UBS House View

Monthly Letter | 13 July 2023 | Chief Investment Office GWM, Investment Research

US resilience

The combination of robust growth and falling inflation has boosted hopes of a soft landing for the US economy.

Market optimism

After a strong rally in the cap-weighted S&P 500 in the first half of the year, we think a lot of optimism is priced in.

Weaker dollar

With inflation receding faster in the US than in Europe, we expect the US dollar to weaken further.

Asset allocation

Fixed income is our most preferred asset class. We upgrade the euro to most preferred.

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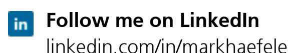

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Into the second half

As we entered 2023, the broad consensus was for the US economy to slow, inflation to fall, and China's growth to accelerate. Six months on, the US economy has proven surprisingly resilient to recession, headline inflation has fallen steadily while core inflation has been slower to decline, and China's post-COVID recovery has disappointed.

Meanwhile, most expectations, including our own, were for broad stock market indexes to fall this year as earnings growth decelerated. Yet the S&P 500 has enjoyed the second-best first half in the last 20 years, powered by a robust US economy, a little bit of inflation-driven nominal earnings growth, and a lot of optimism about a handful of companies associated with artificial intelligence.

In this letter, we examine why all this has happened, whether a US recession, normalization in inflation, and China's recovery are just postponed or outright canceled, and what it all means for the investment outlook.

In short, US data has undoubtedly been encouraging, and the Federal Reserve's likelihood of staging a soft landing improves with every data point demonstrating resilient growth and falling inflation. That said, even though this is a better macro backdrop than we expected at the start of the year, we maintain our preference for high-quality bonds over equities, for three main reasons. First, the good macro news is already priced into the S&P 500, in our view, setting the bar higher for the rest of the year. Second, in the second half, we expect an environment where inflation continues to fall, but growth also slows, potentially close to zero. That situation is good for bonds, but generally not equities. Third, the uncertain scale of the lagged effect of prior interest rate hikes means that both recession and a Fed policy error remain potential risks. Therefore, in our global strategy, we prefer to spend our risk budget in fixed income and currencies rather than overweight broad US markets.

Meanwhile, in China, we expect the recent loss of momentum to prompt an easier monetary policy and targeted fiscal measures designed to support growth.

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What should investors do?

Fixed income is our most preferred asset class. We like high-quality bonds, given attractive yields and their potential to act as a portfolio hedge against the risk of a US recession and Fed policy error. Among riskier parts of the asset class, we prefer US dollar-denominated emerging market sovereign bonds.

We favor parts of the equity market that have lagged this year's rally.

We keep a selective approach within equities and focus on laggards that have underperformed during this year's rally. We like emerging market equities, global consumer staples and industrial stocks, and think equal-weighted US indexes could continue to grind higher if data remains consistent with a soft landing.

That said, the risk-return trade-off for market-cap-weighted US indexes is currently less appealing, in our view, given that the high weighting of a small number of technology stocks increases both aggregate valuations and idiosyncratic risks.

Elsewhere, we note that the US dollar has resumed its downtrend in recent weeks, falling to an eight-year low against the Swiss franc. We recommend that investors position for further dollar weakness over our forecast horizon, including against the euro. In addition, we expect gold prices to move higher.

Why has the US held up better than expected?

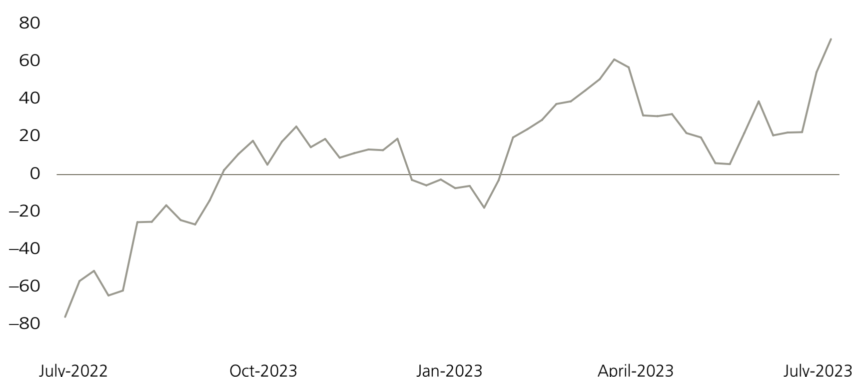
The US labor market has shown resilience, with unemployment below 4%.

