UBS House View

Monthly Extended August 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 and euro as most preferred currencies.

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.

In our global sector strategy, 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. Value stocks remain abnormally cheap against growth stocks, in our view.

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 cools and downside risks to growth remain.

The tightening of lending standards due to pockets of financial instability and higher official policy rates continue to weigh on growth and inflation, and apply downward pressure on nominal interest rates. This is a positive driver for the performance of high-quality bonds.

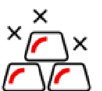
Specifically, we maintain a preference for high grade and investment grade bonds. We are also most preferred on EM credit and neutral on high yield.

Foreign exchange

We upgrade the euro to most preferred. Investors moving away from the US dollar are looking for a liquid alternative asset market, and we think the euro is an obvious option. The European Central Bank (ECB) has maintained a clear commitment to prioritizing the fight against inflation, which is still well-above target. The euro is also strongly undervalued relative to the US dollar, and long-term investors have considerable USD long positions that will need to be cleared eventually. The end of the US tightening cycle would be a good time to do so, in our view.

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

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



Commodities

Our benchmark, the UBS CMCI Commodity Index, ended June 3.1% higher. That said, at one stage, the index was up 7% as weather concerns related to the US corn crop, and suggestions of greater stimulus from the Chinese government emerged. By mid-month, both these drivers had lost their potency, to varying degrees. But we see persistent climate risks, periodic standoffs on the Black Sea grain deal, and further commitments to rebalance the oil market by Saudi Arabia as supportive for 2H. Overall, on a total return basis, commodities remain down 3% YTD, but are flat y/y with 12-month mid-teens expected return.

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: Extended late cycle	Base case: More economic weakness	Downside: Hard landing	*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 continuously 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 in the US are continuously pushed further into the future. China opts for large-scale fiscal stimulus.	The US economy slows further over coming quarters and reaches either side of zero growth by early 2024. Other Western economies also continue to decelerate and experience sub-trend or negative growth. China announces targeted measures to support economic activity.	Falls sharply on a global scale toward late 2023 or early 2024 owing to highly restrictive monetary policy. The US enters a deep recession. China continues to decelerate amid underwhelming fiscal support.	*Global: Oil price* *US, China: PMI data* *US: Change in nonfarm payrolls* *China: Consumer activity* *Europe: Gas prices*
Inflation	Remains firmly above central bank targets.	Continues to slow in the US and in Europe, but 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* *China: fiscal stimulus measures*
Central banks	The Fed halts its rate hiking cycle from Q3 2023 but may consider further rate rises in early 2024. The ECB and the BoE follow a similar path.	Fed, ECB, SNB, and BoE keep interest rates at elevated levels for the rest of the year before rate cuts become more likely in 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* *Bank lending surveys*
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* *Further coup attempts in Russia* *US sanctions on Chinese companies* *Reverse-CFIUS process*

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Analysts: Dirk Effenberger, Daniil Bargman

Asset class targets - December 2023

Key targets for December 2023	spot*	Upside	Base case	Downside
MSCI AC World	821	900 (+10%)	770 (-6%)	670 (-18%)
S&P 500	4,472	4,800 (+7%)	4,100 (-8%)	3,500 (-22%)
EuroStoxx 50	4,360	4,900 (+12%)	4,250 (-3%)	3,650 (-16%)
SMI	11,019	12,800 (+16%)	12,000 (+9%)	9,800 (-11%)
MSCI EM	1,006	1,150 (+14%)	1,050 (+4%)	800 (-20%)
US 10y Treasury yield	3.86%	4.25%	3.25%	2.25%
US 10y breakeven yield	2.28%	3.00%	2.25%	1.50%
US high yield spread**	395bps	400bps	550bps	850bps
US IG spread**	109bps	80bps	120bps	200bps
EURUSD	1.11	1.20 (+8%)	1.14 (+2%)	1.05 (-6%)
Commodities (CMCI Composite)	1,787	2,000 (+12%)	1,900 (+6%)	1,600 (-10%)
Gold***	USD 1,957/oz	USD 1,800-1,900/oz (-5%)	USD 2,100/oz (+7%)	USD 2,300-2,400/oz (+20%)

* Spot prices as of market close of 12 July 2023. Developed market constituents of the MSCI All Country (AC) World index display in the local currency. The MSCI EM 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: asset class targets above refer to the respective macro scenarios. Individual asset prices can be influenced by factors not reflected in the macro scenarios.

Analysts: Dirk Effenberger, Daniil Bargman

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		=	

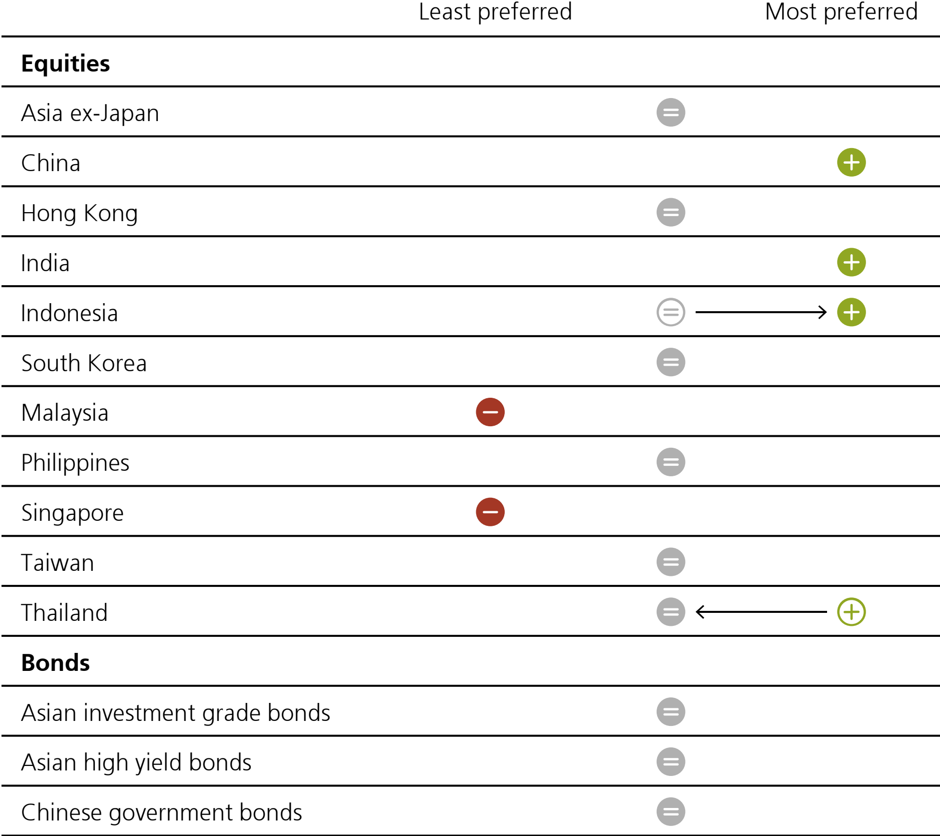
Note: The global asset class preferences reflect the high-level UBS House View. The tactical asset allocation (TAA) positioning of our different investment strategies may differ from this view because our strategies seek specific investment objectives and can frequently adjust portfolio allocation to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

