UBS House View

Monthly Extended July 2023

Chief Investment Office GWM

Investment Research

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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.

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Section 1

Investment views

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.

Within commodities, we like gold and oil.

Regarding currencies, we have the US dollar as least preferred and the Japanese yen as most preferred currency.

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

We continue to advocate allocations to the more defensive, higher-quality segments of fixed income, given the all-in yields on offer and as inflation risks transition to growth risks. Specifically, we maintain a preference for high grade and investment grade bonds.

We also like emerging market credit, where valuations are attractive relative to historical levels, driven by the high yield space. We think this segment factors in a more challenging growth environment while offering upside amid prospects for a weaker USD and higher oil prices.

We are neutral on high yield. Though we believe high yield spreads will trend wider by year-end, and relative returns may be lower than higher-quality segments, total returns should be protected by virtue of higher outright yields.

Foreign exchange

We removed the Australian dollar from our top currency picks. It did not profit as expected during China's economic rebound, and that rebound was weaker than we anticipated. The Reserve Bank of Australia nevertheless turned more hawkish in the last two meetings. This is priced in by now, and we believe that upside potential is more limited in the coming months.

We keep the US dollar as least preferred and the Japanese yen most preferred.

We maintain a neutral positioning on the euro, British pound, and Swiss franc.

Commodities

Disappointing Chinese economic data and cuts to global growth forecasts weighed on industrial metals. We still expect supply constraints to lift oil and industrial metal prices in the second half, but the extent of the gains should be lower than previously assumed. We therefore move commodities to neutral from most preferred.

We keep oil and gold as most preferred and continue to recommend actively managing commodity exposure.

Section 1.2

Risk scenarios

Key scenarios for 2023

	Upside	Base case	Downside	*Things to watch*
Probability	**20%**	**50%**	**30%**	
Market path	**Bonds flat, equities up** Equity markets continue to grind higher as expectations of a recession are continually postponed. Bond markets post mixed returns amid ongoing uncertainty about future monetary policy.	**Bonds up, equities flat to slightly down** Idiosyncratic factors cause diverging performance across markets with global equities trending lower. High-quality bonds outperform as a weakening economic outlook leads to expectations for monetary easing.	**Bonds up, equities down** Global equities post double-digit losses and credit spreads widen. Safe-haven assets such as high-quality bonds, gold, the Swiss franc, and the Japanese yen appreciate.	
Economic growth	Holds up longer than expected as consumer spending and labor markets continue to surprise positively. Recession expectations are pushed further into the future.	The US economy slows further and likely goes into a mild recession sometime between 3Q23 and 1Q24. Other Western economies also continue to decelerate and experience subtrend or negative growth. China continues to accelerate.	Falls sharply on a global scale toward late 2023 or early 2024 owing to highly restrictive monetary policy.	*Global: Oil price* *US, China: PMI data* *US: Change in nonfarm payrolls* *Europe: Gas prices*
Inflation	Remains firmly above central bank targets.	Continues to slow in the US and in Europe. Ends the year above central bank targets before normalizing by mid-2024.	Falls quickly as demand for goods and services collapses.	*US: CPI and PCE inflation* *US: ISM prices-paid subindex* *US: Average hourly earnings* *US: JOLTS openings and hires* *Eurozone: HICP inflation*
Central banks	The Fed halts its rate-hiking cycle from 3Q23 but may consider further rate rises in early 2024. The ECB and the BoE follow a similar path.	The Fed, ECB, SNB, and BoE 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.	Cut interest rates quickly after seeing evidence of a deep recession.	
Financial conditions	Remain tight by historical standards but do not cause systemic stress in the economy.	Remain tight, increasing the market's vulnerability to negative surprises or external shocks.	Tighten dramatically, causing stress in the financial system and increasing the risk of systemic events.	*Global financial conditions indexes*
Geopolitics	The war in Ukraine deescalates, e.g., via a ceasefire agreement.	The war in Ukraine drags on as ceasefire negotiations remain elusive.	The war in Ukraine escalates or US-China tensions intensify.	*Territorial gains by Russia* *Weapon shipments to Ukraine* *Putin support polls* *US sanctions on Chinese companies* *Reverse-CFIUS process*

Asset class targets – December 2023

Key targets for December 2023	spot*	Upside	Base case	Downside
MSCI AC World	812	900 (+11%)	770 (–5%)	670 (–18%)
S&P 500	4,373	4,800 (+10%)	4,100 (–6%)	3,500 (–20%)
EuroStoxx 50	4,376	4,900 (+12%)	4,250 (–3%)	3,650 (–17%)
SMI	11,278	12,800 (+13%)	12,000 (+6%)	9,800 (–13%)
MSCI EM	1,015	1,100 (+8%)	1,050 (+3%)	800 (–21%)
US 10-year Treasury yield	3.79%	4.25%	3.25%	2.25%
US 10-year breakeven yield	2.22%	3%	2.25%	1.5%
US high yield spread**	420bps	400bps	550bps	850bps
US IG spread**	123bps	80bps	120bps	200bps
EURUSD	1.08	1.20 (+11%)	1.14 (+5%)	1.05 (–3%)
Commodities (CMCI Composite)	1,750	2,000 (+14%)	1,900 (+9%)	1,600 (–9%)
Gold***	USD 1,943/oz	USD 1,800–1,900/oz (–5%)	USD 2,100/oz (+8%)	USD 2,300–2,400/oz (+21%)

* Spot prices as of market close of 14 Jun 2023. The MSCI All Country (AC) World index displays in the local currency. The MSCI Emerging Markets index displays in US dollar. 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.

*** Gold is a safe-haven asset whose price tends to rise when risk assets, such as equities, fall, and vice versa.

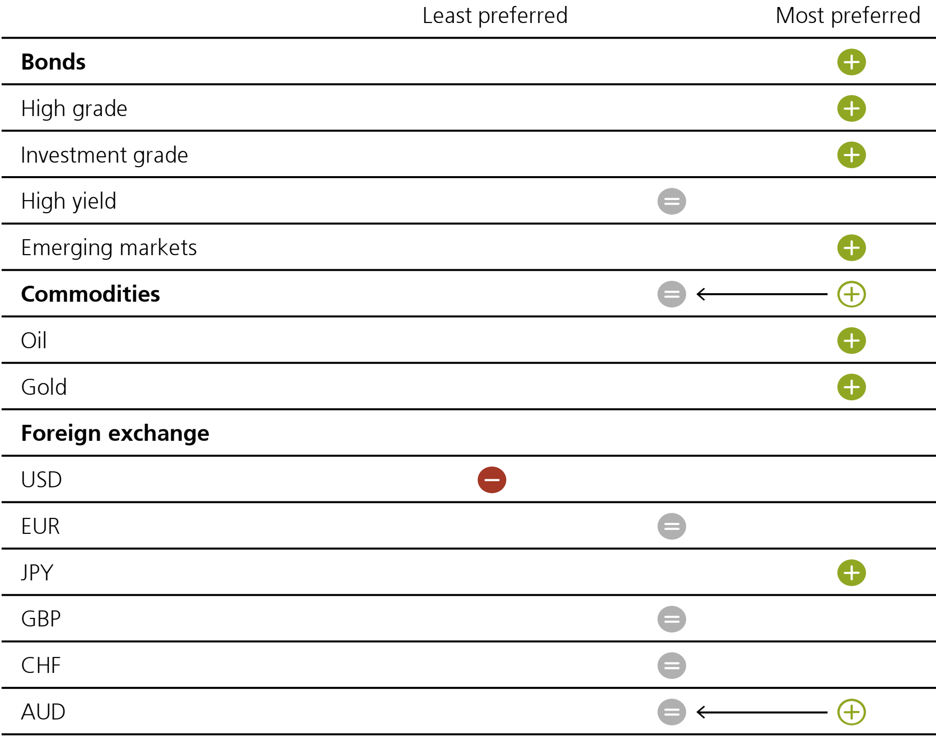
Note: The asset class targets above refer to the respective macro scenarios. Individual asset prices can be influenced by factors not reflected in the macro scenarios.