Shrinking real disposable incomes, the depletion of pandemic-era savings, and the fastest Fed rate-hiking cycle in 40 years were foreseen to have tipped the US into a recession by now. Yet unemployment is still well below 4%, retail sales growth remains robust, and even some supposedly rate-sensitive sectors like homebuilding are in good health.

Figure 1

The US economy has shown resilience

Citi US Economic Surprise Index



Note: The index measures the degree to which economic data is either beating (index rising) or missing (index falling) expectations.
Source: Bloomberg, UBS, as of July 2023

What happened?

Markets may have overestimated the US economy's sensitivity to interest rates.

First, markets may have overestimated the interest rate sensitivity of the US economy, as both consumer and business debt has longer maturities today than in the past. At the beginning of this rate-hike cycle, only about 10% of US mortgages were adjustable-rate, and currently, only about 17% of global corporate debt is

set to mature before 2025. And even for consumers and businesses facing higher rates, there have been offsetting forces: Both inflation and nominal wage growth have been strong, and fiscal policy has implicitly turned expansionary again over the past six months with the federal deficit back up to 6% of GDP.

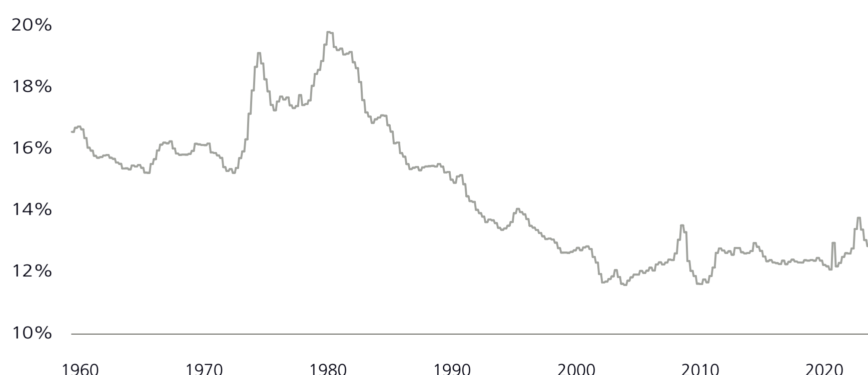
The service sector accounts for around four-fifths of US GDP.

Second, markets may have underestimated the impact of the economic shift toward services. Services now account for 81% of US GDP. By their nature, many services require limited capital investment and have little or no inventory—inventories as a percentage of GDP have declined by 40% since 1980. This means that swings in capital investment and the inventory cycle have a more limited role in driving economic variation than in the past.

Figure 2

Inventories' role in the US economy has structurally declined

Nonfinancial corporate inventories, in % of GDP



Source: Bloomberg, UBS, as of July 2023

Third, the ongoing aftereffects of quantitative easing and COVID-era fiscal stimulus mean that neither higher rates nor the collapse of Silicon Valley Bank has had a material impact on the availability of funding. In the latest NFIB survey of small businesses, only 2% reported they were unable to borrow their desired amount. The market for high yield corporate bond issuance has also reopened following the Silicon Valley Bank bankruptcy: New issuance stood at around USD 22bn in May and USD 12bn in June compared with just USD 4bn in March.

What should we expect going forward?

Current momentum makes it unlikely for a recession to start soon.

The current growth momentum is strong enough to make recession unlikely anytime soon, and a tight labor market should keep consumer confidence high and reduce the severity of any potential recession.

Yet we must remember that monetary policy acts with a lag, and uncertainty remains around if, when, and how much prior tightening will bite.

We see two key risks:

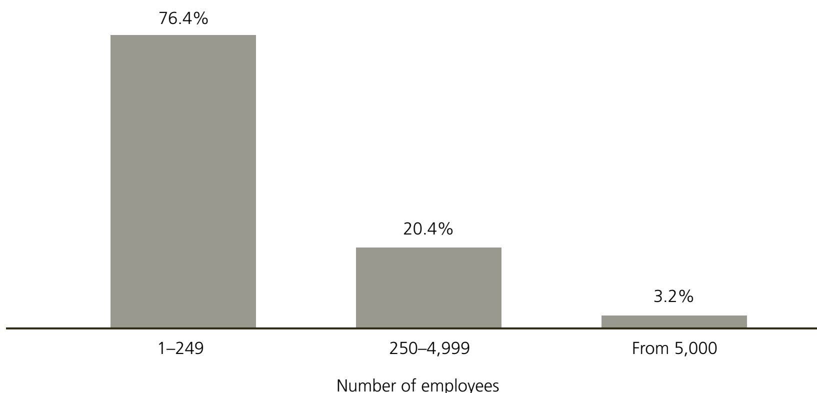
First, consumers and businesses could cut back spending, hiring, and investment as higher interest rates progressively impact their budgets.

