UBS House View

Monthly Extended June 2023

Chief Investment Office GWM

Investment Research

Published

May 18, 2023

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 "

Please see the important disclaimer at the end of the document.

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.

UBS

Section 1

Investment views

UBS

Section 1.1

Asset class outlook

Asset class outlook

Asset allocation

In our global strategy, we keep global equities as least preferred and bonds most preferred. At this stage of the economic cycle, we think bonds offer better value and lower volatility than equities.

Within equities, we 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 view the US dollar as least preferred. Our preference is for the Australian dollar and the Japanese yen.

Equities

As policy rates are expected to stay higher for longer, we see limited room for global equity valuations to improve. We also see earnings at risk as economic growth decelerates and profit margins trend lower. We therefore believe that a cautious view on developed market equities is warranted.

Across regions, we keep US equities as least preferred, and maintain Australian and emerging market equities 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

Rate volatility remains high as we approach the end of global rate-hiking cycles.

Fixed income as an asset class presents an attractive value proposition and we maintain it as most preferred.

We continue to advocate for up-in-quality bias (high grade and investment grade) as the macroeconomic backdrop remains uncertain, corporate fundamentals have deteriorated, liquidity risks are high, and the spread pickup to move down in quality is not overly cheap.

Sovereign emerging market bonds will be sensitive to broader risk-on, risk-off moves. But given attractive valuations, China's growth recovery, and less aggressive Fed tightening, we see scope for outperformance.

Foreign exchange

We view the US dollar as least preferred. We expect it to weaken as markets prepare for the end of the rate-hike cycle.

We maintain the Japanese yen as most preferred. Japan's economy has improved enough for the Bank of Japan to eventually tighten its ultra-loose monetary policy, in our view. We still like the Australian dollar, as it should benefit from China's reopening and a hawkish central bank.

We remain neutral on all other G10 currencies. We think a lack of differentiation in these currencies is sensible at a time when the US is ahead of most major economies in terms of fighting inflation and other macro developments.

Commodities

Commodities have had a meaningful correction in 2Q. Our benchmark UBS CMCI index has been down around 4% this year but seen a broad drop of 3% so far in 2Q, led by energy and industrial metals, while precious metals increased. The key drivers have global growth concerns, high Russian crude exports, and disappointments in Chinese manufacturing leading indicators and credit data.

Still, we maintain our preference for commodities amid low speculator positioning, supply-side risks, renewed policy support for China's manufacturing and property sectors, and the presence of a super El Niño. All these signal upside price risks in 2H, in our view.

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 (eventually) up, equities down** • Severe downturn with global equities posting double-digit losses, credit spreads widening, and interest rates rising further at least initially.	
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.	• May prove more persistent than central banks and markets expect, until economic activity falls.	• *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 midyear then stay on hold for some months before rate cuts become more likely toward end 2023 or early 2024.	• Because of persistent inflation, another monetary tightening episode remains a risk later in 2023 or in early 2024 before a deeper recession follows.	
Economic growth	• Rebounds on the back of stronger private consumption, which is primarily driven by rising real disposable income. Outlook for corporate earnings improves.	• Western economies decelerate further led by the US, and experience subtrend or negative growth. China continues to accelerate. US consumption holds up well over the coming months due to a strong labor market and solid wage growth, but pressure from tight lending standards increasingly weighs on growth in 2H23. In Europe, lower energy prices and higher real incomes cushion the impact of higher policy rates.	• Falls sharply toward late 2023 or early 2024 owing to highly restrictive monetary policy. Chinese growth misses expectations.	• *Global: Oil price* • *US, China: PMI data, consumer confidence* • *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 systemic events. • *Tail risk*: US debt ceiling not raised by June; 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 Ukraine* • *Weapon shipments to Ukraine* • *Putin support polls* • *US sanctions on Chinese companies* • *Reverse-CFIUS process*

Analysts: Dirk Effenberger, Daniil Bargman

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	4,159	4,400 (+6%)	3,800 (–9%)	3,300 (–21%)
EuroStoxx 50	4,323	4,900 (+13%)	4,250 (–2%)	3,650 (–16%)
SMI	11,438	12,500 (+9%)	11,300 (–1%)	9,800 (–14%)
MSCI EM	976	1,100 (+13%)	1,050 (+8%)	800 (–18%)
US 10-year Treasury yield	3.58%	2.5%	3.25%	4.5%
US 10-year breakeven yield	2.23%	2%	2.25%	3%
US high yield spread**	479bps	300bps	550bps	850bps
US IG spread**	137bps	60bps	120bps	200bps
EURUSD	1.08	1.20 (+11%)	1.14 (+6%)	1.07 (–1%)
Commodities (CMCI Composite)	1,751	2,200 (+26%)	2,000 (+14%)	1,600 (–9%)
Gold	USD 1,982/oz	USD 2,300–2,400/oz (+19%)	USD 2,100/oz (+6%)	USD 1,800–1,900/oz (–7%)

* Spot prices as of market close of 17 May 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 be) 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 and income

With cash rates peaking, investors should act soon to own quality sources of income before markets start to price lower interest rates. Those who actively manage diversified income portfolios are well placed to take full advantage of the opportunities. Investors can lock in quality bond yields in high grade (government), investment grade, and sustainable bonds, as well as in select senior loans from financials. We also like emerging market bonds. In equities, we like quality income stocks and select opportunities to generate yield through structured investments.

Lock-in quality bond yields (high grade, investment grade, sustainable bonds, select financials), EM credit
Seek quality income (quality income equities, diversified fixed income solutions)
Yield generating structured investments

Source of funds
- 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 earnings, and relatively high valuations all present risks. Investors overexposed to US equities should diversify (we prefer emerging market stocks and select opportunities in Europe), implement strategies to protect against potential downside, and manage excess exposure to the tech sector.

Protect the downside in the US (structured investments with capital preservation features)
Manage tech exposure (software over semiconductors)
Invest in EM equities
Select European opportunities (Germany, consumer, small- and mid-caps)
Value

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

Position for dollar weakness

We have a least preferred view on the US dollar, and think investors should diversify their dollar cash or fixed income holdings. We believe the US growth premium over the rest of the world will erode in the coming months, and think other central banks will start cutting interest rates later than the Fed. On a relative basis, we prefer the Australian dollar as well as the Swiss franc, euro, pound, and yen. We also see gold as a beneficiary of a weaker dollar and falling US rates, as well as an attractive portfolio hedge at a time of financial and geopolitical uncertainty.

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 potentially 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 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)

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

Analysts: Kiran Ganesh, Sagar Khandelwal, Wayne Gordon

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 • 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 reflect the consequences of two years of poor real wage growth. Tighter credit standards may impact some lower-income households, but access to credit seems to be only a limited constraint on activity. The persistence of low unemployment helps prevent a more severe economic slowdown, as fear of unemployment is not driving precautionary savings. Labor market turnover does seem to have eased in major economies, which is likely to lower labor costs to companies.