Section 1.3

Asset class preferences and themes

Global asset class preferences

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



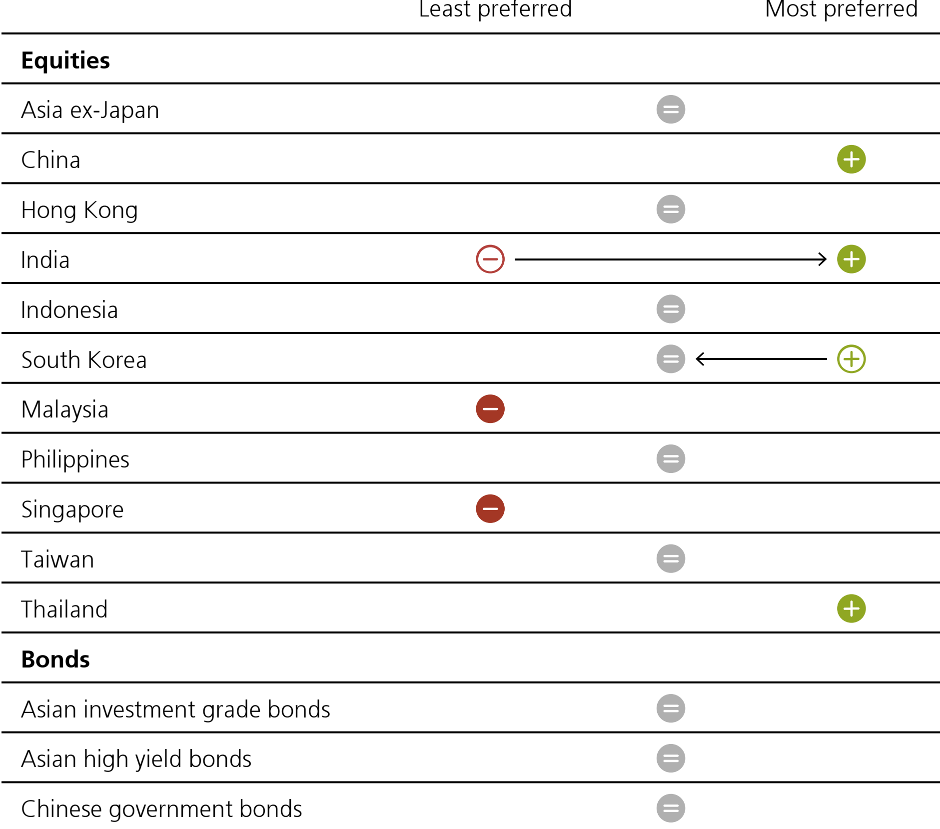
	Least preferred		Most preferred
Bonds			+
High grade			+
Investment grade			+
High yield		=	
Emerging markets			+
Commodities		= ←	(+)
Oil			+
Gold			+
Foreign exchange			
USD	–		
EUR		=	
JPY			+
GBP		=	
CHF		=	
AUD		= ←	(+)

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		=	

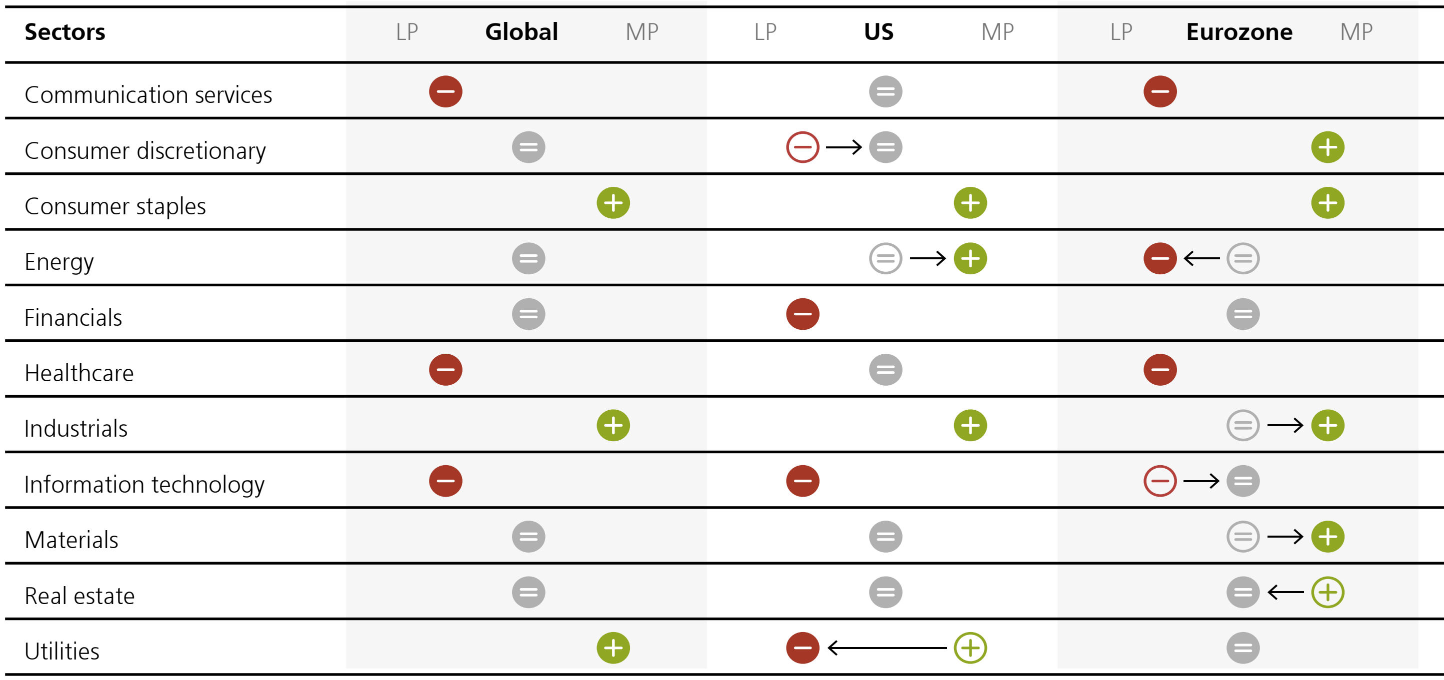
Note: The US asset class preferences reflect the high-level UBS House View. The TAA positioning of our different investment strategies may differ from this view because our strategies seek specific investment objectives and can frequently adjust portfolio allocation to achieve them.

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 emerging market hard-currency sovereign bonds and remain neutral on emerging market 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

Buy quality bonds

More-resilient-than-expected economic data has boosted yields in recent weeks, providing investors with a good opportunity to lock in elevated rates as the Fed engages in a balancing act between inflation, full employment, and financial stability. We see opportunities in high grade (government), investment grade, and sustainable bonds, and select senior financial debt. Actively managed fixed income strategies can help investors take advantage of the breadth of opportunities.

Lock in quality bond yields (high grade, investment grade, sustainable)
Select senior financial bonds
Actively managed fixed income strategies

Source of funds
- Excess liquidity
- Sell expensive / rated bonds
- Excess equities

Seek diverse and durable income

Earning more durable income is not just about high-quality bonds. Among the riskier parts of fixed income, we like emerging market credit. We see opportunities in diverse income strategies to balance fixed income exposure. This includes quality dividend-paying equities across traditional and sustainable strategies (and by region in Switzerland and Asia), US preferred securities, and in volatility-selling strategies.

Emerging market bonds
Quality dividend-paying equities
Swiss income equities
Yield-generating structured investments
US preferred securities

Source of funds
- Sell/expensive rated bonds
- Excess US equities
- Excess IT equities
- Excess healthcare equities

Look for equity laggards

Stock market gains have recently been concentrated in a few areas, and with valuations among some of the best performers now looking stretched, we expect the gap between the leaders and the laggards to close. Investors should protect their holdings through capital preservation strategies and rebalance into the laggards, like emerging markets, defensives, and value.

Capital preservation structured investments
Invest in EM and select European opportunities (vs. US)
US equal-weight vs. cap-weight (i.e., "the rest" vs. tech)
Value vs. growth

Source of funds
- Least preferred equities
- Excess US equities
- Excess IT equities
- Excess growth equities

Position for dollar weakness

We expect rate differentials between the US dollar and other currencies to narrow, and see the dollar's downtrend resuming in the months ahead. We therefore recommend investors with the Japanese yen, euro, British pound, or Swiss franc as their home currency to strengthen their home bias. We also expect gold to reach new all-time highs.

Diversify USD holdings
Gold
Structured strategies on select currencies

Source of funds
- Excess USD cash holdings
- Excess US equities

Diversify with alternatives

We recommend balancing traditional portfolios with an allocation to alternatives. Hedge funds should enable investors to navigate, as well as take advantage of, dislocations in markets in a period of economic uncertainty. Meanwhile, we believe private markets offer a variety of opportunities to earn income and grow wealth over time, including in private equity, private credit, and real estate.

