UBS House View

Monthly Extended May 2023

Chief Investment Office GWM
Investment Research

This report was prepared by UBS AG London Branch, UBS Switzerland AG, UBS AG Hong Kong Branch, UBS AG Singapore Branch and UBS Financial Services Inc.

To see our most recent forecasts, please refer to our publication called "Global forecasts "

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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

UBS

Asset class outlook

Asset allocation

In our global portfolio, we continue to prefer bonds over equities. We think bonds offer better value and lower volatility than equities.

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

Within credit, we prefer high grade, investment grade, and emerging market bonds.

We like broad commodities, including gold and oil.

On currencies, we are least preferred on the US dollar and hold a preference for the Australian dollar and the Japanese yen.

Equities

Following a strong start to the year, global equities lost traction in February and March amid a slower-than-expected moderation in inflation, uncertainty around US regional banks, and the potential impact of tightening credit and liquidity conditions on economic growth. As policy rates are expected to stay higher for longer, we see limited room for global equity valuations to improve.

Across regions, we keep the US as least preferred and maintain Australia and emerging markets as most preferred. By sector, we keep consumer staples, utilities, and industrials as most preferred and information technology, communication services, and healthcare as least preferred. Across styles, we prefer value and quality income to growth.

Bonds

We continue to recommend an up-in-quality bias. Despite recent strong returns, we think the more defensive, higher-quality segments of fixed income remain 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.

We also like emerging market bonds.

This month we upgrade high yield to neutral from a least preferred stance, as although we believe spreads will trend wider by year-end and relative returns may be lower than higher-quality segments, total returns should be protected by virtue of higher outright yields.

Foreign exchange

Together with the Australian dollar, we now also have the Japanese yen as a most preferred currency. With Japan's negative output gap expected to fully close by mid-year, coupled with inflation staying above target, we expect the Bank of Japan to allow a further rise in JGB yields in 2H23. Moreover, the BoJ's holdings of JGBs has ballooned to around 52% of the market (as of end-2022), which underpins an added urgency to modify its current yield-curve control regime.

The US dollar remains least preferred in our global strategy.

We keep a neutral position on the euro, British pound, and Swiss franc.

Commodities

Banking stress and tightening global financial conditions weighed on the commodity sector in March. The more cyclical commodities like energy were strongly impacted, but they have since recovered following the surprise production cuts by key oil producers. Meanwhile, amid the recent market turbulence, gold's safe-haven qualities shined through once again.

We continue to see higher prices ahead for commodities over 2023 and beyond. For this reason, we remain most preferred on commodities overall as well as on oil and gold.

We continue to recommend actively managing commodity exposure.

Section 1.2

Risk scenarios

Key scenarios for 2023

	Upside	Base case	Downside	*Things to watch*
Probability	**15%**	**55%**	**30%**	
Market path	• **Bonds up, equities up** • Risk assets lifted by easing financial conditions and a brightening outlook for global growth.	• **Bonds up, equities down** • Elevated volatility owing to uncertainty about inflation, monetary tightening, economic activity, and geopolitics. Idiosyncratic factors cause diverging performance across markets.	• **Bonds down, equities down** • Severe downturn with global equities posting double-digit losses, credit spreads widening, safe-haven assets benefiting.	
Inflation	• Falls quickly back to central bank targets over the coming months.	• Continues to slow in the US and in Europe but ends the year above central bank targets.	• 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 2H23	• Fed, ECB, SNB, and BoE to complete their hiking cycles by mid-year, to stay on hold for some months before rate cuts become more likely toward end 2023/early 2024.	• Longer period of tighter monetary policy with rate hikes into second half of 2023 followed by a recession and rate cuts next year.	
Economic growth	• Rebounds as the outlook for corporate earnings improves.	• US, Europe, and UK decelerate further, and experience sub trend growth as China reaccelerates. 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 toward 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 more stress in the financial system and increasing the risk of a systemic event. • *Tail risk*: US debt ceiling not raised by July/August; US Treasury defaults; global markets sell off.	• *Global financial conditions indexes* • *US debt ceiling negotiations*
Geopolitics	• The war in Ukraine deescalates, e.g., via a ceasefire agreement.	• The war in Ukraine drags on as ceasefire negotiations remain elusive.	• The war in Ukraine escalates or US-China tensions intensify.	• *Territorial gains by Russia* • *Weapon shipments to Ukraine* • *Putin support polls* • *US sanctions on Chinese companies* • *Reverse-CFIUS process*

Asset class targets - December 2023

Key targets for December 2023	spot*	Upside	Base case	Downside
MSCI AC World	782	880 (+13%)	770 (-2%)	670 (-14%)
S&P 500	4,151	4,400 (+6%)	3,800 (-8%)	3,300 (-21%)
EuroStoxx 50	4,368	4,900 (+12%)	4,250 (-3%)	3,650 (-16%)
SMI	11,312	12,500 (+11%)	11,300 (-0%)	9,800 (-13%)
MSCI China	68	83 (+22%)	78 (+15%)	59 (-13%)
US 10y Treasury yield	3.60	2.50	3.25	4.50
US 10y breakeven yield	2.31	2.00	2.25	3.00
US high yield spread**	441bps	300bps	550bps	850bps
US IG spread**	121bps	60bps	120bps	200bps
EURUSD	1.09	1.18 (+8%)	1.16 (+6%)	1.07 (-2%)
Commodities (CMCI Composite)	1,864	2,300 (+23%)	2,100 (+13%)	1,750 (-6%)
Gold	USD 1,995/oz	USD 2,300-2,400/oz (+18%)	USD 2,100/oz (+5%)	USD 1,800-1,900/oz (-7%)

* Spot prices as of market close of 17 Apr 2023. Values in brackets are expected percentage changes from the quoted spot levels. Dividends, share buybacks and other sources of carry are not included.

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

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

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	−		
Consumer discretionary		=	
Consumer staples			+
Energy		=	
Financials		=	
Healthcare	−		
Industrials			+
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		=	
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		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		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

Manage liquidity as rates peak

Many investors have held more cash than usual in anticipation of higher interest rates. But rates are now approaching a peak. Although the path to lower inflation may not be smooth, we think investors should stay (or plan to get) sufficiently invested and diversified, act soon to lock in attractive yields before markets start to price much lower interest rates, and avoid unnecessary deleveraging.

Diversified asset allocation
Lock-in attractive cash yields
Avoid unnecessary deleveraging

Source of funds
- Excess liquidity

Buy quality bonds

We see attractive opportunities in high-quality fixed income given decent yields and the scope for capital gains in the event of an economic slowdown. We prefer bonds relative to equities, and prefer getting quality exposure through high grade, investment grade, and sustainable bonds. We also like emerging market bonds. Investors who actively manage bond portfolios have the potential to take full advantage of the opportunities.

High grade, investment grade, sustainable bonds
Select financials senior bonds
EM credit

Source of funds
- Redemption on SP, bonds
- Sell/expensive rated bonds
- Excess US equities

Diversify beyond the US and growth

After a strong start to the year, US equities are pricing a high probability of a near-perfect outcome for the US economy. Yet tighter financial conditions, declining corporate earnings, and relatively high valuations all present risks. By contrast, we like emerging market stocks, powered by a weaker dollar, rising commodity prices, strong earnings growth, and China's stronger-than-expected recovery, alongside select opportunities in Europe. We also advocate reducing exposure to growth stocks, after exceptional year-to-date performance. Structured investments and capital preservation strategies could provide ways to attain exposure in a more defensive way.

EM equities (China, Asia semis, EM SI)
Select European opportunities (Germany, consumer)
Global value and quality income
Structured investments (yield-generating and capital preservation)

Source of funds
- Excess US equities
- Excess growth stocks
- Excess healthcare
- Least preferred stocks
- Limited upside list
- Excess US financials

Position for dollar weakness

The US has enjoyed a growth premium relative to the rest of the developed world in recent years, but we believe this will erode in the coming months and think other central banks will start cutting interest rates later than the Fed. Therefore, we have a least preferred view on the US dollar. Investors looking to position for a weaker dollar should diversify their dollar cash or fixed income holdings, reduce allocations to US equities, hedge outright, or position in options or structured strategies that could deliver positive returns in the event of dollar weakness. On a relative basis, we prefer the Australian dollar as well as the Swiss franc, euro, pound, yen, and gold.

Diversify USD cash holdings
Structured strategies (AUD, CHF, EUR, GBP, JPY)
Gold

Source of funds
- Excess USD cash holdings and short-term deposits
- Excess US equities

Diversify with alternatives

Alternative assets provide investors with the opportunity to diversify sources of return at a time of lower "beta" returns from equities, provided investors can tolerate the risks involved. In hedge funds, we like uncorrelated strategies such as macro which can profit from inflections in economic trends. Meanwhile, private market secondaries and distressed strategies could be well-positioned to buy assets at attractive valuations.