Inflation

Headline inflation rates continue to surprise to the downside. Disinflation and deflation in the goods sector are also continuing. Energy is generally a disinflation force. Profit-led inflation is the main cause of current inflation, which is increasingly receiving political focus (as well as a source of consumer anger). The real-world cost of living faced by most consumers is lower than the headline consumer price inflation rate, supporting the idea of a more modest consumer slowdown.

Positive case (15%)

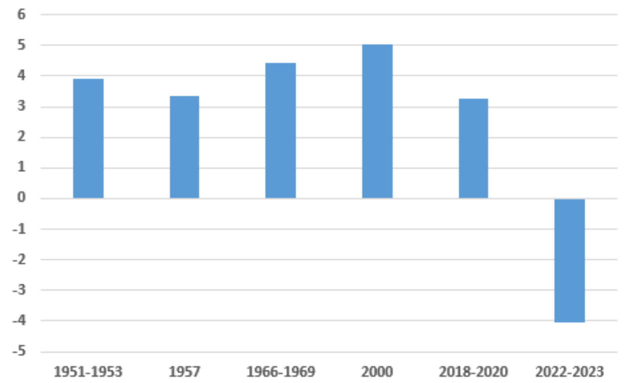
Although nominal wage growth slows, a faster decline in inflation restores stability in real wage growth more quickly, stabilizing consumer demand earlier than anticipated. Middle-income consumers experience below-reported inflation, which helps spending power in an important demographic. Unemployment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

Negative case (30%)

A more rapid tightening of credit standards produces a sharper 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.

Labor strength and weakness

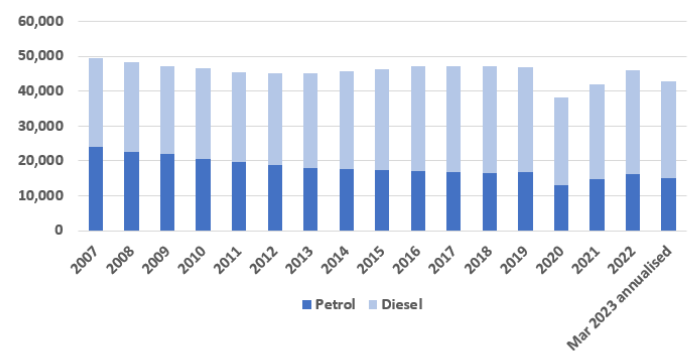
Average real US personal income growth in periods of sub-4% unemployment average



Source: Haver, UBS

UK demand patterns adjust

Volume of petrol and diesel sales below 2019 level, with flexible work arrangement changing price sensitivity



Source: HM Customs and Revenue via RAC Foundation

US economy – Recession risks high as credit tightens

Base case (60%)

Growth

Aggressive rate hikes by the Federal Reserve, combined with recent bank failures, have caused credit conditions to tighten, although relatively few companies have completely lost access to financing. The pace of economic growth is likely to continue to slow, and recession risks are high. Balance sheets are unusually strong for this stage of the business cycle, which should help to prevent a severe downturn.

Inflation

Inflation is clearly down from its peak but remains far above the Fed's 2% target. Inflationary pressure at the producer level has eased, and this should filter through into consumer prices over time. A better balance between supply and demand for labor is taking some pressure off wage growth despite the very low unemployment rate.

Positive case (15%)

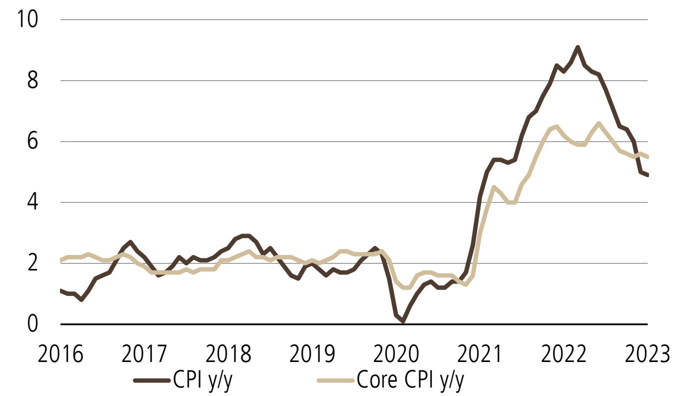
Better labor supply allows businesses to fill in their open job positions. Wage growth slows to a more moderate pace and energy prices stay low, helping to bring inflation down while growth remains robust. The Fed sees enough progress toward its mandates to stop raising rates but does not cut rates before the end of 2023.

Negative case (25%)

The recent stress in the financial system creates downside risks in an environment where banks were already 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 should continue trending lower

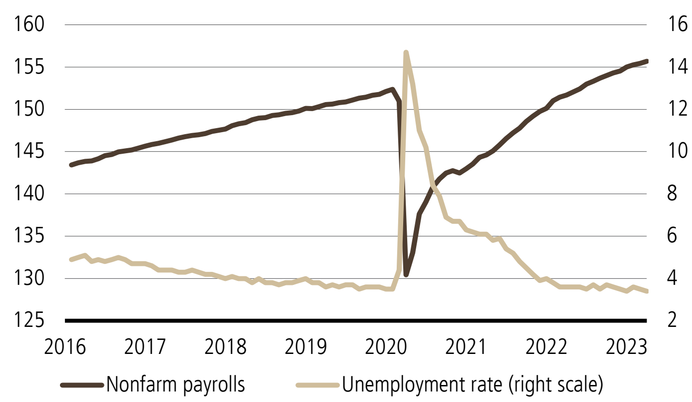
CPI and core CPI, y/y change in %



Source: Bloomberg, UBS

Job growth moderating, unemployment rate low

Nonfarm payrolls in millions, unemployment rate in %



Source: Bloomberg, UBS

Eurozone economy – Further tightening from the ECB

Base case (60%)

Growth

The Eurozone economy was surprisingly 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, but weaker demand resulting from tight monetary policy will have a greater bearing on keeping 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 and high wage growth will likely force the ECB to hike further. We look for deposit hikes through to June, with the peak around the 3.75% level. Beyond this, slower lending growth should allow for a pause in the hiking cycle. Interest rate 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.

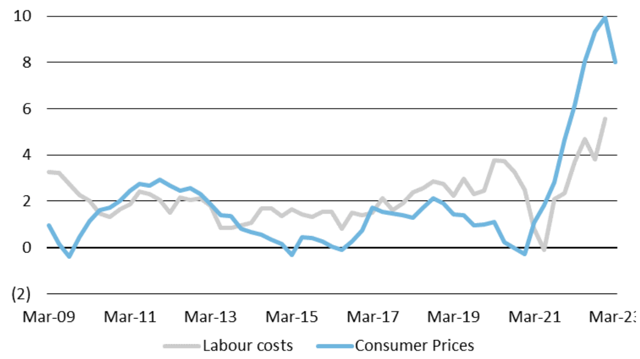
Negative case (25%)

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.