Analysts: Adrian Zuercher, Mark Andersen

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		=	

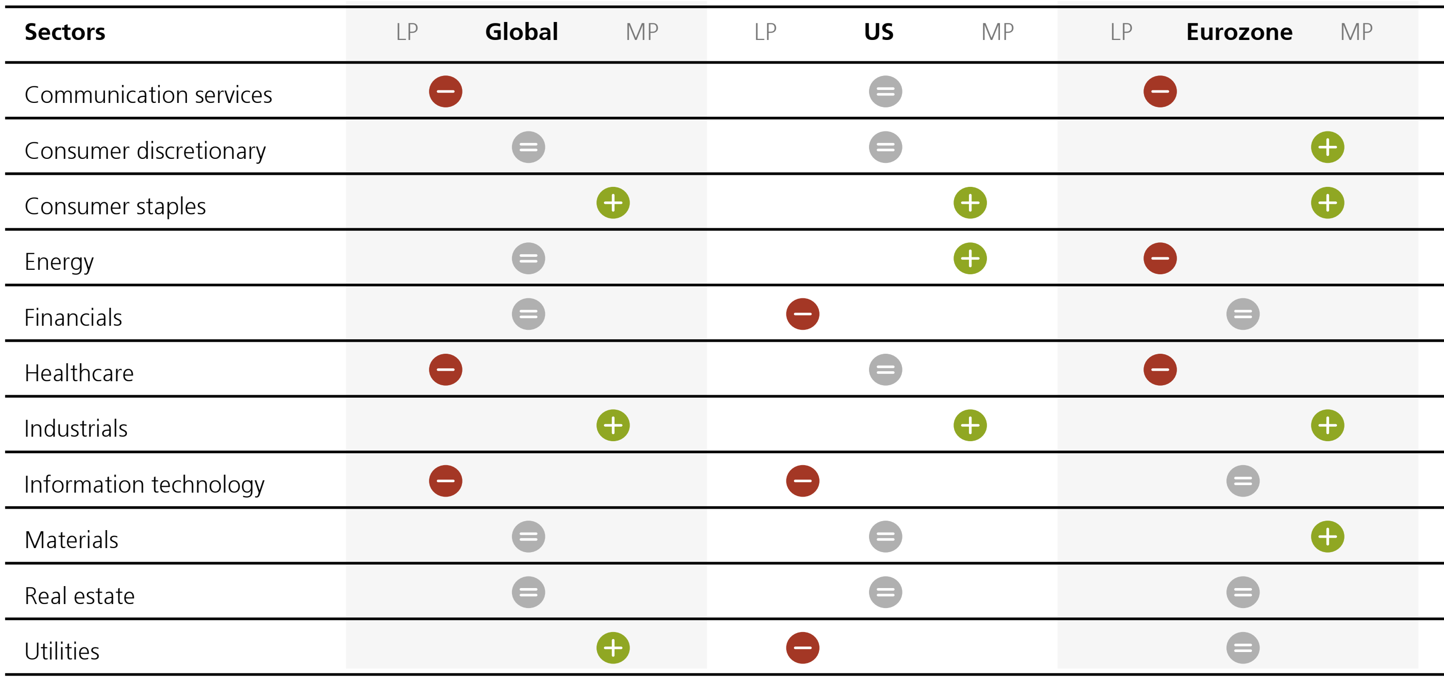
*We hold a most preferred stance on emerging market hard-currency sovereign bonds and remain neutral on emerging market hard-currency corporate bonds.

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.

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, providing investors with a good opportunity to lock in elevated rates as the Fed engages in a balancing act between price stability, 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.

Manage liquidity as rates peak
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 Swiss / 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 infrastructure

Inflation and slower growth ahead has not derailed business spending plans in key areas linked to upgrading infrastructure and supporting the net-zero carbon transition, two secular growth drivers which enjoy substantial policy support in the US and in Europe. Global industrial stocks should continue to benefit from these dynamics in the short run, while longer-term allocations to infrastructure and greentech look well placed in this environment too. Infrastructure-linked assets also often operate on long-term contracts tied to inflation.

Infrastructure including greentech
Industrials incl automation and robotics

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

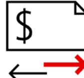
Go sustainable

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 strategies	Excess cash, sell-/expensive-rated bonds, excess equities
Foreign exchange		• JPY, EUR	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 – How much disinflation?

Base case (55%)

Growth

Real consumer spending is still inclined to slow 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 price measures continue to show disinflation. Core price measures have less disinflation, but are generally drifting lower. The cost of living for many middle income consumers is less than the headline reported rates, owing to peculiarities of calculation (generally around housing costs, and the way price discounts are treated in price indexes). Profit-led inflation is very much a political focus, and pressures around margin expansion may accelerate disinflation forces in some sectors.

Positive case (15%)

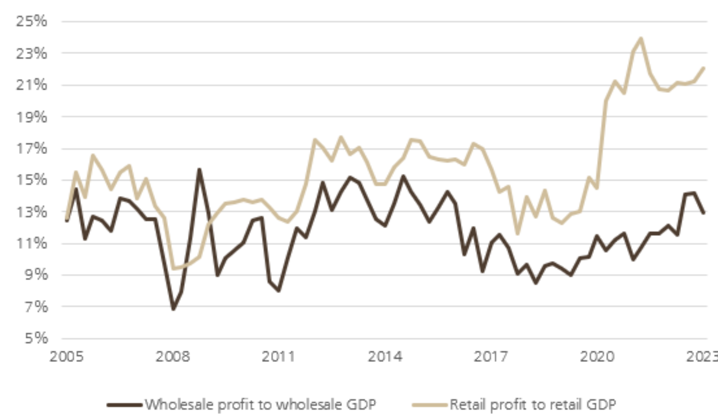
Although nominal wage growth slows, a faster decline in inflation restores stability in real wage growth more quickly, stabilizing consumer demand earlier than anticipated. Middle-income consumers experience below-reported inflation, which helps spending power in an important demographic. Unemployment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

US retail profit margins seem to have expanded

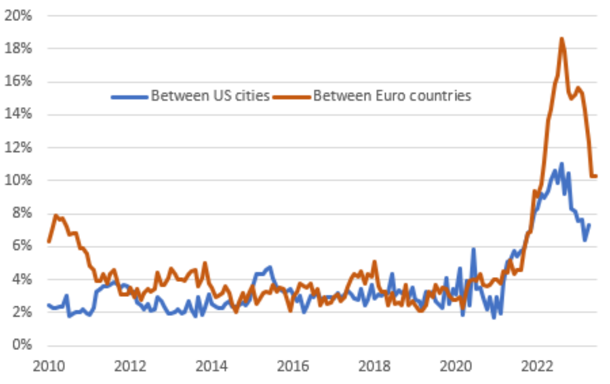
Retail profit ratios soar. Wholesales profit ratios stagnate



Source: BEA, Haver, UBS, as of 10 July 2023

Differences in inflation remain very wide

Highest less lowest regional consumer price inflation rates



Source: Bureau of Economic Analysis, Eurostat, Haver, UBS, as of 10 July 2023

US economy – Fed is not done yet

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 headline inflation is clearly down from its peak, core inflation remains too high, forcing the Fed to continue its rate hiking cycle. Supply chain issues have mostly been resolved, reducing inflationary pressure at the producer level, and this should help retail price inflation in the months ahead.