Hedge funds (macro, equity market neutral, multi-strategy funds, SI, credit long / short)
Private markets (secondaries, distressed debt, venture capital, direct lending, impact investing PE)

Source of funds
- Excess bonds / equities
- Sell / expensive rated bonds
- Concentrated stocks

Invest in real assets

Exposure to "real assets"—including commodities, infrastructure, and select core real estate—can provide investors with additional portfolio diversification and income, as well as the potential for long-term inflation mitigation. We currently see particular appeal in direct and indirect infrastructure exposure and direct commodity exposure. We stay selective in real estate.

Infrastructure (incl greentech, indirect exposure through industrials and utilities)
Commodities
Select real estate (Swiss property, Singapore REITS)

Source of funds
- Excess bonds / equities
- Sell / expensive rated bonds
- Concentrated stocks
- Excess growth
- Excess energy

Go sustainable

Green investment is stepping up around the world in response to the US Inflation Reduction Act. This should benefit innovative companies focused on improving resource efficiency, including energy and water. We also like sustainable bonds, and see a growing opportunity set to implement hedge funds and private markets within sustainable investment strategies, for example in the areas of education and health.

Sustainable bonds
Sustainable thematic equities: renewables and water
Sustainable hedge funds
Private market impact investing (health, education services, circular economy)

Source of funds
- Excess cash
- Traditional counterparts
- Excess healthcare
- Excess energy
- Excess US financials

Key investment ideas by asset class

	We like	Source of funds
Equities	• Sectors: utilities, consumer staples, industrials • Global value • Quality income • Australia • Emerging market equities (China, Asia semis, EM SI) • Select European opportunities (Germany, consumer) • Sustainable thematic equities: renewables and water • Infrastructure (incl greentech, indirect exposure through industrials and utilities)	Limited upside list, CIO least preferred stocks, excess growth stocks, concentrated stocks, excess US stocks, excess healthcare, excess energy, excess US financials, excess cash
Bonds	• High grade, investment grade, sustainable bonds • Select financials senior bonds • EM credit	Redemption on SP/ bonds, sell- / expensive-rated bonds, excess US equities
Foreign exchange	• AUD, JPY	USD
Commodities	• Active commodity exposure • Oil • Gold	Excess cash
Hedge funds, private markets	• Hedge funds (macro, equity market neutral, multi-strategy funds, SI) • Private markets (secondaries, distressed debt, venture capital, direct lending, impact investing PE)	Excess bonds and equities, sell- / expensive-rated bonds, concentrated stocks

Section 2

Macro economic outlook

Global economy – Slower demand, slowing inflation

Base case (55%)

Growth

Consumer spending continues to moderate. Two years of poor real wage growth is now impacting consumer spending, as there are fewer opportunities to either use savings or borrow money. The persistence of low unemployment helps prevent a more severe economic slowdown—workers may not have strong pay bargaining, but they also do not have to increase savings out of fear that they may lose their jobs.

Inflation

Headline inflation rates have started to surprise to the downside. The disinflation and deflation in the goods sector continues, and energy has become a disinflation force. Profit-led inflation remains the most important driver for the time being, although consumer awareness of margin expansion is starting to increase. This should give some companies cause to reflect before raising prices, as there is an increasing risk to brand reputation from such action.

Positive case (15%)

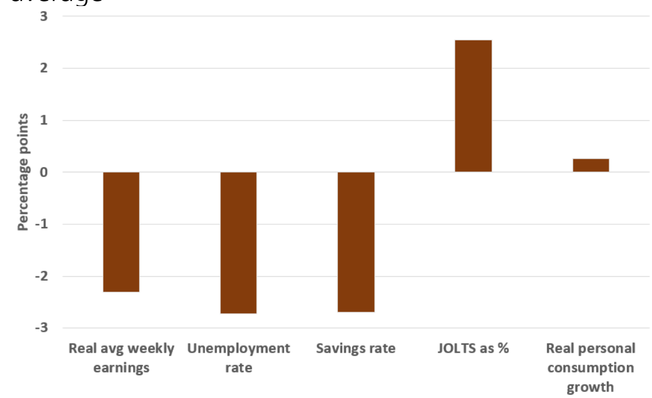
Although nominal wage growth slows, a faster decline in inflation restores real wage growth stability more quickly—stabilizing consumer demand earlier than anticipated. Middle income consumers experience below reported inflation, which helps spending power for an important demographic. Unemployment rates remain low, and strong household balance sheets support demand.

Negative case (30%)

A more rapid tightening of credit standards produces an accelerated slowdown in consumer demand as lower income consumers are not able to supplement weak real incomes with credit use. Fear of unemployment starts to increase, leading to a rise in precautionary spending. This compounds the risks to growth. Companies react to the increased uncertainty and tighter credit standards by retrenching investment plans.

A peculiar US labor market creates a savings dependence

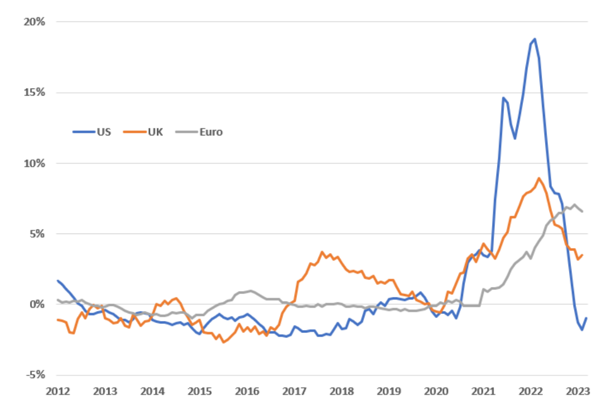
Difference between latest data and Jan 2010–Dec 2019 average



Source: Haver, UBS

Transitory inflation turned to disinflation

Consumer durable goods price inflation, % y/y



Source: Haver, UBS

US economy – Growth will slow, recession risks high

Base case (60%)

Growth

Growth was solid in 1Q23, supported by households spending some of the excess savings they built up during the pandemic. We expect growth to slow from here as the lagged impact of Fed rates hikes weighs on activity, and more households run down their savings. It appears inevitable that banking system stress will hurt credit availability, especially for small businesses, but at this point the damage to the economy is limited.

Inflation

Inflation is clearly down from its peak but remains too high for the Fed. Further progress will have to be made before the Fed can declare victory and stop hiking rates. Easing inflationary pressure at the producer level should filter through into consumer prices over time. A better balance between supply and demand for labor is taking some pressure off wage growth.

Positive case (15%)

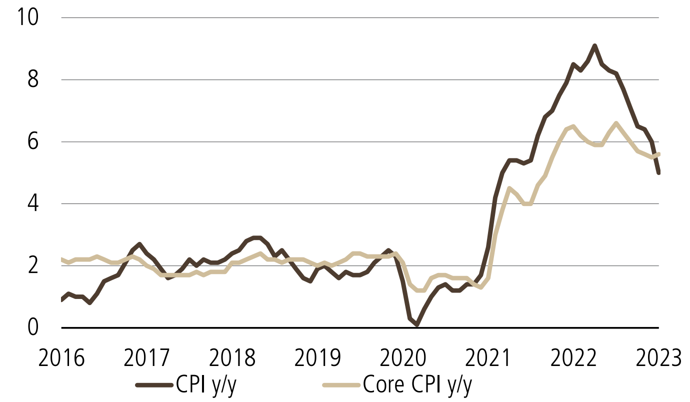
Supply-side bottlenecks continue to ease, while better labor supply allows businesses to fill in their open job positions. Consumer demand aligns with what the supply side is able to produce. Wage growth slows to a more moderate pace and energy prices stay low, helping to bring inflation down while growth remains robust. The Fed sees enough progress toward its mandates to stop raising rates.

Negative case (25%)

The recent stress in the financial system creates downside risks in an environment where banks have already been tightening their lending standards. In addition to the risk of a pullback in consumer spending, we must now consider the possibility of a business-led downturn as borrowing costs increase further. The debt ceiling is another risk to the economy.

Inflation down from its peak

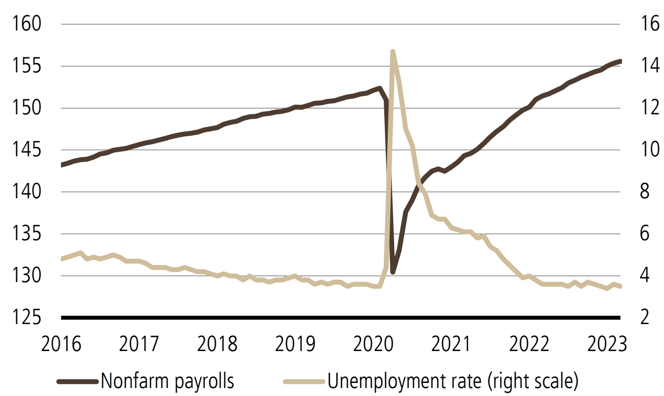
CPI and core CPI, y/y change in %



Source: Bloomberg, UBS

Job growth strong but starting to moderate

Nonfarm payrolls in millions, unemployment rate in %



Source: Bloomberg, UBS

Eurozone economy – ECB to press on with policy tightening

Base case (60%)

Growth

The Eurozone economy was surprising resilient in the first quarter, helped by a sharp fall in energy prices and fiscal support. Recent turmoil in the banking sector will likely lead to modestly tighter lending standards, which should keep economic activity subdued. However, a robust labor market should mean that real income growth improves as headline inflation falls.

