UBS House View

Monthly Extended March 2023

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Investment Research

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This document is a snapshot view. For all other forecasts and information, we advise you to check the Investment Views section in your E-Banking or in Quotes.

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UBS

Section 1

Investment views

Section 1.1

Asset class outlook

Asset class outlook

Asset allocation

Within equities, we still prefer value and quality income versus growth. We also like emerging markets, China, Australia, and the UK.

We prefer high grade, investment grade, and emerging market bonds over high yield.

We like broad commodities and oil.

On currencies, we have a preference for the Australian dollar. We have a neutral stance on the Swiss franc, the euro, the British pound and the Japanese yen.

Equities

Following a strong start into the new year, global equities have lost traction into February amid a slower-than-expected moderation in inflation and the latest upside surprise in US nonfarm payrolls, which lifted the Fed's terminal rate expectations.

We keep US equities as least preferred and UK, Australia and EM as most preferred.

By sector, we upgrade industrials to most preferred and downgrade healthcare and communication services to least preferred.

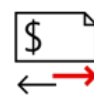
Across styles, we prefer value and quality income to growth.

Bonds

We think more defensive higher-quality segments of fixed income are appealing, given the all-in yields on offer and as inflation risks transition to growth risks. Within this context, we maintain a preference for high grade and investment grade bonds.

Tighter lending standards and slower growth suggest higher corporate default risk, while liquidity risk premiums are likely to rise over time as central banks continue to tighten money supply. As a result, we see high yield spreads as vulnerable relative to the other two segments.

China's recent economic reopening has improved sentiment and is likely to contribute positively to global growth dynamics. EM bonds benefit both directly and indirectly from this.



Foreign exchange

This month we establish a neutral view across all G10 currencies, the one exception being a long position in the AUD which could be financed from any of the major currencies in our neutral basket. Across the other major currencies, we hold a neutral view as we see a transition happening that carries many uncertainties. This is a year of transition with the strongest rate hike cycle in the US for more than 40 years giving way to a more neutral fed policy, and eventually an easing bias.

We see a high likelihood that the introduction of an easing Fed bias will strengthen high beta currencies like the EUR, the GBP and many emerging market currencies versus the USD. Nevertheless, the question is how fast will the easing bias arrive.

Commodities

We see another strong year for commodities in 2023 and forecast high teen percentage total returns on an asset class level.

Our positive view is based on a robust economic recovery in China from 2Q23 onwards, the start of a Fed rate-cutting cycle later in the year, and several unresolved supply-side issues that should keep market balances tight.

We prefer oil and broad commodities over gold.

We keep recommending managing commodity exposure actively.

Section 1.2

Risk scenarios

Key scenarios for 2023

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	Upside	Base case	Downside	*Things to watch*
Probability	**25%**	**50%**	**25%**	
Inflation	• Falls quickly back to central bank targets over coming months.	• Continues to slow in the US and in Europe, but the slowdown tempers in coming months.	• Proves more persistent than central banks and markets expect.	• *US: CPI and PCE inflation* • *US: ISM prices-paid subindex* • *US: Average hourly earnings* • *US: JOLTS openings and hires* • *Eurozone: HICP inflation*
Central banks	• Major central banks cut rates in 2H 2023	• The Fed, the ECB, the SNB, and the BoE to complete their hiking cycles in 1H 2023 but unlikely to cut rates in 2023.	• Longer period of tighter monetary policy with rate hikes beyond 1H 2023, followed by recession and rate cuts in 1H 2024.	
Economic growth	• Rebounds as the outlook for corporate earnings improves.	• US, Europe and UK experience sub-tend growth as China re-accelerates. US consumption holds up well due to a strong labor market and solid wage growth. Lower energy prices cushion impact from higher policy rates in Europe.	• Falls sharply towards late 2023 or early 2024 owing to highly restrictive monetary policy; possible China U-turn on COVID.	• *Global: Oil price* • *US, China: PMI data* • *US: Change in nonfarm payrolls* • *China: Consumer mobility* • *Europe: Gas prices*
Financial conditions	• Ease, lifting market valuations.	• Remain tight, increasing the market's vulnerability to negative surprises or external shocks.	• Tighten further, causing stress in the financial system.	• *Global financial conditions indexes*
Geopolitics / other	• The war in Ukraine deescalates, e.g., via a ceasefire agreement.	• The war in Ukraine drags on. A cessation of hostilities remains an unlikely outcome.	• The war in Ukraine escalates or US-China tensions intensify. • *Tail risk*: US debt ceiling not raised by July/August; US Treasury defaults; global markets sell off.	• *Territorial gains by Russia* • *Weapon shipments to Ukraine* • *Putin support polls*
Market path	• Risk assets are lifted by easing financial conditions and a brightening outlook for global growth.	• Volatility throughout 1H 2023 owing to uncertainty about inflation, monetary tightening, economic activity, and geopolitics. Risk assets start trending higher in 2H 2023 amid turning points in growth, inflation, and rates.	• Severe downturn with global equities posting double-digit losses, credit spreads widening, safe-haven assets benefitting.	

Asset class targets – December 2023

Key targets for December 2023	Spot*	Upside	Base case	Downside
MSCI AC World	765	880 (+15%)	770 (+1%)	670 (-12%)
S&P 500	3,997	4,400	3,800 (-5%)	3,300 (-17%)
EuroStoxx 50	4,250	4,900 (+15%)	4,250 (-0%)	3,650 (-14%)
MSCI China	68	83 (+22%)	80 (+18%)	59 (-13%)
US 10y Treasury yield	3.95%	2.50%	3.00%	4.50%
US 10y breakeven yield	2.43%	2.00%	2.25%	3.00%
US high yield spread**	449bps	300bps	550bps	850bps
US IG spread**	107bps	60bps	120bps	200bps
EURUSD	1.06	1.15 (+8%)	1.10 (+3%)	1.02 (-4%)
Commodities (CMCI Composite)	1,873	2,300 (+23%)	2,200 (+17%)	1,750 (-7%)
Gold	USD 1,835/oz	USD 2,200-2,300/oz (+23%)	USD 2,050/oz (+12%)	USD 1,800-1,900/oz (+1%)

* Spot prices as of market close of 21 Feb 2023. Values in brackets are expected percentage changes from the quoted spot level.

** During periods of market stress, credit bid-offer spreads tend to widen and result in larger ranges.

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

Section 1.3

Asset class preferences and themes

Global asset class preferences

	Least preferred		Most preferred
Liquidity		=	
Equities		=	
Growth	−		
Value			+
Quality income			+
Small caps		=	
United States	−		
Eurozone		=	
Switzerland		=	
Emerging markets			+
Japan		=	
United Kingdom			+
Australia			+
Sectors			
Communication services	− (previously =)		
Consumer discretionary		=	
Consumer staples			+
Energy			+
Financials		=	
Healthcare	− (previously +)		
Industrials			+ (previously −)
Information technology	−		
Materials		=	
Real estate		=	
Utilities		=	

	Least preferred		Most preferred
Bonds		=	
High grade			+
Investment grade			+
High yield	−		
Emerging markets			+
Commodities			+
Oil			+
Gold		=	
Foreign exchange			
USD		=	
EUR		=	
JPY		=	
GBP		= (previously −)	
CHF		=	
AUD			+

Note: The global asset class preferences reflect the high-level UBS House View. The tactical asset allocation (TAA) positioning of our different investment strategies may differ from this view because our strategies seek specific investment objectives and can frequently adjust portfolio allocation to achieve them. Also, these preferences may vary in different regions for various reasons such as currency considerations.

Least preferred
We expect this asset class to deliver the least attractive risk-adjusted returns over the next 12 months within our asset class universe.

Most preferred
We expect this asset class to deliver the most attractive risk-adjusted returns over the next 12 months within our asset class universe.

Asia ex-Japan asset class preferences

	Least preferred		Most preferred
Equities			
Asia ex-Japan		=	
China			+
Hong Kong		=	
India	− ←	(=)	
Indonesia		=	
South Korea		(=) →	+
Malaysia	−		
Philippines		= ←	(+)
Singapore	−		
Taiwan		=	
Thailand			+
Bonds			
Asian investment grade bonds		=	
Asian high yield bonds		=	
Chinese government bonds		=	

Note: The Asia ex-Japan asset class preferences reflect the high-level UBS House View. The TAA positioning of our different investment strategies may differ from this view because our strategies seek specific investment objectives and can frequently adjust portfolio allocation to achieve them.

Least preferred
We expect this asset class to deliver the least attractive risk-adjusted returns over the next 12 months within our asset class universe.

Most preferred
We expect this asset class to deliver the most attractive risk-adjusted returns over the next 12 months within our asset class universe.

US asset class preferences

	Least preferred	Neutral	Most preferred
Cash		=	
Fixed Income		=	
US Gov't FI		=	
US Gov't Short		=	
US Gov't Intermediate	−		
US Gov't Long		=	
TIPS		=	
US Agency MBS			+
US Municipal		=	
US IG Corp FI			+
US HY Corp FI	−		
Senior Loans	−		
Preferreds		=	
CMBS		=	
EM Hard Currency FI*			+
EM Local Currency FI		=	

	Least preferred	Neutral	Most preferred
Equity		=	
US Equity	−		
US Large Cap Growth	−		
US Large Cap Value			+
US Mid Cap		=	
US Small Cap		=	
Int'l Developed Markets		=	
UK			+
Eurozone		=	
Japan		=	
Australia			+
Emerging Markets			+
Other			
Commodities			+
Gold		=	
Oil			+
MLPs		=	
US REITs		=	

Note: The US asset class preferences reflect the high-level UBS House View. The TAA positioning of our different investment strategies may differ from this view because our strategies seek specific investment objectives and can frequently adjust portfolio allocation to achieve them.

Least preferred
We expect this asset class to deliver the least attractive risk-adjusted returns over the next 12 months within our asset class universe.

Most preferred
We expect this asset class to deliver the most attractive risk-adjusted returns over the next 12 months within our asset class universe.

* We hold a most preferred stance on EM Hard Currency sovereign bonds and remain Neutral on EM Hard Currency corporate bonds.

Global and regional sector preferences

Sectors	LP Global MP	LP US MP	LP Eurozone MP
Communication services	− ← =	− ← =	−
Consumer discretionary	=	=	+
Consumer staples	+	+	+
Energy	+	+	=
Financials	=	−	=
Healthcare	− ← +	= ← +	− ← =
Industrials	− → +	=	− → =
Information technology	−	−	−
Materials	=	=	=
Real estate	=	= → +	+
Utilities	=	=	=

Least preferred (LP)
We expect this sector to deliver the least attractive risk-adjusted returns over the next 12 months within our sector universe.

Most preferred (MP)
We expect this sector to deliver the most attractive risk-adjusted returns over the next 12 months within our sector universe.

Messages in focus including linked ideas

Overall stance The latest data suggests our Year of Inflections is happening at different speeds in different regions. After a period of weak growth over the winter, China and Europe's economies are inflecting sooner than expected. In contrast, US growth has proven very resilient, though this may raise the risk of a later, deeper recession as the Fed tries to combat inflation. For investors, we think this backs a selective approach within equities, including favoring emerging market stocks relative to US stocks. Elsewhere, given elevated yields, we continue to see a variety of opportunities to generate income. We also continue to believe uncorrelated hedge fund strategies can play an important role in portfolios as we navigate correlated markets still driven by expectations for central bank policy. For longer-term investors, we see upside in investing sustainably, in stocks aligned to the transition to an 'era of security', and in private markets.