Hedge funds (Discretionary macro, equity low-net, credit, multi-strategy)
Private equity (value buyout, secondaries)
Stay invested in private real estate / private credit

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

Invest in real assets

The Fed could be willing to let inflation stay modestly above target for an extended period. If the delicate balance of financial and price stability tips over into fears that the central bank is risking inflation expectations running out of control, we think allocations to infrastructure, commodities, and select core real estate could help with long-term inflation mitigation, and provide additional portfolio diversification and income.

Infrastructure including greentech
Commodities
Global direct real estate

Source of funds
- Excess bonds/equities
- Sell/expensive rated bonds
- Least preferred equities
- Concentrated equities
- Excess IT and healthcare equities

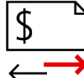
Go sustainable

Green investment, decarbonization commitments, consumer sentiment, and regulation will continue to drive the case for investing sustainably. We like sustainable bonds; environmental, social, and governance (ESG) leaders; and innovative companies that can do more with less, including within energy and water efficiency. We also see opportunities to gain exposure to sustainable themes such as health and climate through hedge fund and private market vehicles.

Sustainable bonds
Sustainable equities: ESG leaders, renewables, and water scarcity
Sustainable hedge funds
Private market impact investing

Source of funds
- Excess cash
- Traditional counterparts
- Excess healthcare equities
- Excess EMU energy equities

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 • Select European opportunities (Germany, consumer) • Sustainable equities: ESG leaders, renewables, and water scarcity • Infrastructure including greentech	CIO least preferred equities, excess US equities, excess IT equities, excess growth equities, excess healthcare equities, concentrated stocks, excess cash
Bonds		• High grade, investment grade, sustainable bonds • Emerging market credit • Select senior financial bonds • Actively managed fixed income solutions	Excess cash, sell-/expensive-rated bonds, excess equities
Foreign exchange		• JPY	USD
Commodities		• Active commodity exposure • Oil • Gold	Excess cash
Hedge funds, private markets		• Hedge funds (discretionary macro, equity low-net, credit, multi-strategy) • Private equity (value buyout, secondaries) • Private real estate/private credit	Excess bonds and equities, sell-/expensive-rated bonds, concentrated equities

Section 2

Macro economic outlook

Global economy – Demand continues to slow

Base case (55%)

Growth

Real consumer spending is still tending to decline across most developed economies, as incomes are still struggling to keep up with inflation. However, household incomes have been supported by low unemployment. Female participation in the workforce has also risen recently, increasing household incomes. Thus, while consumer spending is pulling down overall growth, the pace of decline is less aggressive than might be the case.

Inflation

Headline inflation rates have continued to trend down. National peculiarities in the calculation of inflation will continue to influence differences between the major economies. Political focus on food prices has intensified, and disinflation may accelerate as corporate profit margins come under scrutiny. As inflation continues to moderate, real wages should stabilize and may turn positive, offering a support to growth.

Positive case (15%)

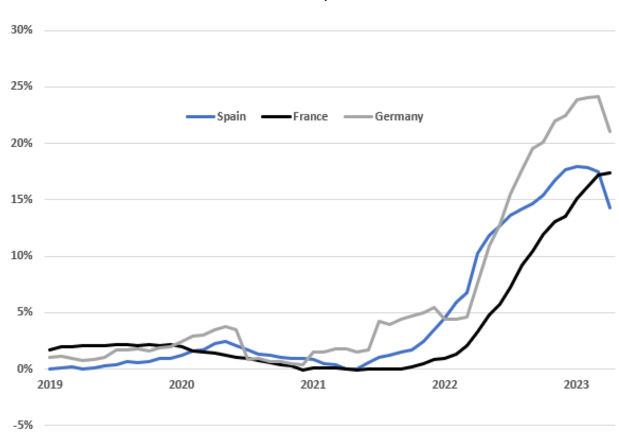
Although nominal wage growth slows, a faster decline in inflation restores stability in real wage growth more quickly, stabilizing consumer demand earlier than anticipated. Middle-income consumers experience below-reported inflation, which helps spending power in an important demographic. Unemployment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

Food inflation in focus

Processed food consumer price inflation in euro economies



Source: Haver, UBS, as of 11 June 2023

US demand patterns – stable levels

Real consumer durable goods spending, Jan 2019=100

Source: Haver, UBS, as of 11 June 2023

US economy – Overcoming obstacles

Base case (60%)

Growth

Growth has held up better than expected despite aggressive rate hikes by the Federal Reserve and stress in the banking system. The strong labor market and savings built up during the pandemic have allowed consumers to keep spending, which in turn is encouraging businesses to hire and invest. New industrial policies related to computer chips and green energy have also promoted economic activity. Recession risks remain elevated as the Fed appears likely to hike rates further.

Inflation

Resilient growth has made it more difficult for the Fed to get inflation down toward its 2% target. While inflation is clearly down from its peak, the Fed needs to see more progress before it declares victory and ends the rate hiking cycle. Supply chain issues have mostly been resolved, helped to reduce inflationary pressure at the producer level, and this should help retail price inflation in the months ahead.

Positive case (15%)

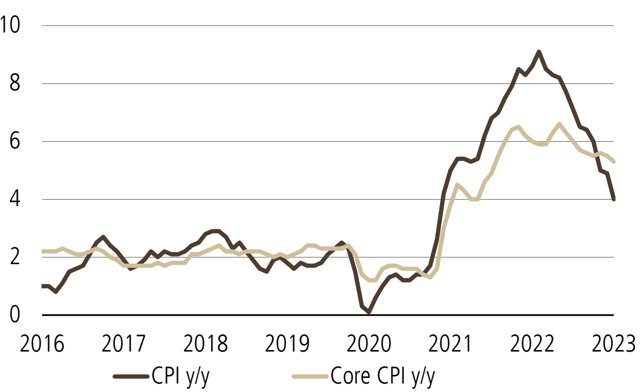
Better labor supply allows businesses to fill in their open job positions. Wage growth slows to a more moderate pace and energy prices stay low, helping to bring inflation down while growth remains robust. The Fed sees enough progress toward its mandates to stop raising rates but does not cut rates before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

Negative case (25%)

Inflation stays elevated, forcing the Fed to raise rates further, adding to stress in the banking system creates and causing a further tightening of credit conditions. Households finally use up their excess savings, leading to a pullback in spending. Seeing consumer demand weakening, business increase the pace of layoffs, and this quickly pushes the economy into a recession.

Headline inflation down but core is sticky

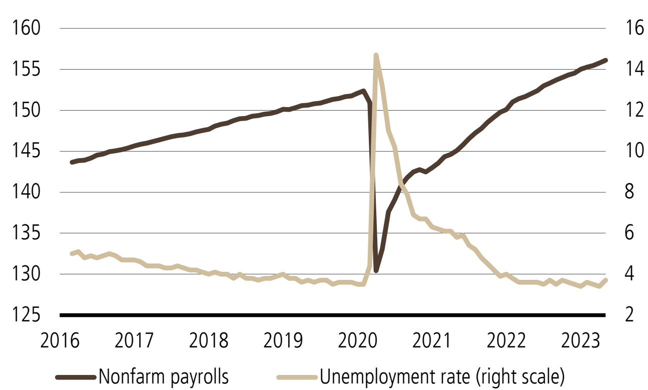
CPI and core CPI, y/y change in %



Source: Bloomberg, UBS, as of 13 June 2023

Labor market remains strong

Nonfarm payrolls in millions, unemployment rate in %



Source: Bloomberg, UBS, as of 13 June 2023

Eurozone economy – More to do for the ECB

Base case (60%)

Growth

The Eurozone economy appears to have fallen into a recession over the winter months, but the outcome was still better than feared amid the peak of the energy crisis. Looking ahead, we expect a modest recovery in growth, but the big picture is one of stagnation, as tight monetary policy replaces inflation as the brake on a more vigorous recovery. Fading fiscal support will be an additional factor that constrains the economy to a period of below-trend growth.

Inflation

Headline inflation fell more than expected in May. Encouragingly, core prices showed the same trends. Price pressures continue to ease both in input prices and forward-looking surveys. We expect inflation to continue to fall in the coming months, but the ECB is likely to continue to tighten monetary policy. We look for the rate-hiking cycle to end in July. Beyond this, quantitative tightening should continue, and discussions around the next phase could begin before year-end.