Positive case (15%)

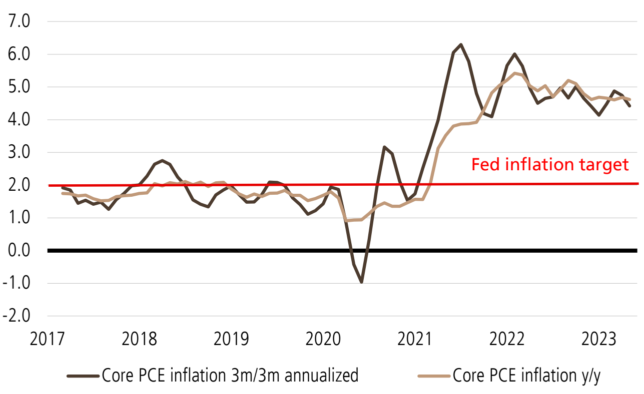
Better labor supply allows businesses to fill in their open job positions. Wage growth slows to a more moderate pace and energy prices stay low, helping to bring inflation down while growth remains robust. The Fed sees enough progress toward its mandates to stop raising rates but does not cut rates before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

Negative case (25%)

Inflation stays elevated, forcing the Fed to raise rates further. Banks continue to tighten their lending standards, making it more expensive for businesses to borrow. Households use up their excess savings, while the resumption of student loan payments leaves less money for spending. Seeing weakening consumer demand, businesses increase the pace of layoffs, and this quickly pushes the economy into a recession.

Inflation still far above Fed's 2% target

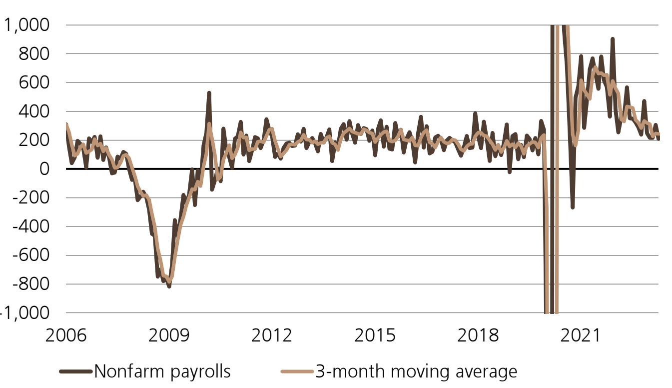
Core PCE, 3m/3m annualized and y/y change in %



Source: Bloomberg, UBS, as of 10 July 2023

Payroll growth back to pre-pandemic trend

Nonfarm payrolls m/m change in 000's



Source: Bloomberg, UBS, as of 10 July 2023

Eurozone economy – More to do for the ECB

Base case (60%)

Growth

We look for the Eurozone economy to stage a modest recovery from the mild recession it endured over the winter months, with divergence continuing to be a theme. The up-to-now strength of the services sector, which has supported peripheral economies relative to those in the core, has started to slow. However, a strong summer for tourism should continue to support divergence. Nevertheless, monetary tightening will weigh on the strength of any recovery.

Inflation

Headline inflation continues its sharp retreat in June, primarily thanks to energy prices. 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 September . Quantitative tightening is set to continue, with discussions around the next phase could beginning before year-end.

Positive case (15%)

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

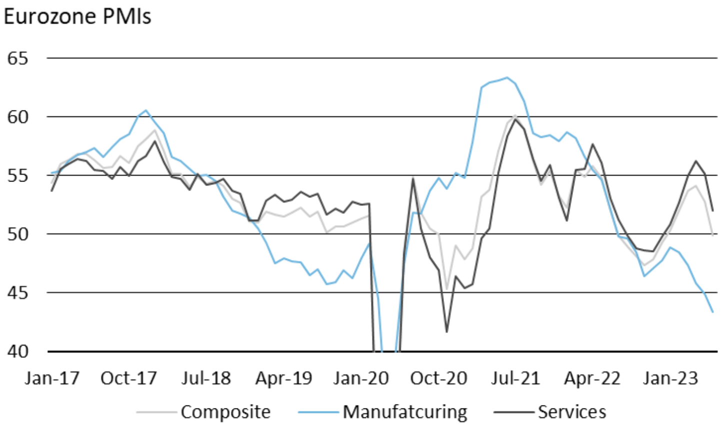
Economic growth in Asia and the US accelerates, with the latter avoiding a recession, boosting demand for Eurozone exports.

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.

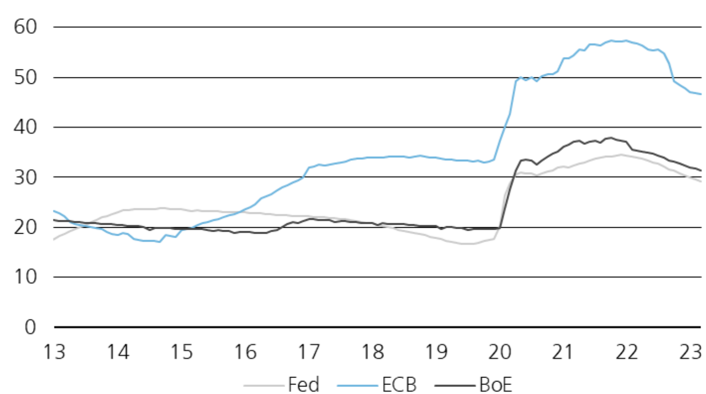
Geopolitical tensions force energy prices materially higher. Fiscal policy is too slow to respond or is tightened too early.

Activity surveys show the up-to-now resilient services sector slowing



Source: Haver Analytics, UBS, as of 10 July 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 signals further tightening

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 remained in place.

Inflation

Inflation has recently returned to the SNB's target range. However, part of the decline has been driven by base effects in energy. In 2H23, these effects are likely to fade, which, together with higher rents, should lead to an increase in inflation again.

The SNB hiked its policy rate by 25bps to 1.75% in June and signaled that further tightening may be appropriate. We expect the SNB to hike in September by 25bps, which would bring the terminal rate to 2%. At the same time, the SNB is likely to continue to sell FX reserves. Interest rate cuts are unlikely before 2H24.

Positive case (15%)

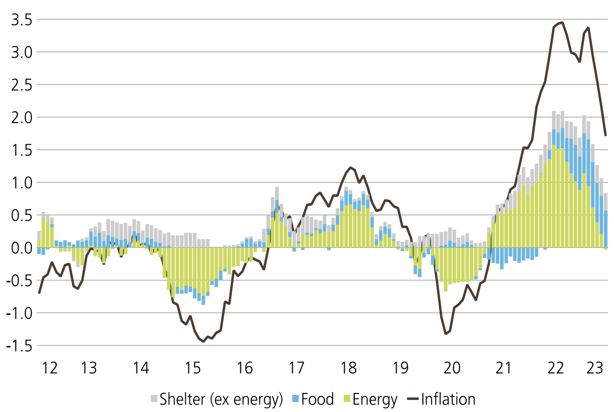
Better global growth momentum: A swift calming of the turmoil in the banking system and reduced inflationary pressures boost global demand. Switzerland benefits from the stronger global backdrop and a weakening of the safe-haven Swiss franc.