Although headline inflation is falling, wage pressures persist

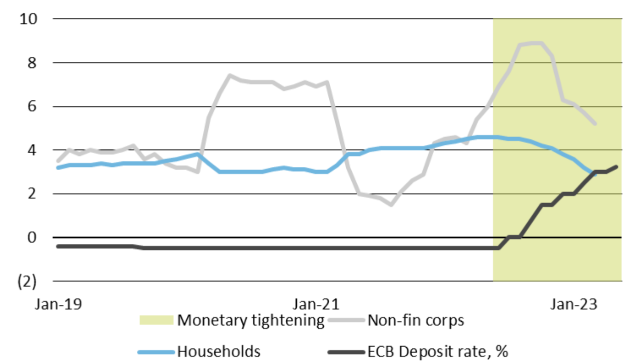
Year-on-year, %



Source: Haver Analytics, UBS

Monetary tightening is already causing lending growth to slow

Year-on-year, %



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 subpar Swiss GDP growth this year. However, as an energy shortage has become very unlikely, a recession should be averted.

Inflation

Inflation retracted to 2.6% in April 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 Swiss National Bank raised its policy rate by 50 basis points to 1.5% and hinted at further tightening ahead. We expect another hike in June (25bps) for a terminal rate of 1.75%. At the same time, the SNB is selling foreign exchange reserves to help ease imported inflationary pressure. Interest rate cuts are unlikely until 2024.

Positive case (20%)

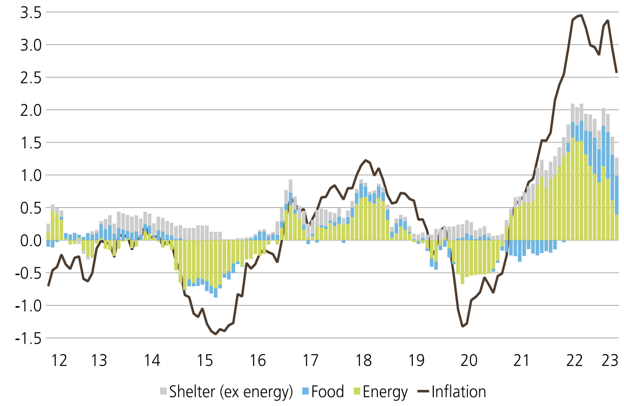
Better global growth momentum: A swift calming of the turmoil in the banking system and reduced inflationary pressures boost global demand. Switzerland benefits from the stronger global backdrop and a weakening of the safe-haven Swiss franc.

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 continued to fall in April

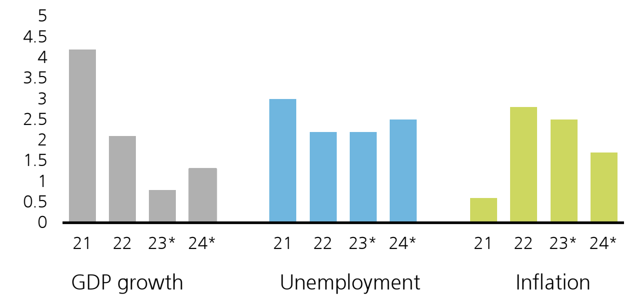
Year-over-year change in Swiss CPI and contribution of selected components, in %



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 – Consumption-led recovery to continue

Base case (70%)

Growth

Economic data for April showed a softening in momentum after a strong 1Q. Retail sales surged 18.4%, led by auto and services. Investment growth for the January-to-April period eased to 4.7%, dragged by the property sector despite resilient infrastructure and manufacturing. Export growth also remained resilient at 8.5%, driven by Southeast Asia, Russia, and Africa. January-to-April credit growth stabilized at 10% while household loans weakened. We expect full-year GDP growth of at least 5.7%.

Inflation

CPI inflation fell to 0.1% year-over-year in April due to falling food and energy prices. We expect it to pick up to 2% on average. Producer price deflation is likely to persist before approaching 0% by year-end.

Positive case (20%)

Consumption recovers strongly and the property market rebounds faster than expected.

Geopolitical risks remain contained without a material spillover effect.

The US economy manages a soft landing.

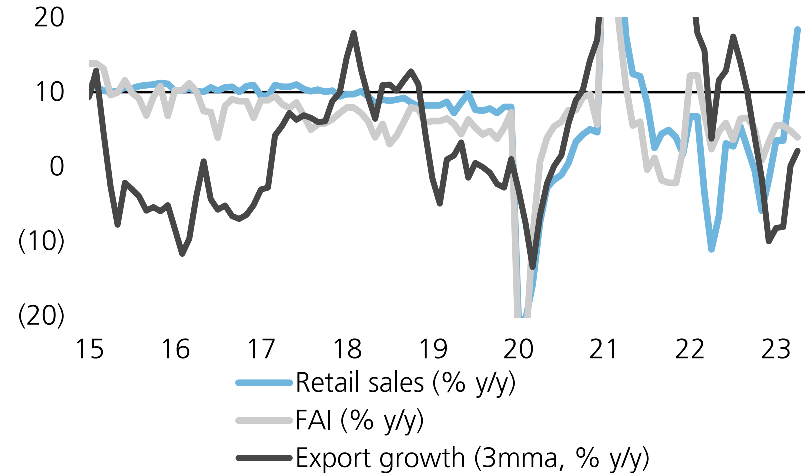
Negative case (10%)

Property activity is weaker than expected.

The US falls into a deep recession due to the lagged effect of rate hikes.

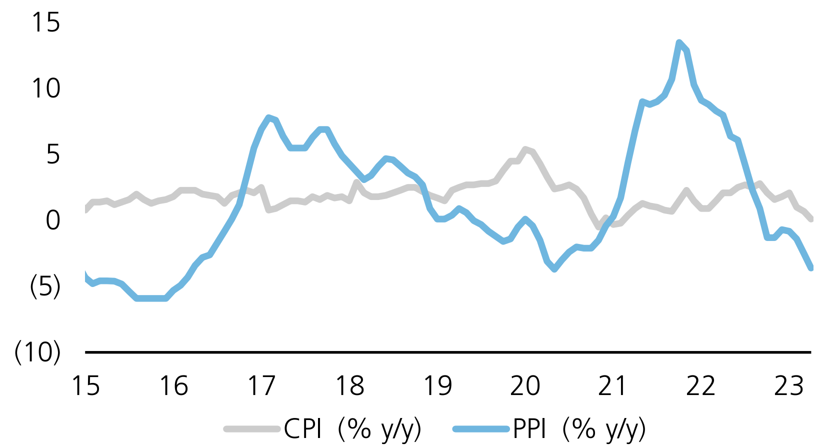
The US imposes much stricter restrictions on China's tech sectors.