Inflation

Headline inflation continues to fall in the Eurozone, led by the fading impact of last year's spike in energy prices. Nevertheless, sticky core inflation should mean the ECB presses on with policy tightening. We look for deposit hikes through to May, with the peak around the 3.5% level. Beyond this, the impact of previous highs and tighter credit conditions will be increasingly felt in the economy, allowing a pause in the hiking cycle. Interest rates cuts are not likely before 2024.

Positive case (15%)

Economic activity normalizes sooner, supported by a sharp fall in inflation and no interruption to bank lending.

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.

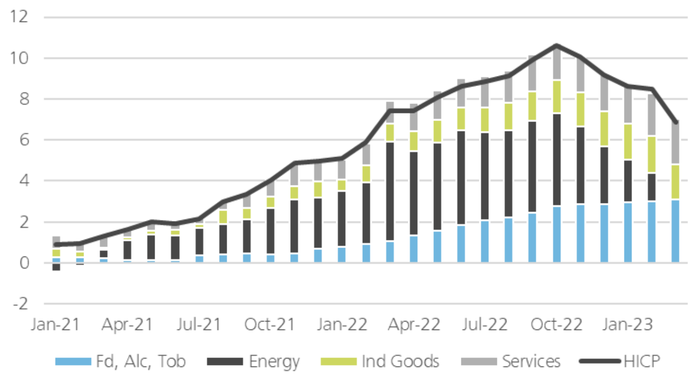
Negative case (25%)

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

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

Headline inflation is falling fast due to energy prices, core inflation likely to be stickier

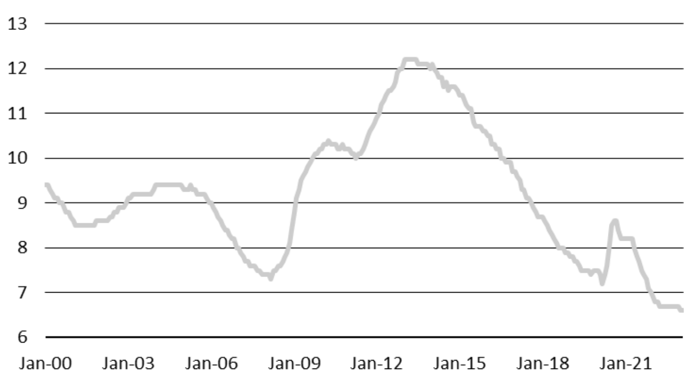
Flash HICP, headline, % y/y, and contributions, ppt



Source: Haver Analytics, UBS

Strong labor markets should support a recovery in real household incomes

Eurozone unemployment rate, %



Source: Haver Analytics, UBS

Swiss economy – SNB stays on course

Base case (70%)

Growth

Amid elevated inflation, high energy prices, and weak momentum in the Eurozone, we expect sub-par Swiss GDP growth this year. However, as an energy shortage has become very unlikely, a recession should be averted.

Inflation

Inflation retracted to 2.9% y/y in March on the back of fading energy contribution. We expect inflation to further fall in the coming months given improved supply chains and lower energy prices. Second-round effects remain a risk.

At its monetary policy assessment in March, the SNB raised its policy rate by 50 basis points to 1.50% and hinted at further tightening ahead. We expect another hike in June (25bps) for a terminal rate of 1.75%. Interest rate cuts are unlikely until 2024.

Positive case (20%)

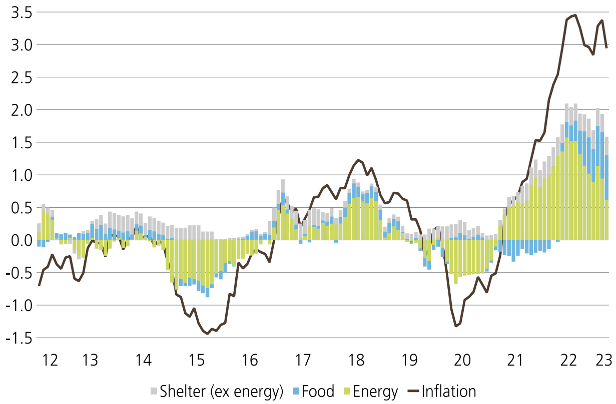
Better global growth momentum: An easing of supply chains, and a swift calming of the turmoil in the banking system and energy issues reduce inflationary pressures and boost global demand. Switzerland benefits from the stronger global backdrop and a weakening of the safe-haven Swiss franc.

Negative case (10%)

Eurozone slump pushes Switzerland into a recession: For Switzerland to fall into a recession, multiple preconditions must be met: Sticky inflation due to strong second-round effects; a deep Eurozone recession and a strong appreciation of the Swiss franc; or a global banking crisis.

Inflation fell in March

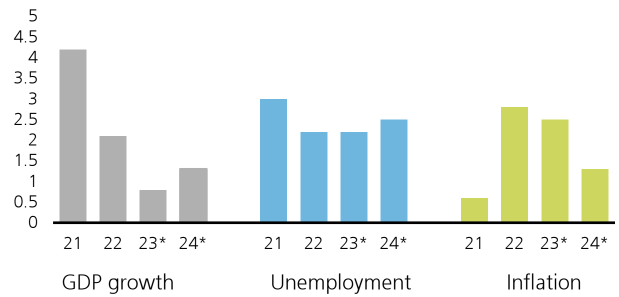
Year-on-year change in Swiss CPI and contribution of selected components, in %



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 – Recovery beat expectations

Base case (70%)

Growth

1Q GDP growth rebounded notably to 4.5% y/y, led by strong consumption with a 66.6% contribution. March retail sales jumped to 10.6% y/y driven by service and auto; investment kept resilient at 5.1% y/y, and good exports recovered to 0.5%. 1Q credit growth accelerated to 10% y/y on warming housing sales. We expect full-year GDP growth of at least 5.7% y/y, powered by ~10% y/y consumption growth.

Inflation

1Q CPI inflation fell to 1.3% y/y due to falling food and energy prices. It is likely to reach ~2% y/y for the full year. PPI deflation is likely to continue for a few months before turning to around 0% in 2H.

Positive case (20%)

Consumption recovers very strongly, and the property market warms up faster than expected.

Geopolitical risks remain contained without a material spillover effect.

The US economy manages a soft landing.

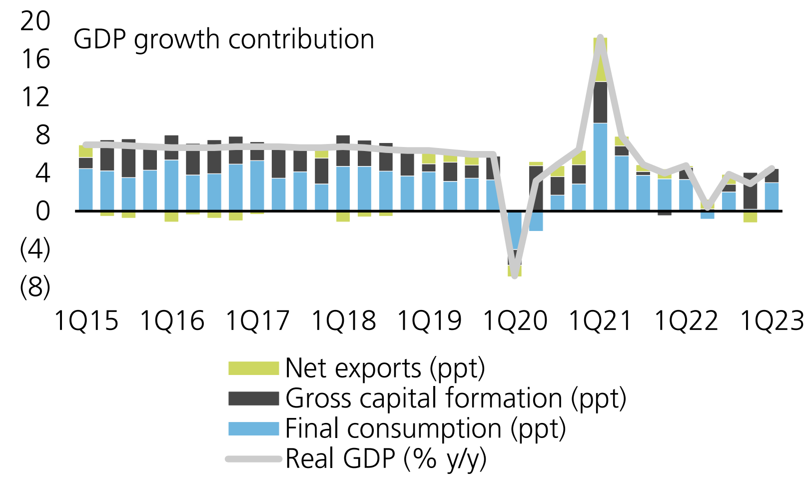
Negative case (10%)

Property activities stay weaker than expected.

The US dips into a deep recession on lagged effect of rate hikes.

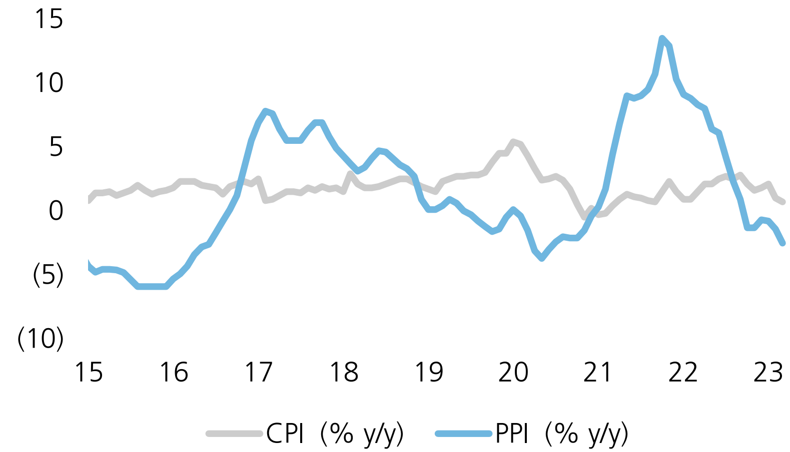
The US imposes much stricter restrictions on China's tech sectors.