Positive case (15%)

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

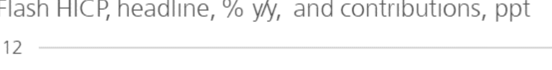
Economic growth in Asia and the US accelerates, with the latter avoiding a recession, boosting demand for Eurozone exports. Progress is made on trade talks with the US, and outstanding Brexit issues with the UK are resolved.

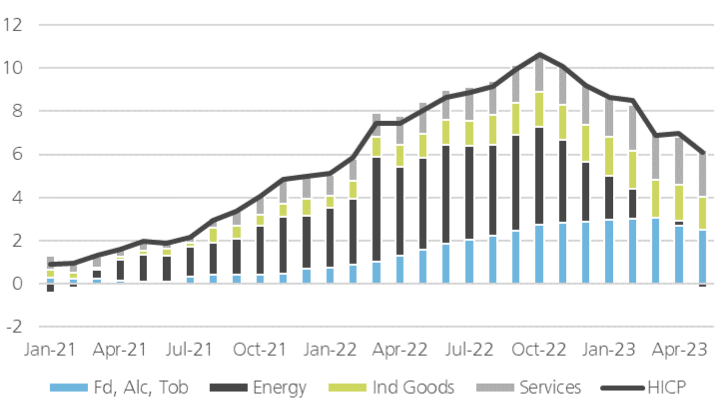
Negative case (25%)

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.

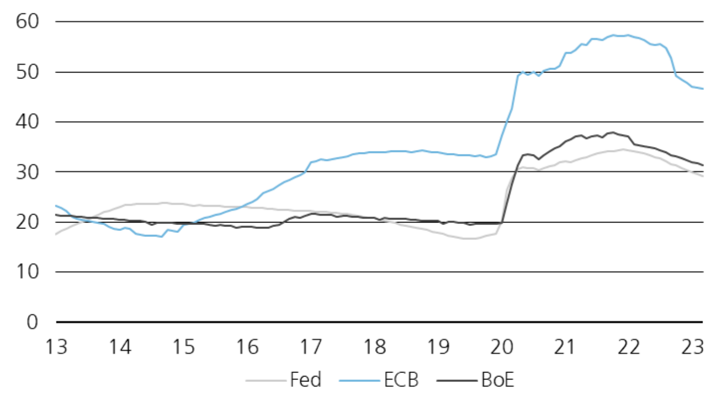
Inflation surprised to downside in May, with all sectors seeing price pressures decline





Source: Haver Analytics, UBS, as of 7 June 2023

ECB balance sheet set to shrink further, having already experienced a sharp reduction



Source: Haver Analytics, UBS, as of 7 June 2023

Swiss economy – SNB set to hike despite lower inflation

Base case (70%)

Growth

We expect Swiss GDP to grow at a below-average pace in 2023. Relatively high inflation, rising interest rates, and a sluggish Eurozone economy are likely to weigh on growth. While several risks to the Swiss economy have diminished, thanks to greater energy security in Europe and China's reopening, the biggest risk—a deep US recession—has become more pronounced.

Inflation

Inflation retracted to 2.2% in May amid less contribution from energy prices. We expect inflation to fall further in the coming months given improved supply chains and lower energy prices. Second-round effects remain a risk.

Recent SNB speakers have clearly signaled more tightening ahead. We expect another hike in June (25bps) for a terminal rate of 1.75%. A September hike remains a risk, but we think the SNB would prefer to sell foreign reserves in case of persistent inflation pressure. Interest rate cuts are unlikely before mid-2024.

Positive case (20%)

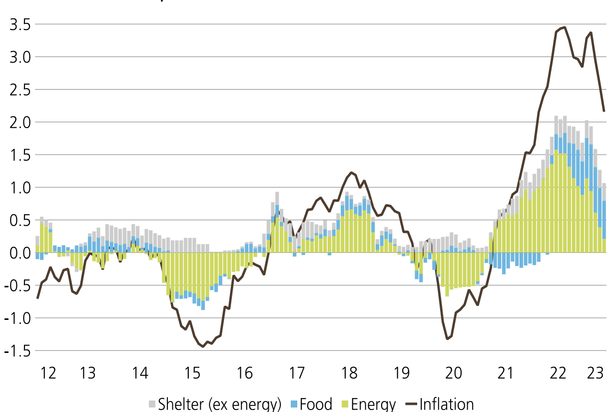
Better global growth momentum: A swift calming of the turmoil in the banking system and reduced inflationary pressures boost global demand. Switzerland benefits from the stronger global backdrop and a weakening of the safe-haven Swiss franc.

Negative case (10%)

US growth slump pushes Switzerland into a recession: For Switzerland to fall into a recession, some preconditions must be met: sticky inflation due to strong second-round effects, and a deep US-recession that leads to a slump in Eurozone growth and a strong appreciation of the Swiss franc.

Inflation continued to retract in May

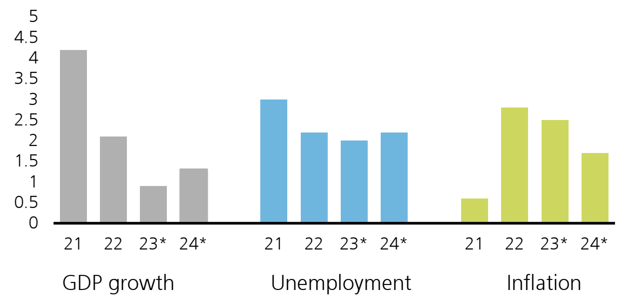
Year-over-year change in Swiss CPI and contribution of selected components, in %



Source: Macrobond, UBS, as of 13 June 2023

Inflation and GDP growth to weaken

Swiss GDP growth, unemployment, and inflation rate, in % (* = UBS forecast)



Source: Macrobond, UBS, as of 13 June 2023

Chinese economy – Recovery on track but softening

Base case (70%)

Growth

The recovery continues despite some softening after a strong 1Q. Retail sales remain the main driver, up 9.3% for the January-to-May period, led by services and auto. Over the same period, investment growth eased to 4%, dragged by property despite resilient infrastructure and manufacturing. The central bank cut the 7-day reverse repo and medium-term lending facility (MLF) rate by 10 basis points in June. More targeted policy support is likely, but not a bazooka approach. We expect full-year GDP growth around 5.5%, led by consumption.

Inflation

Consumer inflation stayed low at 0.2% in May due to falling food and energy prices. We expect a mild pickup in 2H and an average of 1% for the full year. Producer price deflation is likely to persist by year-end. Further monetary easing is likely in 2H, with another one or two cuts to banks' required reserves or a 20bps cut to the MLF rate.

Positive case (15%)

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.

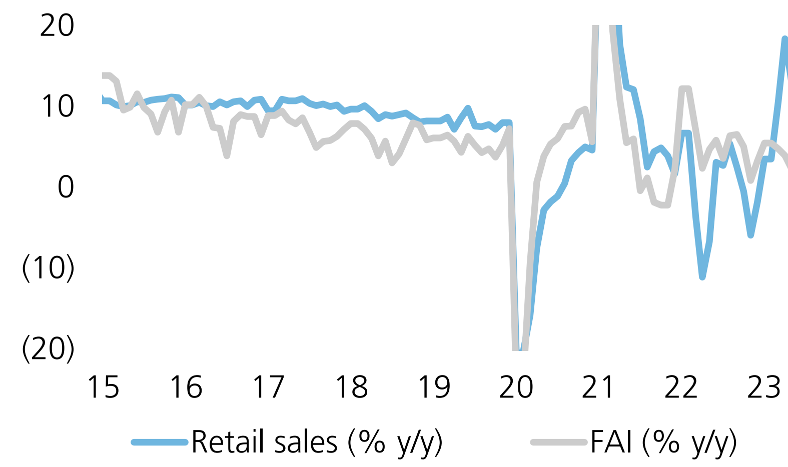
Negative case (15%)

Property activity is weaker than expected.