Negative case (15%)

US downturn 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 fell below 2% in June

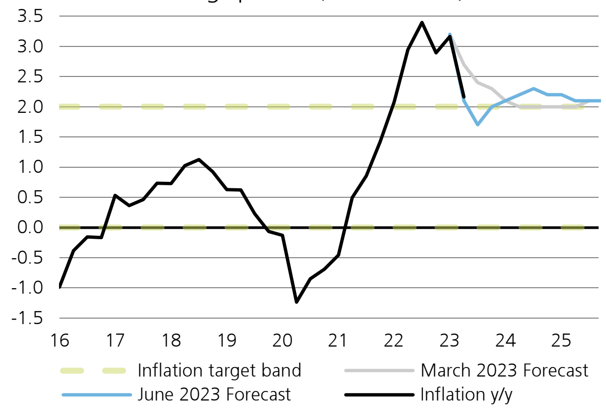
Year-over-year change in Swiss CPI and contribution of selected components, in %



Source: Macrobond, UBS, as of 7 July 2023

SNB's inflation forecast signals further tightening

Conditional inflation forecast (based on a stable policy rate in the coming quarters) of the SNB, in %



Source: Macrobond, SNB, UBS, as of 7 July 2023

Chinese economy – Continued recovery on policy support

Base case (70%)

Growth

The recovery has softened after a strong 1Q. For the first five months, retail sales grew by 9.3% y/y led by services and auto, while investment growth eased to 4% y/y on the weak property sector despite resilient infrastructure and manufacturing. More targeted policy support is expected, but large-scale stimulus remains unlikely. We expect full-year GDP growth of 5–5.5% y/y, backed by policy support and continued consumption recovery.

Inflation

Consumer inflation stayed low at near 0% mainly due to falling food and energy prices. We expect a mild pickup in 2H leading to ~1% for the full year. Producer price deflation is likely to persist by year-end.

We expect another one or two cuts to banks' required reserves and a 20bps cut to the MLF rate in 2H.

Positive case (15%)

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

Geopolitical risks remain contained without dramatic spillovers.

The US economy manages a soft landing.

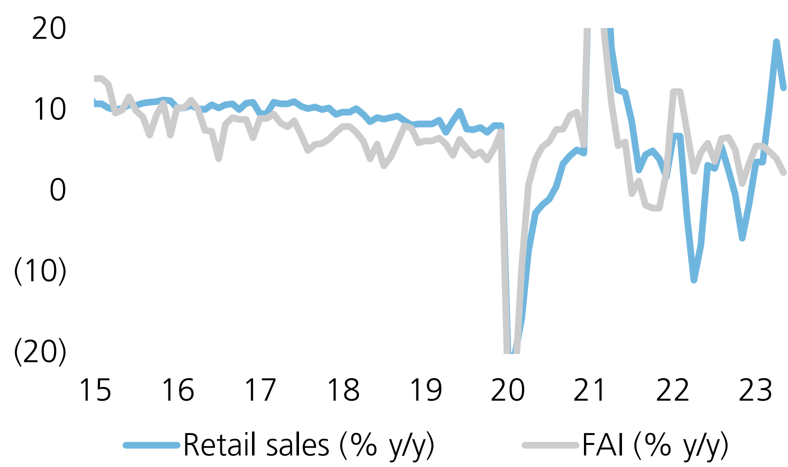
Negative case (15%)

Property activity is weaker than expected.

The US falls into a deep recession due to the lagged effect of high rates.

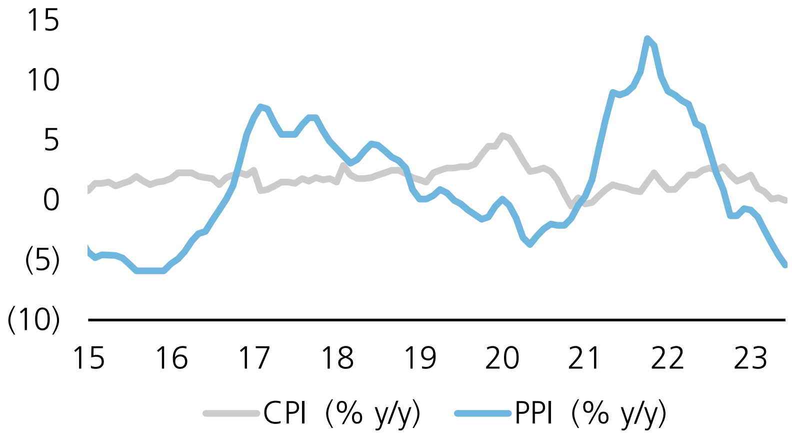
The US imposes much stricter restrictions on China's tech sectors.

Recovery momentum softened in 2Q



Source: CEIC, UBS, as of 10 July 2023

CPI inflation to stay low; PPI deflation to persist



Source: CEIC, UBS, as of 10 July 2023

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 and are a few percentage points above our year-end target, yet the outlook does not seem to be improving. Economic growth is expected to weaken in the coming months while central banks are committed to trimming inflation, increasing the risk of recession.

Equity valuations unattractive versus bonds. On a P/E basis, the MSCI All Country World Index is currently at 16.4x—13% above its long-term average of 14.6x, but still too high versus our fair value 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 3.9%, the lowest since the 2008 global financial crisis, and the earnings yield is only 1.7%, 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 a contracting manufacturing sector.

US equities least preferred. The MSCI USA forward P/E multiple is 19.7x today, a 23% premium to the long-term average of 16.1x and well above the level implied by real rates and other variables (i.e. ISM and credit spreads). The market rally is at odds with still-depressed manufacturing sentiment. Typically, there is a strong 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

Australian and emerging market equities most preferred. Australian earnings growth expectations are close to 15% for this year, and valuations have improved. The 12-month P/E stands at 14.9x, a 3% premium to the 20-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.

Despite the softer-than-expected economic growth momentum in April and May, we expect a reacceleration of the recovery in 2H backed by more policy support. We believe potential policy easing could also help to lift investor sentiment and strengthen market confidence on corporate earnings. China is trading at 10.2x, a 13% discount to the long term average, 38% discount to global equities, and 48% discount to US stocks.

Consumer staples, utilities, and industrials most preferred. Relative earnings revisions for consumer staples are positive versus the overall market. 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.

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

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; automotives (EV transition); and the reshoring of operations (e.g., more automation).

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 (15x 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 45% premium to history and 65% 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. As such, it is 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 re-accelerates: Solid economic growth in the US and emerging markets drive a sharper improvement in corporate profits in 2023 and 2024.

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

Interest rate volatility remains elevated as bond markets continue to look to price the end of policy tightening and recession risks. As central banks last year embarked on aggressive front-loaded rate hiking cycles to cool both realized and expected inflation, it became evident that lower-for-longer interest rate assumptions needed to be recalibrated. Cracks first started to surface last year in areas such as UK pension schemes, followed by US regional banks in the first half of this year, and now in pockets of commercial real estate and the corporate sector. 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. This has essentially resulted in deeply inverted yield curves as the front end continues to grapple with where central banks are likely to take terminal policy rates, whereas the long end prices policy pivots and probabilities of recessionary outcomes. Within this context, we see bonds offering appealing risk-adjusted returns relative to other asset classes and hence maintain a most preferred stance.