Consumption-driven recovery to continue



Source: CEIC

Inflation has remained mild



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 global equities as least preferred and bonds as most preferred. Global equities are back near year-to-date highs, close to our year-end target, yet the outlook does not seem to be improving. Economic growth is holding up, but with central banks committed to trimming inflation, recession risks loom large. Manufacturing is contracting. And while the banking turmoil in March showed policymakers' ability to balance financial risks, history suggests aggressive tightening cycles rarely end in a soft landing.

Equity valuations unattractive versus bonds. On a P/E basis, the MSCI All Country World Index (ACWI) has corrected from a high of about 20x since the pandemic to around 15.6x today, moderately above the long-term average of 14.5x but still too high versus our fair value model of a 12-month forward P/E of 13–14x. Compared to high grade bonds, global equities are not attractive: The equity risk premium continues to fall and currently stands at 4.5%, a low since the 2008 global financial crisis, and the earnings yield is only 2.6%, the lowest since 2009. Meanwhile, the cost of equity is above 8.8% (back to 10-year highs), consistent with future negative returns versus high-quality sovereign and corporate bonds.

Earnings risks skewed to the downside. With US earnings growth turning negative in 4Q22, the dip in leading economic indicators raises the risk of a subsequent decline in 1Q23, which would usher in an earnings recession. We estimate a contraction in global and US earnings by 3% and 4.5%, respectively, versus the consensus forecast of 0% for both. Furthermore, earnings momentum is deteriorating, and earnings estimate downgrades are outpacing upgrades. Given these indicators, we think equity volatility is poised to rise.

US equities least preferred. US stocks did poorly in 2022, but this can be mostly explained by the change in discount rates. 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 18.4x today with real rates now positive. However, the relationship has dislocated; equity valuations have declined from their peak but are still above the level implied by real rates and other variables (e.e., ISM and credit spreads).

Australian and emerging market equities most preferred. Australian earnings growth expectations are close to zero for this year, but valuations have improved: The 12-month P/E stands at 14x, more than an 8% discount to the 10-year average and under that of global equities. The commodity story remains intact as well. For emerging markets, China's reopening and a fading headwind related to the US dollar mean earnings momentum and estimate revisions have bottomed versus developed countries, and valuations look appealing.

Consumer staples, utilities, and industrials most preferred. Consumer staples' relative earnings momentum is positive and strengthening. While absolute valuations appear expensive, they are in line with historical averages. Utilities' defensive profile and earnings resilience in an economic slowdown should help in a volatile environment. Utilities are a traditional safe haven during downturns; when uncertainty rises, utilities will likely outperform the broader index thanks to a stable revenue base and high levels of regulation. For industrials, we expect the next capital spending cycle to be strong in a number of areas: the energy transition and decarbonization (e.g., energy efficiency, renewables); defense, after two decades of underspending for most NATO states in Europe; mining and oil and gas, due to higher commodity prices; automotive (EV transition); and reshoring of operations (e.g., more automation).

Preference: Least preferred

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 is positioned to benefit during an economic slowdown; 2) it should outperform during market sell-offs and when volatility rises; and 3) dividends are safer than earnings while quality companies' balance sheets remain healthy and capital returns well covered.

Sector preferences

Most preferred: Utilities, consumer staples, industrials

Least preferred: IT, healthcare, communication services

Analysts: Claudia Panseri, Adrian Zuercher, Mark Andersen

Equities

Healthcare, information technology, and communication services least preferred. The softening USD is a headwind for pharmaceutical companies outside the US. Valuations now look expensive following last year's strong relative sector performance. The communication services sector has performed strongly year-to-date, while the main players are in a cost-restructuring phase following a wave of layoffs, and idiosyncratic risks from competition are on the rise. 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 global equity benchmark remains high (IT trades at 25% premium to history and 47% premium to the market), 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.

Prefer value and quality-income stocks over growth stocks. In an environment of high inflation, we maintain our preference for value and high-quality stocks. The equity markets and factor performance have seen significant and volatile moves in the past weeks. Amid market and economic uncertainty, we suggest investors continue to stay defensive. One key factor to concentrate on is defensive value (high free cash flow generation or high return on equity), which require more of a stock-picking approach than sector selection. We remain negative on growth names, which 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 a 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: Solid economic growth in the US and emerging markets drive a 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: Additional escalation between Russia and Ukraine leads to a further disruption of Russia's energy supplies. Oil and natural gas prices rise sharply and remain elevated.

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

Bonds

Market volatility remains elevated as financial instability concerns have now joined inflation concerns at the top of investor worries. As central banks last year embarked on aggressive front-loaded rate hiking cycles in order to cool both realized and expected inflation, it became evident that lower-for-longer interest rate assumptions needed to be re-calibrated. Cracks first started to surface last year in areas such as UK pension schemes, and we are now seeing them in the banking system. The policy response thus far has been to offer targeted liquidity and facilitate private sector solutions to the banking troubles. Within this context, we see bonds offering appealing risk-adjusted returns relative to other asset classes and hence maintain a most preferred stance.

Within the asset class, we maintain an up in quality bias expressed through high grade (HG) and investment grade bonds (IG). There are select 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 prone to rise over time as global money supply continues to shrink. As a result, we see HY spreads as being vulnerable relative to IG and HG. Therefore, we are neutral on HY. EM bonds have suffered over the last few years from sluggish China growth and the aggressive tightening of monetary policy in the US. We see these headwinds reversing going forward. There is an element of credit beta sensitive to risk markets, which suggests the bulk of the performance will come from carry and upside on special situations in the distressed space.

High grade bonds: We maintain our most preferred recommendation on HG bonds. With growth decelerating, we expect the recent moderation in inflation to continue. 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. Rate volatility has been trending lower, but we can envisage periodic spikes higher as it remains too early to declare victory on the inflation fight. Despite this, the recent financial instability in the banking sector is an additional tightening of monetary policy and should put further downward pressure on nominal growth and interest rates. This should translate into ongoing strong total returns for the asset class going forward. This segment is rated AA- or better, and therefore exhibits minimal default risk. The higher level of interest rates provides a sizable cushion should rates move higher. In the event of a sharper slowdown, rates would move lower across the curve, and the asset class would strongly benefit given its defensive characteristics. Considering a number of scenarios, we see the risk-return as compelling**.**

Investment grade (IG) bonds: Like HG bonds, we maintain the asset class at most preferred. Switching from lower-quality to higher-quality credit makes sense given growth risks and tighter financial conditions. The high interest rate sensitivity of the US and EUR investment grade complexes detracted from total returns last year. But 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 4.2%. The recent stress in the banking sector and tighter monetary policy from the ECB will likely continue to weigh on growth and, with a lag, put downward pressure on inflation. On US IG, yields for all maturity and intermediate profiles are around 5%. Credit fundamentals on the US IG corporate side remain solid and should provide protection in a slowing earnings environment.

Preference: Most preferred

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.

Analysts: Frederick Mellors

Bonds

High yield (HY) bonds: We shift the asset class to neutral from least preferred. On a relative value basis, we see risks of spread widening and decompression versus higher-quality markets as the tightening of financial conditions translate into higher corporate defaults. As liquidity becomes more challenging, credit risk premiums should also widen. That said, 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. Additionally, the outright level of yields in US HY and EU HY are above 8% and 7% respectively, which has attracted capital flows more recently and supported performance, hence our neutral stance.

Emerging market (EM) sovereign bonds: We maintain EM bonds as most preferred. We see the asset class benefiting from an ongoing recovery in Chinese growth, which is already reflected in the latest economic data. Financial stability concerns in the US have led to markets pricing in a milder outlook for the Fed's rate trajectory compared to a few weeks ago. This, coupled with our expectation for a weaker USD, is also positive for EM credit. 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. The sovereign index yield is now around 8.6% and the corporate index yield is around 7.0%.

FX

This month, we move the Japanese yen to most preferred from neutral. We expect the Bank of Japan (BoJ) to eventually follow all other G10 central banks and tighten its ultra-loose policy. Japan was a laggard in reopening its economy after COVID-related lockdowns. Consequently, inflation, employment, and house prices rebounded later than in other G10 countries. The macro trends speak for a policy pivot, and the longer Japan holds off on this shift, the more urgent we think it will become. The timing has become more difficult to predict, and we believe it could happen in any of the next three policy meetings. So, we see the yen as a longer-term, but high-potential outperformer.