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

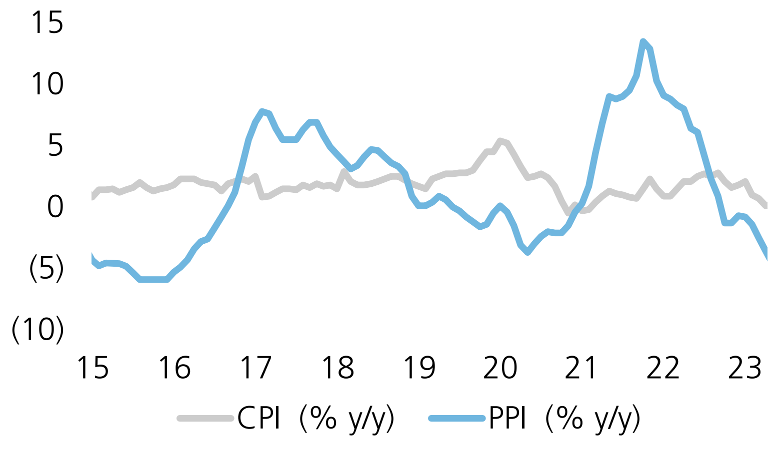
The US imposes much stricter restrictions on China's tech sectors.

Recovery still led by consumption



Source: CEIC, UBS, as of 15 June 2023

CPI inflation to stay low; PPI deflation to persist



Source: CEIC, UBS, as of 15 June 2023

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Analysts: Yifan Hu, Kathy Li

Section 3

Asset class views

Section 3.1

Summary of major asset classes

Equities

Preference: Least preferred

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 to year-to-date highs, a few percentage points above our year-end target, yet the outlook does not seem to be improving. Economic growth is weakening while central banks are committed to trimming inflation, increasing the risk of recession. Manufacturing is also 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 15.9x currently—10% 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 4.5%, a low since the 2008 global financial crisis, and the earnings yield is only 2.2%, 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 a mild earnings recession this year. We estimate a contraction in global and US earnings by 1% and 2% respectively, versus the consensus forecast of 0% for both. After first-quarter results, forward earnings revisions have improved and estimate upgrades have outpaced downgrades. We think this trend is inconsistent with falling new orders and contracting manufacturing.

US equities least preferred. The S&P 500 forward P/E multiple has collapsed from 21x at the start of 2022, when real rates were negative, to 18.9x 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 2% for this year, and valuations have improved. The 12-month P/E stands at 14x, a 10% 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. China is trading at 9.9x, a 16% discount to the long-term average, 38% discount to global equities, and 48% discount to US stocks.

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 should 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).

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

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

Equities

Healthcare, communication services and information technology least preferred. The softening USD is a headwind for pharmaceutical companies outside the US. Trading at 17.4x 12-month forward earnings versus other defensive sectors such as utilities (14.7x 12-month forward P/E), valuations now look expensive. The valuation gap between IT and the global equity benchmark remains high and continues to increase (IT trades at a 30% premium to history and 53% premium to the market). Tense US-China relations and the race for global tech supremacy are other risks facing certain tech industries.

The communication services sector has been one of the best performers since the beginning of the year. However, while performance of the tech sector versus the overall benchmark far exceeds its relative earnings growth premium, communication services' earnings growth expectations are less overpriced than in IT, in our view. That said, investors should be aware that the market-cap-weighted version of the sector is highly concentrated, with Alphabet and Meta accounting for almost 30% of the total, and as such at risk after the strong rally since the beginning of the year.

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 market and factor performance have seen significant and volatile moves in recent months. 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: 900

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 response thus far has been to separate monetary policy and lender of last resort responsibilities. Namely, central banks remain committed to keeping policy rates restrictive until inflation is closer to their designated target rates. But they have shown a willingness to offer targeted liquidity and facilitate private sector solutions to address 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.

Withing 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 growth in China and the aggressive tightening of monetary policy in the US. We see these headwinds dissipating, although we do acknowledge that China's reopening has underwhelmed thus far. Valuations are attractive relative to historical levels, driven by the high yield space. We think this segment incorporates a more challenging growth environment, while offering upside on prospects for a weaker USD and higher oil prices. Additionally, there is a material amount of distress in lower-rated issuers where favorable political or restructuring outcomes present upside potential.

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. 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 4.3%. 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 mid 5%. Credit fundamentals on the US IG corporate side remain solid and should provide protection in a slowing earnings environment.

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.

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Analysts: Frederick Mellors

Bonds

High yield (HY) bonds: We are neutral on 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. In developed markets, monetary policy remains restrictive, though we appear to be nearing the end of rate-hiking cycles and we would expect the disinflation process to continue. Specifically, with regard to the Federal Reserve, we think this implies the USD is likely to weaken, which would translate into cheaper external funding requirements for emerging markets. Economic growth is slowing across regions, but overall holding up relatively well, especially in the US. China is facing some loss of momentum in its economic recovery after a strong first quarter. Looking ahead, we think an increase in consumer confidence will be important to sustain the rebound. In this regard, we note that China's monetary policy has become more stimulative, while policy support may also ramp up on housing, consumption, and employment to boost private sector confidence.

We see value in sovereign bonds, where valuations are attractive relative to historical levels driven by the high yield space. We think this segment incorporates a more challenging growth environment, while offering upside on prospects for a weaker USD and higher oil prices. 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 now around 8.5% 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 or early next year. The economy is now in the middle of the inflection point we have been looking for in 2023, in our view. This period is volatile and the Fed needs more time before easing its policy rate. Still, the general direction of a weakening USD seems clear as the US was one of the first ones to hike rates and is most probably also the first one to abandon tightening. In that phase, international investors have strong incentives to repatriate funds out of the US into higher yielding emerging markets or into formerly negative yielding G10 currencies.

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.

We removed the Australian dollar from our top currency picks. It did not profit as expected during China's economic rebound and that rebound was weaker than we anticipated. The Reserve Bank of Australia nevertheless turned more hawkish in the last two meetings. This is priced in by now, and we believe that upside potential is more limited in coming months. We also believe upside in the Australian dollar is more limited given the Fed needs more time before easing its policy rate.

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 weren't completely unfazed by US dollar strength in recent weeks, but once again high carry currencies with rather calm domestic backdrops performed better than peers. We think carry currencies are 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. Key risks stem from inflation proving to be more persistent and the Federal Reserve and its peers delivering more interest rate hikes 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 neutral view on commodities overall but remain most preferred on crude oil and gold.

Oil deficit deepens in 2H23. Better-than-expected US oil production and higher Russian, Iranian, and Venezuelan exports have unexpectedly kept the global market in a surplus in 1H23. However, we expect this to reverse quickly as we move into 2H23, when we estimate an average deficit of 1.5mbpd—and potentially larger if Saudi Arabia extends its additional 1mbpd supply cut beyond July. With the extension of the production cut deal into 2024, OPEC+ supply is likely to be lower than previously expected over the next 18 months, pointing to a moderately undersupplied market in 2024. This underpins our forecast for higher oil prices.

Gold remains most preferred. The gold price has hovered around USD 1,950/oz despite broad USD strength and a recalibration of Fed expectations. According to IMF data, official gold reserves also declined by 71 metric tons in April—the first net decrease in over a year—amid notable selling by the Turkish central bank due to local dynamics and continued buying by China. Technically, a retracement to around USD 1,870/oz is possible, but we keep our forecast of USD 2,100/oz by year-end and USD 2,250/oz by mid-2024 unchanged.

El Niño a major risk for wheat and soft commodities. The US government weather service has declared El Niño is now underway. The last time a strong El Niño took place was in 2015–16, and the world saw its hottest year on record. Wheat, rice, and soft commodities are often the most impacted by this phenomenon, though regional weather events are also damaging crops in North America. We maintain our recommendations for long wheat and live cattle.

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 3.2

Details per asset class

Eurozone equities

Central scenario

DJ Euro Stoxx 50 December 2023 target: 4,250

We maintain our neutral stance on Eurozone equities. Although the region has just entered a technical recession following two quarters of negative GDP growth, downside risks to earnings seem partially priced in at current levels, and valuations look fair to us.

In the second half of the year, we expect regional divergences in economic growth to continue, inflation to fall, central banks to stop hiking interest rates, and potentially some modest stimulus measures in China. Inventory de-stocking is likely to keep weighing on activity in the near term, but we see signs of inventory digestion turning more supportive of growth by year-end. We also see the potential for a gas oversupply in Europe, which could push gas prices even lower, helping support profit margins.

We favor sectors and themes that can benefit from these macroeconomic trends, with attractive valuations. We like consumer-related sectors as consumer sentiment improves thanks to strong wage growth, falling inflation, and the end of central bank rate hikes. Rising air traffic and longer-term investment themes support our preference for industrials. Materials offer attractive value with upside from the end of de-stocking, China's economic recovery, or lower gas prices. German equities should also benefit if these drivers turn more favorable, and Eurozone small and mid-caps offer material upside at current valuations should the macroeconomic outlook improve in the second half.