Within the asset class, we maintain an up-in-quality bias expressed through high grade (HG) and investment grade bonds (IG). There are select opportunities in the more growth-sensitive areas of high yield (HY) and emerging markets (EM). However, we are cognizant that tighter lending standards operate with a lag on fundamentals, and current slower growth and earnings in developed economies suggest higher default risk in the future. Additionally, liquidity risk premiums are prone to rise over time as global money supply continues to shrink. As a result, we see HY spreads as being vulnerable relative to IG and HG. Therefore, we are neutral on HY. EM bonds have suffered over the last few years from sluggish 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, particularly in the high yield sovereign EM space, are attractive relative to historical levels. We think this segment offers upside potential on prospects for a weaker USD, an end to policy rate tightening ,and favorable restructuring outcomes for a number of distressed special situations.

High grade bonds: We maintain our most preferred recommendation on HG bonds. With growth below trend and risks to the downside, we expect the recent cooling 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 financial instability in the banking sector in the first half of the year 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 carries 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.

Preference: Most preferred

CIO themes

Resilient credits

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

Income returning to fixed income

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

Bonds

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 4.5%. The recent stress in the banking sector and tighter monetary policy from the European Central Bank (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.

High yield (HY) bonds: We are neutral on the asset class given that relative to the higher-quality segments, we see more pronounced risks of spread widening and decompression as the tightening of financial conditions translates into higher corporate defaults for the more leveraged, cyclical companies. 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 is 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 rhetoric around policy support is ramping up toward property, 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 offers upside potential on restructurings as issuers are working with the IMF and other international lenders on debt relief and moving towards a more sustainable debt path. The sovereign index yield is now around 8.5% and the corporate index yield is around 7.3%.

FX

The US dollar remains least preferred in our global strategy. The Federal Reserve is very close to the end of its hiking cycle, and markets are already focusing on the timing for rate cuts. The strong tightening since March 2022 is now putting the economy under pressure. The Fed is teetering on the edge of the inflection point we have been looking for in 2023. Currency markets are volatile in this period of transition, as the Fed picks its moment to shift its policy stance. Still, the general direction of a weakening USD seems clear, as the US was the first mover in hiking rates and will probably also be the first to ease policy. In that phase, international investors have strong incentives to repatriate funds out of the US into higher-yielding emerging market or formerly negative-yielding G10 currencies.

We upgrade the euro to most preferred. Investors moving away from the US dollar are looking for a liquid alternative asset market, and we think the euro is an obvious option. The European Central Bank (ECB) has maintained a clear commitment to prioritizing the fight against inflation, which is still well-above target. The euro is also strongly undervalued relative to the US dollar, and long-term investors have considerable USD long positions that will need to be cleared eventually. The end of the US tightening cycle would a good time to do so, in our view.

We keep the Japanese yen at most preferred. We expect the Bank of Japan (BoJ) to eventually follow all other G10 central banks in tightening 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 happen in 2H23. So, we see the yen as a longer-term, but high-potential outperformer.

We keep a neutral position on the British pound, and Swiss franc. They should outperform the USD, but we think the Swissie and sterling will still lag the EUR. We believe, for example, it would be advantageous for a Swiss franc-based investor to hold euro bonds as the exchange rate is expected to trade sideways, while the yield is higher on the euro and would provide more carry. We see EURGBP as close to the bottom of our expected trading range.

Emerging market currencies forfeited some gains from mid-June onward as expectations for further tightening by the Federal Reserve crept up. That said, they have still delivered 4% in total return terms so far this year. Large-scale monetary easing in emerging markets looks unlikely in the short run, while global economic growth is subdued and investors are looking for options to gain some additional yield. This should still benefit carry currencies. The Mexican peso and Czech koruna are valid options in Europe and Latin America, in our view. Key risks stem from inflation proving more persistent than expected and the Federal Reserve seeing the need to deliver more interest rate hikes than currently priced, and the global economy falling into a recession.

In Asia Pacific, we expect a sequential rebound in China's growth from its 2Q trough, which should help currencies such as the AUD, the Chinese yuan, and the Thai baht to regain ground. 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.

OPEC+ seeks to tighten the market faster. OPEC+ has been curbing output since 4Q22, and with further cuts announced (Saudi Arabia extended its +1mb/d for August, and Russia +0.5 mb/d). One frequently asked question: why such a muted price response so far? Two main reasons: 1) non-OPEC supply has lifted faster than expected; 2) Higher exports from Iran and Venezuela. With oil demand seasonally rising during the northern hemisphere summer alongside supply cuts, we expect the result should be larger oil inventory declines over 3Q23.

Industrial metal demand tepid, but it's a global issue. Amid weak China data and local government debt concerns, it may surprise some that metal demand has been quite robust as apartment completions and accelerated grid spending keep annual growth in the high-single/low-teens. But China's export data points to weakening ex-China demand ahead. Short-term, we remain neutral on the sector as cost-support kicks-in, but underwhelming investment in new mines and the energy transition remains as the overarching bullish theme.

Gold faces short-term headwinds. US non-farm payrolls data missed to the downside, which lifted the gold price as US government bond yields declined alongside the US dollar. That said, we see risks of the price revisiting the USD 1,850–1,900/oz range if Fed hawkishness persists. Moreover, we note the rate of central bank purchasing is leveling off alongside retail demand. ETF buying is recommended for the next leg up, which typically comes 1–3 months ahead of Fed cuts.

Climate risks for agriculture shouldn't be dismissed. Our long recommendations in wheat and live cattle reached their targets mid-June; we took profit and look for opportunities to re-enter. El Niño threats are yet to take shape—the Indian monsoon, for example, is now around average. A receding US Midwest drought has also weighed on prices. While global weather risks eased, light positioning and likely upside surprises in purchases from key importers keep our bias for wheat and soft commodity prices skewed to the upside.

Where to invest

Prefer active over passive exposure to commodities. Historically, bull and bear markets have been long-lasting, but a protracted downcycle (like 2011–15) isn't expected. We believe investors who favor the energy transition and climate-related themes should have some exposure to broad commodities. Our expected return is a mid-teens percentage over 6–12 months.

Opportunities in longer-dated oil contracts. Longer-dated oil contracts are trading cheaper than spot prices. While commodity markets tend to price in the "now," futures curves don't hold much predictive power. Vanishing available spare capacity should support longer-dated contracts, in our view.

Gold as a hedge. Ongoing global growth uncertainties, geopolitics, and the likely peak in US rates (and associated weakness in the USD) should bolster ETF demand for gold into 2024. More importantly, we advocate for gold as a long-term hedge within a portfolio context, and recommend investors allocate a mid-single-digit percent of their portfolio to gold.

Volatility-selling strategies. On an individual commodity level, we see opportunities to engage in selling downside in crude oil, copper, aluminum, silver, platinum, and wheat.