The US dollar remains least preferred in our global strategy. The Federal Reserve is coming closer to the end of its tightening cycle, and markets are discussing the timing for possible rate cuts later this year. We are in the middle of the inflection point we have been looking for in 2023, in our view. This period will be volatile. Still, the general direction of a weakening USD seems clear, and international investors have strong incentives to repatriate funds out of the US.

We keep a neutral position on the euro, British pound, and Swiss franc. The Eurozone, UK, and Swiss central banks are lagging the Fed in this rate-hike cycle, which helped the USD to outperform its peers while the Fed pressed ahead with its tightening efforts. Now, the situation is reversing, and we think the EUR, GBP, and CHF are all likely to gain versus the USD. The key question for investors is: Which currencies are best to help unwind USD exposure? For those whose investments are not based in USD, we think the first decision is to strengthen their home bias. We see upside for all three currencies against the USD. For USD-based investors, our advice is to strengthen their alternative currency of choice. Depending on the region, this might be the EUR, CHF, or GBP.

The Australian dollar continues to be our top currency pick globally. Among the G10 currencies, it is the best placed to benefit from China's economic rebound. Next on our preference list are the JPY and the CHF. In both Japan and Switzerland, economic conditions—i.e., the mix of inflation, employment, and consumer demand—are calling for tighter monetary policy. We think the CHF is due for a larger appreciation than we have seen already. Swiss inflation is moderate relative to other countries, and the Swiss National Bank is committed to reducing its large balance sheet. A slow but steady appreciation of the CHF should also shield Switzerland from potential financial market turbulence.

The EUR and the GBP should both benefit from a steadily improving economy and from their respective central banks fighting inflation, which is still higher than in the US. This is their highest priority. The euro, more so than the pound, is also gaining from repatriation flows. Higher bond yields and a decline in the yield spread to the US should bring a more balanced financing situation, further supporting the EUR.

Emerging market currencies have done well since mid-March as expectations for the Fed's future policy path once again started to price in the first potential rate cuts at the end of the year. Carry currencies also recovered swiftly from weakness fueled by banking sector turmoil. Tightening lending standards, which should reduce the need for the Fed to hike rates aggressively, and weaker US growth momentum lead us to expect emerging market currencies to ourperform the USD in total return terms over the course of the year. That said, the market's tendency to jump from narrative to narrative lately should mean this outperformance comes with bigger swings. We continue to like opportunities in select high-carry emerging market currencies, including the Mexican peso and Czech koruna. A key risk is the global economic slowdown morphing into a recession.

In Asia Pacific, we remain optimistic that China's reopening will boost regional growth prospects. We favor being long the AUD, the Chinese yuan, and the Thai baht, which we see as the key beneficiaries. We also like to own high-yielding Asian currencies such as the Indonesian rupiah and the Indian rupee, against a backdrop where the Fed is close to ending its rate-hike cycle.

Analysts: Thomas Flury, Teck Leng Tan, Tilmann Kolb

Commodities

We continue to believe the structural bull case for commodities is intact, so we are playing the long game. Our stance is backed by China's recovery, an expected inflection point in the Fed's rate-hiking cycle and the associated weaker US dollar, several unresolved supply-side issues due to lacking investment or geopolitics, persistently low inventories in key consuming countries, and ongoing weather risks. These catalysts for higher prices will endure amid elevated volatility in other risk assets, in our view. So, we maintain our total return outlook of around 20% over the next 12 months for the whole asset class. Sector-wise, we expect energy, industrials, and precious metals to make the greatest contributions to our broad index target, which is reflected in our active commodity strategy. Risks to our view include a deeper recession in the US, a loss of momentum in key parts of China's recovery like property, and a swift end to the war in Ukraine.

The surprise "voluntary" production cut by nine oil producers is set to tighten the oil market further from May onwards. Together with rising Chinese crude imports, we continue to expect higher oil prices ahead.

Industrial metal prices are likely to be volatile in the near term on global growth concerns. But with China activity gathering momentum, structurally low inventories, and ongoing supply challenges, we expect market balances to stay tight for most metals and favor higher prices over the coming quarters.

Recent shocks in global banking have altered the script on growth, rates, and ultimately precious metals prices. We now forecast the gold price to eventually break its previous record high and target USD 2,200/oz by the end of March 2024. Hence, with uncertain times set to continue over the year ahead, we recommend holding gold as a portfolio hedge.

The extension of the Black Sea grain deal and strong export volumes from Brazil have weighed on prices. But the production outlook in the US and Europe remains unclear, and the probability of an El Niño event by year-end has risen to 60%. Historically, this event has negatively affected yields for corn, rice, and wheat. Weaker lean hog performance has weighed on the index overall. We expect the current liquidation of animals to tighten fundamentals in the US, particularly for cattle. We expect cattle prices to rise into 2024 as weather conditions normalize and drive restocking of herds across key producing regions in the US.

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 maintain our neutral stance on Eurozone equities. While the recent volatility across the banking sector and its impact on credit conditions may weigh on economic growth in the second part of the year, downside risks to earnings seem partially priced in at current levels, with valuations looking fair to us.

Fears around the banking sector have eased in recent weeks, but we still expect this to weigh on economic growth via tighter credit conditions and weaker near-term business confidence. The 1Q reporting season therefore takes on added importance as one of the first opportunities to hear from companies about the impact on their business from the recent turmoil.

We expect that earnings slowed further in 1Q but are close to bottoming, with European and China growth expected to improve in the second half of the year. We forecast Eurozone earnings to fall 5% in 2023 (consensus +2%), and grow 5% in 2024 (consensus +9%).

Although we forecast downgrades to consensus earnings estimates, we believe this is already largely priced in and a manageable headwind for equities. Current valuations (12.4x forward P/E) are at a 7% discount to history and downgrades to consensus earnings estimates are relatively normal. Consensus has revised earnings estimates lower in 14 of the past 22 years, but in eight of those 14 years, Eurozone equities posted positive returns.

Our current preferences are positioned to withstand uncertainty around the growth outlook, but benefit from lower bond yields. This supports our preference for the consumer sectors and real estate. Although cyclical, we continue to like German equities as they benefit from falling European gas prices and China's reopening. In the medium term, we like Europe's greentech and digital leaders as beneficiaries of government 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.

European medtech

We expect European medtech stocks to outperform pharmaceuticals stocks. A more stable healthcare operating environment, improving consumer confidence, and lower inflation all point to a recovery.

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.

Eurozone equities

Upside scenario

DJ Euro Stoxx 50 December 2023 target: 4,900

Looser central bank policy, in response to the current uncertainty, could alleviate downside pressure on valuations.

Inflation falls quickly, allowing cental banks to ease policy in the medium term, supporting valuations that have been under pressure from sharply higher discount rates.

Recession avoided. Earnings could surprise to the upside if economic growth holds up better than expected, or China's recovery surprises to the upside. This is an upside risk to our earnings forecast.

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.

Downside scenario

DJ Euro Stoxx 50 December 2023 target: 3,650

Growth disappoints with the US entering a recession later this year, driving weaker earnings growth and lower valuation multiples in the near term.

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

Ongoing banking uncertainty could lead to tighter financial regulation and lending standards, and knock-on effects to business confidence.

Political risks or other 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 or less availability of LNG could raise the risk of production stoppages in Europe next winter.

US equities

Preference: Least preferred

Central scenario

S&P 500 December 2023 target: 3,800

he turmoil in the banking sector appears to have been short-lived, with US equities now back near their year-to-date highs. Questions remain whether the crisis is fully over and what the overall impact may be, but actions taken by regulators have quelled most depositor and investor concerns. We previously highlighted that the recent bout of panic in the banking sector is very different from the global financial crisis, and we think comparisons to that episode are not appropriate. Still, the stress in the banking sector could make it harder for some segments of the economy to access capital on favorable terms.

The first-quarter earnings season is kicking off, and in the wake of the banking sector turmoil, some investors seem to fear a sharp hit to US corporate profit growth. While we share these concerns to some extent, it will likely take more time for tighter credit conditions to have an impact. Instead, we expect results to be resilient based on a slowing but still-healthy jobs market, improving supply chains, cost-cutting, and the weaker US dollar. So far, results and guidance have been good. We expect S&P 500 EPS to decline 1–3% year-over-year, representing an earnings beat of 3–5%. Still, consensus bottom-up expectations for 5% EPS growth in the second half of the year look too high.

Even though first-quarter results may beat expectations and the banking crisis should further subside, we believe corporate profits still face challenges ahead. First, the yield curve is inverted, and if history is a guide, economic conditions could be more challenging late this year. Second, lending standards have been tightening for some time, and the recent banking sector turmoil will likely add to the headwinds for lending activity, which should continue to put pressure on corporate profit growth. Also, the only other instances when the Feeral Reserve's Senior Loan Officer Opinion Survey (SLOOS) was at current levels was during the COVID-19 pandemic, global financial crisis, and the dotcom bust. Finally, both high inflation and a reasonably strong labor market make us skeptical the Fed will be able to cut interest rates this year. As a result, we think the Fed will likely need to keep monetary policy restrictive, forestalling any reacceleration in economic growth that could reignite inflation.