For consumers, while mortgage borrowing tends to be very long term, interest rates on car loans and credit cards reset more frequently, and rising bank deposit rates are increasing the relative attractiveness of saving over spending.

Figure 3

Tighter credit conditions would weigh on small businesses, which account for most job openings

Job openings by establishment size based on number of employees, May 2023 BLS estimate, in %



Source: Bloomberg, UBS, as of July 2023

For businesses, the 500 basis points of Fed rate hikes and tighter bank lending standards mean the interest rates they are paying are much higher than 18 months ago. Since small businesses account for most of the excess demand for labor, this could also progressively soften the labor market.

The risk of a Fed policy error remains.

Second, while the Fed is likely pleased with the direction of the data in recent months, policy error remains a risk.

To be sure, it will be a challenge for the Fed to consider cutting interest rates while incoming data shows core inflation remains well above target. But if the Fed underestimates the lagged effect of the rate hikes it has already implemented, and keeps rates too high for too long, it risks tipping the economy into recession.

What does it mean for investors?

Although resilient economic data has improved the Fed's likelihood of staging a soft landing, uncertainty remains around the timing and scale of the lagged effect of the past rate hikes. In this context, we like the all-in yields on offer in high-quality fixed income and the potential for capital appreciation should investors shift their focus toward growth risks.

Why has inflation stayed high?

Headline inflation has fallen this year.

As we entered 2023, consensus expectations were for inflation to fall, and that has proven correct. In the US, headline consumer price inflation has fallen to 3% from a peak of 9.1% last June, and Eurozone inflation has slowed to 5.5% from 10.6% last October.

Yet while headline inflation has moved lower, core inflation has proven stickier than expected. Core consumer price inflation has only fallen to 4.8% from a peak of 6.6% in the US, and to 5.4% from 5.7% in the Eurozone.

What happened?

Wage growth has contributed to stickier core inflation.

First, US demand has proven more resilient than expected while output remains above potential, and this combination is continuing to generate price pressures. We can see this most clearly in labor markets: In the US, average hourly earnings rose 4.4% year-over-year in June, while in the euro area, wage growth has accelerated to levels not seen since the establishment of the single currency.

Second, a wave of profit-led inflation added to price pressures as some companies sought to raise prices to protect or even grow their margins. In the US, the share of retailers' profits in retail GDP rose to 22% in 1Q23, up 1.4 percentage points since 1Q22.

Figure 4

Companies raising prices to increase profit have contributed to persistent inflation

Wholesale profit relative to wholesale GDP, and retail profit relative to retail GDP, in %

Source: Haver, UBS, as of July 2023

Third, shifting consumer preferences have played a role. For example, demand for vacations has become less price-elastic since the pandemic, meaning that consumers appear reluctant to curtail spending in this area despite higher prices.

What should we expect going forward?

US CPI data for June showed a further slowdown in inflation.

US consumer price data for June showed a step down in inflation. Supply-side bottlenecks have eased, and inflationary pressure has been reduced at the producer level. US data on new leases also suggests that the shelter component of consumer price inflation should slow in the months ahead.

Should inflation continue to fall rapidly, a data-dependent Fed will have more leeway to end the rate-hiking cycle sooner, though for now it is likely too early to say that the inflation problem has been solved. Core inflation remains well above the Fed's 2% target, and we still expect it to end the year above that level. Tight labor markets also mean both that wage growth may not fall quickly toward levels consistent with 2% inflation, and that resilient consumer spending could support prices.

What does it mean for investors?

With inflation receding faster in the US than Europe, we expect the dollar to weaken.

One key consequence of the steady retreat in global inflation will be a weaker US dollar, in our view, as price pressures ease faster in the US than in Europe. Consumer energy subsidies in Europe meant inflation was slower to rise but will also be slower to fall. In turn, this should mean that interest rate differentials with the US will narrow—leading more investors to seek yield in Europe rather than the US. We forecast EURUSD to rise to 1.18 by June 2024, from 1.11 today.

Why has China disappointed?

At the end of 2022, China opted for a "big bang" exit from its zero-COVID policy, supporting expectations that 2023 would bring a sharp consumption-led recovery. GDP growth did recover initially, but recent data have shown a loss of momentum. Retail sales increased by a lower-than-expected 12.7% year-over-year in May, slowing from an 18.4% gain in April. Meanwhile, fixed-asset investment grew by 4% in the first five months of 2023, decelerating from 4.7% in the January-to-April period.