Recovery led by consumption



Source: CEIC

CPI inflation to stay mild; PPI deflation to persist



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 strategy, 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 showcased 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 currently—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, in our view. The equity risk premium continues to fall and currently stands at 4.8%, 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 8.5% (back to 10-year highs), consistent with future negative returns versus high-quality sovereign and corporate bonds.

Earnings risks skewed to the downside. The dip in leading economic indicators and tightening credit conditions raise the risk of an earnings recession this year. 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 (i.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, a more than 8% discount to the 10-year average and below 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 compared with developed countries, and valuations look appealing to us.

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, Ivan Peric

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. The valuation gap between IT and the global equity benchmark remains high (IT trades at 22% premium to history and 46% 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.

Analysts: Claudia Panseri, Adrian Zuercher, Mark Andersen, Ivan Peric

Bonds

Market volatility remains elevated as financial instability concerns have now joined inflation and growth 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 and pockets of commercial real estate. 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, although do acknowledge that China's reopening has underwhelmed thus far. There is an element of credit beta sensitivity 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 are neutral the asset class given that relative to the higher quality segments, we see risks of spread widening and decompression 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, although we do acknowledge that the recovery is more modest than originally anticipated. 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 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 7.2%.

FX

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 the Japanese yen at most preferred. 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 should materialize within 2H23. So, we see the yen as a longer-term, but high-potential outperformer.

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 continued to perform well over the past month, benefiting from the Fed likely having reached its peak policy rate. Carry currencies, our favorites in the emerging market space, look set to further benefit from a setup where near-term large scale easing looks unlikely, the global economy is growing in a subdued fashion, and investors are looking for options to gain some additional yield. The Mexican peso and Czech koruna are valid options in EMEA and Latin America, in our view. Not all currencies performed well though, with the South African rand likely to continue to struggle in the near term with domestic challenges. Global drivers can also temporarily weigh again on emerging market currencies, as the market continues to jump from narrative to narrative. Key risks stem from inflation proving to be more persistent than currently expected and the global economic slowdown morphing into a recession.

In Asia Pacific, we maintain our view 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 largely done with its rate-hike cycle.

Commodities

We hold a most preferred view on commodities, crude oil, and gold.

Expectations curbed for oil prices in 2H. We have trimmed our forecast for Brent prices from USD 105/bbl to USD 95/bbl by year-end given higher-than-expected supply and as recession fears keep investors on the sidelines. Several OPEC+ countries have voluntarily removed barrels from the market, and demand from the Northern Hemisphere is set to rise during the summer. We therefore expect larger inventory draws to materialize and bring investors back to the oil market.

Gold supported by solid investment and central bank demand. The first quarter saw strong bar and coin demand, along with central banks continuing to diversify into the yellow metal. We expect gold prices to hit a record high as US policy rates peak and then decline over the next 12 months, and as the US dollar weakens.

China concerns weighing on industrial metals. Copper prices dropped to around USD 8,200/mt and most other industrial metals have also fallen as concerns mount regarding the sustainability of China's industrial recovery. New loans in China were the lowest in six months following a strong January–March period, while growth in total social financing fell well below expectations. That said, demand for industrial metals has been relatively steady this year, and the recovery in property sales has beaten expectations. While we do not foresee large-scale stimulus packages from the central government for now, direct consumption support via tax breaks for investment is possible. This and renewed supply-side issues could push copper prices back toward USD 10,000/mt by 1H24.

USDA sees more grain and oilseed supplies. As is customary in May, the United States Department of Agriculture (USDA) introduced its first supply and demand estimates for key crops such as wheat, corn, and soybeans over the next year. The numbers were bullish for wheat but bearish for corn and soybean. Given the heightened risk of El Niño, we think the USDA yield estimates reflect a best-case scenario. Historically, during El Niño years, yields for soft commodities and key food grains like wheat and rice have been below trend. Hence, we see upside risks to the prices of these commodities in 2023–24.

Preference: Most preferred

CIO themes

Commodities: Reimagining commodity investing

Given the longer-lasting bull and bear markets in commodities and the unique characteristics and drivers of individual sectors and structural trends, we think it makes sense for those who invest in the sector to pursue an actively managed strategy. Our 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 do not have a lot of predictive power. Due to falling oil inventories, the futures curve is downward-sloped, meaning longer-dated contracts are cheaper. Dwindling 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 European equities. While continuous volatility across the banking sector and its impact on credit conditions could take a toll on economic growth in the second half of the year, downside risks to earnings seem partially priced in with valuations looking fair to us.

Corporate earnings for the first quarter are coming in ahead of expectations and there are early signs that profit margins are starting to stabilize thanks to lower commodity prices and cost-cutting. Strong corporate pricing power has resulted in a more modest earnings recession than in previous economic downturns, in our view, but we nevertheless still see some downside risk to consensus estimates. We forecast earnings falling 5% in 2023 (consensus +2%) and growing 5% in 2024 (consensus +9%).

At 12.4x forward P/E, current valuations are at a 7% discount to history. This looks fair to us in the context of above-average interest rates and modest downside risk to consensus earnings forecasts. We believe equities can withstand modest downgrades as this is 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 a combination of beneficiaries of improving trends and attractive value opportunities. China's reopening and falling inflation should boost the consumer sectors, and we see attractive value in Germany, real estate, and small- and mid-caps, which should be supported by falling gas prices, peaking interest rates, and bottoming growth expectations. In the medium term, we like Europe's greentech and digital leaders as beneficiaries of government investment plans.

CIO themes

Eurozone small- and mid-caps

We see attractive value in small- and mid-sized companies, and expect inflections in the macro outlook to emerge in the second half, supporting these companies more than large-caps.

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.

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.

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.

Sector Preferences:

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

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

US equities

Preference: Least preferred

Central scenario

S&P 500 December 2023 target: 3,800

We continue to view the risk-reward in US equities as unattractive over the coming months. A number of indicators are suggesting caution ahead. First, the yield on 2-year Treasuries has been higher than 10-year Treasuries (an inverted yield curve) for over a year. Over the last 50 years, a recession has always occurred after a yield curve inversion. Based on the average time from inversion to recession, this risk may become more pronounced near the end of the year. Second, banks are tightening lending standards, which will likely keep downward pressure on corporate profits. Therefore, bottom-up consensus expectations for an acceleration in corporate profit growth in the second half of the year look aggressive. Furthermore, it would be unusual to experience an economic soft landing while banks are tightening access to capital. Third, while the Fed may be done hiking interest rates, it will be a long time before it starts cutting rates because inflation remains too high. Market expectations for rate cuts before the end of the year look aggressive.