At 12.1x forward P/E, Eurozone equities are trading near a 10% discount to the long-term average. This looks fair to us, considering the above-average interest rates and modest downside risks to consensus earnings estimates. We forecast earnings will fall 5% (consensus +2%) this year and grow 5% next year (consensus +8%). That said, there is a dispersion of valuations within the market, and we still see a number of attractively valued segments with scope for upside if the macroeconomic backdrop is better than expected.

CIO themes

Eurozone small- and mid-caps

We see attractive value in small and mid-sized companies, and expect inflections in the macroeconomic outlook to emerge in 2H23, 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 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.

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

Analysts: Matthew Gilman, Rolf Ganter

Eurozone equities

Upside scenario

DJ Euro Stoxx 50 December 2023 target: 4,900

Inflation falls quickly, allowing central 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 is better than expected or China's recovery strengthens.

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

Lower European gas prices are possible; there is a risk of oversupply in the coming months as European gas storage levels approach full capacity.

Downside scenario

DJ Euro Stoxx 50 December 2023 target: 3,650

Growth disappoints with the US entering a recession later this year, triggering 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 sector uncertainty could lead to tighter financial regulations 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. Unforeseen disruptions to gas supplies, in combination with a cold winter or tight LNG supply, could raise the risk of production stoppages during winter.

Sector Preferences:

Most preferred: consumer discretionary, consumer staples, industrials, and materials.

Least preferred: communication services, energy, and healthcare.

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

Analysts: Matthew Gilman, Rolf Ganter

US equities

Preference: Least preferred

Central scenario

S&P 500 December 2023 target: 4,100

The year-to-date rally in US stocks has extended further, and the S&P 500 is now more than 20% above its October low, meeting the common definition of a bull market. Stocks have been buoyed by resilient economic data, the winding down of Fed rate hikes, better-than-expected corporate profits, enthusiasm about AI-driven growth for a handful of meg-cap tech stocks (driving very narrow market breadth), and previously depressed market sentiment and light positioning. While we acknowledge the better economic and corporate profit data (and therefore raise our S&P 500 EPS estimates and price targets as explained below), we believe stocks have run ahead of fundamentals and seem to be pricing in a very benign outcome. Yet there are still questions about how low inflation will fall and the impact of still-challenging access to capital for key segments of the economy, such as housing.

To us, it doesn't appear likely that the economy can remain resilient while inflation falls low enough to satisfy the Fed. The Fed's own forecasts suggest a period of weak economic growth and an increase in unemployment in order to reduce inflation to target. In other words, it seems that something has to give. Either the Fed will accept somewhat higher-than-target inflation, or it will have to raise rates further than expected to get inflation lower. With the S&P 500 trading at a relatively lofty forward P/E of 18.5x, the market appears vulnerable to either of these risks (stickier inflation or weaker growth). This is especially true now that investor sentiment is no longer depressed. There has been a notable increase investor bullishness in recent weeks, suggesting less dry powder on the sidelines to propel stocks further, and perhaps some "weak hands" in the market if there are any negative surprises.

We would also highlight that the market rally is at odds with still-depressed manufacturing sentiment. Typically, there is a good correlation between stocks and manufacturing sentiment gauges such as the ISM manufacturing purchasing managers' index. In addition, banks continue to tighten lending standards, suggesting there will continue to be pressure on corporate profits. From this perspective, stocks seem to be ahead of fundamentals.

Despite our concerns outlined above, 1Q earnings season was better than we had anticipated. We are therefore raising our S&P 500 EPS estimates by USD 5 for this year and next. Our new estimates are USD 215 (–2.3% y/y) and USD 235 (+9.3% y/y) for 2023 and 2024, respectively. As a result, we are raising our December 2023 S&P 500 price target from 3,800 to 4,100 and our June 2024 price target from 4,300 to 4,400. With mega-cap growth stocks once again very expensive, we would encourage investors to seek opportunities in some of the year-to-date laggards.

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.
- Energy: Oil prices have been under pressure due to a better-supplied oil market than expected. However, global economic growth should drive demand growth which, in conjunction with OPEC supply cuts and increases in the US strategic petroleum reserve, should eventually drive oil prices higher. Valuations are pricing in a somewhat dire outlook.
- 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. In the coming months, we may start to see an improvement in the ISM manufacturing index, which has historically been correlated with performance.

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

Analysts: David Lefkowitz, Nadia Lovell, Matthew Tormey

US equities

Upside scenario

S&P 500 December 2023 target: 4,800

Resilient economic growth: High wages attract more workers to return to the labor force, and demand for labor remains strong. Real incomes continue growing and household cash cushions remain. 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: 3,500

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 war in Ukraine: 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

- Financials: Although the banking crisis has ebbed, we believe a number of headwinds remain: Recession risks are higher-than-normal, 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 benefited from the "AI-driven" rally and investors typically seek higher-quality growth companies at this stage of the business cycle. 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.
- Utilities: In the near term, increased regulatory risks and resilient economic data may lead to underperformance. Excess demand for labor should keep the job market strong, and the risk of a hard landing seems less likely. We prefer to have defensive exposure through the consumer staples sector, which continues to exhibit pricing power and benefits from resilient consumer spending.

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

UK equities

Central scenario

FTSE 100 December 2023 target: 8,000

We expect the global economy to slow through the year, in particular as the lagged impacts of tighter credit conditions feed through and excess savings are used up. With a fall in US real and nominal GDP over the course of the year, we also anticipate a contraction in earnings. For the MSCI UK, which is more impacted by global economics than UK economics, we 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. Two more potential rate hikes from the Bank of England in June and August would be helpful for UK financials, but would likely be offset by other factors such as tighter lending conditions or greater competition on deposits. 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 weak outlook is already priced in by the UK equity market.

The FTSE 100 trades on a 12-month forward P/E of 10.3x—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.

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

Swiss equities

Central scenario

SMI December 2023 target: 12,000

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 negative sales volume growth in certain areas, 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 reported 2021 numbers provides a much cleaner picture. In 2024, we expect profits to increase 7%, led by positive organic sales growth and margin trends.

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.

Swiss equity valuation multiples are a bit above the 25-year average, which we think is 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. 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.

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 around 6% in spring 2022 as well as in 2023, achieving a new all-time high. We expect another low-single-digit percentage increase in spring 2024 as well as in 2025.

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

Swiss equities

Upside scenario

SMI December 2023 target: 12,800

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 and 2023, they recovered by 6% each. In our upside scenario, we would expect mid-single-digit percentage rises next year (i.e., for the business year 2023) and in 2025.

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. The 1Q23 earnings season proved better than expected and helped reverse the negative net earnings revisions for Chinese and emerging market stocks.

The MSCI Emerging Markets index valuation, at 12.1x 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 is even deeper at 63% versus its long-term average of 53%. In our view, these valuations 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 external headwinds are also fading as interest rates peak and the US dollar weakens. By contrast, we expect US equities to derate from the current 18.6x 12-month forward P/E, which in our view does not reflect the weakness in US economic and earnings growth as recent data suggest.

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 time 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 given the turnaround in negative earnings revisions and potential stimulus from the government supporting the market in the near term. We also continue to like Thailand, where easing inflation and recovering inbound tourism should support an earnings recovery in 2Q23, although uncertainty could linger in the short term before the new government forms potentially in August. We have also upgraded India from least preferred to most preferred, supported by constructive macro drivers, solid corporate fundamentals, and valuation multiples, which have derated over the past 18 months. Finally, we have downgraded South Korea from most preferred to neutral to take profit as we think the market seems to have priced in too much of the second-half revival and may face headwinds from a global slowdown in the near term.

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, India (New)

Least preferred

Malaysia, Singapore

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

Analysts: Alejo Czerwonko, Xingchen Yu.

Japanese equities

Central scenario

TOPIX December 2023 target: 2,200

We are neutral on Japanese equities in our global portfolio. The TOPIX index has outperformed MSCI World this year. The index is up 19% year-to-date, versus 11% for MSCI ACWI, driven by international inflows and a weaker yen; the USDJPY hit a 13-year high on 13 June. The performance over the last two months was particularly notable—driven by yen weakness, the tech rally, and increasing talk of a snap election in the near term due to a rise in the approval rating of Prime Minister Fumio Kishida's cabinet.