Scenarios	MIF name	MIF description	Linked ideas	Source of funds
Downside*	**Seek uncorrelated hedge fund strategies**	Recent data highlighting that inflation in the US could prove to be more persistent than hoped, mean that monetary policy expectations are likely to remain a key market driver in the months ahead. This can lead to both equities and bonds moving in tandem, and means that uncorrelated hedge fund strategies such as macro, equity market neutral, and multi-strategy funds could play a particularly important role in diversifying portfolios.	- Macro - Equity market neutral - Multi-strategy	- Excess bonds / equities - Sell- / expensive-rated bonds - Concentrated stocks
Base case	**Diversify beyond the US and growth**	We favor a more selective approach within equities and recommend investors diversify beyond the US and growth stocks. We like value, including energy, which should be more resilient if inflation proves sticky or rates go up by more than expected. Earlier inflection points in China and Europe favors outperformance in select European names, EM equities, and some early-cycle markets relative to the US. And with uncertainty around the US economic outlook still elevated, we also like more defensive areas like consumer staples while utilizing capital preservation strategies where applicable.	- Global value including energy - Emerging market equities - Global consumer staples - Capital protection structured investments	- Excess US stocks - Excess growth stocks - Excess IT - Excess communication services - Excess healthcare - Least preferred stocks - Limited upside list
	Seek income opportunities	Bond yields have increased in recent weeks, reflecting the prospect of higher interest rates and boosting the range of options for investors seeking income. We see particular opportunity in investment grade bonds, resilient credits, emerging market credit, select AT1s, and quality income stocks. Investors should also ensure they take steps to actively manage their liquidity. A slowing US economy means we are cautious on high yield credit.	- Active liquidity management - Investment grade bonds - Emerging market credit - Select AT1s - Swiss real estate - Quality income stocks - Yield-generating structured investments	- Excess cash - Limited upside list - Least preferred stocks - Sell- / expensive-rated bonds - Excess senior loans - Excess high yield
	Invest sustainably	Despite relative underperformance in certain parts of the sustainability investment universe over the past year, the long-term performance of sustainable investments remains strong on an absolute and relative basis. Sustainability can be a key driver of corporate performance, and we believe that companies that manage their business, stakeholder, and environmental impact better should also be well positioned to deliver on financial results. Investors do need to pay particular attention to portfolio diversification by sector, style and asset class to ensure more consistent performance through the cycle.	- Sustainability-linked LTIs - ESG equity strategies incl. engagement and improvers - Thematic sustainable fixed income - Sustainable asset allocations	- Excess cash - Excess IT - Traditional counterparts
	Position for the era of security	One year after Russia's invasion of Ukraine, the war continues, and the world's energy landscape has been fundamentally changed. Meanwhile, recent heightened tensions between the US and China have led to renewed focus on national and technological security. We believe we are at the early stages of a new 'era of security', in which energy security, food security, and technological security will be increasingly prioritized, even if they come at the cost of efficiency. This will have effects across the investment landscape, including in themes like renewable energy, greentech, and cybersecurity.	- Energy security (active commodity exposure, clean air and carbon reduction, energy efficiency, greentech) - Food security (agricultural yield) - Cybersecurity - Infrastructure	- Excess cash - Excess IT - Least preferred stocks - Limited upside list
	Seek value and growth in private markets	Putting fresh capital to work in private markets following a period of declines in public market valuations has historically been a rewarding strategy. In the current environment, value-oriented strategies are becoming increasingly attractive, in our view.	- Secondaries - Distressed / restructuring debt - Value-oriented buyouts - Direct lending	- Excess cash - Excess equities - Excess growth stocks
Upside	**Anticipate the inflections**	China's re-opening, and an end to the winter gas crisis in Europe mean that growth prospects in emerging markets and Europe look stronger at present. We therefore see opportunity in emerging market equities, including China and stocks exposed to China's reopening, and commodities. We also think early-cycle markets like Germany; select semiconductor stocks, and select Asia-Pacific currencies look well positioned to benefit from an upturn in growth in the region.	- Emerging market equities (incl. China and China re-opening plays and Asia semiconductors) - Select European themes (Germany, consumer recovery, medtech) - Commodities - Currency structures incl. AUD - Phasing strategies	- Excess cash - Excess US stocks - Limited upside list - Least preferred stocks

3L disclaimer: Timeframes may vary. Strategies are subject to individual client goals, objectives and suitability. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved. *Investment ideas mapped against the downside scenario would perform well relative to other portfolio assets in a downside scenario, in our view. This doesn't exclude the possibility that, in absolute terms, individual ideas may perform better in central or upside scenarios than in the downside scenario. More information on goto/mif

Key investment ideas by asset class

		We like	Source of funds
Equities		• Sectors: Energy, consumer staples, industrials • Global value • Quality income • UK, Australia, China • Energy security, food security and cybersecurity • Emerging market equities (incl. China and China re-opening plays and Asia semiconductors) • Select European themes (Germany, consumer recovery, medtech)	Limited upside list, CIO least preferred stocks, excess growth stocks, concentrated stocks, excess IT, excess US stocks, excess communication services, excess healthcare, excess cash
Bonds		• Investment grade bonds and high grade bonds • Select short-duration bonds, resilient credit • Emerging market credit • Select AT1s • Yield-generating structured investments • Thematic sustainable fixed income	Sell- / Expensive-rated bonds, excess senior loans, excess high yield, excess cash
Foreign exchange		• AUD	Excess cash
Commodities		• Active commodity exposure • Oil	Excess cash
Hedge funds, private markets		• Macro • Equity market neutral • Multi-strategy • Secondaries • Distressed / restructuring debt • Value-oriented buyouts • Direct lending	Excess cash, excess bonds, excess equities

Section 2

Macro economic outlook

Global economy – Slower demand, slowing inflation

Base case (50%)

Growth

Negative real wage growth in developed economies is slowing consumer demand, and with that overall growth. However, employment remains relatively strong, limiting the need for precautionary savings. Changing consumption patterns also mean that some parts of the economy have more resilience. Seasonal adjustment may add to data volatility in the early part of the year.

Inflation

Inflation rates have peaked and are starting to moderate. Consumer durable goods are in disinflation or deflation as demand has switched towards services. While profit margin expansion has pushed inflation higher in certain sectors, weakening consumer demand and less consumer acceptance of price increases is likely to squeeze margins in some sectors. Base effects from energy will push the year over year inflation lower from the second quarter.

Positive case (25%)

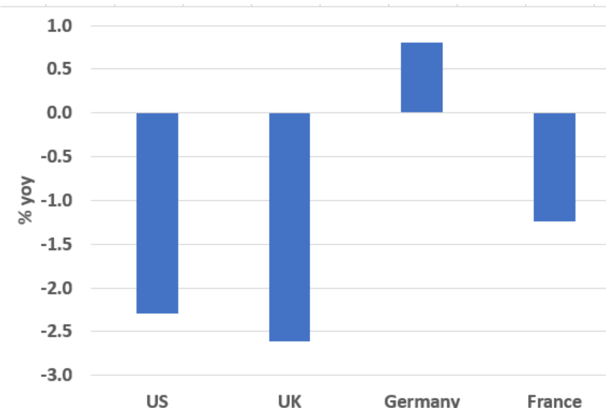
A faster decline in inflation will restore real wage growth stability more quickly, stabilizing consumer demand earlier than anticipated. Inflation rates for middle income consumers are already less than the headline rate in many economies, which helps spending power in an important demographic.

Negative case (25%)

Real wages remain negative for a longer period of time. Nominal wage growth slows faster than expected, while inflation remains higher. Interest rates rise further than expected, and increasing unemployment causes households to start to increase their precautionary savings rates.

Consumer demand has a weak foundation

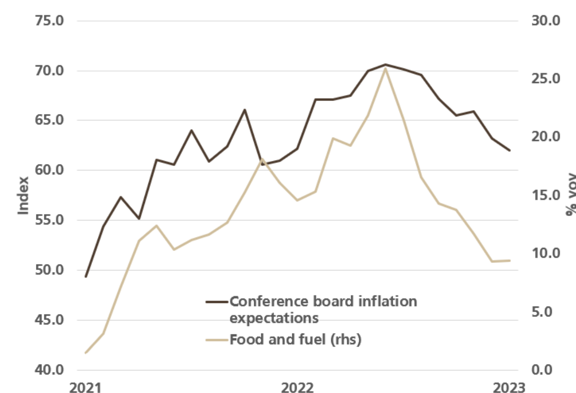
Real disposable income growth, latest quarter



Source: Haver, UBS

Consumer inflation expectations should fall

US inflation expectations versus food and fuel



Source: Haver, UBS

US economy – Fed rate hikes threaten recovery

Base case (50%)

Growth

Growth has surprised to the upside in recent months as the strong labor market boosts wage income and consumers spend some of the savings they built up during the pandemic. A period of sub-trend growth appears likely as the Fed continues to tighten monetary policy, raising borrowing costs for both businesses and consumers.

Inflation

Inflation is clearly down from its peak. A better balance between supply and demand for goods has allowed some overheated prices to start falling back toward pre-pandemic levels. However, service prices are still rising. Businesses continue to lift prices in the face of robust demand and rising wages. Renters face higher payments when they renew their leases. The Fed will continue hiking rates until inflation is on a path toward its 2% target.

Positive case (25%)

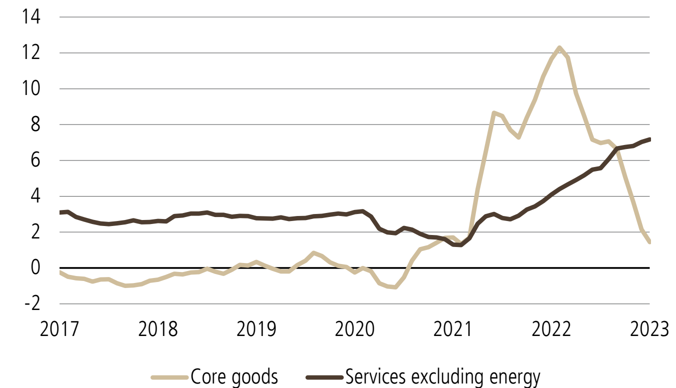
Supply-side bottlenecks continue to ease, while better labor supply allows businesses to fill in their open job positions. Consumer demand aligns with what the supply side is able to produce. Wage growth slows to a more moderate pace, helping to bring inflation down without a recession. The Fed sees enough progress toward its mandates to stop raising rates.

Negative case (25%)

Inflation remains elevated, forcing the Fed to continue raising rates. Consumers pull back on spending, and seeing weaker demand, businesses stop hiring. The economy falls into recession and the unemployment rate rises from the current historically low levels.

Inflation now driven by services

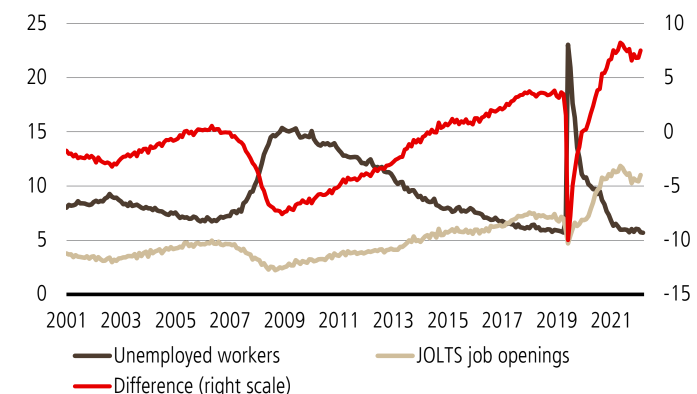
CPI core goods and services, y/y change in %



Source: Bloomberg, UBS

Labor market is extremely tight

Job openings and unemployed workers, in millions



Source: Bloomberg, UBS

Eurozone economy – Recession likely avoided

Base case (60%)

Growth

The Eurozone economy proved to be more resilient than feared through the winter months, helped by a sharp fall in energy prices, and fiscal support. The improved outlook for gas demand will likely mean that the Eurozone does not experience the same problems next year. We look for GDP growth of 0.8% in 2023, below trend, better than feared.

Inflation

Inflation continues to fall in the Eurozone, although the data is likely to remain volatile. Nevertheless, we think that inflation will remain uncomfortably high for policymakers at the ECB through the first half of the year, and look for deposit hikes through to May, with the peak around the 3.25% level. Risks to this call are tilted to upside, with a higher peak with rates staying there a sizeable risk.

Positive case (15%)

Economic activity normalizes sooner, supported by a sharp fall of inflation.

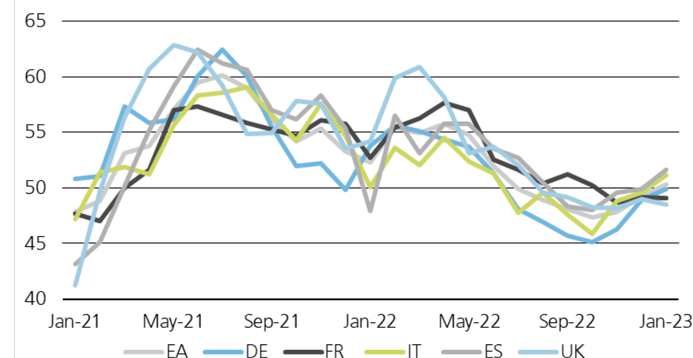
Economic growth in Asia and the US accelerates, with the latter avoiding a recession, boosting demand for Eurozone exports. Progress is made on trade talks with the US, and outstanding Brexit issues with the UK are resolved.

Negative case (25%)

ECB overtightens monetary policy by placing too much weight on near-term inflation. Tighter financial conditions could see demand for credit shrink hurting consumption and investment.

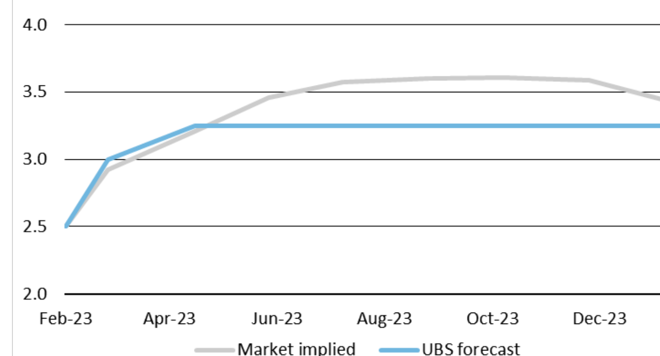
Geopolitical tensions force energy prices materially higher, emerges. Fiscal policy is too slow to respond or is tightened too early.

Lead indicators are recovery, pointing to ongoing, albeit subdued, growth



Source: Haver Analytics, UBS

ECB hikes to continue through to May



Source: Refinitiv, UBS

Swiss economy – Inflation surges in January

Base case (70%)

Growth

Against the backdrop of elevated inflation, high energy prices and weak momentum in the Eurozone, we expect Swiss GDP growth to slow in the winter months. However, as an energy shortage has become very unlikely, a recession should be averted.