Analysts:Dominic Schnider, Giovanni Staunovo, Wayne Gordon

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 growth divergence to continue, inflation to fall, central banks to stop hiking rates, and potentially some modest stimulus in China. Inventory destocking is likely to keep weighing on activity in the near term, but we see signs inventory digestion could turn more supportive for growth by year-end. We also see the potential for gas oversupply in Europe pushing energy prices even lower, helping support profit margins.

We favor sectors and themes that can benefit from these macro trends, with attractive valuations. We like the consumer 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 an end of destocking, China's economic recovery, or lower gas prices. German equities should also benefit if these drivers turn more favorable, and we think Eurozone small- and mid-caps offer material upside at current valuations should the macro outlook improve.

At 12.0x forward P/E, Eurozone equities (the MSCI EMU Index) are trading at a 10% discount to the long-run average. This looks fair to us in the context of elevated interest rates and modest downside risk to consensus earnings estimates. We forecast earnings to fall 5% (consensus +3%) this year and grow 5% next year (consensus +8%). That said, we still see a number of attractively valued segments with scope to outperform if the macro 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.

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.

Economic recovery. Earnings could surprise to the upside if economic growth is better than expected in 2024 or China's recovery strengthens.

Companies keep pricing power. If companies can maintain some pricing power, 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 liquefied natural gas 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.

US equities

Preference: Least preferred

Central scenario

S&P 500 December 2023 target: 4,100

The US equity market posted its second-best first-half performance in the past 25 years, and the S&P 500 is 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 mega-cap tech stocks (driving narrow market breadth), and previously depressed market sentiment and light positioning. The better economic and corporate profit data led us to recently raise our S&P 500 EPS estimates and price targets; yet, we believe stocks have run ahead of fundamentals and seem to be pricing in a very benign outcome. 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.

Second-quarter earnings season has begun. Based on our expectations for earnings beats, we look for a 3–5% year-over-year decline in S&P 500 EPS, which could be the trough for the earnings "recession." The bar for earnings season appears low. As usual, analysts have trimmed EPS estimates over the last few months. And based on the results from the early reporters and resilient economic data, we think these estimates look conservative. But from a market perspective, the bar could be higher given the strong equity market performance in recent weeks. In fact, the S&P 500 is completing its strongest pre-earnings season performance since 1Q21. So even if earnings results are good, this seems to already be largely expected by market participants.

Overall, we think near-term upside in equity markets looks limited. First, valuations are high. The S&P 500 forward P/E is roughly 19x despite expectations for only 6% forward earnings growth, much lower than the solid double-digit growth expectations when valuations were at similar levels in the past. Second, sentiment is no longer depressed, suggesting there is less scope for money to come off the sidelines and push markets higher. Third, economic surprise indexes are elevated, which usually means a higher bar for further positive surprises. We suspect any disappointing economic data could shake faith in the soft-landing narrative that is increasingly consensus. Fourth, stocks appear to be ahead of fundamentals and are pricing in a meaningful improvement in business sentiment as measured by the ISM Manufacturing index. Finally, the Fed's own forecasts suggest a period of weak economic growth and an increase in unemployment in order to reduce inflation to target. This outcome is certainly not priced in, in our view.

Sector preferences

Most preferred

- Consumer staples: While this defensive sector will likely lag in a soft-landing scenario, we think it's prudent to have some protection in the portfolio in the event of a hard landing. The sector trades at a discount to the market, which we believe is attractive in the context of the sector's defensive growth profile.
- Energy: Oil prices have been pressured by 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 lead to oil inventory declines and higher oil prices. Valuations are pricing in a somewhat dire outlook. The sector also appears a cheap hedge for any unexpected increase in inflation.
- Industrials: The sector should 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.

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 stays strong. Real incomes continue to grow 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: We believe a number of headwinds remain: Recession risks are high, 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 the fact that investors typically seek higher-quality growth companies at this stage of the business cycle. But this has pushed valuations to elevated levels. In a soft landing, investors will likely rotate into cheaper cyclical areas, and in a hard landing, valuations look vulnerable.
- Utilities: Increased regulatory risks and resilient economic data may lead to underperformance. Excess labor demand should keep the job market strong, and the risk of a hard landing seems less likely. We prefer to have defensive exposure through consumer staples, which continues to exhibit pricing power and benefits from resilient consumer spending.

UK equities

Central scenario

FTSE 100 December 2023 target: 8,000

We expect the global economy to slow further, with developed market GDP growth hovering close to 0% at various points throughout the year. We also anticipate a mid-single-digit decline in UK earnings for 2023. Due to the expected year-over-year changes in underlying commodity prices, we believe 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. UK inflation is taking longer to fall given the tighter labor market, and as a result the Bank of England is set to continue raising rates this year. Therefore, 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 poor outlook is already priced into the UK equity market.

The FTSE 100 trades on a 12-month forward P/E of 10.4x—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: 8,400

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.

Lower economic growth: Should developed economies sink into a full recession and thus global economic growth slows more than anticipated this would be negative for earnings and the valuation of equities.

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

Swiss equities

Central scenario

SMI December 2023 target: 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. We expect ongoing upward pressure on the CHF versus the EUR and even more so 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 firms and service companies, and selectively on 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.

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 2022–23 period.

Sustainable dividends: wiss 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 (EM) equities as most preferred. EM aggregate manufacturing PMIs are still in expansionary territory, and the gap with developed markets (DMs) has opened up further given the weakening momentum there. Importantly, in contrast to their DM peers, many EM central banks, thanks to continuously decelerating inflation prints, are expected to ease in 2H23, which should be positive for several major EM stock markets.

The MSCI Emerging Markets index's valuation, at 12x 12-month forward P/E, is largely in line with the 10-year average and is at a 37% discount to the S&P 500. On a price-to-book basis, the discount is even deeper at 64% versus its 10-year average of 54%. In our view, the gap does not factor in better earnings growth prospects for EMs in 2024 relative to developed markets. By contrast, we expect US equities to derate from the current 19x 12-month forward P/E, which does not reflect the expected weakness in US economic and earnings growth, in our view.

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 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 in the near term. Policy stimulus measures should support the market, and there are several positive developments including clarity from tech-related regulations and the resumption of US-China talks. We have downgraded Thailand to neutral given the weaker-than-expected tourism recovery and election-related risks. Meanwhile, we have upgraded Indonesia to most preferred from neutral on a relatively better macroeconomic environment and earnings outlook. We continue to like India, supported by constructive macroeconomic drivers, solid corporate fundamentals, and reasonable valuation multiples, which have derated over the past 18 months.

Upside scenario

MSCI EM December 2023 target: 1,150

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

Japanese equities

Central scenario

TOPIX December 2023 target: 2,200

We are neutral on Japanese equities in our global portfolio. TOPIX fell in mid-June but rebounded later to 33-year highs and has outperformed MSCI World year-to-date in terms of the yen. Large-cap quality stocks, beneficiaries of a weaker JPY, and semiconductor-related names have driven the 19% YTD rally, while quality value names have lagged. We advise being selective in the near term and diversifying into laggards such as banks and domestic-oriented consumer discretionary and service sectors to capture potential structural changes.