With the S&P 500 trading at a forward P/E of 18x, the risks outlined above do not appear to be reflected in equity market valuations. Not only is 18x higher than average, but valuations higher than these levels are also typically associated with bottom-up consensus next-12-months earnings growth expectations of 14%, on average, compared to 5% today. With the outlook uncertain, we think it is helpful to gauge the upside versus downside risks. In a soft landing, we think the S&P 500 could rise to 4,400 by year-end (18x P/E, USD 245 EPS in 2024) which is about 5–10% higher than current levels. However, in a hard landing, the index could fall by 20% to 3,300. The upside opportunity does not appear compelling relative to the downside risks and the reasonable returns available in the fixed income market. Our year-end price target remains 3,800.

All that being said, we acknowledge that the outlook could be a bit brighter by the middle of next year and introduce a June 2024 S&P 500 price target of 4,300. If the US economy slips into a recession, investors could already be looking forward to economic recovery by the middle of next year. Alternatively, in the soft-landing scenario, the lagged effects of Fed rate hikes will likely be in the rearview mirror, suggesting fewer downside risks. Overall, the range of outcomes for June 2024 remains wide, and we will continue to be guided by our assessment of risk versus reward.

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.

Analysts: David Lefkowitz, Nadia Lovell, Matthew Tormey

US equities

Upside scenario

S&P 500 December 2023 target: 4,400

Resilient economic growth: High wages attract more workers to return to the labor force. US economic growth proves to be durable 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 the global economy to slow further, with developed market GDP growth hovering close to 0% at various points throughout the year. We also anticipate a mid-single-digit decline in UK earnings this year. Due to the expected year-over-year changes in underlying commodity prices, we think the energy and mining sectors will see negative earnings growth this year, as will consumer discretionary given the pressure on the consumer from inflation and interest rates. Another potential rate hike from the Bank of England in June would be helpful for UK financials, but would likely be offset by other factors such as tighter lending conditions or greater competition. Meanwhile, we anticipate sterling will strengthen somewhat over the course of the year, which would also weigh on the international earnings of the FTSE 100. However, much of this grim outlook is already priced in by the UK equity market.

The FTSE 100 trades on a 12-month forward P/E of 10.6x—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 drop 4% over the 2022–23 period, supported by price increases to help offset 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 be limited in 2023, but is expected to increase 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 25-year average, which we think is just about fair 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 25-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 modestly 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 low-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 high-single-digit percentage in 2023 versus 2021, and the SMI would thus be trading at an unjustified premium of well over 10% to its 25-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 this month while awaiting clarity from the 1Q23 earnings season, which could be an important near-term catalyst for Chinese and other emerging market stocks.

The MSCI Emerging Markets index's valuation, at 11.8x 12-month forward P/E, is largely in line with the 10-year average and is at a 35% discount to the S&P 500. On a price-to-book basis, the discount to the S&P 500 is even deeper at 61% versus its long-term average of 53%. In our view, these valuation discounts are not justified by fundamentals—which we expect to remain resilient relative to the developed market peers—and should tighten in the coming months. Some important external headwinds are also fading as interest rates peak and the US dollar weakens. By contrast, we expect US equities to derate from 18x 12-month forward P/E currently, which does not reflect the weakness in US economic and earnings growth as suggested by recent data.

A strong US dollar, an uptick in geopolitical tensions, a pronounced US recession, and a slower-than-expected economic recovery in China are risks to the outlook for emerging market equities.

Within emerging markets, 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 is likely to lead to a turnaround in the current negative earnings revisions and should drive a market rebound after a near four-month long profit-taking. We also continue to like Thailand, where easing inflation and recovering inbound tourism should continue to support an earnings recovery in 2Q23 and see the recent general election as an important clearing event. 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: A 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 (ESG) 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.

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 allocation. The TOPIX has outperformed the MSCI World year-to-date, with the performance in April particularly notable after a price correction in March due to the US/EU banking sector turmoil. Historically, Japanese equities tend to perform well from March to June given the full-year results season. In addition to the seasonality, greater pressure on low P/BV stocks to increase their corporate value/ROE from the Tokyo Stock Exchange is leading to expectations of higher share buybacks and dividend payouts this year. While we expect corporate earnings growth to flatten in FY2023 (ending 31 March 2024) from high-single-digit growth in FY2022, we believe the downside is well protected for Japanese stocks in 2023.

There may be the risk of a temporary pause in performance after the FY2022 results season, but we believe the downside is limited given: 1) A bottoming of consensus earnings revisions; 2) stabilizing FX and a stronger yen outlook are favorable for international investors (after 40% JPY depreciation vs. the USD in the last two years), which could lead to money inflows; 3) the push to increase corporate value by the Tokyo Stock Exchange, leading to increased share buybacks and higher dividend payouts; and 4) undemanding valuations (TOPIX P/E at 13.6x in line with 10-year average).

We think Japan's reopening will continue to provide investment opportunities in 2023. Japan's reopening came a lap behind most other countries, with the government only opening borders last October. A subdued yen is an impetus to visit Japan, and China's reopening will likely boost Chinese tourist arrivals.

We also see opportunities in value stocks due to the Tokyo Stock Exchange's push for companies to increase ROE and corporate value. We expect higher dividend payouts and share buybacks in the near term and potentially business portfolio restructurings in the medium term.

Upside scenario

TOPIX December 2023 target: 2,300

Stronger-than-expected re-opening spending: A full reopening of Japan's borders and the expected increase in Chinese visitors 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 would lead to stronger top-line growth for Japanese corporate earnings.

Higher ROE: The possibility of business portfolio restructurings or increased investments with the aim to increase ROE pressured by the Tokyo Stock Exchange could be a re-rating catalyst for Japanese equities in the longer term.

Downside scenario

TOPIX December 2023 target: 1,700

Recession: The US slipping 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.

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

Asian ex-Japan equities

Central scenario

MSCI Asia ex-Japan December 2023 target: 680

We keep a neutral stance on MSCI Asia ex-Japan. Certain macro indicators are showing early signs of the cycle bottoming, such as the shipment over inventory ratio and real M1 growth. Regional PMI also remains in a stable range, with the average of 10 countries above 50 for four months in a row. But the negative PPI is a headwind for corporate profitability and there is also generally vulnerable risk sentiment exposed to a potential US correction. We expect the market to be volatile in the next couple of months. We stay most preferred on Korea, China, and Thailand, and least preferred on India, Malaysia, and Singapore.

We like Korea for the combination of its valuation, the semiconductor cycle bottoming out, and high sensitivity to a lower USD. History suggests that even in a slowing US growth environment, Korea can still perform well as long as there is no severe US recession. On the flows side, foreign institutional investors continue to like Korean equities. For Thailand, we see macro conditions staying on a recovery path. Its current account is turning stronger (USD 1.3bn surplus as of end-Feb vs deficit in the previous month). PMI momentum is also strong—April data jumped to a record 60.4 from 53.1 in March, with indexes for output, new orders, purchasing, and input stocks all surging to new highs.