Inflation

Inflation increased from 2.8% in December to 3.3% in January. However, the latest increase is mainly due to the annual change in electricity prices that takes place in January. We still expect inflation to fall on the back of fading energy contribution and improved supply chains in the coming months.

We expect the SNB to raise rates by 50bps to 1,5% in March and then to keep rates unchanged as inflation is likely to return to below the 2%-mark by the middle of the year.

Positive case (20%)

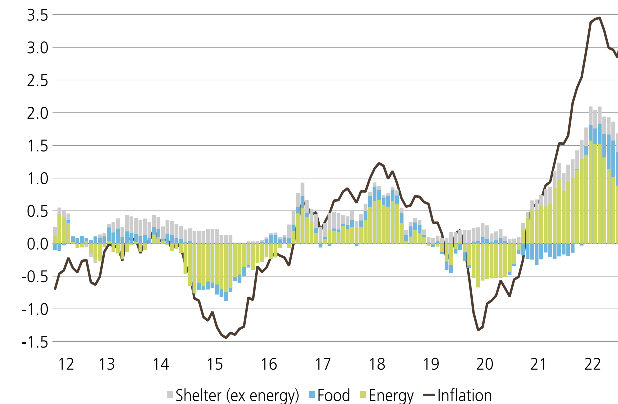
Better global growth momentum: An easing of supply chains and energy issues reduce inflationary pressures and boost global demand. Switzerland benefits from the stronger global backdrop and a weakening of the safe-haven Swiss franc.

Negative case (10%)

Eurozone slump pushes Switzerland into a recession: For Switzerland to fall into a recession multiple preconditions must be met: elevated energy prices and restricted gas supplies; a deep Eurozone recession and a strong appreciation of the Swiss franc.

One-off effects increase inflation

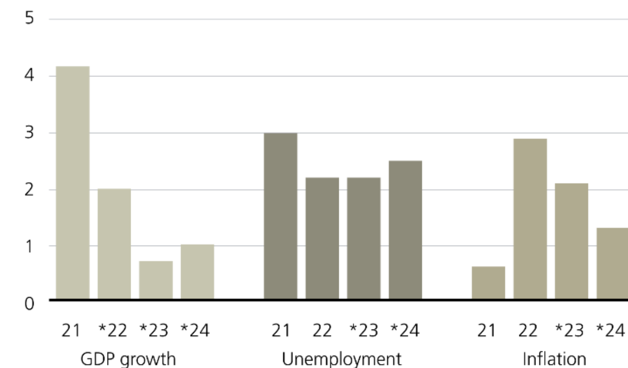
Year-on-year change in Swiss CPI and contribution of selected components, in %



Source: Macrobond, UBS

Inflation and GDP growth to weaken

UBS forecast for Swiss GDP growth, unemployment and inflation rate, in %, *forecast



Source: Macrobond, UBS

Chinese economy – Recovering on reopening

Base case (70%)

Growth

China's consumption continued recovering on reopening since mid-Jan, with a pace faster and stronger than expected. The trend will continue fueled by excess savings during the pandemic. Investment will keep resilient led by infrastructure and manufacturing. The government is likely to set China's GDP growth at "above 5%" in March NPC, versus 3% actual in 2022.

Inflation

2023 CPI inflation is to pick up mildly to ~3% y/y from 2.0% in 2022. Non-food inflation could move higher than food inflation on recovering services, normalizing supply chains and mild energy inflation. Still, mild inflation leaves room for supportive fiscal and monetary policy.

Positive case (20%)

Consumption recovers stronger than expected on policy support.

Infrastructure investment growth may see more upside risk with strong pipeline of mega investment plans announced by local governments.

Negative case (10%)

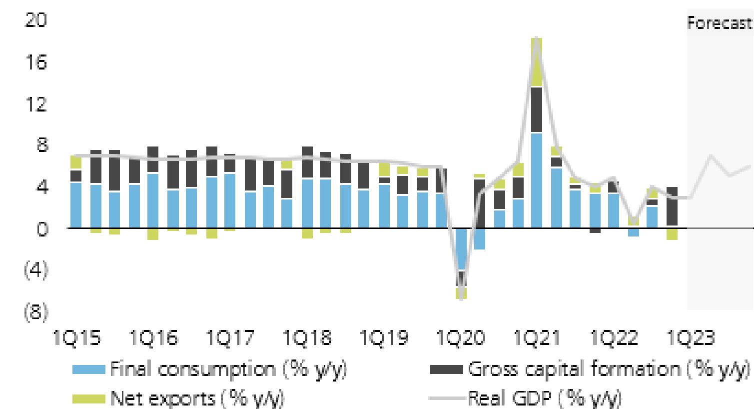
Property activities continued slumping without narrowing decline by 1H23.

The US dips into a deep recession with a more hawkish Fed tightening cycle.

The US imposes much stricter restrictions on China's tech sectors.

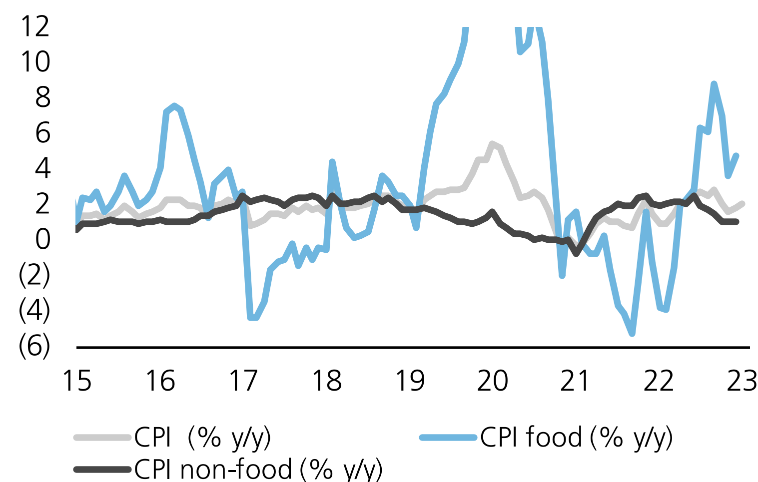
GDP growth likely to rebound stronger than expected

GDP growth breakdown



Source: CEIC

CPI inflation to rise mildly but still manageable



Source: CEIC

Section 3

Asset class views

Section 3.1

Summary of major asset classes

Equities

Central scenario

MSCI AC World December 2023 target: 770

In our global tactical asset allocation, we keep equity at neutral. Within equities as a whole, we prefer the UK, Australia and Emerging Markets over US stocks. Across sectors, we upgrade industrials to most preferred and downgrade healthcare and communication services to least preferred. We still like global energy and consumer staples, and stay least preferred on information technology. Across styles, we prefer value and quality income to growth.

Risks around EPS are skewed to the downside. With US earnings growth turning negative in 4Q 2022, the dip in leading economic indicators raises the risk of a subsequent decline in the first-quarter of 2023, which would usher in a earnings recession. We estimate global and US earnings to contract by 3% (vs. 0% consensus forecast) and 4.5% (vs. +0% consensus forecast) respectively. Furthermore, earnings momentum continues to deteriorate, and earnings downgrades are outpacing upgrades. With these indicators in negative territory, we think equity volatility could resume.

We believe valuations remain unattractive versus high grade bonds. The MSCI AC World P/E multiple has corrected from a high of about 20x since the pandemic to around 15.5x today, moderately above the long-term average of 14.5x. Conversely, MSCI US index's lofty valuation poses the highest downside risk: at 18.5x, it equates to approx. 19% premium over the global benchmark. Compared to high grade bonds, global equities are not attractive yet; the equity risk premium is falling and the cost of equity is consistent with future negative returns versus high-quality sovereign bonds.

US equities are rated as least preferred. US stocks have performed negatively in 2022. However, the market performance can be mostly explained by the change in discount rates. Real yields have soared over recent months. Changes in real yields have largely reflected the shift in Federal Reserve policy rather than growth expectations. The S&P 500 forward P/E multiple has collapsed from 21x at the start of 2022 when real rates were negative to 18.5x today when real rates are positive. However, the relationship has dislocated; equity valuations have declined from their peak but still trade above the level implied by the recent relationship with real rates.

We are keeping the UK, Australia and Emerging Markets as most preferred. We still see tailwinds from high energy and commodity prices with the UK and Australia being the main beneficiaries thanks to their respective index tilt toward energy and materials. The UK's valuation is also very attractive; based on 12-month forward P/E, the MSCI UK is trading at a 32% discount to the MSCI AC World. As for EM, with China reopening, the US dollar headwind has been subsiding, earnings momentum and revisions have bottomed versus developed countries and valuations look appealing, in our view.

Energy and consumer staples stay most preferred. The energy sector delivered good performance last year, but we still see some upside versus global equities in the coming months. First, we expect the sector to extend share buybacks and dividends; second, while earnings growth and net earnings revisions should deteriorate on lower oil prices, expectations for a higher Brent oil price in 2023 should avert an earnings collapse (consensus appears far too negative on 2023 earnings growth forecasts); and third) valuations look appealing (the sector is trading at 8.3x 12-month forward earnings, a 46% discount to the MSCI AC World index). With regard to consumer staples, relative earnings momentum is positive and strengthening, and while absolute valuation appears expensive, it is in line with historical averages.

CIO themes

23 for '23

2023 should bring turning points for inflation, interest rates and economic growth while financial markets deal with a complex geopolitical backdrop. 23 for '23 is a bottom-up focused global stock selection that aims to reflect our highest conviction stock ideas exploiting these inflections, while incorporating dynamically tactical ideas.

Sustainable investing, global leaders

The wealth of sustainability-related information available to investors is often overlooked by the mainstream investment community, in our view. Integrating such factors, along with traditional financial parameters, into security selection can help identify investment opportunities and risks. Our global sustainable investing (SI) equity preference list features 20–25 stocks with risk-return profiles we consider attractive and that exhibit better-than-average UBS SI scores.

Global quality income

Three reasons to invest in the Global Quality Income theme: 1) It benefits during an economic slowdown; 2) it outperforms in market sell-offs and when volatility rises; and 3) dividends are safer than earnings while balance sheets remain healthy and capital returns well covered.

Sector preferences

Most preferred: Energy, consumer staples, industrials

Least preferred: IT, healthcare, communication services

Equities

We upgrade industrials to most preferred. We expect the next capex cycle to be strong: energy transition/decarbonization capex (energy efficiency, renewables spending), higher defense spending after two decades of underspending for most NATO states in Europe, higher mining/oil&gas capex due to higher commodity prices, automotive capex (EV transition), reshoring of capacities (more automation capex) should support capital spending and industrials earnings growth in the coming years.

We downgrade healthcare and communication services to least preferred. The softening dollar is a headwind for pharmaceutical companies outside of the US. Valuations now look expensive following last year's strong relative sector performance. We also downgrade communication services. The sector has performed strongly year-to-date, while the main sector players are in a phase of cost restructuring following a wave of layoffs and idiosyncratic risks from competition are on the rise.

We keep information technology as least preferred. Global tech stocks have underperformed global equities since the beginning of 2022. In this environment of higher rates and slowing demand, we expect IT to continue to underperform value. The valuation gap between IT and the benchmark remains high, while further earnings downgrades in the tech sector can be expected. Tense US-China relations and the race for global tech supremacy are other risks facing certain tech industries.

We continue to prefer value and quality income to growth stocks. In an environment of rising bond yields and high inflation, we maintain our preference for value and high-quality stocks. Growth names are still expensive in relative terms and negatively correlated to the rise in real rates.

Upside scenario

MSCI AC World December 2023 target: 880

Inflation cools quickly and the US and European economies do not enter into recession: Inflationary pressures quickly dissipate, and the Fed and other central banks become more accommodative.

Geopolitical de-escalation: A ceasefire ends the war in Ukraine and reduces the risk of further sanctions against Russian commodities.

Economic growth reaccelerates: A reopening in China and solid economic growth in the US drive an even sharper improvement in corporate profits in 2023.

Downside scenario

MSCI AC World December 2023 target: 670

Inflation runs hot: Inflation surprises again on the upside and central banks are forced to hike more than expected.

Geopolitical escalation: The Russia-Ukraine war proves more protracted, increasing the risk of a prolonged and widespread disruption to commodity supplies, either as a result of the war directly or due to stronger sanctions aimed at immediately cutting off Russian energy exports. In this scenario, oil could hit USD 150/bbl and gas may need to be rationed, particularly in Europe.

Coronavirus: Lockdowns are reimposed in China, delaying a return to normal economic activity.