Overall, we believe US equity markets will continue to be somewhat range-bound in the next few months, with the S&P 500 trading between the high 3,000s and low 4,000s as investors continue to oscillate between soft-landing hopes and hard-landing fears. In our base case, our June and December S&P 500 price targets are 3,900 and 3,800, respectively. But the range of outcomes remains wide. In a soft landing whereby inflation is clearly defeated and the Fed can start cutting interest rates, the market could rise to 4,400 (5–10% upside). In a hard landing, the S&P 500 could fall around 20% to around 3,300. For investors who want to be very tactical, we think this is a good way to gauge risk-reward in US equities until it becomes more clear which scenario will play out.

Finally, we think it is important to bear in mind that equity valuations are somewhat elevated, with the S&P 500 forward P/E above 18x. Historically, the market multiple has only traded at levels higher than this when forward consensus profit growth expectations averaged 14% or long-term interest rates were below 2%.

Sector preferences

Most preferred

- Consumer staples: Earnings growth should be more resilient than other sectors as macro headwinds persist. Relative valuations are reasonable in the context of the sector's defensive growth profile.
- Industrials: The sector should continue to benefit from secular growth in areas like defense, reshoring/onshoring, investments in energy supply (fossil and renewable), infrastructure spending, and aerospace. The sector offers some cyclical exposure relative to our two other most preferred sectors, which are more defensive.
- Utilities: The sector is a classic defensive and should offer ballast in a portfolio, especially given some of the headwinds that we see ahead and arguably cheap valuations for a late-cycle environment. Our fixed income team's outlook for lower long-term interest rates over the balance of the year should make the sector's high dividend yield more appealing.

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 despite aggressive Fed rate hikes.

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.

Sector preferences

Least preferred

- Consumer discretionary: The sector has been a strong performer this year despite continued questions about consumer demand for goods and high sector valuations. Elevated mortgage rates and poor homebuyer affordability are headwinds for the housing-related segments of the sector. The sector would be particularly vulnerable if hard-landing fears become more prevalent.
- Financials: As the banking crisis has ebbed, the sector has rebounded, but other headwinds remain: Recession risks are elevated, funding costs are rising, loan growth may slow, and regulatory scrutiny will likely intensify, which could lead to lower shareholder payouts.
- Information technology: The sector has been a safe haven during the banking stress. But this has pushed valuations to elevated levels. In addition, as corporate profits come under pressure, there may be risks to IT enterprise spending and, ultimately, smartphone demand.

UK equities

Central scenario

FTSE 100 December 2023 target: 8,000

We expect global growth to slow further, with developed market GDP growth hovering close to zero percent at various points throughout the year. As such, we anticipate a mid-single-digit decline in UK earnings this year. The year-on-year changes in oil prices and sterling in particular are no longer supportive for the UK earnings backdrop. Meanwhile, while financials still benefit from higher interest rates currently, we think rates are near their peaks. Additionally, it remains to be seen whether deposit competition will increase and if lending criteria will tighten following the recent turbulence in the banking sector, which could provide some additional downside risk to bank earnings and economic growth overall. However, much of this slow outlook is already priced by the UK equity market.

The FTSE 100 trades on a 12-month forward P/E of 10.5x—around 20% below its long-run average—and more than a third lower than global equities (MSCI AC World). However, this is a reflection of its composition, which consists mostly of value sectors such as financials, energy, and commodities. We see the 4% dividend yield of the UK market as attractive in the context of moderate expected capital appreciation.

Upside scenario

FTSE 100 December 2023 target: 8,800

Valuation: 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.

Swiss equities

Central scenario

SMI December 2023 target: 11,300

After a strong 2021, we expect corporate profits to be flat over the 2022–23 period, supported by price increases to 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 2023 profit expectations to 2021 provides a much cleaner picture.

Since early June 2022, the Swiss National Bank (SNB) has been increasing its prime interest rate to mitigate 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 may moderate in 2023, but is likely to continue versus the USD in the medium term.

With regard to investment strategy, we recommend focusing on quality companies, and select cyclicals and mid-caps. Companies with attractive and sustainable dividend and free cashflow yields are particularly appealing to us.

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 around 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.

Swiss equities

Upside scenario

SMI December 2023 target: 12,500

Robust Swiss profits: If there is only a modest global economic downturn this year, corporate profits could 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 increased a bit. In 2023, we expect currency losses to be significantly negative again.

Downside scenario

SMI December 2023 target: 9,800

Economic and political risks: Significant 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.

Emerging market equities

Preference: Most preferred

Central scenario

MSCI EM December 2023 target: 1,050

We keep emerging market equities as most preferred. Emerging economies are proving resilient, with manufacturing PMIs sitting comfortably in expansion territory. Economic activity and credit data from China illustrate that the country's post-COVID recovery is stronger than anticipated.

The MSCI Emerging Markets index valuation, at 12x 12-month forward P/E, stands in line with the 10-year average and is at a 34% discount to the S&P 500. On a price-to-book basis, the discount to the S&P 500 is even deeper at 60% versus its long-term average of 53%. In our view, this level of valuation discounts are not justified by fundamentals and should tighten in the coming months. We think real growth in emerging economies will gradually trickle down to corporate earnings, especially as interest rates peak and the US dollar softens. By contrast, we expect US equities to weaken from current levels as US economic and earnings growth moderates.

A strong US dollar, an uptick in geopolitical tensions, and a pronounced US recession constitute risks to the outlook for emerging market equities.

Within emerging markets, we expect 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 their 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 and believe the ongoing earnings recovery will drive a valuation rerating. We also continue to like Thailand where retreating inflation and recovering inbound tourism should continue to support an earnings recovery in 2Q23. Korea remains a most preferred market benefiting from a weaker US dollar and a bottoming semiconductor cycle.

Upside scenario

MSCI EM December 2023 target: 1,100

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: 800

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

Least preferred

Malaysia, Singapore, India

Japanese equities

Central scenario

TOPIX December 2023 target: 2,100

We are neutral on Japanese equities in our global asset class universe. Japan's TOPIX benchmark had outperformed global equities (MSCI All Country World Index) before the recent sell-off (+11% this year as of 9 March), but has fallen by mid-single-digits since then. We see limited downside risks to share prices from here given that Japanese banks are well capitalized; valuations are relatively cheap in comparison to other developed markets: companies are aggressively buying back shares and paying out higher dividends at the fiscal year-end (31 March); and the expected recovery in the Chinese economy and rising number of inbound visitors from China should help accelerate Japan’s tourism rebound in 2H.

We see tactical opportunities in select large-cap Japanese banks. They are trading at 0.5–0.6x P/B and offer relatively high dividend yields, and the liquidity in their balance sheets is supported by large domestic retail deposits. Markets recently focused on Japanese lenders' exposure to US debt, which led to a sell-off of over 15% in major Japanese banks in mid-March. We think these concerns are overdone, with Japanese lenders backed by much higher retail cash deposits, loan-to-deposit ratios of near 60%, and no obvious catalysts to drive any liquidity events.

We expect 8% profit growth for FY22 (ending 31 March 2023) and 0% growth in FY23 based on our expectations of the yen strengthening toward 2024. The TOPIX is trading at 12.7x P/E—below the long-term average and at a wide discount versus the MSCI ACWI—so valuations are mitigating the downside risks, 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, in our view.

Upside scenario

TOPIX December 2023 target: 2,200

Stronger-than-expected re-opening spending: A full reopening of the 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: A strong Chinese economic recovery after the zero-COVID policy exit and the US remaining resilient despite US/EU banking turmoil 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 strengthens sharply, 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 the borders in October 2022, the number of inbound tourists is 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 services 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 an 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.

Asian ex-Japan equities

Central scenario

MSCI Asia ex-Japan December 2023 target: 680

We keep a neutral stance on MSCI Asia ex-Japan. The macro situation in the region is on better footing than many other regions, with average PMIs for ten Asian countries rising from the lows of November over the past few months. The economic surprise index for the region has also gained momentum in recent weeks, offering support for the upcoming season earnings. Therefore, we expect the market to be rangebound in the coming months as China's demand recovery partially cushions the US slowdown.

Our preference for North Asia markets remains unchanged. We stay most preferred on Korea, China, and Thailand, and least preferred on India, Malaysia, and Singapore.

Korea is an early cyclical market that tends to trade on forward-looking earnings growth more advanced than other Asian peers. We continue to expect the semiconductor cycle to trough during this quarter, which should help Korean tech earnings—a big component of the equity index—recover in the future. For Thailand, the market has retreated over the past few months, largely due to a pause in the tourism improvement and ongoing political uncertainty amid the general elections. But going forward, we think the economy will stay on the recovery path. Chinese tourists should gradually return to Thailand once flight capacity bottlenecks ease. Domestic consumer confidence will also continue to improve and earnings should remain solid, in our view.