For China, we acknowledge the latest April economic activity data are weaker than expected. But we believe 1Q23 earnings will be an improvement on 4Q22, which should help to lift the currently very low confidence on Chinese assets. Moreover, China looks underpriced versus the rest of Asia ex-Japan given the relative earnings strength. In the near term, we will closely monitor Chinese tech companies' earnings results, and how markets react to them. Government stimulus is also a key factor that could materially improve consumer sentiment.

On the flip side, while India has pared some of its early losses this year, we think the near-term upside potential remains less attractive than the broader Asia ex-Japan region, considering the expectation of a US equity market correction in the near future. For Malaysia, we continue to see some macro headwinds. Manufacturing PMI stood at 48.8 and remained in contraction territory for the eighth straight month. Demand remained generally subdued, pressuring firms to limit production and scale back their purchasing activity. Our key concern for Singapore is on banking sector, as forward guidance is still cautious given net interest margins have likely peaked. Loan growth expectations have also been moderated and demand for wealth management margin financing is muted.

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 (Southeast Asian) markets.

Key drivers include relative earnings strength, policy easing in China, and attractive valuations.

Main risks include a commodity super-cycle, new lockdowns in Southeast Asia, 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 going forward, 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 like high grade 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 pickup 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. High grade 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 prove unable to withstand the policy tightening required to subdue inflation—a banking crisis being a case in point.

Well-anchored inflation expectations: Weak demand helps inflation drop quickly, with energy prices falling and the labor market losing 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 at an early stage. 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 federal 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. Looking ahead, we think return prospects in higher quality fixed income look appealing given elevated all-in yield levels and as major DM central banks come closer to the end of their hiking cycles.

While rate volatility has moderated, it is likely to remain elevated as concerns shift from inflation to economic growth. 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 in March as deteriorating risk sentiment related to concerns about 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.

On US IG fundamentals, we regard current credit metrics as solid, with improved levels of interest 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 slightly above 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 are positives for forward-looking returns as this should provide a sizable offset to potential further credit spread widening.

As for EUR IG, the average yield sits at 4.2%. Index spreads are now trading at 172 basis points, above their long-term average. This is broadly consistent with the growth outlook, which is expected to remain subdued in the near term. The European Central Bank remains committed to lowering inflation and is likely to raise rates again in June as price pressures—though falling—will likely still be uncomfortably high, while monetary policy tightening is working its way into the economy, as evidenced by tightening lending standards and slowing lending growth.

We maintain an up-in-quality bias and think IG bonds stand to deliver attractive risk-adjusted returns, given all-in yields and the shifting balance between inflation risks and growth risks.

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

The sharp move higher in global interest rates resulted 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 close underweight positions and actively consider 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 central bank 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 2.4%.

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 8.7% and 7.4% (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 ongoing recovery in the Chinese economy and hence relatively stronger growth than the developed world, expected higher commodity prices as well as prospects for a weaker USD.

China registered stronger-than-expected first quarter growth, led by consumption. Looking ahead, we think an increase in consumer confidence will be important to sustain the recovery. In this regard, we note that monetary policy has become more stimulative, while policy support may also ramp up on housing, consumption, and employment to boost private sector confidence. 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 is likely to weaken, 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 8.5%, while the yield on the corporate index (CEMBI Diversified) is around 7.2%. We expect mid- to high 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 of the war 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.

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 emerging market 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 emerging market assets.

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

Asian bonds

Central scenario

JACI composite spread December 2023 target: 260bps

Over the past month, the Asia High Yield (HY) spread has widened 107.5 bps, driven largely by China HY, while the Asia Investment Grade (IG) spread has remained more resilient. As a result, Asia HY underperformed IG for a further month. We thin it is probable that this trend will continue in the coming weeks given heightened global risk sentiment due to the possibility of a US recession and ongoing Chinese property developer defaults in the offshore USD bond space.

Within Asia credit, we favor the investment grade (IG) segment. We believe IG bonds could provide better risk-reward in the near term. The 5.3% yield to maturity and subdued new issues YTD are keeping demand strong for existing bonds. The current spread valuation level is also attractive in our view, trading at 80th percentile (2014 to now). For China IG, risk factors like heightened geopolitical tensions and LGFV debt concerns could trigger some spread widening. But overall, we still feel comfortable holding high quality Asia IG bonds.

For Asia HY, on the other hand, we think the journey ahead will remain bumpy. The recent high frequency data shows moderation on property sales momentum in China after a temporary pick up in March. The recent KWG default, despite its maturity extension in 2022, hit risk sentiment toward the sector. Dalian Wanda Group—the only property name that has managed to issue bonds this year—also appears to be struggling. Bloomberg reports Dalian Wanda is in talks with major Chinese banks on a plan to extend principal repayments for some onshore borrowings. Overall, we see few positive catalysts in the near term unless property sales/investment data turns better than market expectations. We think bond selection is key when managing exposure in the Asia HY segment.

Upside scenario

JACI composite spread December 2023 target: 230bps

Much faster recovery after full reopening: If China recovers faster and stronger than expected in the coming months, we see upside in Asia credits.

Sharp rebound in China housing sales: So far, policy has focused on supporting the liquidity of important Chinese property developers, but housing sales recovery seems 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 falls faster than expected.

Downside scenario

JACI composite spread December 2023 target: 330bps

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

Increased 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 Asia assets.

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

Gold

Preference: Most preferred

Central scenario

Gold December 2023 target: USD 2,100/oz

Gold prices came off recent highs after US President Joe Biden expressed confidence in avoiding a government default as debt ceiling negotiations move forward. At around USD 1,950/oz at the time of writing, gold is now more than 4% below its year-to-date high reached earlier this month. However, that still leaves the yellow metal 7.4% higher YTD and on track to break its all-time high later this year. Multiple medium- to longer-term drivers support our view.

First, central bank demand should remain robust. Last year marked the 13th consecutive year of net gold purchases by global central banks and the highest level of annual demand on record. Based on the 1Q23 data from the World Gold Council, we continue to expect central banks to buy around 700 metric tons of gold this year, which is much higher than the average over the last decade. We think central bank buying continues amid heightened geopolitical risks and a desire to diversify.

Second, broad US dollar weakness also supports gold. We believe headwinds to the US dollar should intensify as we approach a pivot by the Federal Reserve, possibly in 2H. The European Central Bank, by contrast, still has more tightening to go. Finally, rising US recession risks can prompt safe-haven flows, particularly through ETFs and physical demand. So, we keep our forecast of USD 2,100/oz by year-end and forecast it to be USD 2,250/oz by June 2024. For us, gold should be seen as longer-term hedge in a portfolio context.