Bonds

With indications that inflationary pressures are abating, major central banks have started to moderate the pace of rate increases. After a series of aggressive initial hikes in 2022, policymakers appear poised to wait for the full effects of tightening to materialize. While this has supported a move lower in rates going into this year, there has been renewed upward pressure on rates in recent weeks as the market has repriced the path of policy rates higher on the back of the strength of the labor market, and related to this, concerns about sticky services inflation. Looking ahead, while interest rate volatility may remain elevated, we see a much more even balance in terms of direction. Central banks have succeeded in repricing expectations, and we are now closer to the end of the rate hiking cycle than to the beginning. To achieve structurally higher interest rates, economic growth needs to step up, while we think growth is likely to weaken as we have yet to see the full impact of monetary policy tightening. Investor demand for fixed income exposure has increased. All-in yields look appealing, particularly relative to opportunities in other asset classes. Within this context, we maintain a preference for high grade (HG) and investment grade bonds (IG). There are also opportunities in the more growth sensitive areas of high yield (HY) and emerging markets (EM). However, we are cognizant that tighter lending standards operate with a lag on fundamentals and current slower growth and earnings in developed economies suggest higher default risk in the future. Additionally, liquidity risk premiums are likely to rise over time as global money supply continues to shrink. As a result, we see HY spreads as vulnerable relative to IG and HG. Therefore, we have a least preferred stance on HY. EM bonds have benefited from the decline in US inflation, a shift in China's COVID policy stance, and increased support for China's property sector. We see the performance drivers for this segment coming from carry and upside on special situations in the distressed space, including amongst sovereigns willing and able to work with the IMF or other international lenders. We have EM bonds as most preferred. Read more

High grade (HG) bonds: We maintain our most preferred recommendation on HG bonds. With growth decelerating, it is our assumption that a moderation in inflation will continue, particularly as the cumulative effects of monetary policy tightening continues to work its way through the economy. We acknowledge that labor markets remain tight, wage growth robust, and core service inflation high. Therefore, there is an element of complacency in the market regarding the assumption that rate hikes are close to the end. As such, rate volatility has been trending lower however we can envisage periodic spikes higher as it remains too early to declare victory on the inflation fight. Despite these risks, we see strong total returns for the asset class going forward. They are rated AA- or better, therefore have minimal default risk. The higher level of interest rates provides a sizable cushion, should rates move higher and further mark-to-market losses be recorded. In the event of a sharper slowdown, rates would move lower across the curve, and the asset class would benefit strongly given its defensive characteristics. Read more

Investment grade (IG) bonds: We maintain the asset class at most preferred. Switching from lower-quality to higher-quality credit makes sense given growth risks and the policy tightening undertaken so far. The high interest rate sensitivity of the US and EUR investment grade complexes has been a detractor from total returns this year. Looking ahead, we see the balance of risks more equally distributed as concerns shift from inflation to growth. Within EUR IG, the average yield is around 4%. The war in Ukraine and the European Central Bank's (ECB) recent hawkishness have slowed economic growth on the continent, however a mild December weather wise reduced the risks of an energy crunch and subsequently we have seen an incremental improvement to sentiment. On US IG, yields for all maturity and intermediate profiles are now around 5.4%. Credit fundamentals on the US IG corporate side remain robust and should provide protection in a slowing earnings environment. Read more

CIO themes

Resilient credits

Resilient credits offer a decent income, following a sharp rise in interest rates and credit spreads. Our selection of tenors around five to seven years offers additional potential outperformance over riskier bonds (and stocks) in case of a recession, where interest rates would likely decline materially, while risk premiums of resilient credits would only rise moderately. Investors concerned about recession risk should prefer this positioning over shorter-dated bonds with higher credit risk.

Income returning to fixed income

Global interest rates have moved sharply higher, resulting in mark-to-market losses this year for fixed income investors. Given that interest rates are now much higher and there are significant expectations priced in regarding central bank rate hikes, we believe the risk-return to the asset class has been restored. So, we think investors should consider closing underweight positions, and actively look at select opportunities in the front end of the yield curve.

Bonds

High yield (HY) bonds: We maintain our least preferred tactical recommendation on the asset class. Our concern with the lower-rated segment is that as fundamentals continue to deteriorate, market liquidity will become more challenging and credit risk premiums could widen significantly. The fundamental backdrop in HY is arguably not too bad. There has only been a limited amount of time since the last downturn, so we have not had the classic buildup of financial excess or leverage seen in previous cycles. In fact, the average credit quality in HY has improved. And in US HY, the energy sector—which has been a source of defaults in past downturns—is benefiting from globally elevated energy prices. Additionally, the outright level of yields in US HY and EU HY are around 8.5% and 7%, respectively, which have attracted capital flows more recently and supported performance. Over the medium- to longer-term investment horizon, we see justification for riding out the likely near-term downside risks for investors holding well-diversified positions and who are willing to continue stomaching mark-to-market volatility. However, for those with a more tactical mindset, we recommend moving up in quality at this juncture, given concerns around market liquidity and headwinds coming on the earnings side. By moving up in quality, investors can still benefit from higher outright levels of rates and reduce their credit spread volatility in the process. Read more

Emerging market (EM) sovereign bonds: We have EM bonds on a most preferred stance. Recently they have profited from a decline in US inflation, a shift in China's COVID policy stance, and increased support for China's property sector. With these incrementally more positive developments, recession risks have declined or been pushed into the future. Risks remain regarding the fallout from tighter financial conditions and the impact on fundamentals. Additionally, the cooling of inflation is a positive development however labor markets remain tight and core service inflation elevated. As such, although central banks are closer to the end of their rate hiking cycles than the beginning, uncertainty remains. Tactically speaking, we acknowledge that the China reopening is a big deal and will both directly and indirectly benefit EM through growth, sentiment, commodities, and capital flows. As such, we see the recent market strength lasting further, thus the asset class recommendation. The value in EM credit sits in the distressed segment. The proportion of the index trading at spreads above 600bps remains elevated. Within this category, we find value in some larger sovereign issuers that are willing and able to work with the IMF or other international lenders, or where we see upside to potential restructuring scenarios. We believe this provides upside to prices and the overall EM complex. We note that the sovereign index yield is now around 8.5% and the corporate index yield is around 6.9%. Read more

FX

This month we establish a neutral view across all G10 currencies, the one exception being a long position in the Australian dollar which could be financed from any of the major currencies in our neutral basket. Across the other major currencies, we hold a neutral view as we see a transition happening that carries many uncertainties. This is a year of transition, with the strongest rate hike cycle in the US for more than 40 years giving way to a more neutral Federal Reserve policy, and eventually an easing bias. We see a high likelihood that the introduction of an easing Fed bias will strengthen high-beta currencies like the EUR, the GBP, and many emerging market currencies versus the USD. Nevertheless, the question is how fast will the easing bias arrive? Over the past 24 months, assumptions on the terminal federal funds rate, i.e., the highest rate in this hiking cycle, underwent frequent upward corrections, and when the top would be reached it was regularly pushed further into the future. In this adjustment process, we learned that one needs to stay sensitive to incoming data and keep a flexible stance in currency exposure. When uncertainties about the economic and policy path are rising, short-term trading is often more rewarding than a heavy position for long-term trends, when performance is measured on a quarterly basis rather than across many years.

We still believe that an investor looking for strategic performance over the longer term would benefit from selling USD versus EUR, GBP, or emerging market currencies right now, and should use the current USD rally to unwind their dollar position. However, if the major concern is near-term performance, a long USD position might make more sense. In the middle of these two views lies our stance, which reflects our tactical recommendation to have a neutral allocation.

Being bullish on the USD can be because US growth is solid and the Fed chases high inflation with surprisingly strong rate hikes. This has been the case over the past two years and indeed over the past couple of weeks. Being bullish on the USD can also be because of one's view on the likelihood of a global recession, where all central banks look to cut interest rates. Being bullish on the other G10 currencies would be in light of a recovery in global growth coupled with a moderation in inflation. This is our forecast, and hence we maintain our long-term our bearish view on the USD.

In Asia, we expect the Chinese yuan to appreciate steadily in 2023 thanks to growth tailwinds from China's reopening as well as measures to support its property sector. We also expect the Singapore dollar to trend stronger thanks to its central bank's policy of gradual, trade-weighted currency appreciation.

While surprises to US labor market and service sector data are likely to recur, we believe fading Fed hawkishness over the course of the year, together with stronger economic growth outside the US, presents an opportunity to collect high nominal yields in select emerging market currencies from the EMEA region and Latin America. We think the Mexican peso and Czech koruna are attractive in this regard, and while the South African rand's carry appeal is lower, it should benefit from China's reopening. In Asia, the Indonesian rupiah and Indian rupee have relatively attractive yields, and come with manageable volatility profiles, in our view. The risk to these high-yielding currencies, apart from global risks, would stem from some central banks turning dovish too soon, which would weigh on their respective currencies.

Analysts: Thomas Flury, Teck Leng Tan, Tilmann Kolb

Commodities

We see another strong year for commodities in 2023, and forecast high-teen percentage total returns on an asset class level. Our positive view is based on a robust economic recovery in China from 2Q23 onwards, the start of a Fed rate-cutting cycle later in the year, and several unresolved supply-side issues that should keep market balances tight. Read more

Still looking for higher oil prices Russia announced plans to reduce production in March. The move—likely in response to the European embargo on Russian crude and refined product imports—aims to improve oil revenues by narrowing the discount of Russian oil to Brent. Meanwhile, China's reopening is lifting the country's oil demand. We expect greater domestic demand to result in higher crude imports over the coming months, tightening market balances further. Read more

Precious metals feel the US rates pain: US data has beaten expectations with labor data, sticky inflation readings, and surprisingly resilient retail sales all supporting dollar strength. And this has weighed on precious metals in February. At the same time, money markets have cut the probability of Fed rate cuts this year while lifting the possibility of a higher terminal federal funds rate (now estimated to end up above 5%). Importantly, we maintain the view that the US economy will slow this year and inflation will ease, while the Fed is likely to pause or even pivot, meaning the US dollar should decline. Ongoing solid central bank demand, together with a return of ETF buyers, should be supportive for gold this year. Read more

Base metals counting strongly on China: Our constructive demand view for industrial metals banks on a trough in global activity in 1Q and an acceleration from 2Q onwards. China's reopening should drive this growth narrative with the country accounting for the most demand by region. Beyond cyclical demand considerations, sector specific factors—like the demand associated with the green transition—remain at play as well. Both demand drivers together should ensure a robust uptake for industrial metals, despite subdued activity in the US and Europe.

La Niña fades but regional weather-related risks persist: Agricultural markets have outperformed the broader commodities this year; the major surprise being soft commodities where despite having a greater sensitivity to slowdowns in discretionary consumption, key contributors were sugar and coffee. In grains, the sub-index has managed to keep its head above water year-to-date as well, Hard Red Winter wheat and soybean meal gaining ground although the USDA's February inventory forecast was above analysts' projections. While La Niña dissipates, regional weather-related risks in Argentina, southern areas of Brazil, central parts of the US and Western Europe mean parts of the market remain on high alert. CMCI Livestock, against our view, declined 3.5% year-to-date. Lean hogs have been the weak link, elevated index-related roll costs, lower wholesale pork prices and upside surprises to US production estimates weighed on performance. Here, we expect some recovery while live cattle prices are expected to rise further as cattle availability is only set to worsen in 2023-24.

Preference: Most preferred

CIO themes

Commodities: Reimagining commodity investing

Given the longer-lasting bull and bear markets in commodities, and the unique characteristics and drivers of individual sectors and structural trends, we advise clients who invest in commodities to pursue an actively managed strategy. The CIO Active Commodity Strategy is designed to capture these benefits while improving risk-adjusted returns versus passive commodity investments.

Crude oil: Opportunities in longer-dated oil contracts

Longer-dated oil contracts are trading cheaper than spot prices. While commodity markets tend to price in the "now," futures curves don't have a lot of predictive power. Due to falling oil inventories, the futures curve is downward-sloped, meaning longer-dated contracts are cheaper. Vanishing available spare capacity should support longer-dated contracts, in our view.

Preferences

Directional

Long longer-dated Brent oil contracts

Yield pickup

Brent crude oil

Gold

Platinum

Copper

Nickel

Section 2.1

Details per asset class

Eurozone equities

Central scenario

DJ Euro Stoxx 50 December 2023 target: 4,250

We are neutral on Eurozone equities in our global asset class universe. While fears of energy crunches in the Eurozone have faded on the back of a milder-than-expected winter, geopolitical tensions are still looming over the region, which is also likely to enter a period of slower growth. All in all, downside risks to earnings seem partially priced in at current levels, with valuations looking fair to us.

Fourth quarter company results are holding up relatively well so far. The number of companies beating or missing consensus earnings estimates is close to the long-run average, helping to allay fears of a severe earnings downturn. After 19% growth in 2022, we continue to expect earnings to fall by around 5% in 2023 (consensus +1%). This suggests further downgrades to consensus forecasts in the coming months, but we believe equities can withstand that at current valuations.

Eurozone equities (MSCI EMU) are now up 28% from their September 2022 lows. While some of this is driven by a rebound in sentiment, much of the move has been supported by an improving fundamental outlook. A faster-than-expected China reopening, subsiding inflation pressures, lower European gas prices and better-than-feared 4Q results season, all justify the move higher, in our view. Even after this large move, we do not view Eurozone equities as expensive. They currently trade on 12.8x forward P/E, a small discount to their long-run average (13.4x). This looks fair to us given the risk to consensus earnings estimates, so we expect equities to be broadly flat between now and year-end.

