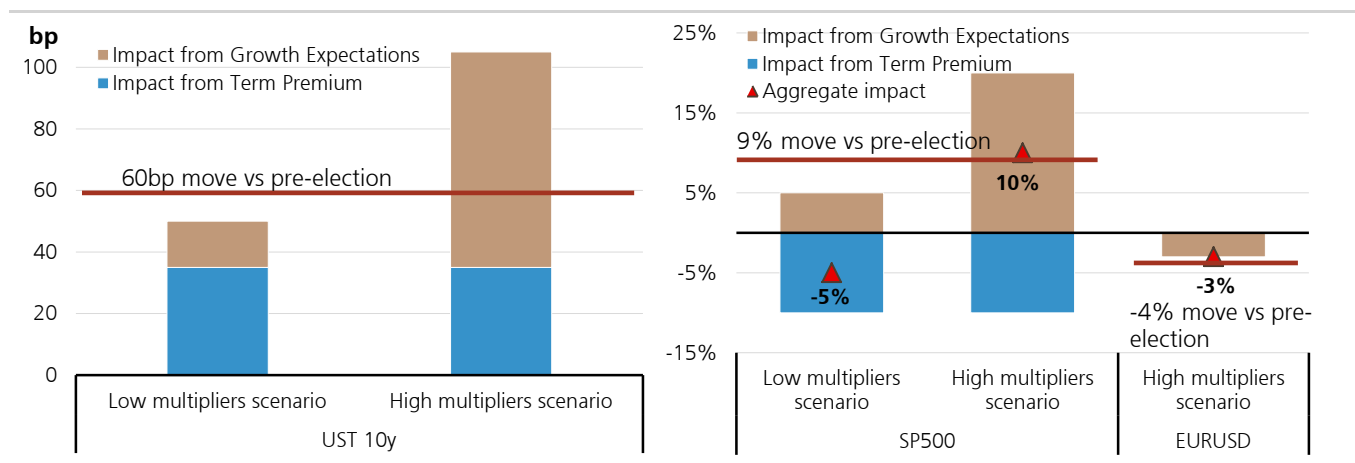
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**Figure 1: Since the Global Financial Crisis, the new market cycle has become short, volatile but ultimately forgettable**



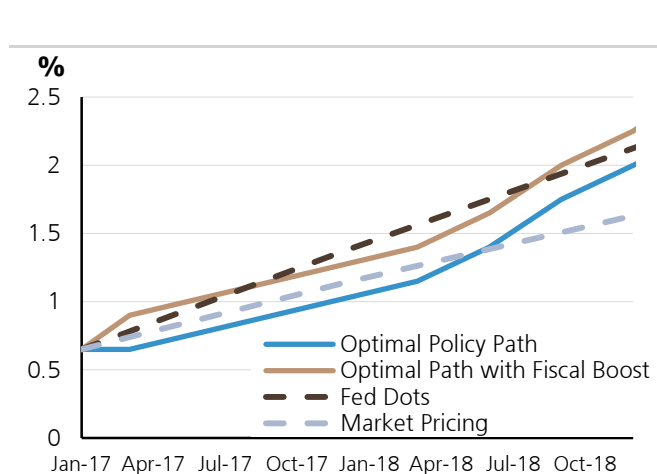
Source: Bloomberg, UBS Calculation. Note: annual changes on monthly data.

**Figure 2: Our modelled impact of 1 trillion of fiscal spending on 10y US yield, EURUSD, and S&P500 vs market moves**



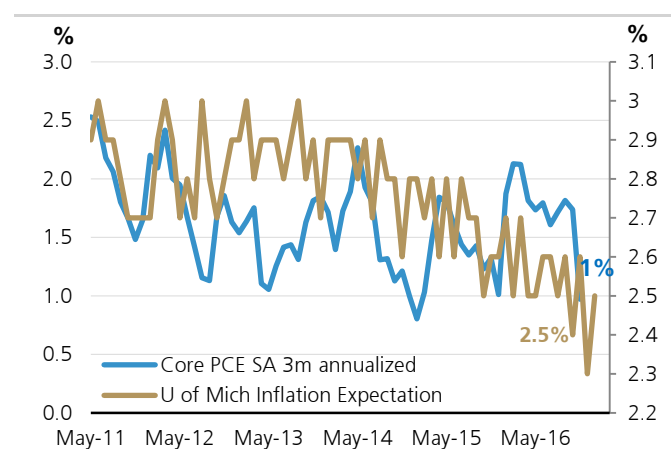
Source: Bloomberg, UBS calculations

**Figure 3: Relation still hinges crucially on a dovish Fed**



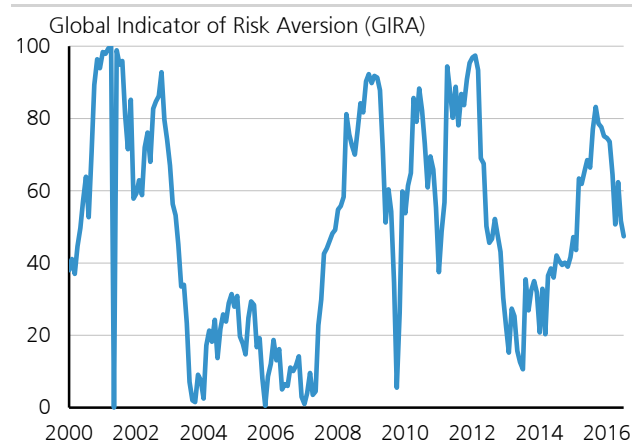
Source: Bloomberg, Haver, UBS calculations

**Figure 4: Inflation and inflation expectations likely to continue hovering around low levels**



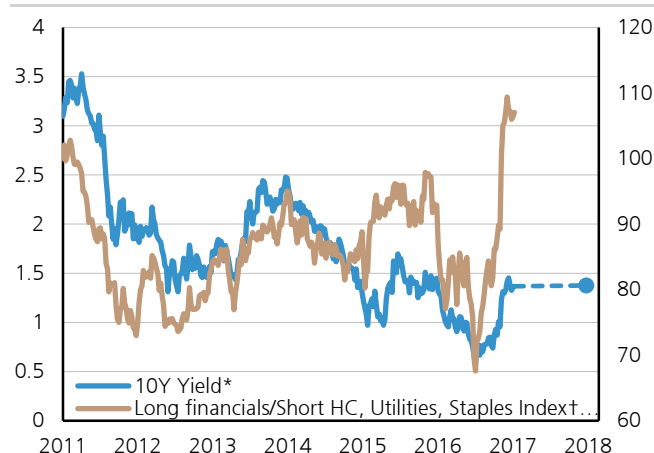
Source: Bloomberg, Haver, UBS

**Figure 5: Risk aversion index now moving below 50 and into "complacency" territory for the first time in a while.**



Source: Bloomberg, Haver, UBS calculations

**Figure 6: The rotation to financials has outpaced the rise in yields, partly driven by regulatory expectations.**



Source: Bloomberg, UBS calculations

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Risks of multi-asset investing include but are not limited to market risk, credit risk, interest rate risk, and foreign exchange risk. Correlations of returns among different asset classes may deviate from historical patterns. Geopolitical events and policy shocks pose risks that can reduce asset returns. Valuations may be adversely affected during times of high market volatility, thin liquidity, and economic dislocation.

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