We also keep China as most preferred. China's 1Q macro data fared better than expected, especially for consumption. However, the market reaction reveals a lack of confidence in the second leg of the domestic recovery. Here, we think sustained solid macro figures in the next few months are needed to reboot investor confidence. Based on the strength of the 1Q macro data, we do expect better growth for 1Q23 earnings.

For India, however, we think further profit-taking is likely after the market benefited from post-COVID capital inflows. The recent earnings season has also started to show some cracks on the corporate fundamental side. Meanwhile, Malaysia continues to struggle with macro headwinds and earnings momentum is trailing its regional peers. For Singapore, the outlook for the banking sector (47% of the index) is becoming less supportive as the net interest margin cycle nears a peak.

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, and attractive valuations.

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

Market preferences

Most preferred: Korea, China, Thailand

Least preferred: India, Singapore, Malaysia

Asian ex-Japan equities

Upside scenario

MSCI Asia ex-Japan December 2023 target: 760

Fed starts rate cuts

Asian equities are likely to rebound strongly if the Fed starts to cut rates or stops quantitative tightening, especially if the economic slowdown is less severe than feared and inflation drops faster than expected.

Strong China housing demand recovery

A meaningful recovery in property investment in China later this year is likely to push Asian equity markets higher given the subdued expectations on this front.

Strong demand recovery in tech

Asian 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: 555

Sharp slowdown in DM growth

If US/Europe growth turns out to be much worse than our mild recession assumptions, Asian equities could be impacted.

Re-escalation in Sino-US tensions

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

Further stress from global banking sector

If more banks come under solvency pressure, it could push funding cost higher and potentially cause a credit crunch and negative market reaction.

High grade

Preference: Most preferred

Central scenario

10-year US Treasury yield December 2023 target: 3.25%

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 to be approaching a point where they are ready to pause and assess the full effects of tightening so far. Against this backdrop, we continue to recommend an overweight position in high grade (HG) bonds. Our rationale is that central banks have succeeded in ensuring inflation expectations remain stable and financial conditions are now restrictive, as evidenced by the recent pick-up in financial instability. We acknowledge there may be further upward pressure on short-end rates as central banks contend with the more persistent sources of inflationary pressures that we see currently. To achieve structurally higher interest rates across the curve, however, economic growth needs to step up. We think growth is decelerating because of tighter financial conditions, with significant uncertainty about whether the US economy is going to experience a mild or a deep recession, particularly in view of recent banking sector turmoil. Accordingly, while interest rate volatility will 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 Fed policy tightening triggers a recession. It could occur should the economy, contrary to the Fed's analysis, prove unable to withstand the policy tightening required to subdue inflation—a banking crisis being a case in point.

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 or excessive tightening in financial conditions, 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 2Q23. 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.

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. We think the Fed is now coming close to the end of its hiking cycle as we think its policy is in restrictive territory. But rate volatility is likely to remain elevated amid some continued uncertainty on the terminal rate. At the same time, current yields provide a good degree of buffer against the risk of higher interest rates. Importantly, high-quality bonds tend to be resilient in a recession as credit spread widening is usually offset to a good degree by falling interest rates. This was observed last month as deteriorating risk sentiment related to concerns in the banking sector on both sides of the Atlantic caused IG spreads to widen. However, total returns were resilient as falling government bond yields more than offset the widening in credit spreads.

While rate volatility has moderated, it is likely to remain elevated as concerns shift from inflation to economic growth. On US IG fundamentals, we regard current credit metrics as solid with improved levels of coverage and leverage. We anticipate some degradation in metrics ahead as earnings growth slows, in which case downgrades are likely to increase and could pressure spreads upwards. However, average US IG yields are at historically elevated levels of over 5% while spreads are sitting around their long-term average. The higher outright yields and the fact that spreads are a much smaller proportion of total returns than in the recent past is a positive for forward-looking returns as this should provide a sizable offset to potential further credit spread widening.

Within EUR IG, the average yield sits at 4.2%. Index spreads are now trading at 154 basis points, or above their long-term average. We expect the Eurozone economy to avoid a recession, supported by lower gas prices and 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.

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 to 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 consider 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.

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

US 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 economic growth fears and default risks, and leads to wider credit spreads.

High yield

Central scenario

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

We are constructive on bonds as an asset class. However, with the more growth-sensitive segments such as HY, we are advocating a more selective, up-in-quality bias. We expect economic growth and earnings to slow as the lagged effect of all the policy tightening of the last twelve months continues to work its way through the system. Although markets have stabilized somewhat and there is some optimism regarding the scope for interest rate cuts later this year, the recent regional bank failures in the US are likely to have second-order effects in terms of tighter lending standards going forward. Additionally, a policy pivot is unlikely in the near term given current inflation rates. This has implications for prospective defaults and credit risk premiums, which is why we forecast spreads widening into year-end.

Many companies were fortunate 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 mix. Our view is that credit metrics will deteriorate from here, and more levered companies without reasonably priced market access will be forced into aggressive balance sheet restructuring. As a consequence, we estimate corporate defaults could rise above their long-term average to around mid-single-digit rates, compared to the current level of 2%.

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, which gives some comfort. Leverage has declined as earnings have increased, while debt growth has been muted. Furthermore, 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.

Currently, the level of credit risk premium is not overly cheap. This is the compensation credit investors require over and above expected credit losses. As a central bank pivot remains unlikely in the short term (in the absence of a systemic crisis), liquidity should continue to be drained from the financial system. Central banks have shown a willingness to actively use their balance sheets temporarily when market conditions turn into dysfunction, however this is reactive rather than proactive.

Although we forecast wider spreads in HY and relative underperformance versus higher-quality segments, the current level of outright yields in US HY and EU HY are around 8.4% and 7.3% (in local currency), respectively, at an index level. This is important as the high yield market generates significant carry with every passing day. Additionally, in the event of spread widening, the higher level of rates provides a sizable buffer against mark to market losses. Our return to a neutral stance from least preferred takes into consideration this dynamic and the fact that total returns may not be materially lower unless we have a severe economic downturn.

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.

High yield

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 raise policy rates and withdraw liquidity. This provides a much more predictable policy path and leads to a loosening of financial conditions, which is supportive of 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.

Emerging market bonds

Preference: Most preferred

Central scenario

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

We keep emerging market credit as most preferred as we see the asset class benefiting from the rebound in the Chinese economy and hence relatively stronger growth than the developed world. Evidence of China's recovery has been mixed, but there are tentative signs that the property market is finally turning and domestic spending has been robust. Importantly, monetary policy has become more stimulative, which should underpin credit growth. In developed markets, monetary policy remains restrictive, though we appear to be near the end of rate-hiking cycles. Specifically, with regard to the Federal Reserve, this implies the USD may be close to a peak, which would translate into cheaper external funding requirements for emerging markets.

We see value in sovereign bonds, where valuations are attractive relative to historical levels driven by the high yield segment. The proportion of the EMBIG Diversified sovereign index trading at spreads above 600 basis points remains elevated. Within this category, we find value in some larger issuers that are willing and able to work with the IMF or other international lenders, or where we see upside to potential restructuring scenarios.

The sovereign index yield is currently around 8.6%, while the yield on the corporate index (CEMBI Diversified) is around 7%. We expect mid-single-digit total returns (non-annualized) for the asset class in a baseline scenario over the next six months, supported by carry and moderate spread compression.

Investors need to be mindful that the range of possible outcomes at this stage is wide, and market volatility remains elevated. Risks to our constructive view include a worsening of financial stability in key developed and emerging markets, a deteriorating inflation outlook that forces central banks to tighten policy further, much weaker economic growth that leads to softer commodity prices and renewed US dollar strength, and various idiosyncratic risks such as growing US-China tensions and a further escalation in Ukraine.

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, high US Treasury yields, and global economic growth concerns. 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.

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 deliver further 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.

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

Asian bonds

Central scenario

JACI composite spread December 2023 target: 260bps

Over the past month, spreads on Asia credits have diverged from global peers. While Asia IG and HY spreads have widened 9bps and 74bps, respectively, EM sovereign and corporate spreads have tightened 15–25bps and US high yield spreads have tightened nearly 50bps. TProfit taking has moved the China high yield names, while a later-than-expected IMF package to Sri Lanka brought those bonds lower.

Within Asia credit, our conviction remains on the investment grade segment. Despite the volatility in rates, a 5.5% yield to maturity for JACI IG today is very similar to levels a month ago. In our base case of an orderly global slowdown as China provides an upside buffer, we expect the JACI IG spread to be range-bound over the next few months. Given where the yield is today, the spread would likely need to widen by over 50bps to erase the carry benefit for the next six months. And ieven if the benchmark yield falls by 50bps, we estimate the spread would have to widen by 100bps to cause a loss when holding it over the next six months. Even if such a situation arises, in our view, adding exposure at such levels would make more sense given IG spreads rarely stay at stressed valuations for long from a historical perspective.