We favor a balanced portfolio that can withstand uncertainty around the growth outlook but benefits from falling inflation, lower European gas prices and a consumer led China recovery. This includes parts of the market that we believe were oversold in 2022 such as Germany and Real Estate, and consumer sectors that benefit from China reopening, bond yields peaking and inflation falling. In the medium term, we like Europe's greentech and digital leaders as beneficiaries of upcoming investment plans.

CIO themes

Consumer recovery

We like European consumer stocks that are poised to benefit from an improving consumer outlook as wages rise, inflation pressures ease, central banks stop hiking, and China reopens.

German equities – attractively priced quality

We like German equities given attractive relative valuations and improving sentiment indicators as energy crisis fears subside and the outlook for growth begins to improve.

Investing in Europe's digital leaders

In this theme, we employ a framework that identifies European companies are poised to benefit from the accelerated transition to a more digital world.

Investing in Europe's greentech leaders

This theme recommends companies that will likely play a key role in Europe's energy transition and stand to benefit from the Green Deal—the biggest green stimulus program the world has ever seen.

Sector Preferences:

Most preferred: consumer discretionary, consumer staples, and real estate.

Least preferred: communication services, healthcare, and information technology.

For an up-to-date view refer to links on slides 31 and 32.

Analysts: Matthew Gilman, Rolf Ganter

Eurozone equities

Upside scenario

DJ Euro Stoxx 50 December 2023 target: 4,900

Inflation falls quickly and rate hikes slow, supporting valuations that have been under pressure from sharply higher discount rates.

Recession avoided. Earnings could surprise to the upside if a "soft-landing" scenario emerges, where growth is better than expected.

Companies keep pricing power. If companies can maintain some pricing power in 2023, margins may not contract as much as we expect, and revenues could overshoot expectations again—leading to upside risks to our earnings forecasts.

Europe exits the winter with above-average gas storage levels. This could materially reduce the risk of a gas shortage next winter and support high valuation multiples.

Downside scenario

DJ Euro Stoxx 50 December 2023 target: 3,650

Growth disappoints as a result of the lagged impact of tighter monetary policy, driving earnings growth and valuation multiples lower.

Sticky inflation could keep central bank policy tighter for longer, which would weigh on valuations and raise the risk of a deeper growth downturn.

Political risks or unforeseen consequences of higher yields could emerge at a fragile time given high government debt levels and the reliance of some economies on disbursements from the EU recovery fund.

Gas concerns re-emerge next winter. Further disruption to gas supplies that raises the risk of production stoppages next winter is a downside risk for valuations and potentially earnings.

For an up-to-date view refer to links on slides 31 and 32.

US equities

Preference: Least preferred

Central scenario

S&P 500 December 2023 target: 3,800

US stocks are off to a good start this year, propelled by better near-term US and global economic growth prospects. US consumer spending has been supported by solid labor market dynamics and healthy household balance sheets. Despite mixed signals on inflation, inflation pressures are generally easing. Cautious investor positioning going into the year has also helped propel gains as some market participants may have been caught offside by the improvement in global growth. The fact that some of the most speculative stocks in the market have led this rally suggests a good portion of it has been driven by short covering in areas that were very poor performers last year.

Still, the outlook from here is tricky. Ultimately, we think the lagged effects of Fed rate increases will have a more meaningful negative impact on economic growth. But it may take more time for these risks to materialize than we had previously expected. The lagged effects will mostly likely show up first in housing construction employment, which has yet to decline despite a sharp slowdown in housing activity. Builders and contractors are still burning through a large backlog of activity. These backlogs will likely become more depleted over the course of the year because new home affordability is very poor. But until then, investors may become even more convinced that an economic soft landing is achievable, which could support equity markets in the near term.

That being said, the upside potential for US stocks in a soft landing that coincides with a victory over inflation is probably no more than ~10%. The S&P 500 forward P/E is already at 17.5x. We struggle to see the multiple rising much from here. Since the early 1980s, the only time the P/E has been higher than 18x was during periods when profit growth was very rapid (10–20% growth) or interest rates were at rock-bottom levels similar to 2020–21 when the 10-year Treasury yield averaged around 1%. Furthermore, inflation may not fall enough in a soft landing scenario, which increases the risk that the Fed will have to raise rates even further than expected.

On the flip side, if the US economy does slip into a full-blown recession—which is still a material risk—the S&P 500 could fall by 20%. We have raised our S&P 500 price target for June from 3,700 to 3,900 in recognition of the better near-term growth. However, we lower our year-end price target from 4,000 to 3,800. Our new price targets reflect our view that the risks to economic growth seem more likely to materialize later, rather than earlier in the year, as we had previously assumed. Growth in the near term is still being supported by strong consumer balance sheets.

We caution that the range of potential outcomes over the next several months is somewhat wide, and investors should be prepared for continued upside and downside volatility. Furthermore, with S&P 500 EPS about 10% above trend and valuations higher than normal, we don't think conditions are in place for a sustained, lengthy bull market from here.

Sector preferences

Most preferred

- Consumer staples: Earnings growth should be more resilient than other sectors as macro headwinds persist. Relative valuations are very reasonable in the context of the sector's defensive growth profile.
- Energy: The sector remains cheap relative to oil prices. We believe the sector's free cash flow yield is very attractive, capital discipline has improved, and the sector should benefit from continued strong demand. There appears to be more upside than downside risk in oil prices.
- Real estate: Nearly half of the sector is composed of companies with a good secular growth outlook with exposure to industrial, wireless towers, and data centers. If interest rates fall due to concerns about economic growth or falling inflation, the secular growth companies within real estate could get a relative valuation boost.

Least preferred

- Communications services: The competitive environment is more challenging and digital advertising spending remains at risk in an economic slowdown.
- Financials: Recession risks remain elevated, and if the unemployment rate rises, earnings will take a hit. Additionally, bank deposit rates are rising, which could crimp net interest income growth. Finally, a potential fall in long-term interest rates could crimp profitability.
- Information technology: As corporate profits come under pressure, there may be risks to IT enterprise spending. Relative valuations remain lofty and above pre-pandemic levels.

For an up-to-date view refer to links on slides 31 and 32.

Analysts: David Lefkowitz, Nadia Lovell, Matthew Tormey

US equities

Upside scenario

S&P 500 December 2023 target: 4,400

Resilient economic growth: High wages attract more workers to return to the labor force. US economic growth proves to be durable, and supply-side bottlenecks are resolved.

Inflation cools quickly: Inflationary pressures quickly dissipate. The Fed ends its rate-hiking cycle and pivots to rate cuts. This lifts expectations for economic growth and corporate earnings.

Progress in Ukraine: Ukraine and Russia agree to negotiate a settlement, triggering a significant improvement in investor sentiment.

Downside scenario

S&P 500 December 2023 target: 3,300

Recession: The US slips into a full-blown recession in the next 6–12 months, primarily driven by Fed rate hikes, which choke off economic growth and lead to a notable increase in the unemployment rate.

Inflation remains elevated: Inflation stays hot and central banks are forced to raise interest rates even more than expected or keep them at lofty levels for longer than expected. Stagflation risks increase as wage-price spirals start to form.

Further disruption from Ukraine war: Additional escalation leads to a further disruption of Russia's energy supplies. Oil and natural gas prices rise sharply and remain elevated.

For an up-to-date view refer to links on slides 31 and 32.

Analysts: David Lefkowitz, Nadia Lovell, Matthew Tormey

UK equities

Preference: Most preferred

Central scenario

FTSE 100 December 2023 target: 8,300

The UK equity market has had a strong start to the year, as for most equity regions, driven by increasing hopes of a potential soft landing for the global economy.

The FTSE 100 recently touched new all time highs, mostly driven by earnings which also reached all time highs last year. Our view is that the FTSE 100 will continue to make new highs over the course of this year. Whilst we anticipate an overall earnings decline of around 5% this year, this is mostly driven by year on year declines in commodity prices along with some negative impacts on the consumer from negative real wages. The majority of others sectors are still expected to post positive earnings growth for 2023. Meanwhile, we expect a moderate re-rating of the UK equity market, as yields and inflation stabilize through the year.

UK companies are currently reporting their results for the fourth quarter of 2022. For the most part, companies are meeting or beating expectations. Some guidance is being downgraded in light of potential peaking interest rates, but also there is a trend of companies beating expectations in terms of dividends and share buybacks.

The FTSE 100 trades on a 12-month forward P/E of 10.7x—around 20% below its long-run average—and more than a third lower than global equities (MSCI AC World). This continues to support our preference for UK equities in our regional market preferences. We see the 4% dividend yield on the UK market as attractive in the context of moderate expected capital appreciation.

Upside scenario

FTSE 100 December 2023 target: 9,000

Valuation: An earlier-than-expected end to rate hikes, or a reduction of the UK's discount versus global equities, offers upside risk to valuations.

Oil price: Higher oil prices could provide additional upside to FTSE 100 earnings, especially relative to other regions.

Better global growth: If global economic growth is better than expected, this could support higher earnings than we currently anticipate, and boost equity valuations.

Downside scenario

FTSE 100 December 2023 target: 6,700

Oil price: If the price of Brent falls, earnings growth could be hurt as the energy sector contributes around 25% of FTSE 100 earnings.

Stagflation risks: A combination of weaker global growth expectations, high inflation, and rising bond yields could put further downward pressure on equities.

Stronger sterling: Sterling strength would be a drag on the FTSE 100, which generates close to 75% of its revenues outside the UK.

For an up-to-date view refer to links on slides 31 and 32.

Analysts: Caroline Simmons, Matthew Gilman

Swiss equities

Central scenario

SMI December 2023 target: 11,300

In 2021, a significant economic recovery, an overall lack of currency losses, economies of scale, and more M&A transactions led to a 24% increase in corporate profits. Consequently, aggregate earnings for Swiss Market Index (SMI) companies significantly exceeded the previous record year of 2019. Dividend payments also increased by around 6% in spring 2022.

We expect corporate profits to now be flat over the two-year 2022–23 period, supported by price increases to (at least partially) compensate for cost inflation, M&A deals, and robust cost management. A drag on profits will likely come from selectively negative sales volume growth, restructuring costs, and currency losses. We prefer a two-year view on profit trends due to substantial one-off operating costs—primarily in the financials sector—that weighed on underlying profit trends in 2022; so, comparing the 2023 profit expectations to 2021 provides a much cleaner picture.

Since early June 2022, the Swiss National Bank (SNB) has been increasing its prime rate to moderate inflation pressures despite a recent slowdown in Swiss and global growth. Higher CHF interest rates support the Swiss franc, which in turn weighs on Swiss profits since 90% of them are generated in foreign currencies. Upward pressure on the CHF versus the EUR is likely to moderate in 2023, but may continue versus the USD in the medium term.

With regard to investment strategy, we recommend keeping a good mix of defensive underlying assets and cyclically-sensitive supplementary securities. High-quality financials also enhance portfolios given the benefits from rising interest rates.

Swiss equity valuation multiples are a bit above the 20-year average, which we think is slightly expensive given normalizing interest rates. Dividend yields remain attractive despite now higher bond yields, in our view. At over 3%, the expected yield is above the 20-year average of 2.4%. We think the key drivers for Swiss stock prices from here will be companies showing profit improvement and, to a lesser degree, multiple expansion. Hence, stock selection is important.

With European and global economic growth prospects weakening, the defensive characteristics of the Swiss market look favorable compared to other equity markets. Its slightly expensive valuation, however, leaves limited upside potential, in our view.

Aside from a worsening of the pandemic, key risks include protectionism, international trade disputes, an economic downturn, currency losses, and Switzerland-EU negotiations.

CIO themes

Swiss high-quality dividends

Swiss dividend-paying equities are attractive, in our view. The average yield of the Swiss equity market, at over 3%, is higher than that of Swiss franc-denominated corporate and government bonds. Historically, dividend yields have tended to be similar to or lower than bond yields. Balance sheets and profitability are generally robust, suggesting that market-wide distributions are sustainable despite risks to corporate profits on the back of weaker economic prospects. For the SMI, the total cash distribution amount only moderated slightly in 2021 versus 2020, and rebounded by 6% in 2022, achieving a new all-time high. We expect another low-single-digit percentage increase in 2023 as well as in 2024.

For an up-to-date view refer to links on slides 31 and 32.

Analyst: Stefan R Meyer, Claudia Panseri

Swiss equities

Upside scenario

SMI December 2023 target: 12,500

Robust Swiss profits: As a result of an only modest global economic downturn this year, we expect corporate profits to expand by a mid-single-digit percentage over the two-year 2022–23 period.

Sustainable dividends: Swiss dividends have generally grown every year since 2009. In 2021, however, total SMI dividends fell by 3%. In 2022, they recovered by 6%. In our upside scenario, we would expect mid-single-digit percentage rises this year (i.e., for the business year 2022) and next.

Manageable currency impact: In 2020, currency effects were clearly negative, while those in 2021 were insignificant. In 2022, they were significant again. In 2023, we expect currency losses to be a negative.

Downside scenario

SMI December 2023 target: 9,800

Economic and political risks: ignificant global economic risks, negative currency trends, and international political disputes are headwinds for a small country with above-average international exposure.