Chinese households have favored saving over spending.

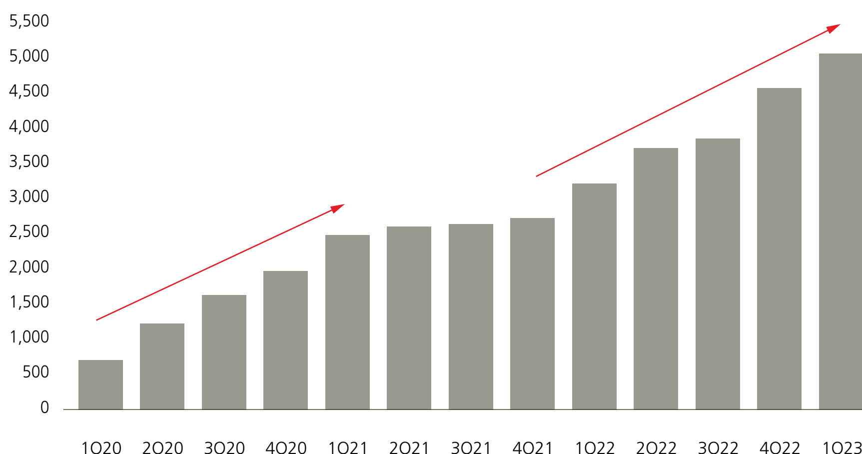
Consumers have proven surprisingly cautious, with lower property values and stalling income growth, leading households to favor saving over spending. Accumulated household excess savings increased by 11% in the first quarter of this year. Unlike many developed countries, China refrained from cash handouts or subsidies during the pandemic.

Meanwhile, weaker property sector activity has weighed on investment growth, as developers hold back from buying land and starting projects in the absence of financing support. Beijing has refrained from its usual approach of delivering "bazooka" support to the market, and year-to-date new property starts have dropped 23% year-over-year.

Figure 5

Private-sector sentiment has been subdued, as shown by high precautionary savings

China's household excess accumulated savings, in CNY bn



Source: CEIC, WIND, NBS, UBS, as of July 2023

What should we expect going forward?

We expect further government measures to support growth.

We do expect the government to do more to stimulate growth. We expect monetary support to continue with rate cuts, but more economic impact is likely to come from fiscal measures. Infrastructure stimulus, an extension of the strong policy push in 2022, is likely and should help offset weakness in real estate investment. Consumer stimulus is also likely to continue at a sector level, including support for purchases of electric vehicles, home appliances, and other big-ticket items.

This should help improve sentiment and employment and broaden the consumption recovery. Modest housing relaxations like mortgage rate cuts and an easing of home-purchase restrictions should also help stabilize the property market. This stimulus, in our view, will support GDP growth of around 5–5.5% in 2023. The July Politburo meeting is the next event to watch for signs of more stimulus.

What does it mean for investors?

Policy support should feed through into better corporate earnings.

We expect monetary and fiscal stimulus to support GDP growth and feed through into better corporate earnings in emerging markets. The trend in earnings revisions for MSCI China turned positive in May, and we forecast 14% corporate earnings growth this year. Valuations are still attractive: The MSCI China's forward price-to-earnings ratio is 9.3 times, or just around 16% higher than last October's crisis trough. Meanwhile, the resumption of Sino-US dialogue with Treasury Secretary Janet Yellen's visit to China should help put a near-term "floor" under US-China relations, though frictions over technology are likely to persist.

Asset class targets

	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 10-year Treasury yield	3.86%	4.25%	3.25%	2.25%
US 10-year breakeven yield	2.28%	3%	2.25%	1.5%
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: The asset class targets above are for December 2023 and refer to the respective macro scenarios. Individual asset prices can be influenced by factors not reflected in the macro scenarios.

Source: UBS, as of July 2023

As a result, we retain a most preferred view on emerging market equities in our global strategy—Chinese equities account for around 30% of the MSCI Emerging Markets index, and we expect low-teens percentage upside through the end of the year. Within Chinese equities, we prefer a barbell strategy of recovery beneficiaries and high-yielding defensive sectors. We also see competitively positioned internet companies as attractive.