After the sharp rally, there is some risk of profit-taking this summer given: 1) Valuations are no longer cheap versus their 10-year average (TOPIX P/E 14.6x versus 10-year average of 13.7x), even though they are still attractive compared to the S&P 500; 2) international investors are likely to have already built up Japanese equity positions from extremely low levels in 2022 (buying more Japanese equities YTD than they sold during the last two years); 3) there are usually fewer share buyback announcements during summer; and 4) the uncertainty surrounding US interest rate hikes in June/July.

However, we think Japanese stocks still offer relative safety at current levels thanks to: 1) relatively solid corporate earnings (FY2023 +3%); 2) a low risk of recession, as Japan's economic cycle is a lap behind most other countries due to its delayed reopening and ultra-loose monetary policy; 3) a greater push from the Tokyo Stock Exchange to improve shareholders' returns; and 4) an expected slower yen appreciation trend against the USD.

We think Japan's reopening will continue to provide investment opportunities in 2023. Japan's reopening came after 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 restructuring in the medium term.

Upside scenario

TOPIX December 2023 target: 2,500

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

Higher ROE: Potential business portfolio restructurings or increased investments with the aim to increase ROE pressured by the Tokyo Stock Exchange could be a rerating catalyst for Japanese equities in the longer term.

Sustainable inflation: The result of the 2023 Shunto wage negotiations was a 3.7% rise in wage growth, and core inflation shot up above 3% in 1Q23. If wage growth is sustained, rising inflation expectations could help Japan achieve sustainable inflation, and there could be structural changes in the economy.

Downside scenario

TOPIX December 2023 target: 1,900

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.

US inflation remains elevated: Inflation stays hot and the US central bank is forced to raise interest rates even more than expected, leading to a correction in valuations.

Sharp yen strengthening: Earnings growth would decline, especially for exporters in the tech and auto sectors, if the yen strengthens sharply.

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

Asian ex-Japan equities

Central scenario

MSCI Asia ex-Japan December 2023 target: 680

We continue to stay neutral on Asia ex-Japan equities. Early signs of stabilization are still emerging in Asia, as more than half of the ten Asia ex-Japan markets have buoyant Purchasing Managers' Index (PMI) data—at levels above 50. On the other hand, US ISM PMI data has marked the seventh consecutive month of contraction in the manufacturing sector. Moreover, the risk of global slowdown still exists. As a result, we maintain our focus on relative opportunities within the market, instead of taking direction on beta exposure. We are now most preferred on India, China, and Thailand, and least preferred on Malaysia and Singapore.

We have upgraded India from least preferred to most preferred. 1Q GDP in India held up better than expected. A decline in inflation has broadly taken place across services, energy, food, and others. The external deficit is narrowing. These should support growth and might open up room for a policy rate cut in late 2023. Furthermore, market valuations have come down and are now at around the 5-year average level. Going forward, we think earnings recovery should be the main driver for Indian equities.

On the other hand, we have downgraded Korea from most preferred to neutral. Korea has benefited from the AI-driven rise across the globe and is one of the best performing markets this year (17.5% as of June), with highest return in the region in the past month. We see high long-term growth potential from AI, but in the near term, this cyclical market looks to have priced in too much of the second-half revival and may face headwinds from a global slowdown.

For China, the macro recovery has slowed. The May NBS manufacturing PMI edged down further by 0.4 from April to 48.8, and the non-manufacturing PMI fell slightly from 56.4 remained resilient at 54.4. The growth recovery is imbalanced but not derailed, in our view. Global mutual and hedge fund positions in China are light. Domestic credit conditions are improving. Most importantly, there is room for China to ease more if needed. Thus, we maintain our most preferred view on China. We will keep a close eye on the China-US relationship, as well as any further weakness in the economy in the near term.

Elsewhere, we keep Thailand as most preferred. With among the strongest PMI momentum in the region, we think Thailand's economy should continue recovering. Solid tourist inflows, particularly from China, is a boon. On the other side, we keep Singapore and Malaysia as least preferred. The decline in banks' net interest margins (NIM) in Singapore will likely continue, in our view. Malaysia's manufacturing PMI declined to 47.8 in May, marking the ninth contraction in a row and the steepest fall in 2023 amid weakened demand. We believe near-term upside for these markets is less attractive than their Asia ex-Japan peers.

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: India (New), China, Thailand

Least preferred: Malaysia, Singapore

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

Analysts: Adrian Zuercher, Crystal Zhao, Vanny Wang,

Asian ex-Japan equities

Upside scenario

MSCI Asia ex-Japan December 2023 target: 760

Fed starts rate cuts

Asian equities would likely 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 subdued expectations.

Strong demand recovery in tech

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

Downside scenario

MSCI Asia ex-Japan December 2023 target: 555

Sharp slowdown in DM growth

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

Re-escalation in Sino-US tensions

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

Further stress from global banking sector

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

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

Please see important disclaimers and disclosures at the end of the document

Analysts: Adrian Zuercher, Crystal Zhao, Vanny Wang,

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: 2.25%

Economic growth: In the upside scenario for high grade bonds, 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: 4.25%

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 5.25% around 3Q23. In the downside scenario, inflation remains persistently elevated and the market prices in a more extended hiking cycle, ending at a higher level. The pricing of the terminal rate moves up, and interest rates move higher across the curve, likely accompanied by a greater inversion of the curve.

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

Analyst: Frederick Mellors, Anna Zabai

Investment grade

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 around their long-term average. The higher outright yields and the fact that spreads are a much smaller proportion of total returns than in the recent past 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 4.3%. Index spreads are now trading at 164 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 July as price pressures—though falling—will likely still be uncomfortably high. Meanwhile, 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.

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

Analysts: Frederick Mellors, Carolina Corvalan

Investment grade

Upside scenario

Bloomberg Barclays US Int. Corp December 2023 target: 80bps

Bloomberg Barclays Euro-Agg. Corp. December 2023 target: 90bps

Extended late cycle

Growth is resilient as consumer spending and labor markets surprise positively. The Fed is on hold is Q3 but considers further rate rises in early 2024.

Downside scenario

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

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

Deep recession

Highly restrictive monetary policy causes a global recession in late 2023 / early 2024.

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

Analysts: Frederick Mellors, Carolina Corvalan

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 more growth-sensitive segments such as HY, we are advocating a 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 fifteen months continues to work its way through the system. 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 3.1%.

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.

We remain neutral on HY bonds. Although we forecast scope for wider spreads in HY in the coming quarters and likely relative underperformance versus higher-quality segments, the current level of outright yields in US HY and EU HY are elevated at around 8.6% and 7.3% (in local currency), respectively, at an index level. This is important as the high yield market generates significant carry with every passing day. The higher level of rates provides a sizable buffer against mark-to-market losses that could occur from potential widening in credit spreads.

CIO themes

Income returning to Fixed Income

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

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

High yield

Upside scenario

ICE BofA US high yield spread December 2023 target: 400bps / ICE BofA Euro high yield spread December 2023 target: 390bps

Extended late cycle

Growth is resilient as consumer spending and labor markets surprise positively. The Fed is on hold in 3Q, but considers further rate rises in early 2024.

Downside scenario

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

Deep recession

Highly restrictive monetary policy causes a global recession in late 2023 or early 2024.

Emerging market bonds

Preference: Most preferred

Central scenario

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

In developed markets, monetary policy remains restrictive, though we appear to be nearing the end of rate-hiking cycles and we would expect the disinflation process to continue. Specifically, with regard to the Federal Reserve, we think this implies the USD is likely to weaken, which would translate into cheaper external funding requirements for emerging markets.

Economic growth is slowing across regions, but overall holding up relatively well, especially in the US. China is facing some loss of momentum in its economic recovery after a strong first quarter. Looking ahead, we think an increase in consumer confidence will be important to sustain the rebound. In this regard, we note that China's monetary policy has become more stimulative, while policy support may also ramp up on housing, consumption, and employment to boost private sector confidence.

We see value in sovereign bonds, where valuations are attractive relative to historical levels driven by the high yield space. We think this segment incorporates a more challenging growth environment, while offering upside on prospects for a weaker USD and higher oil prices. 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. The possibility of a global recession or reaccelerating inflation requiring tighter policy in the US and elsewhere is a key risk to our views. In addition, US-China relations remain tense, and a further deterioration could severely hurt market sentiment.

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.

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

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

Emerging market bonds

Upside scenario

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

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

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

Downside scenario

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

Prolonged economic slump: A sharp global economic slowdown leads to weaker 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.