We advise selectivity in the near term for four reasons: 1) Valuations are still attractive compared to the S&P 500, but no longer cheap versus the historical average (TOPIX P/E 14.3x versus 10-year average at 13.7x); 2) international investors have already rebuilt their Japanese equity positions from extremely low 2022 levels. In fact, recent weekly data shows foreign investors have become net sellers; 3) 1QFY2024 results (June quarter) and additional share buyback announcements are unlikely to be major catalysts; and 4) we think further yen depreciation is unlikely with a peak in US rates ahead.

However, we think Japanese stocks still offer relative safety at current levels and downside is limited 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 ROE; and 4) an expected slower yen appreciation trend against the USD.

We think banks will benefit from the BoJ's potential yield curve control changes in 2H23, and a relatively high dividend yield (4%) mitigates downside risk. Reopening beneficiaries remain attractive to us, with the first summer since the reopening now underway. A weaker yen is an impetus to visit Japan, and China's reopening should also boost arrivals. Value stocks also benefit from a potential increase in share buybacks and dividends due to near-term pressure to improve ROE.

Upside scenario

TOPIX December 2023 target: 2,500

Global economic growth remains resilient: A strong Chinese economic recovery 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 of increasing ROE pressured by the Tokyo Stock Exchange could be a rerating catalyst for Japanese equities in the longer term.

Sustainable inflation and wage growth: The result of the 2023 Shunto wage negotiations was a 3.7% rise in wage growth (a 28-year-high), and core inflation shot up above 3% in 1Q23 (the highest since 1981). If moderate wage growth and inflation are sustained in 2024, 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.

Asian ex-Japan equities

Central scenario

MSCI Asia ex-Japan December 2023 target: 680

We maintain a neutral stance on MSCI Asia ex-Japan. Many Asia ex-Japan markets are displaying early signs of stabilization, with manufacturing PMIs at buoyant levels above 50. But the risk of a heavy global slowdown remains following eight straight months of contraction in the US ISM PMI. We stay focused on relative opportunities within the region, instead of taking directional beta exposure.

We upgrade Indonesia from neutral to most preferred. As a robustly growing economy with external surpluses, Indonesia's market should be resilient against currency shocks. Declining domestic inflation could open room for policy rate cuts later this year. More than half of Indonesia's market exposure is to financials or banks, which could deliver steady double-digit earnings growth, in our view. Rising foreign interest should also continue to act as a market tailwind. On the other hand, we downgrade Thailand from most preferred to neutral. A positive outcome in the parliamentary vote could provide near-term optimism to the equity market but fundamentally, Thailand's tourism recovery is stalling as travelers from China have yet to return in force.

China stays as most preferred. The current positioning of global mutual and hedge funds in China is light, and Chinese equity market valuations are attractive. We maintain our view that the market will deliver double-digit earnings growth this year. We believe the upcoming late-July Politburo meeting bears close watching for more potential policy support to help the economy regain growth momentum. We'll also continue to monitor any shifts within the US-China relationship and for any further economic weakness.

We continue to like India. As the headwinds from a strong dollar fade, we think India will continue to benefit from a narrower external deficit and declining domestic inflation, and remain one of the fastest growing economies in the region this year. Continuous foreign inflows should support the market's projected outperformance. Furthermore, the market's earnings growth is currently bottoming, with valuations much more reasonable now than in the last two years.

Meanwhile, we keep Singapore and Malaysia as least preferred. Singapore bank earnings growth is expected to fall as interest rates peak. Malaysia's manufacturing PMI ticked down to 47.7 in June from 47.8 in the previous month, indicating the 10th contraction in a row and the steepest fall since January. We believe near-term upside for these markets remains less attractive than for 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: Indonesia (New), India, China

Least preferred: Malaysia, Singapore

Asian ex-Japan equities

Upside scenario

MSCI Asia ex-Japan December 2023 target: 760

Fed starts rate cuts earlier than expected

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

Strong China housing demand recovery

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

Strong demand recovery in tech

Asian tech 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.

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 will continue to decelerate because of tighter financial conditions, with significant uncertainty about whether the US economy is going to experience a mild or a deep recession. 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.

Investment grade

Preference: Most preferred

Central scenario

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

Interest rates across developed markets surged last year as central banks tightened policy in response to elevated inflation. Given the high interest rate sensitivity of the US and European investment grade (IG) bond segments, the speed and magnitude of the move higher in rates more than offset income earned over the period and hence resulted in poor total returns. Looking ahead, we think return prospects in higher-quality fixed income look appealing given elevated all-in yield levels and as major developed market central banks come closer to the end of their hiking cycles.

US government bond yields took a leg higher over the month as the market repriced the policy rate path higher in light of signs of resilient economic data in the US. US IG spreads tightened, which helped to offset the rise in government bond yields.

US IG yields of 5.4% are at a historically elevated level. 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.

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, recent rating trends remain positive.

As for EUR IG, the average yield sits at 4.4%. Index spreads are now trading at 153 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—remain uncomfortably high. Meanwhile, monetary policy tightening is working its way into the economy, as evidenced by tightening lending standards, slowing lending growth, and relatively weak PMIs.

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

CIO themes

Resilient credits

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

Income returning to fixed income

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

Investment grade

Upside scenario

Bloomberg Barclays US Int. Corp December 2023 target: 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 in 3Q 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.

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. Spreads have tightened on the riskier credit segments over the month as the market has repriced the risk of recession in light of resilient US economic data. At current spreads of around 400 basis points in USD HY, the market appears to be discounting a benign default environment in the year ahead, consistent with above-trend growth.

However, 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. Lending standards remain tight, pointing to downside risks to growth and upside risks to defaults over the coming 12 months. The recent regional bank failures in the US could also lead to 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, in our view. 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 3.2%.

We have not seen the classic buildup of financial excess and leverage since the last default cycle in 2020 related to the COVID-19 pandemic, which gives some comfort. Leverage has declined as earnings have increased, while debt growth has been muted. Furthermore, the energy sector in the US, which is often a source of defaults in downturns, is in a relatively healthy state by virtue of higher energy prices.

Currently, the level of credit risk premium is not overly cheap in our view. 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 8.8% and 7.7% (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.

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, this implies the US dollar is likely to weaken, which would translate into easier financial conditions for emerging markets, while we also expect US Treasury yields to decline over the coming months.

US growth has been more resilient than expected, and near-term recession risks have been repriced. 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.

Despite the sharp rise in US Treasury yields over the past month, EM bonds were resilient and delivered positive performance, besting higher-quality developed market bonds such as USD high grade. EM bond spreads tightened, led by the lower-rated high yield segment. Valuations of EM bonds are now fair on average, in our view. Although spreads may narrow further if a US soft-landing scenario becomes more likely, our base case sees them trending broadly sideways for the rest of the year.

The sovereign index yield is currently around 8.6%, while the yield on the corporate index (CEMBI Diversified) is around 7.5%. 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 mostly by carry.

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 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, but they can also aid in portfolio yield enhancement and diversification, in our view.