Valuations: While dividend yields are attractive, corporate profits may be down by a mid-single-digit percentage in 2023 versus 2021, and the SMI would thus be trading at an unjustified premium of over 10% to its 20-year forward P/E average.

Sector composition: The SMI has a high exposure to defensive industries that tend to have rich valuations with downside risks as inflation and nominal bond yields rise.

For an up-to-date view refer to links on slides 31 and 32.

Emerging market equities

Preference: Most preferred

Central scenario

MSCI EM December 2023 target: 1,100

We hold a most preferred stance on emerging market equities. Over the past month, MSCI EM saw a mid-single-digit pullback as markets reassessed expectations of the Federal Reserve's terminal rate and geopolitical tensions rose. We still expect China's economic reopening to be a catalyst for EM stocks' outperformance relative to their developed market peers. The pickup in Chinese consumer demand is set to benefit emerging Asia and increase the demand for raw materials, supporting several commodity producers in the emerging world.

Emerging market equities' valuations, on a 12-month forward P/E basis trading at 11.9x, are in line with their 10-year average. In our view, the implications from China's economic normalization are not fully reflected in current valuations. In the meantime, emerging market equities' earnings revisions and momentum have likely bottomed especially relative to developed markets.

A deep US recession, if materialized, is a key headwind to emerging market stocks. Other risks include a strong US dollar and an uptick of global geopolitical tensions.

Within emerging markets, we expect high-quality structural earnings growth leaders such as internet and e-commerce companies to outperform the broader MSCI EM benchmark. Meanwhile, ESG leaders can help mitigate downside risks and current valuations are attractive, in our view. For investors with a multiyear investment horizon, we recommend exposure to three thematic opportunities: frontier markets, emerging market infrastructure, and emerging market healthcare.

From a geographic standpoint, we remain positive on Chinese equities. Despite their poor performance in recent days, the drivers for Chinese equities to outperform their EM peers remain intact in our view. We also continue to like Thailand. A combination of retreating inflation and a continued recovery of inbound tourism should support an earnings recovery in 2Q23. We also upgraded Korea from neutral to most preferred stance to position for an early cyclical recovery and a bottoming semiconductor cycle.

Upside scenario

MSCI EM December 2023 target: 1,150

Sizable GDP growth recovery: Continued economic recovery would benefit corporate earnings and lift valuation multiples.

Global monetary policy: A less hawkish policy stance would bring about a more benign external environment.

China policy support: Stronger-than-expected policy easing and faster demand recovery in China would support emerging market stocks.

Downside scenario

MSCI EM December 2023 target: 850

Global GDP growth fears: Persistently high inflation could force central banks to tighten more aggressively, sending economies into a deep recession.

US dollar strength: Emerging market stocks typically suffer in a strong US dollar environment.

Geopolitics: A further deterioration in US-China relations and the war in Ukraine would hurt emerging market assets.

CIO themes

ESG matters in emerging markets

This theme offers investors an opportunity to add value to their portfolios by incorporating environmental, social, and governance considerations into their investment decisions. The wide disparity in ESG performance among emerging market companies means investors should focus on those with strong management to reduce the risk of tail-risk events, particularly in relation to governance (e.g., accounting and audit issues) as well as severe environmental accidents.

EM internet and e-commerce

As economic and corporate profit growth normalizes in emerging markets, we believe it is time to reposition in high-quality and structurally attractive internet and e-commerce stocks. We expect these stocks to outperform the MSCI EM index by 10–15% over the next 12–18 months, driven by resilient earnings prospects and attractive valuations relative to recent history and their global internet peers.

Market preferences

Most preferred

China, Thailand, Korea (new)

Least preferred

Malaysia, Singapore, India (new)

For an up-to-date view refer to links on slides 31 and 32.

Analysts: Alejo Czerwonko, Xingchen Yu.

Japanese equities

Central scenario

TOPIX December 2023 target: 2,100

We are neutral on Japanese equities in our global asset class universe. We see limited downside risks to share prices, given their cheap valuations and resilient earnings trends relative to other developed markets. We think China's faster-than-expected reopening should also be positive for select Japanese companies in 2023, particularly in the machinery-related and consumer sectors. Other factors that may spur earnings growth include the ongoing domestic reopening and the increase in inbound tourism, supported by a weaker yen versus pre-pandemic levels.

Under new Bank of Japan governor, Kazuo Ueda, we continue to expect that the BoJ is likely to abandon its yield curve control (YCC) policy in 2H23, leading the 10-year JGB yield to rise to 0.8–1.2%, but leaving the negative rate policy unchanged. Without raising the short-term policy rate, we think it is unlikely for the financial sector to see further upside. We have therefore taken profit and closed our "Japan financial winners" theme.

We expect 8% profit growth for FY22 (ending 31 March 2023) but we have also revised our FY23 forecasts down to 0% growth (from 3%) based on our expectations of a yen appreciation toward 2024. However, with the TOPIX P/E at 12.6x—below the long-term average and at a wide discount versus the MSCI All Country World Index—valuations support the downside risk, in our view.

We think Japan's economic reopening should be a bright spot in 2023. We also believe Japanese cyclical stocks, including the high-tech, chemicals, and machinery sectors, should stand to benefit from the end of the inventory correction cycle in 2H23. Greentech themes may also present opportunities as long-term investment strategies.

Upside scenario

TOPIX December 2023 target: 2,200

Stronger-than-expected re-opening spending: A full reopening of its borders and the expected increase in Chinese visitors to Japan in 2023 could fuel a faster consumption recovery and boost earnings beyond our forecasts.

Global economic growth remains resilient: Strong Chinese economic recovery after the zero-COVID policy exit and the US remaining resilient would lead to stronger top-line growth for Japanese corporate earnings.

Lower input costs: Higher costs of inputs, including commodities and logistics, have squeezed margins over the past two quarters. Any softening or stabilization in prices would lift the earnings outlook.

Downside scenario

TOPIX December 2023 target: 1,700

Recession: Risks that the US slips into a full-blown recession and increased tensions between the US and China would put downward pressure on Japan's economic and earnings growth outlook.

Higher inflation for longer: An acceleration in inflation would affect consumer sentiment, and rising input costs could hurt 2023 earnings.

Stronger yen: Earnings growth would decline if the yen sharply strengthens, especially for exporters such as those in the tech and auto sectors.

CIO themes

Be ready for Japan's normalization

After the Japanese government reopened its borders in October 2022, the number of inbound tourists are increasing. We think China's reopening is likely to accelerate the trend in 2023. The weaker yen is also providing an impetus to visit Japan. We think the service and consumer sector companies that survived the pandemic will benefit from pent-up demand and a less competitive business environment during the normalization period.

Japan's corporate governance improves shareholder returns

Japanese companies are becoming more shareholder-friendly, supported by earnings recovery from the pandemic, and a reduced need to hold emergency cash reserves. We think blue-chip companies are accelerating share buybacks and dividend payments.

For an up-to-date view refer to links on slides 31 and 32.

Analysts: Toru Ibayashi, Chisa Kobayashi

Asian ex-Japan equities

Central scenario

MSCI Asia ex-Japan December 2023 target: 730

We are constructive on Asia ex-Japan equity markets after a period that saw valuations derate, earnings expectations depress, and outflows from the region. But we are not yet outright long the market as the sharp relief rally since builds up the chance of a near-term consolidation. As a result, we prefer to only marginally add on equity risk by focusing on pair trades that can offer performance regardless of the market direction.

This month, we upgrade Korea to most preferred. Korea is an early cyclical market, which tends to trade on forward-looking earnings growth earlier than other Asian peers. CIO expects 45% earnings growth for MSCI Korea in 2024 (following an estimated 30% decline in 2023). The rebound in Asia semiconductor stocks from last November is also in line with our sector view of a DRAM pricing trough in 2Q23. Plus, the Korean market historically tends to outperform the region when the USD weakens and US yields decline.

Meanwhile, we keep China and Thailand as most preferred. After a near 60% rebound rally from their October low, Chinese equities have retreated 10% from the January high. Looking ahead, we think evidence of an actual fundamental recovery is needed to give the rally a second push. What matters for the market is the delta change of macro growth and earnings momentum, and we expect to see early signs of the corporate outlook from earnings releases in the coming days and weeks. For Thailand, the economy remains well on its recovery path, mainly driven by a further rebound in international tourism. Encouragingly, Thailand's manufacturing PMI increased to the second-highest on record of 54.5 in January from 52.5 in December, with output, new orders, and employment all increased.

On the other hand, we downgrade the Philippines to Neutral. Our previous most preferred view on the Philippines positioned for a peak in the USD and US rates, both of which have materialized in the past few months. But looking ahead, we think the bar is high for the Philippines to outperform Asia ex-Japan heavyweights such as mainland China, Korea, or Taiwan. Meanwhile, we downgrade India to least preferred in order to finance our more optimistic outlook on North Asia. India has been, and will continue to be, a structurally long market for emerging market investors due to its long-term solid earnings growth and domestic driven nature. But on tactical terms, we expect it to underperform the rest of Asia as investors rotate from earlier leaders (e.g. India) to laggards (e.g. China, Korea).

Elsewhere, we maintain our least preferred view on Malaysia and Singapore. Malaysia's manufacturing PMI dropped further to 46.5 in January, declining for the sixth straight month. We think Malaysia remains an ideal funding source for other Asia markets. For Singapore, we maintain the view that Singapore faces a market rotation risk since it was one of the outperformers last year.

CIO themes

Playing Asia catch-up within emerging markets

This theme aims to position in Asian laggards that we expect to catch-up with their EM peers this year through cheap growth (China) and cheap value (ASEAN) markets.

Key drivers include relative earnings strength, policy easing in China, attractive valuations, and a strong USD outlook.

Main risks include a commodity super-cycle, new lockdowns in ASEAN, and an escalation in Sino-US frictions.

Market preferences

Most preferred: Korea (New), China, Thailand

Least preferred: India (New), Singapore, Malaysia

For an up-to-date view refer to links on slides 31 and 32.

Analysts: Adrian Zuercher, Crystal Zhao, Vanny Wang,

Asian ex-Japan equities

Upside scenario

MSCI Asia ex-Japan December 2023 target: 760

Fed turns less hawkish than market pricing

Asian equities are likely to rebound if the Fed delivers fewer rate hikes or less aggressive QT than current market expectations amid still solid earnings growth.

Strong China housing demand recovery

A meaningful recovery in consumption and property sales in China is likely to push Asia equity markets up more given the subdued expectations on this front.

Strong demand recovery in tech

Asia tech has corrected the earliest among global peers. If we see a faster-than-expected final demand pickup in this space, it would lift the Asian market as a whole since tech is a key component of MSCI Asia ex-Japan.

Downside scenario

MSCI Asia ex-Japan December 2023 target: 580

Sharp slowdown in US growth or China's recovery

If US growth turns out to be much worse than our mild recession assumption, or if China's growth recovery is much slower and shallower than expected, Asian equities could suffer.

Re-escalation in Sino-US tensions

Risk sentiment should weaken if the US adds secondary sanctions on Chinese firms or financial institutions.

Stronger-than-expected DM central bank tightening

If the Fed and the ECB surprise markets with the magnitude of their monetary tightening, there will likely be further headwinds for global GDP growth and growth stock valuations.

For an up-to-date view refer to links on slides 31 and 32.

Analysts: Adrian Zuercher, Crystal Zhao, Vanny Wang,

High grade

Preference: Most preferred

Central scenario

10-year US Treasury yield December 2023 target: 3.00%

With indications that inflationary pressures are abating, major central banks have started to moderate the pace of rate increases. After a series of initial aggressive hikes in 2022, policymakers appear poised to wait for the full effects of tightening to materialize. Against this backdrop, we continue to recommend an overweight position in high grade (HG) bonds. Our rationale is that central banks have succeeded in repricing expectations and that we are closer to the end of the rate hiking cycle than to the beginning. That said, we acknowledge that there may be further upward pressure on rates as central banks contend with the more persistent sources of inflationary pressures that we see currently. To achieve structurally higher interest rates, however, economic growth needs to step up. We think growth is currently decelerating because of tighter financial conditions, with significant uncertainty about whether the US economy is going to experience a mild or deep recession. Accordingly, while interest rate volatility may likely remain elevated after declining from its October peak (with high interest rates providing a buffer for returns), we see a much more even balance in terms of direction. HG bonds are rated AA– or better, and therefore have minimal default risk. Given the sharp repricing higher in rates in 2022, we see an attractive asymmetric absolute return profile looking forward in light of the shifting balance of risks between high inflation and decelerating growth.

Upside scenario

10-year US Treasury yield December 2023 target: 2.50%

Economic growth: In the downside case for the US economy, the risk is that a more aggressive Fed triggers a recession. This is not our base case, but the risk is there. It could occur should the economy, contrary to the Fed's analysis, prove unable to withstand the policy tightening required to subdue inflation.

Well-anchored inflation expectations: Inflation drops quickly enough so that the Fed begins to take out insurance against a recession. In this scenario, energy prices drop and the labor market loses momentum.

Fed goes on hold: In response to falling inflation, the Fed halts its rate hiking cycle and perhaps even cuts policy rates to take out insurance against recession. Balance sheet runoff goes on hold.