However, for Asia HY, we think the journey ahead will still be bumpy. On the positive side, China property sales improved in March with sequential growth of nearly 50%. However, high-frequency data for April is already pointing to some giveback. Contract sales have also seen a very uneven recovery, with state-owned companies exhibiting better momentum while many private developers continue to struggle. We think bond selection is key when managing exposure in the Asia HY segment.

In summary, we believe the right strategy in the near term remains tilting to the high-quality investment grade segment. Here, we see more certainty and visibility on near-term returns with the peak of the Fed's hiking cycle approaching.

Asian bonds

Upside scenario

JACI composite spread December 2023 target: 230bps

Much faster recovery after full reopening: Recent China macro data confirms a broad-based recovery is underway. If the recovery is faster and stronger than expected in 2Q, there should be upside for the Asia credit space.

Sharp rebound in China housing sales: So far, policy has focused on supporting the liquidity of important Chinese property developers, but the housing sales recovery seems uneven and mixed. A quick rebound in housing sales later this year 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 if inflation comes off faster than expected.

Downside scenario

JACI composite spread December 2023 target: 330bps

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

Broader-scale crisis in banking sector: If there is further spillover from the latest banking sector stress, market sentiment will likely 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.

Gold

Preference: Most preferred

Central scenario

Gold December 2023 target: USD 2,100/oz

Jolted by the banking turmoil, spot gold prices have broken through the USD 2,000/oz barrier on several occasions in recent weeks for the first time since the immediate aftershock of Russia's invasion of Ukraine. While worries about a repeat of the global financial crisis have been largely assuaged by swift government action in the US and Switzerland, recent gyrations in credit default swap spreads illustrate it will take months, possibly years, for confidence to be fully restored.

Until now, lifting rates was the most obvious way for central banks to prevent elevated inflation risks from seeping into expectations. But recent events indicate policymakers must now combat inflation without risking financial stability. The tightening of US banks' lending standards could result in a quicker slowdown in activity, and if severe, bring forward US interest rate cuts. Importantly for gold, these developments mean real US interest rates have likely peaked. Gold demand typically rises and falls on shifting expectations of US real rates, the dollar, and the business cycle outlook.

A key feature of its most recent rally is the return of financial investors to the market, with exchange-traded funds (ETFs) as well as futures and options markets all recording the strongest demand in over a year. March was the first month of net inflows from ETFs in almost a year, and central bank demand has remained solid.

In the near term, gold will likely remain sensitive to short-term reversals in interest rate expectations, wider-reaching deposit guarantees, and US dollar strength. But with elevated uncertainty and the looming prospect of a recession, the downside risk to prices if a soft landing of the US economy materializes or Federal Reserve hawkishness returns looks significantly less than the potential upside if another shock were to occur.

With heightened uncertainty calling for meaningful hedges, we still see gold as a buy in a portfolio context. For silver, we think regional industrial activity crosscurrents will limit the metal's recent outperformance versus gold. With nearly double the price volatility and higher storage costs, silver is also a less appealing portfolio hedge than gold, in our view. We continue to favor platinum over palladium; the former is benefiting from substitution in autocatalysts at the expense of the latter thanks to lower prices. Also, power disruptions in South Africa may have a bigger impact on platinum than palladium mine supply.

Upside scenario

Gold December 2023 target: USD 2,300–2,400/oz

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

Downside scenario

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

The Fed becomes even more hawkish and hikes interest rates aggressively, strongly pushing up US real rates and triggering substantial outflows from gold ETFs.

Crude oil

Preference: Most preferred

Central scenario

Brent crude oil December 2023 target: USD 105/bbl

Voluntary production cuts are nothing new, but the scale of this round is unprecedented. Because they are voluntary, the nine participating OPEC+ group members have more flexibility to reverse the cuts if conditions warrant it. According to the Saudi energy ministry, the proposed cuts are a "precautionary measure aimed at supporting the stability of the oil market." With most of the nine members getting close to OPEC+'s production cap, we should see a substantial proportion of the promised cuts materialize. As we already expected Russian production to stay lower for longer, we think the effective drop in supply will be closer to 1 million barrels per day (vs. the announced 1.66mbpd). We continue to see Saudi Arabia and the other OPEC+ members keeping their hands on the oil reins and remaining in control of the market.

These cuts come on the heels of growing concerns over oil demand recovery following the banking sector turmoil, which could weigh on economic activity. It is also possible the surprise cuts were aimed at clearing the buildup of short futures and options positions in recent weeks. Moreover, the group may be seeking to tackle concerns about underinvestment after the Biden administration failed to follow through on its earlier pledge to refill US strategic petroleum reserves if WTI fell into the production cost curve of US shale producers (pledged price level to buy: USD 67–72/bbl; average breakeven cost of USD 62/bbl). Higher prices should prevent US shale producers from cutting investments.

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

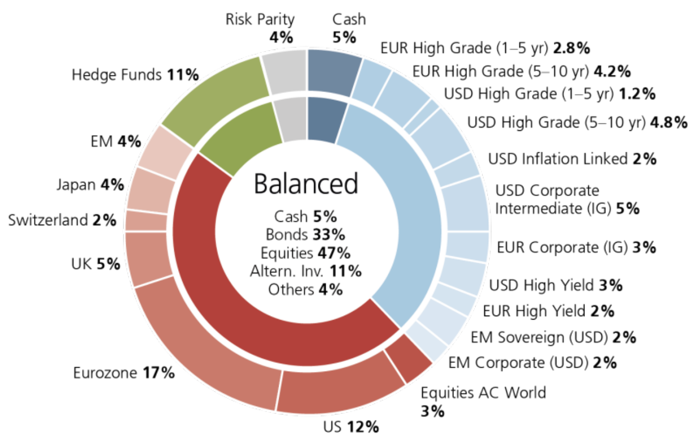
Downside risks include a deep recession or renewed extended mobility restrictions that weigh on the oil demand recovery. A hard landing for the Chinese economy in 2023 would also pose a downside risk, as emerging Asia is the engine of oil demand growth. Another concern is that capital discipline in the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

Section 4

Appendix

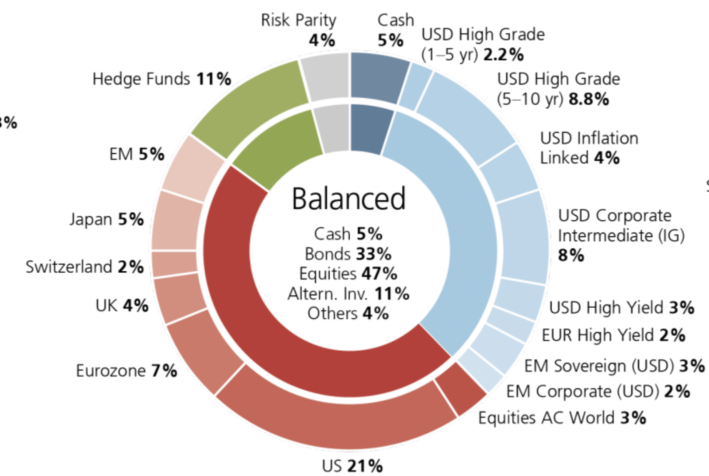
Strategic Asset Allocations (SAAs)

EUR (local portfolio with home bias)



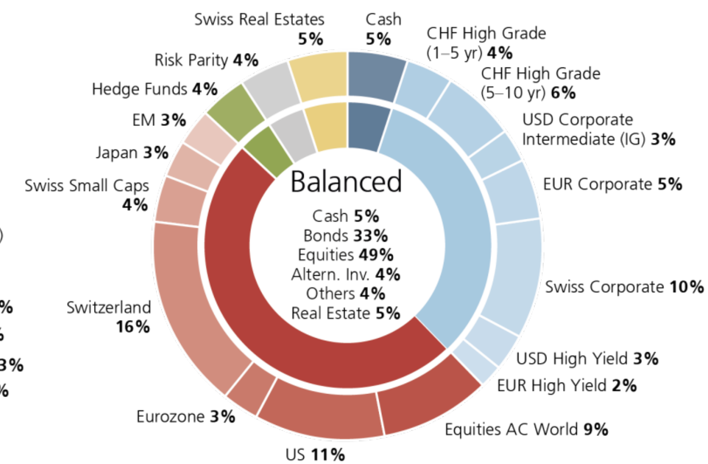
Note: Portfolio weightings are for EUR SAA with a home bias and a balanced risk profile. We expect a balanced EUR SAA to have an average total return of 5.3% p.a. and a volatility of 8.5% p.a. over the next 15 years.

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 6.6% p.a. and a volatility of 8.7% 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 4.9% p.a. and a volatility of 8.5% p.a. over the next 15 years.

Source: UBS, as of January 2023

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