Oil and gas bonds

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

Sustainable bonds

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

Opportunities in sukuks

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

Emerging market bonds

Upside scenario

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

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

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

Downside scenario

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

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

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

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

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

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

Asian bonds

Central scenario

JACI composite spread December 2023 target: 260bps

US treasuries sold-off over June with the Federal Reserve (Fed) signaling potential further rate hikes. In Asia, as spreads tightened further, high yield (HY) bonds delivered a positive monthly return (0.88%, as of July 10th), which outperformed investment grade (IG) bonds. But given the weakening macro backdrop and stronger technicals for IG, we stay defensive with a preference for the IG segment.

Asia IG credits are likely to provide better risk-reward in the near term, in our view. Asia IG has an attractive combination of yield level and high quality. JACI IG's current yield at 5.8% is on the higher end of its historical trading range post the GFC period. Overall, Asia IG ratings remain intact as two-thirds of Asia IG issuers have credit profiles linked to their sovereign ratings. On the technical side, the imbalance of subdued issuance and strong demand should provide some downside cushion. Although the spread level on JACI IG looks tight (below its historical average), in our view spread valuation should not be a constraint on performance.

For Asia HY, we believe short-term challenges remain. China HY rebounded in June on policy stimulus hopes, but recently it became a drag on overall performance given the downward pressure on developers' fundamentals, with property sales remaining subdued. Last week, Sino-Ocean's shareholders appointed CICC to conduct due diligence on the company, leading to speculation on potential debt restructuring. Looking forward, any negative headlines or defaults could further dent market sentiment. We believe the policy stimulus is still the driver of HY developer bonds. Should the policymaker be able to fine tune implementation and execution of existing financing facilities, in addition to promoting demand-side measures, we may see Asia HY rally. Overall, we stay cautious on this segment and believe that bond selection is key when managing exposure.

Upside scenario

JACI composite spread December 2023 target: 230bps

A pick-up in reopening momentum: Should China's recovery gain momentum, 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 swift 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: preads 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.

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.

Crude oil

Preference: Most preferred

Central scenario

Brent crude oil December 2023 target: USD 90/bbl

Various oil market participants remain skeptical that Russia is implementing its pledged production cut. To verify compliance, the market—and we—track Russian oil exports. The IEA estimates Russian crude and refined product exports fell 0.6mbpd m/m in June to 7.3mbpd, the lowest level since March 2021. Petro-Logistics, a seaborne oil trade analytics company, estimates that Russian waterborne exports dropped further in the first 12 days of July by almost 830,000bpd, with crude down by a bit more than 550,000bpd and refined products down a little more than 270,000bpd. Important here is that both crude and products are down, as there was some market concern that higher product exports might offset lower crude exports. This suggests that Russia is scaling back production.

Also, Russian flagship Urals crude recently moved above the price cap set by the Group of Seven nations. Buying above the price cap remains possible, but those exports need to rely on "dark fleet" tankers insured by companies in emerging markets. India has already considerably increased purchases of cheaper Russian crude, so the country might have to reduce imports until it finds alternative tankers.

We retain a positive price outlook. With oil demand seasonally rising during the Northern Hemisphere summer alongside lower supply from OPEC+ countries, falling oil inventories should see higher oil prices in the months ahead.

Upside scenario

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

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

Downside scenario

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

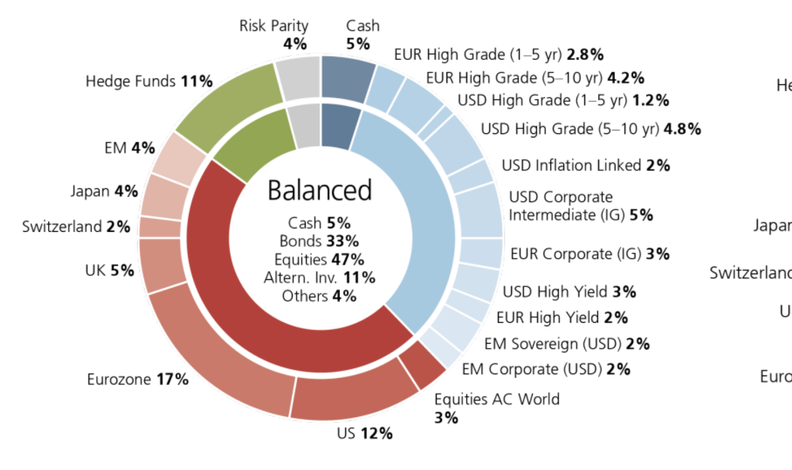
Downside risks include a deep recession or renewed extended mobility restrictions that weigh on the oil demand recovery. A hard landing for the Chinese economy in 2023 would also pose a downside risk, as emerging Asia is the engine of oil demand growth. Another concern is that capital discipline in the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

Section 4

Appendix

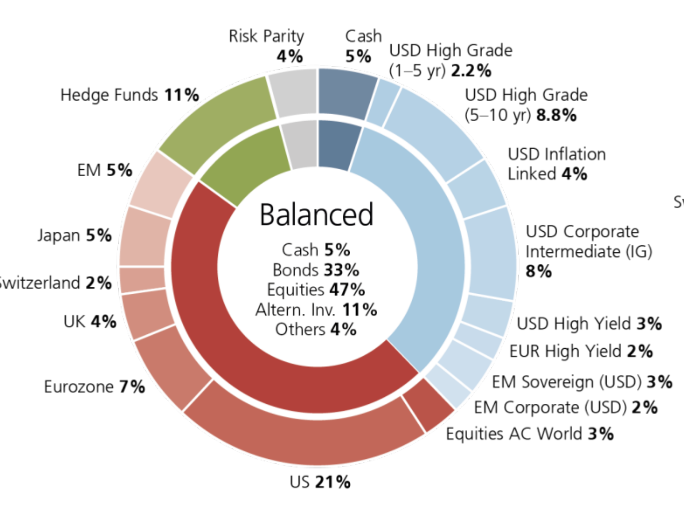
Strategic Asset Allocations (SAAs)

EUR (local portfolio with home bias)



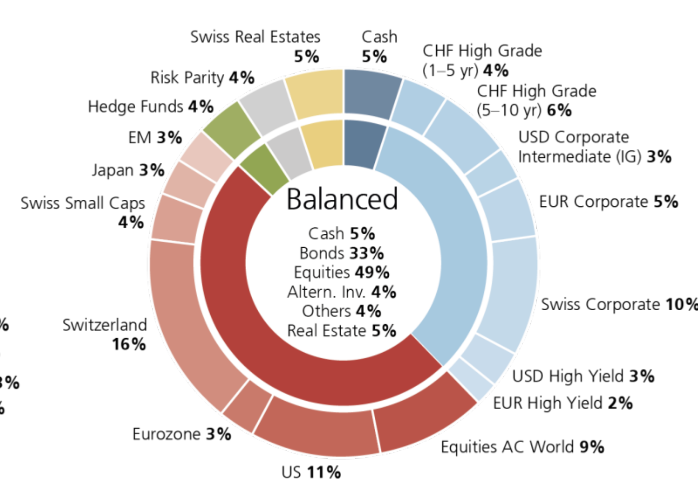
Note: Portfolio weightings are for EUR SAA with a home bias and a balanced risk profile. We expect a balanced EUR SAA to have an average total return of 5.3% p.a. and a volatility of 8.5% p.a. over the next 15 years.

USD



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

CHF (local portfolio with home bias)



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

Source: UBS, as of January 2023

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