Downside scenario

10-year US Treasury yield December 2023 target: 4.50%

Economic growth: US GDP growth remains above trend in the face of Fed tightening. The job market is strong, and wages increase at a rapid pace. Inflation stays elevated, and the Fed is forced to hike more aggressively and to a higher level than currently priced in, and at the same time accelerates the shrinking of its balance sheet through active sales.

Market pricing: The market currently prices the fed funds rate peaking close to 5% around early 2023. In the downside scenario, inflation remains persistently elevated, and the market prices in a more extended hiking cycle, ending at a higher level. The pricing of the terminal rate moves up, and interest rates move higher across the curve, likely accompanied by a greater inversion of the curve.

For an up-to-date view refer to links on slides 31 and 32.

Analyst: Douglas S. Rothstein, Frederick Mellors

Investment grade

Preference: Most preferred

Central scenario

December 2023 spread targets: 120bps (USD IG) / 170bps (EUR IG)

Interest rates across developed markets surged last year as central banks tightened policy in response to elevated inflation. Given the high interest rate sensitivity of the US and European investment grade (IG) bond segments, the speed and magnitude of the move higher in rates more than offset income earned over the period and hence resulted in poor total returns. Heading into the end of 2022 and commencing this year, performance had begun to recover on signs of inflation trending lower and central banks approaching the end of their policy rate hiking cycles, and both rates and spreads tightened. With this, money has begun to return to the asset class. However, performance has stalled in recent weeks, primarily driven by higher rates as the market has repriced the path of policy rates higher on the back of the strength of the labor market, and related to this, concerns about sticky services inflation.

While well off its 2022 peak levels, rates volatility remains historically elevated. We think it could remain elevated as concerns shift from inflation to growth. On US IG fundamentals, we regard current credit metrics as solid with improved levels of coverage and leverage. Looking forward, we anticipate some degradation in metrics as earnings growth slows, in which case downgrades are likely to increase and could pressure spreads upwards. Average US IG yields are at historically elevated levels of over 5%. At the same time, spreads are now sitting below their long-term average. However, we gain comfort from the higher outright yields and the fact that spreads are a much smaller proportion of this than the recent past. This should provide a sizable offset to potential renewed spread widening.

Within EUR IG, the average yield sits at 4.1%, lower than its October peak of 4.6%. Index spreads are now trading at 144 basis points, which is close to its long-term average. We expect the Eurozone economy to avoid a recession, supported by lower gas prices in addition to state-support packages to limit energy costs for households and firms. However, we expect growth to remain relatively subdued in the near-term. The European Central Bank remains committed to lowering inflation, and monetary policy tightening is working its way into the economy. The announcement of planned ECB tapering of asset purchases (EUR 15bn per month as of March or half of expected monthly APP bond reinvestments) was a hawkish surprise. However, the impact for credit markets was muted and spreads were relatively contained around the announcement date. Looking ahead, there is the risk of crowding out, as the anticipation of rising European government bond supply in coming weeks could have an impact on corporate credit spreads for new issues.

At this juncture, our recommendation is for investors to either approach the asset class selectively by focusing on bottom-up opportunities in fundamentally sound credits, or switch from lower-rated non-investment grade credits into the asset class.

CIO themes

Resilient credits

Resilient credits offer a decent income following a sharp rise in interest rates and credit spreads. Our selection of tenors around five to seven years offers additional potential outperformance over riskier bonds (and stocks) in the case of a recession, where interest rates would likely decline materially, while risk premiums of resilient credits would only rise moderately. Investors concerned about recession risk should prefer this positioning over shorter-dated bonds with higher credit risk.

Income returning to fixed income

Global interest rates have moved sharply higher, resulting in mark-to-market losses last year for fixed income investors. Given that interest rates are now much higher and there are significant expectations priced in regarding central bank rate hikes, we believe the risk-return balance for the asset class has been restored. Accordingly, we believe investors should consider closing underweight positions and actively look at select opportunities in the front-end of the yield curve.

For an up-to-date view refer to links on slides 31 and 32.

Investment grade

Upside scenario

Bloomberg Barclays US Int. Corp December 2023 target: 60bps

Bloomberg Barclays Euro-Agg. Corp. December 2023 target: 70bps

Inflation and Fed policy

Inflation moderates at a swift pace, taking the pressure off the Federal Reserve to normalize policy rates and withdraw liquidity. This provides a much more predictable policy path and leads to a loosening of financial conditions, which is supportive for economic growth prospects.

Downside scenario

Bloomberg Barclays US Int. Corp. December 2023 target: 200bps

Bloomberg Barclays Euro-Agg. Corp. December 2023 target: 250bps

Inflation and Fed policy:

Inflation remains persistently high, forcing central banks to tighten policy more aggressively. This raises growth fears and default risks, and leads to wider credit spreads.

War in Ukraine:

The prolonged war in Ukraine increases the likelihood of further disruption to commodity flows. This would have a detrimental effect on growth and earnings, and increase the possibility of a sharp recession.

For an up-to-date view refer to links on slides 31 and 32.

High yield

Preference: Least preferred

Central scenario

December 2023 spread targets: 550bps (USD HY) / 550bps (EUR HY)

HY has had a good start to the year as declining inflation and prospects of a near-term end to monetary policy tightening has buoyed risk sentiment, though concerns that policy rates would need to be raised higher in light of strong labor market data has led to some consolidation in recent weeks. The large outright yields on offer in the asset class has also grabbed the attention of investors. We think growth is likely to continue to slow as the impact of tighter financial conditions works its way through the system. We are constructive on fixed income as an asset class, however with the more growth-sensitive segments such as HY, we are advocating being more selective with a quality bias.

Although there is optimism on the inflation front, levels remain well above central bank targets—which is why they are yet to officially signal an end to the rate hiking cycles. Many companies were fortunate enough to lock in lower funding costs prior to the sharp moves higher in rates. As time passes, this benefit diminishes as maturities approach and refinancing needs increase. This, coupled with a more challenging earnings backdrop, is a nasty cocktail. Our view is that credit metrics will continue to deteriorate from here and more levered companies without reasonably priced market access will be forced into aggressive balance sheet restructuring. This is what underpins our current least preferred asset class recommendation.

We think corporate defaults could rise above their long-term average to around mid-single digits, compared to the current level of 1.9%. Of some comfort is the fact that we have not seen the classic buildup of financial excess and leverage since the last default cycle in 2020 related to the COVID-19 pandemic. Leverage has declined as earnings have increased, while debt growth has been muted. On top of this, the energy sector in the US, which is often a source of defaults in downturns, is in a relatively healthy state by virtue of higher energy prices. As a result, our spread forecasts are wider than today, but not as aggressively as would be the case in a traditional economic downturn or turn in the default cycle.

Taking aside default risk, we do have some concerns around the current levels of credit risk premiums, which is the compensation credit investors require over and above expected credit losses. These we consider to be tight. This may be due to market hopes that central banks will pivot quickly to backstop credit markets or due to excess liquidity in the system (because of the large growth in the money supply resulting from COVID-related fiscal and monetary stimulus measures). Our assessment is that a central bank pivot remains unlikely in the short term, liquidity will continue to be drained from the financial system, and any policy response to support credit markets will be reactive rather than proactive in that the credit risk premiums will need to widen first.

Over the medium to longer term, for investors holding well-diversified positions and who are willing to stomach mark-to-market volatility, we see justification for riding out the likely near-term downside risks. The current level of outright yields in US HY and EU HY are around 8.7% and 7% (in local currency), respectively, at an index level. This is appealing relative to history and potential returns in other asset classes. Additionally, the repricing in spreads and yields has happened in a short period of time, creating a scenario where the majority of bonds are currently trading at deep discounts to par and hence generating positive convexity. This means that prices will rise by more on a fall in yields than a comparable rise in yields.

CIO themes

Income returning to Fixed Income

Global interest rates have moved sharply higher, resulting in mark-to-market losses last year for fixed income investors. Given that interest rates are now much higher and there are significant expectations priced in regarding central bank rate hikes, we believe the risk-return balance of the asset class has been restored. So, we believe investors should consider closing underweight positions and actively look at select opportunities in the front-end of the yield curve.

For an up-to-date view refer to links on slides 31 and 32.

High yield

For investors with a more tactical mindset, we recommend moving up in quality given concerns about market liquidity and expected headwinds for earnings, which we think are likely to reprice spreads wider. By moving up in quality, we believe investors can still benefit from higher outright levels of rates and reduce their credit spread volatility in the process.

Upside scenario

ICE BofA US high yield spread December 2023 target: 300bps / ICE BofA Euro high yield spread December 2023 target: 290bps

Inflation and Fed policy

Inflation moderates at a swift pace, taking the pressure off the Federal Reserve to normalize policy rates and withdraw liquidity. This provides a much more predictable policy path and leads to a loosening of financial conditions, which is supportive for economic growth prospects.

Downside scenario

ICE BofA US high yield spread December 2023 target: 850bps / ICE BofA Euro high yield spread December 2023 target: 850bps

Inflation and Fed policy: Inflation remains persistently high, forcing central banks to tighten policy more aggressively than expected. This raises economic growth fears and default risks, and leads to much wider credit spreads.

War in Ukraine: The prolonged war in Ukraine increases the likelihood of further disruption to commodity flows. This would have a detrimental effect on growth and earnings, and increase the possibility of a sharp recession.

For an up-to-date view refer to links on slides 31 and 32.

Analysts: Frederick Mellors

Emerging market bonds

Preference: Most preferred

Central scenario

December 2023 spread targets: 425bps (EM sovereign bonds) / 300bps (EM corporate bonds)

With indications that inflationary pressures are abating, several major central banks have started to moderate the pace of rate increases. Although inflation is unlikely to trend lower in a linear fashion, we take comfort from the fact that many central banks have succeeded in restoring medium-term inflation expectations at or near their target levels. We think the Fed and the ECB, as well as other central banks from developed and developing countries, should complete their hiking cycles in the first half of this year, and then wait for the full effects of tightening to materialize.

At the same time, China's rapid dismantling of COVID restrictions has paved the way for a faster-than-anticipated economic reopening, while policymakers are emphasizing the need for monetary and fiscal support to aid the domestic recovery. China's reopening should support global growth prospects in 2023, supporting EM fixed income in general.

Spreads on EM sovereign and corporate bonds have tightened since their October peak reflecting these positive developments. We continue to think spreads are likely to remain supported in the coming months by signs of further progress on these drivers. We see value in EM sovereign bonds where current valuations are attractive relative to historical levels, driven by the HY segment. The proportion of the index trading at spreads above 600bps remains elevated. Within this category, we find value in some larger sovereign issuers that are willing and able to work with the IMF or other international lenders, or where we see upside to potential restructuring scenarios.

We hold a most preferred stance on the asset class. The sovereign index yield is now around 8.5% and the corporate index yield is around 7.1%. We expect mid-single-digit total returns for the asset class in a baseline scenario in the coming six months (non-annualized), supported by carry and moderate spread compression. But investors need to be mindful that the range of possible outcomes at this stage remains somewhat elevated. In particular, we have yet to see the full economic impact of the tightening efforts by the Fed on the US economy, and the key risk for our constructive view is a sharp US recession.

CIO themes

Short-duration bonds

Select short-duration bonds from emerging market issuers lie in a "sweet spot" within the asset class in the current market environment—one characterized by high inflation, rising US Treasury yields, and global economic growth concerns emanating from the war in Ukraine. Not only can they mitigate duration risk, they can also aid in portfolio yield enhancement and diversification, in our view.

Oil and gas bonds

We see opportunities in the oil and gas space, given our positive view on oil prices. With lingering uncertainties, selectivity is essential.

Sustainable bonds

Sustainable bonds include green, social, and sustainability (GSS) bonds, and sustainability-linked bonds. We think sustainable bonds are a good way to diversify portfolios.

Opportunities in sukuks

Islamic investors adhering to Sharia restrictions are most likely to choose from Sharia-compliant debt instruments, such as sukuks. In recent years, sukuks have become an increasingly popular investment choice in conventional bond portfolios. We think sukuks offer diversification opportunities.

For an up-to-date view refer to links on slides 31 and 32.

Analysts: Michael Bolliger, Alejo Czerwonko, Frederick Mellors, Carolina Corvalan

Emerging market bonds

Upside scenario

EMBIG Diversified / CEMBI Diversified spread December 2023 targets: 300bps / 280bps

A quick economic recovery: China's economy recovers faster than expected with stronger policy support, coupled with a global economy that exhibits resilience to the tightening of financial conditions.

Commodity price recovery: A further price appreciation in commodities improves the terms of trade for commodity-exposed issuers and strengthens fiscal positions.

Downside scenario

EMBIG Diversified / CEMBI Diversified spread December 2023 targets: 600bps / 550bps

Prolonged economic slump: A sharp global economic slowdown leads to weaker EM currencies, deteriorating credit quality due to fiscal vulnerabilities, and wider spreads.

Fed tightens aggressively: Inflation remains higher for longer, and the Fed is forced to accelerate monetary policy tightening, slowing economic growth in the process.