Messages in Focus

Buy quality bonds *Manage liquidity as rates peak* *Lock in quality bond yields (high grade, investment grade, sustainable)* *Select senior financial bonds* *Actively managed fixed income strategies*	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.
Seek diverse and durable income *Emerging market bonds* *Quality dividend-paying equities* *Swiss income equities* *Yield-generating structured investments* *US preferred securities*	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.
Look for equity laggards *Capital preservation structured investments* *Invest in emerging markets and select Swiss / European opportunities (vs. US)* *US equal-weight vs. cap-weight (i.e., "the rest" vs. tech)* *Value vs. growth*	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.
Position for dollar weakness *Diversify USD holdings* *Gold* *Structured strategies on select currencies*	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 with alternatives *Hedge funds (discretionary macro, equity low-net, credit, multi-strategy)* *Private equity (value buyout, secondaries)* *Stay invested in private real estate / private credit*	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.
Invest in infrastructure *Infrastructure including greentech* *Industrials including automation and robotics*	Inflation and slower growth ahead have not derailed business spending plans in key areas linked to upgrading infrastructure and supporting the net-zero carbon transition, two secular growth drivers that 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.
Go sustainable *Sustainable bonds* *Sustainable equities: ESG leaders, renewables, and water scarcity* *Sustainable hedge funds* *Private market impact investing*	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.

Scenarios and investment outlook

We see three main scenarios for the next six months.

We see three main economic and market scenarios for the next six months:

- In our upside scenario, developed market inflation stays above target, yet economies remain resilient to higher interest rates. Meanwhile, in China, the government opts for large-scale stimulus, promoting a reacceleration of growth. Such a scenario could see equities continue to grind higher, supported by more cyclical sectors and markets. We assign a 20% probability to this outcome.
- In our base case, inflation falls, though not rapidly, so central banks keep interest rates at elevated levels for the rest of the year. This progressively slows US GDP growth to either side of zero by early 2024. The Chinese government responds to a slowing momentum with targeted measures to support growth of around 5–5.5%. In such a scenario, we think equities would struggle to rally much further, though fixed income returns would be more compelling, as investors begin to anticipate interest rate cuts. We assign a 50% probability to this outcome.
- In our downside scenario, the current resilience in developed market growth proves only to be a function of higher interest rates taking time to filter through the system. Both inflation and growth fall sharply as the rate hikes already implemented start to have an impact. The Chinese economy continues to decelerate as government stimulus disappoints. We think such a scenario would see lower equity prices, as investors fear potential second-order effects for financial stability, and bonds rally, as markets price future central bank rate cuts. We assign a 30% probability to this outcome.

Equities. Our scenarios show that the range of potential outcomes for equities is wide and, with so few stocks contributing to so much of the performance of market-cap-weighted US indexes, idiosyncratic factors are likely to play a larger role than in the past.

We focus on equity laggards where valuations are lower and idiosyncratic factors are less likely to play a significant role in driving returns. We like emerging market equities, as well as global consumer staples and industrial stocks. We also prefer equal-weighted US indexes to cap-weighted indexes.

Bonds. Fixed income remains our preferred asset class. In our view, the recent rise in yields provides investors with a good opportunity to lock in yield in high-quality fixed income. We prefer high grade (government) and investment grade bonds, which offer attractive all-in yields and should be better placed than stocks if economic headwinds intensify. Among riskier areas of fixed income, we like emerging market bonds.

The euro and the Japanese yen are our preferred currencies.

Currencies. We have a least preferred view on the US dollar and a most preferred view on the euro and the Japanese yen. With inflation falling more quickly in the US than in Europe or the UK, we think the Fed is likely to consider rate cuts sooner than other central banks. By contrast, high inflation is likely to keep the European Central Bank hawkish, and rising rates should increase the euro's appeal. Moreover, we think negative economic surprises are now priced into the currency's valuation, and the Eurozone's improving trade balance should also be supportive.

Meanwhile, recent yen weakness has been partly reversed on concerns over the threat of currency intervention by the Bank of Japan and following softer June US inflation data. We think the yen will appreciate further as the improving economic backdrop and concerns about the negative spillover effects of a weaker yen should prompt the Bank of Japan to tighten its very loose monetary policy in the second half.

We are neutral on broad commodities but continue to like both oil and gold.

Commodities. We see balanced risk and reward in broad commodity indexes. Weaker-than-expected growth in China means that concerns about industrial metal demand remain elevated. That said, secular demand drivers (such as the net-zero carbon transition) should provide longer-term support, and in energy, supply discipline means that inventories remain at structurally low levels.

We continue to like both oil and gold. The oil market is likely to tighten further in the second half, and we forecast Brent crude prices rising to USD 90/bbl by year-end. Gold prices should be supported by a resumption of the US dollar's downtrend, in our view, and we like the yellow metal as a diversifier and a hedge within portfolios.

Mark Haefele
Chief Investment Officer
Global Wealth Management

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