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 95/bbl

Oil prices bounced in early April after several members of the OPEC+ group announced voluntary production cuts starting in May, but have since traded close to the lows seen in early 2022. While the International Energy Agency (IEA) in its latest oil market report released on 16 May indicated that demand remains robust—we estimate current demand is around 101 million barrels per day (mbpd)—futures and options positioning data show that investors remain on the sidelines and unwilling to add long positions.

Many market participants had a positive price outlook at the start of this year, but investors have avoided the underlying over recession fears in the US and, more recently, weak economic data out of China (although the IEA estimates that Chinese demand hit a record high of 16mbpd in March). Other factors include doubts around Russia's production cut pledge of 0.5mbpd in recent months in view of elevated oil exports, as well as higher crude exports from some Middle Eastern oil producers in April. This has led to concerns over weaker production compliance, but higher exports are likely due to lower domestic demand. Also of note is that the oil market still needs to digest the sizable inventory build of 3mbpd in January, a result of the mild winter in the Northern Hemisphere and a supply increase in 2H22. The increase in inventories, which were boosted by the release of strategic oil reserves last year, has weighed on prices since mid-2022. And we expect to see larger inventory draws in the months ahead. With lower oil production in May—caused by the OPEC+ voluntary production cuts and wildfires in Canada—we anticipate oil production to fall back toward 100mbpd in 2Q23 from around 101mbpd in 1Q.

At the same time, demand is likely to approach 102mbpd in June, supported by higher demand in the Northern Hemisphere (fueled by the driving season in the US) and the Middle East (oil used to generate power to cool down buildings). We expect the oil market to be undersupplied by nearly 1.5mbpd in June. Against this backdrop, we think investors will return to the oil market as larger inventory draws become visible, thus supporting prices. So, we retain a positive price outlook. But as we now anticipate Russian oil production to stay at around 9.6mbpd and no longer fall toward 9mbpd, we have curbed our forecasts: We now see Brent at USD 90/bbl and WTI at USD 85/bbl by end-September (cut by USD 15/bbl), and at USD 95/bbl and USD 90/bbl, respectively, by both end-December and end-March 2024 (down USD 10/bbl).

We continue to advise risk-taking investors to add long exposure via first-generation indexes or longer-dated Brent contracts, or to sell Brent's downside price risks. Our preference remains to gain exposure to oil via Brent and not WTI. With elevated political uncertainty, the US administration could, for example, ban exports of refined products (and eventually crude). While we see a low probability of this event, such a decision could weigh heavily on US prices.

Analysts: Giovanni Staunovo, Dominic Schnider, Wayne Gordon

Crude oil

Upside scenario

Brent crude oil December 2023 target: USD 120–150/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

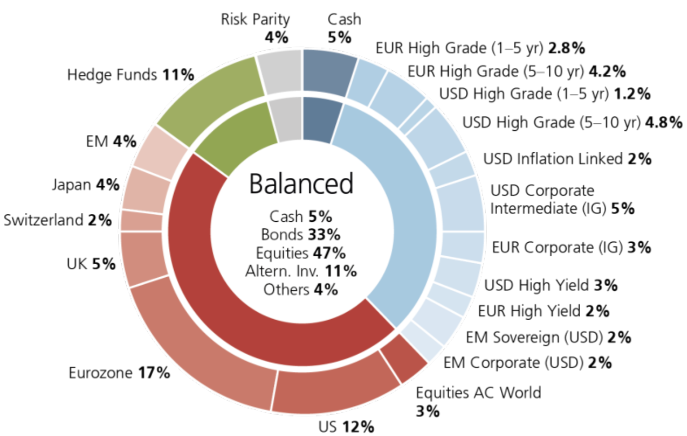
Downside risks include a deep recession or renewed extended mobility restrictions that weigh on the oil demand recovery. A hard landing for the Chinese economy in 2023 would also pose a downside risk, as emerging Asia is the engine of oil demand growth. Another concern is that capital discipline in the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

Section 4

Appendix

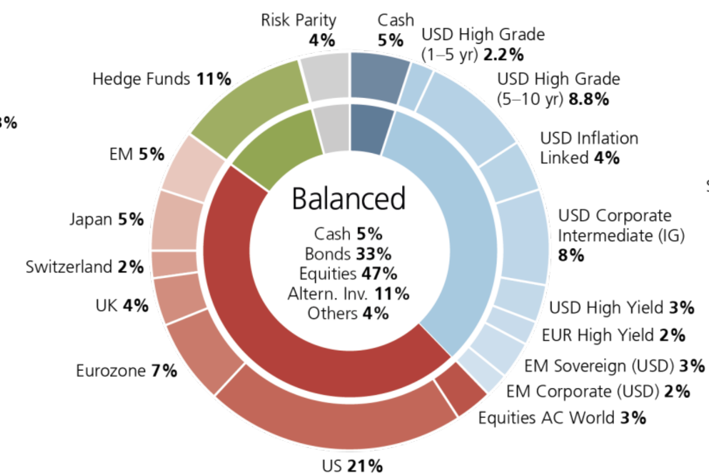
Strategic Asset Allocations (SAAs)

EUR (local portfolio with home bias)



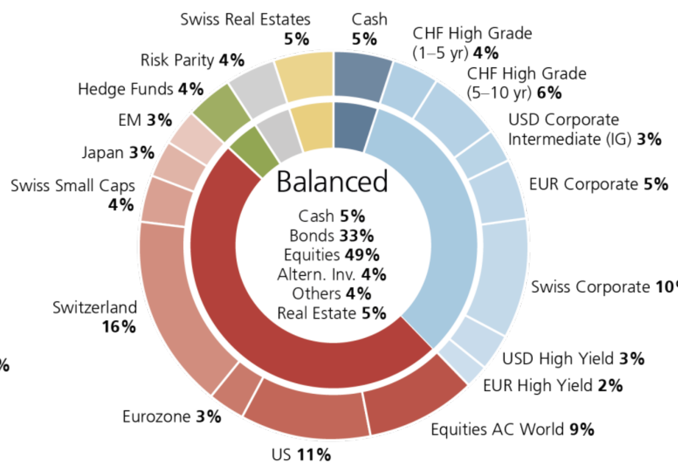
Note: Portfolio weightings are for EUR SAA with a home bias and a balanced risk profile. We expect a balanced EUR SAA to have an average total return of 5.3% p.a. and a volatility of 8.5% p.a. over the next 15 years.

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

Contact list

Global Chief Investment Officer GWM

Mark Haefele
mark.haefele@ubs.com

UBS CIO GWM Global Investment Office

Global Asset Allocation
Adrian Zuercher
adrian.zuercher@ubs.com

Global Asset Allocation
Mark Andersen
mark.andersen@ubs.com

UBS CIO GWM Regional Chief Investment Offices

US
Solita Marcelli

APAC
Min Lan Tan
min-lan.tan@ubs.com

EMEA
Themis Themistocleous
themis.themistocleous@ubs.com

Switzerland
Daniel Kalt
daniel.kalt@ubs.com

Risk information

UBS Chief Investment Office's ("CIO") investment views are prepared and published by the Global Wealth Management business of UBS Switzerland AG (regulated by FINMA in Switzerland) or its affiliates ("UBS").