Increased Russia-China-US tensions: Heightened friction emanating from either the war in Ukraine or broader geopolitical tensions hurts risk sentiment, strengthening the US dollar and curbing appetite for EM assets.

Rising populism: Increased conflicts within and between countries could arise as populist policies become more widespread globally.

For an up-to-date view refer to links on slides 31 and 32.

Analysts: Michael Bolliger, Alejo Czerwonko, Frederick Mellors, Carolina Corvalan

Asian bonds

Central scenario

JACI composite spread December 2023 target: 260bps

Since early February, US Treasury yields have climbed 40–60bps across one to 10-year tenors as the market repriced the terminal fed funds rate following strong US payroll and consumption data. Total returns for Asia credit were negatively affected by rising benchmark yields last month, but the spread stayed firm. Asia high yield underperformed investment grade in the period as profit taking occurred in the China HY space following the sharp relief rally since November. At these yields (JACI IG yield 5.7% at time of writing), our conviction on IG bonds is even firmer given the more attractive risk-reward over the next 12 months. With the downside tail risk in China growth fading amid a pent-up demand-driven recovery, we think the credit risk of owning Asia IG (where China accounts for roughly half) has fallen.

Meanwhile, we think Asia high yield is likely to consolidate in the next couple of weeks and months. So far, the spread for JACI HY has tightened from a high of 1500bps last year to below 700bps now. In other words, the short covering looks largely behind us. What will direct its path going forward depends on two key factors: 1) whether global HY sees a significant credit correction; and 2) when and how much China housing sales can improve. Right now, the uncertainty remains high on these two fronts. Therefore, we continue to suggest cherry-picking good quality issues instead of diving into the whole universe.

For China property, January sales numbers remained weak (top 100 developers –32% y/y, top 10 developers –22% y/y), partially due to muted activities during the Chinese New Year holiday. It will likely take time for willing homebuyers to return and feel more confident about future income growth. Top-down policy will probably stay supportive until we see a meaningful pickup in housing transactions/activities. For example, the average mortgage rate for a first-time buyer in 103 mainland Chinese cities fell to 4.04 per cent in February, the lowest level since 2019 (from Beike Research Institute, as of 21 February 2023). Earnings wise, weak results for FY2022 are well anticipated. What matters for the market is whether developers can offer a brighter outlook in their forward guidance in the company result season. One possible upside surprise could come from a potential lowering of the mortgage rates for existing homeowners, though the chance of this in the near-term is not high.

Separately, we think there is still upside in the Macau gaming sector (12% of Asia HY) given evidence of strong recovery across visitation and gross gaming revenue from last December. Also, China's reopening supports the aviation industry, Hong Kong landlords, insurers, and securities firms with exposure to the Hong Kong market, in our view. One key risk we closely monitor is the India corporate space, where sentiment remains vulnerable to the spill-over effects of adverse corporate headlines.

For an up-to-date view refer to links on slides 31 and 32.

Analysts: Adrian Zuercher, Crystal Zhao, Vanny Wang,

Asian bonds

Upside scenario

JACI composite spread December 2023 target: 230bps

Much faster recovery after full reopening: If China's macro data recovers faster and stronger than expected, there will be further upside in Asia credits.

Sharp rebound in China housing sales: So far, policy has focused on supporting the liquidity of important Chinese property developers, but housing sales remain quite weak. A quick rebound in housing sales would offer fundamental support to the credit metrics of this sector.

More dovish-than-expected central bank actions: Spreads would likely compress if the Fed stops hiking sooner than expected and becomes less aggressive with quantitative tightening.

Downside scenario

JACI composite spread December 2023 target: 330bps

Much higher default rates The HY sector may see a sell-off if default rates far exceed current market pricing.

Broader-scale crisis in India credit: If there is spillover from negative headlines into India credits, market sentiment will deteriorate.

Deep US/Europe recession: If the US or Europe fell into a deep recession, growth in Asia and sentiment toward Asian credits would be impacted.

For an up-to-date view refer to links on slides 31 and 32.

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Analysts: Adrian Zuercher, Crystal Zhao, Vanny Wang,

Gold

Central scenario

Gold December 2023 target: USD 2,050/oz

Gold demand in 2022 hit its highest level since 2011, with demand (excluding OTC sales) rising 18% y/y to 4,741 metric tons, according to World Gold Council data. Central bank demand surprised to the upside: The official sector (including sovereign wealth funds) added 1,136 metric tons, the highest level ever. While ETFs experienced outflows of 110 metric tons, bar and coin demand rose 2% (1,217 metric tons). As such, total investment demand climbed 10% y/y (1,107 metric tons). Jewelry demand—curbed by lockdowns and elevated prices—declined by 2% y/y to 2,190 metric tons, driven by a 15% drop in Chinese demand to 571 metric tons.

Global mine supply increased by only 1% y/y to 3,612 metric tons; Chinese production rebounded, but this was mostly attributed to base effects after wide-ranging shutdowns in 2021. Recycling volumes were also subdued, which meant total gold supply rose just 2% y/y to 4,755 metric tons over 2022. Looking ahead, while we expect central banks and China's reopening to contribute to demand, a lift in ETF and hedge fund buying is needed for higher prices, in our view. Potential catalysts for such an increase include rising US recession risks, a Fed pivot, and broad USD weakness—all of which we expect over the course of 2023. We therefore recommend adding small positions as a hedge in a portfolio context and/or selling the metal's downside price risks. A sharp lift in US real rates is the main headwind/risk.

Upside scenario

Gold June 2023 target: USD 2,200–2,300/oz

The Fed becomes dovish, introducing another round of quantitative easing measures, or it allows inflation to overshoot, which would once again support investment demand for gold.

Downside scenario

Gold June 2023 target: USD 1,800–1,900/oz

The Fed becomes even more hawkish, hiking interest rates aggressively in 2023 and pushing up US real rates strongly, which would likely trigger substantial outflows from gold ETFs.

For an up-to-date view refer to links on slides 31 and 32.

Analysts: Wayne Gordon, Dominic Schnider, Giovanni Staunovo

Crude oil

Preference: Most preferred

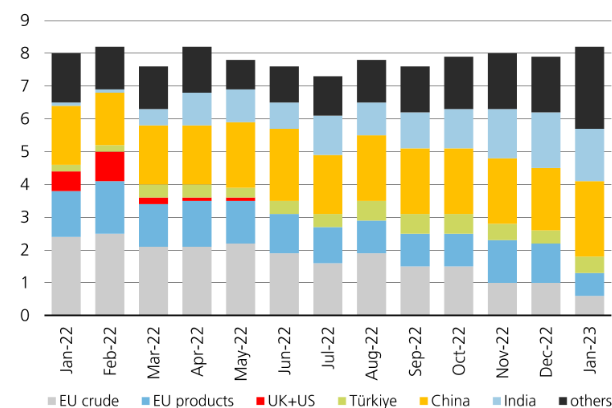
Central scenario

Brent crude oil December 2023 target: USD 105/bbl

We continue to hold a positive outlook for crude prices, driven by recovering oil demand supported by the reopening of the Chinese economy. High frequency indicators for Chinese mobility show a surge in domestic flights and road congestion over recent weeks. A pickup in international flights originating from China will, in our view, support jet fuel demand in other countries, particularly in Asia. We look for Chinese demand to rise by 0.8mbpd and global demand by 1.6mbpd in 2023. Following a strong 2022, we think 2023 demand in the OECD, particularly in Europe and the US, will likely be weak; we forecast demand in the US to be at the same level in 2023 as last year and European demand to decline. In sum, we continue to expect global oil demand to rise to record levels above 103mbpd in the second part of this year.

Additionally, we continue to expect Russian oil production to decline as a result of the European embargo on Russian oil imports. In this context, Russia's deputy prime minister Alexander Novak recently indicated that the country will cut its oil production by 0.5mbpd in March. Russian oil exports show a pickup in Russian refined product exports to Africa, but the increase is unlikely to completely offset the drop in European imports. Unsurprisingly, preliminary data for the month of February indicate a drop in both seaborne crude and refined product exports, with crude down around 300kbpd and refined products by a tad more than 250kbpd in the first 16 days of February versus January, according to Petro-Logistics. Severe weather in the Black Sea might have also weighed on flows, so we will continue to closely monitor exports.

Russian crude and refined product exports in mbpd



Source: IEA February 2023 Oil Market Report, UBS

Upside scenario

Brent crude oil December 2023 target: USD 130–160/bbl

Upside risks to our forecasts include a large and long-lasting disruption of Russian crude production and destabilizing political events in oil-producing regions like Libya, Venezuela, Nigeria, and the Middle East, which could trigger a sharp drop in supply for a sustained period. A faster-than-expected recovery in oil demand as mobility picks up in China and an even slower production response (i.e., increase) from the US would also be price-supportive.

Downside scenario

Brent crude oil December 2023 target: USD 40–70/bbl

Downside risks include a deep recession or renewed extended mobility restrictions that weigh on the oil demand recovery. A hard landing of the Chinese economy in 2023 would also pose a downside risk, as emerging Asia is the engine of oil demand growth. Another concern is that capital discipline in the US could start to erode. Also, the return of disrupted oil production in Venezuela and Iran could weigh on prices.

For an up-to-date view refer to links on slides 31 and 32.

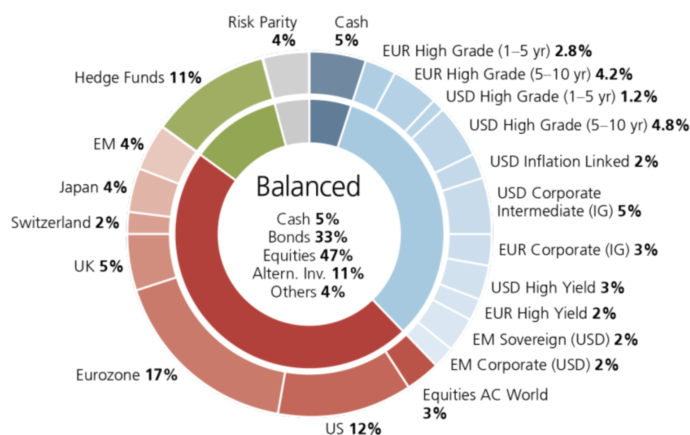
Analysts: Giovanni Staunovo, Dominic Schnider, Wayne Gordon

Section 3

Appendix

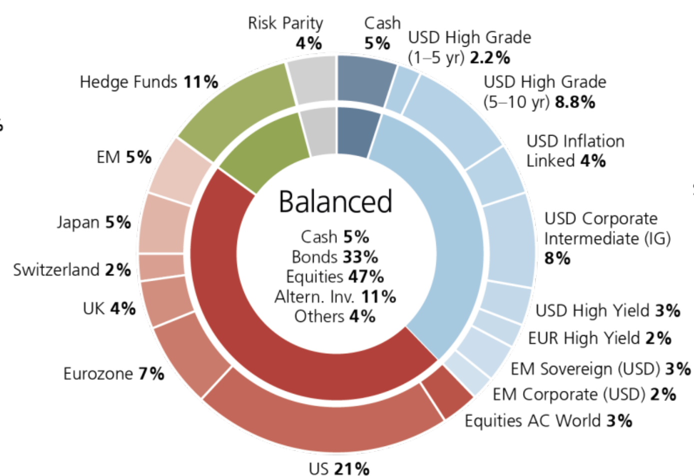
Strategic Asset Allocations (SAAs)

EUR (local portfolio with home bias)



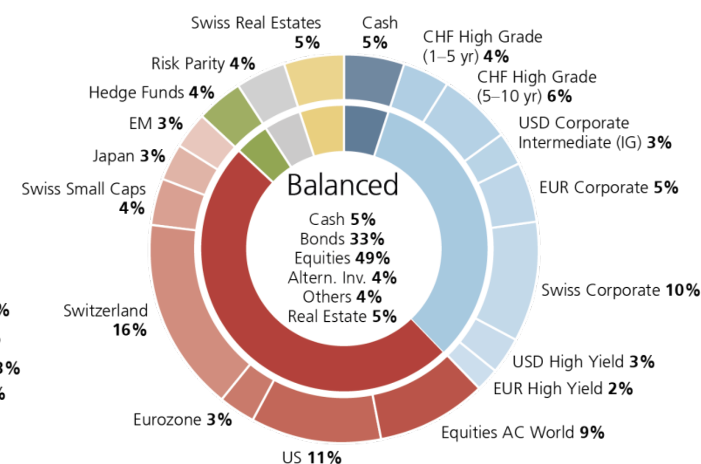
Note: Portfolio weightings are for EUR SAA with a home bias and a balanced risk profile. We expect a balanced EUR SAA to have an average total return of 4.1% p.a. and a volatility of 8.4% p.a. over the next 15 years.

USD



Note: Portfolio weightings are for a USD SAA with a balanced risk profile. We expect a balanced USD SAA to have an average total return of 5.3% p.a. and a volatility of 8.5% p.a. over the next 15 years.

CHF (local portfolio with home bias)



Note: Portfolio weightings are for CHF SAA with a home bias and a balanced risk profile. We expect a balanced CHF SAA to have an average total return of 3.7% p.a. and a volatility of 8.3% p.a. over the next 15 years.

Source: UBS, as of January 2022

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