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

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

Asian bonds

Central scenario

JACI composite spread December 2023 target: 260bps

In Asia, the spread on Asia credit (JACI) tightened 21bps over the past month, whereas Asia high yield (HY) bonds tightened 66bps and Asia investment grade (IG) bonds tightened 16bps. As a result, Asia HY outperformed IG from a total return perspective.

Within Asia credit, we like the investment grade segment as we believe IG bonds could provide better risk reward in the near term compared to high yield. JACI IG's current yield-to-maturity (5.6%), with its high quality (average rating A-), appears attrative in the current environment. Furthermore, issuance of Asia IG corporate bonds has been subdued year-to-date (largely driven by China), keeping demand for existing IG bonds strong. Despite some tightening in the past month, the current spread valuation level looks attractive to us, trading at ~73rd percentile since 2014. Going forward, given the expectation of lower rates along with a peaking Fed rate cycle, we are comfortable holding high quality Asia IG bonds.

For Asia HY, we believe short-terms challenge remain, especially for China HY. China property sales data in May was still weak. Going forward, if there is no meaningful policy support for property developers, we think the journey ahead will remain bumpy. Within Asia HY, we maintain our view that bond selection is key when managing exposure to this segment.

Upside scenario

JACI composite spread December 2023 target: 230bps

Much faster recovery after full reopening: If China's recovery is faster and stronger than expected, 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 uneven and mixed. A quick rebound in housing sales later this year would offer fundamental support to the credit metrics of this sector.

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

Downside scenario

JACI composite spread December 2023 target: 330bps

Much higher default rates: The HY sector 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.

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

Analysts: Adrian Zuercher, Crystal Zhao, Vanny Wang,

Gold

Preference: Most preferred

Central scenario

Gold December 2023 target: USD 2,100/oz

The gold price dipped below USD 1950/oz post the US jobs report, which was its lowest level since mid-March. Overall, US macro data has surprised positively while core PCE prices also beat expectations recently, which among other things led to a recalibration of Fed expectations. As an example, just a few weeks earlier, peak US rates seemed locked in. Now, a hawkish pause in June seems to be the new base line with another 25bp hike almost fully priced for the July meeting.

Of course, broad US dollar strength has been another consequence of Fed repricing, which has been an added headwind for gold. Finally, according to IMF data, official gold reserves declined by 71 metric tons in April, which was the first net-decrease in over a year. The Turkish central bank was reported as the major seller, but the World Gold Council believes these sales were due to local dynamics rather than a change in the central bank's long-term strategy.

So what's next? We acknowledge, technically, a retracement to around USD 1,870/oz is possible. But, also, at this level, we see risks as firmly skewed to the upside on a six- and 12-month horizon. Moreover, a delay in the start of the US rate cutting cycle is possible, but we still don't rule it out by year-end and maintain sequential rates cuts will follow over 2024. As such, we keep our forecast of USD 2,100/oz by year-end and USD 2,250/oz by mid 2024 unchanged. Importantly, we see gold as a 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.

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

Crude oil

Preference: Most preferred

Central scenario

Brent crude oil December 2023 target: USD 90/bbl

Many think oil prices are low because oil demand is weak. While demand growth in OECD countries has been lackluster in 1H23, this has been offset by strong demand growth in China, India, and the Middle East. But despite the solid demand recovery, global visible oil inventories did not fall in the first four months of this year because supply growth was also solid. Besides higher supply from Russia, as highlighted in our last report, the latest data from the Energy Information Administration has prompted us to raise our US supply forecast by around 0.2mbpd. Also, production in countries exempted from OPEC+ production cuts is running higher despite US sanctions. Production in Iran is close to 3mbpd, the highest level since late 2018, while Venezuelan production at 0.8mbpd stands at early 2020 levels.

However, we retain a positive outlook for oil prices as we see the oil market undersupplied thanks to the voluntary production cuts by OPEC+ countries implemented in May, and Saudi Arabia removing additional barrels from the market in July. Following a projected market deficit of 0.7mbpd in May, we expect a deficit of around 1.5mbpd in June and more than 2mbpd in July. Once these deficits become visible in on-land oil inventories, we expect oil prices to trend higher. We therefore 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.

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.

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

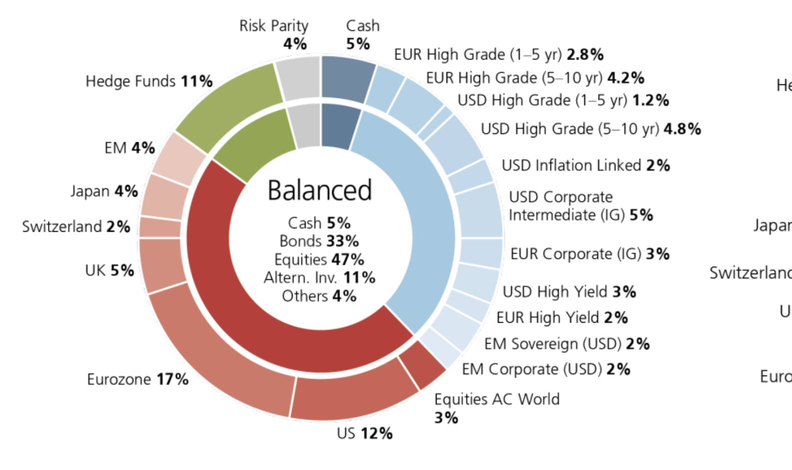
Analysts: Giovanni Staunovo, Dominic Schnider, Wayne Gordon

Section 4

Appendix

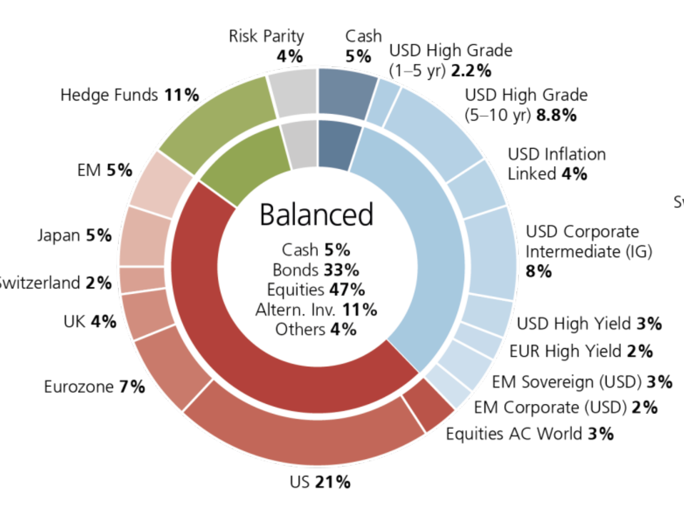
Strategic Asset Allocations (SAAs)

EUR (local portfolio with home bias)



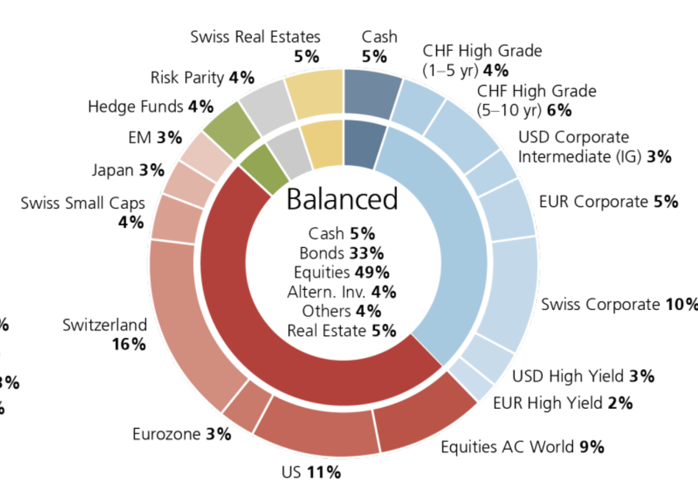
Note: Portfolio weightings are for EUR SAA with a home bias and a balanced risk profile. We expect a balanced EUR SAA to have an average total return of 5.3% p.a. and a volatility of 8.5% p.a. over the next 15 years.

USD



Note: Portfolio weightings are for a USD SAA with a balanced risk profile. We expect a balanced USD SAA to have an average total return of 6.6% p.a. and a volatility of 8.7% p.a. over the next 15 years.

CHF (local portfolio with home bias)



Note: Portfolio weightings are for CHF SAA with a home bias and a balanced risk profile. We expect a balanced CHF SAA to have an average total return of 4.9% p.a. and a volatility of 8.5% p.a. over the next 15 years.

Source: UBS, as of January 2023

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