The investment views have been prepared in accordance with legal requirements designed to promote the **independence of investment research**.

Generic investment research – Risk information:

This publication is **for your information only** and is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product. The analysis contained herein does not constitute a personal recommendation or take into account the particular investment objectives, investment strategies, financial situation and needs of any specific recipient. It is based on numerous assumptions. Different assumptions could result in materially different results. Certain services and products are subject to legal restrictions and cannot be offered worldwide on an unrestricted basis and/or may not be eligible for sale to all investors. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness (other than disclosures relating to UBS). All information and opinions as well as any forecasts, estimates and market prices indicated are current as of the date of this report, and are subject to change without notice. Opinions expressed herein may differ or be contrary to those expressed by other business areas or divisions of UBS as a result of using different assumptions and/or criteria.

In no circumstances may this document or any of the information (including any forecast, value, index or other calculated amount ("Values")) be used for any of the following purposes (i) valuation or accounting purposes; (ii) to determine the amounts due or payable, the price or the value of any financial instrument or financial contract; or (iii) to measure the performance of any financial instrument including, without limitation, for the purpose of tracking the return or performance of any Value or of defining the asset allocation of portfolio or of computing performance fees. By receiving this document and the information you will be deemed to represent and warrant to UBS that you will not use this document or otherwise rely on any of the information for any of the above purposes. UBS and any of its directors or employees may be entitled at any time to hold long or short positions in investment instruments referred to herein, carry out transactions involving relevant investment instruments in the capacity of principal or agent, or provide any other services or have officers, who serve as directors, either to/for the issuer, the investment instrument itself or to/for any company commercially or financially affiliated to such issuers. At any time, investment decisions (including whether to buy, sell or hold securities) made by UBS and its employees may differ from or be contrary to the opinions expressed in UBS research publications. Some investments may not be readily realizable since the market in the securities is illiquid and therefore valuing the investment and identifying the risk to which you are exposed may be difficult to quantify. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS, into other areas, units, divisions or affiliates of UBS. Futures and options trading is not suitable for every investor as there is a substantial risk of loss, and losses in excess of an initial investment may occur. Past performance of an investment is no guarantee for its future performance. Additional information will be made available upon request. Some investments may be subject to sudden and large falls in value and on realization you may receive back less than you invested or may be required to pay more. Changes in foreign exchange rates may have an adverse effect on the price, value or income of an investment. The analyst(s) responsible for the preparation of this report may interact with trading desk personnel, sales personnel and other constituencies for the purpose of gathering, synthesizing and interpreting market information.

Tax treatment depends on the individual circumstances and may be subject to change in the future. UBS does not provide legal or tax advice and makes no representations as to the tax treatment of assets or the investment returns thereon both in general or with reference to specific client's circumstances and needs. We are of necessity unable to take into account the particular investment objectives, financial situation and needs of our individual clients and we would recommend that you take financial and/or tax advice as to the implications (including tax) of investing in any of the products mentioned herein.

This material may not be reproduced or copies circulated without prior authority of UBS. Unless otherwise agreed in writing UBS expressly prohibits the distribution and transfer of this material to third parties for any reason. UBS accepts no liability whatsoever for any claims or lawsuits from any third parties arising from the use or distribution of this material. This report is for distribution only under such circumstances as may be permitted by applicable law. For information on the ways in which CIO manages conflicts and maintains independence of its investment views and publication offering, and research and rating methodologies, please visit www.ubs.com/research. Additional information on the relevant authors of this publication and other CIO publication(s) referenced in this report; and copies of any past reports on this topic; are available upon request from your client advisor.

Risk information

Options and futures are not suitable for all investors, and trading in these instruments is considered risky and may be appropriate only for sophisticated investors. Prior to buying or selling an option, and for the complete risks relating to options, you must receive a copy of "Characteristics and Risks of Standardized Options". You may read the document at https://www.theocc.com/about/publications/character-risks.jsp or ask your financial advisor for a copy.

Investing in structured investments involves significant risks. For a detailed discussion of the risks involved in investing in any particular structured investment, you must read the relevant offering materials for that investment. Structured investments are unsecured obligations of a particular issuer with returns linked to the performance of an underlying asset. Depending on the terms of the investment, investors could lose all or a substantial portion of their investment based on the performance of the underlying asset. Investors could also lose their entire investment if the issuer becomes insolvent. UBS Financial Services Inc. does not guarantee in any way the obligations or the financial condition of any issuer or the accuracy of any financial information provided by any issuer. Structured investments are not traditional investments and investing in a structured investment is not equivalent to investing directly in the underlying asset. Structured investments may have limited or no liquidity, and investors should be prepared to hold their investment to maturity. The return of structured investments may be limited by a maximum gain, participation rate or other feature. Structured investments may include call features and, if a structured investment is called early, investors would not earn any further return and may not be able to reinvest in similar investments with similar terms. Structured investments include costs and fees which are generally embedded in the price of the investment. The tax treatment of a structured investment may be complex and may differ from a direct investment in the underlying asset. UBS Financial Services Inc. and its employees do not provide tax advice. Investors should consult their own tax advisor about their own tax situation before investing in any securities.

Important Information About Sustainable Investing Strategies: Sustainable investing strategies aim to consider and incorporate environmental, social and governance (ESG) factors into investment process and portfolio construction. Strategies across geographies and styles approach ESG analysis and incorporate the findings in a variety of ways. Incorporating ESG factors or Sustainable Investing considerations may inhibit the portfolio manager's ability to participate in certain investment opportunities that otherwise would be consistent with its investment objective and other principal investment strategies. The returns on a portfolio consisting primarily of sustainable investments may be lower or higher than portfolios where ESG factors, exclusions, or other sustainability issues are not considered by the portfolio manager, and the investment opportunities available to such portfolios may differ. Companies may not necessarily meet high performance standards on all aspects of ESG or sustainable investing issues; there is also no guarantee that any company will meet expectations in connection with corporate responsibility, sustainability, and/or impact performance.

External Asset Managers / External Financial Consultants: In case this research or publication is provided to an External Asset Manager or an External Financial Consultant, UBS expressly prohibits that it is redistributed by the External Asset Manager or the External Financial Consultant and is made available to their clients and/or third parties.

USA: This document is not intended for distribution into the US and / or to US persons.

For country information, please visit ubs.com/cio-country-disclaimer-gr or ask your client advisor for the full disclaimer.

Version A/2023. CIO82652744