UBS House View

Monthly Extended September 2023

Chief Investment Office GWM

Investment Research

Published

August 17, 2023

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

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

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This document is a snapshot view. For all other forecasts and information, we advise you to check the Investment Views section in your E-Banking or in Quotes.

UBS

Section 1

Investment views

Section 1.1

Asset class outlook

Asset class outlook

Asset allocation

In our global strategy, we **move global equities from least preferred to neutral** given our view of a more balanced equity risk-reward outlook. Bonds stay our 'most preferred' asset class, albeit with a smaller relative preference versus equities than before.

Within equities, we continue to prefer value and quality income versus growth. We also like emerging markets, including China.

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

Within commodities, we hold a preference for oil.

Within currencies, we keep the US dollar as least preferred and the euro as a most preferred currency.

Equities

While global equity valuations remain unattractive with limited room for rerating, we think the earnings outlook has improved. On the back of US economic resilience, we **neutralize our stance on global equities** this month, but continue to prefer bonds to equities.

Across regions, **we downgrade Australia to neutral,** keep US equities as least preferred, and emerging market equities as most preferred.

By global equity sector, **we downgrade materials to least preferred, and upgrade energy and communication services to most preferred and neutral**, respectively. Consumer staples, utilities, and industrials stay as most preferred, and information technology and healthcare as least preferred.

Across styles, we prefer value and quality income to growth.

Bonds

We continue to advocate for more defensive allocations toward higher-quality segments of fixed income, given the all-in yields on offer and as inflation cools, downside risks to growth remain, and restrictive monetary policy continues to transmit into the real economy. Specifically, we maintain a preference for high grade and investment grade bonds, and are neutral on high yield.

On the emerging market credit side, recent performance has been strong due to expectations that we are close to the end of rate hiking cycles, while there have been some positive developments across distressed sovereign issuers. So, valuations are no longer cheap, in our view, and **we shift our preference to neutral from most preferred.**

Foreign exchange

We **downgrade the Japanese yen from most preferred to neutral.** Given relative US economic strength and tweaks to lessen the Bank of Japan's yield curve control, we see limited catalysts that will outweigh the negative 5% carry that a long yen, short dollar position entails. Near term, US-Japan yield differentials could also remain wide due to US Treasury refunding as well as the BoJ's management of the speed of the JGB yield increase. Nonetheless, we continue to see a long yen position as an effective downside hedge, particularly if implemented using optionality.

We keep the US dollar as least preferred and the euro as most preferred.

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

Commodities

The benchmark UBS CMCI index rallied around 7.5% m/m in July, driven primarily by the energy sector. Though all sectors exhibited positive returns in the month, energy (13%) pushed up the gains and has since offset some of the weakness in industrial and precious metals, as well as agricultural segments, in early August. We therefore keep oil as most preferred.

We downgrade gold from most preferred to neutral due to the rising likelihood of a soft landing for the US economy, and subsequently higher nominal and real US yields into year-end.

Looking ahead, we predict a positive return for the asset class as a whole into year-end and target low-teen total returns on a 12-month basis. We also continue to recommend actively managing commodity exposure.

Section 1.2

Risk scenarios

Key scenarios until June 2024

	Upside: Return to goldilocks	Base case: Soft landing	Downside: Hard landing	*Things to watch*
Probability	*20%*	*60%*	*20%*	
Market path	**Bonds slightly up, equities sharply up** Equity markets and other risk assets rally as bonds also appreciate. Equity valuations expand as policy interest rates fall.	**Bonds up, equities flat to slightly up** Equity markets remain volatile but continue to grind higher amid slow but stable growth, falling inflation and normalizing financial conditions.	**Bonds up, equities sharply 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	The US continues to grow around the trend rate of approx. 2% as labor markets, household balance sheets, and corporate earnings prove resilient, and the improvement in manufacturing offsets a slowdown in services. China opts for large-scale fiscal stimulus. European growth improves.	The US economy slows below trend but continues to grow over the next 12 months. Other Western economies 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 mid-2024 owing to the delayed impact of monetary tightening and/or additional tightening efforts to tame persistent core inflation. China continues to decelerate amid underwhelming fiscal support.	*US, China: PMI data* *US, Europe: Industrial production* *US: Capital goods orders* *US, China Europe: consumer spending* *US: Housing starts* *Europe: Gas prices*
Inflation	Returns to central bank targets more quickly than anticipated.	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 collapse.	*Global: Oil prices* *US: CPI and PCE inflation* *US: ISM prices-paid subindex* *US: Average hourly earnings* *US: Change in nonfarm payrolls* *US: JOLTS openings and hires* *Eurozone: HICP inflation* *China: Fiscal stimulus measures*
Central banks	Major central banks start cutting policy rates in early 2024 as inflation normalizes ahead of expectations, in order to avoid monetary policy becoming too restrictive in real terms.	Major central banks start cutting policy rates by 2Q24 as inflation normalizes. The Fed lowers its policy rate by up to 100bps next year.	Major central banks cut interest rates by 200bps or more from mid-2024 after seeing evidence of a deep recession.	
Financial conditions	Ease quickly as a better growth-inflation mix is priced in.	Ease gradually amid building expectations of upcoming monetary easing.	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. Progress is made in bilateral relations between the US and China.	The war in Ukraine drags on as ceasefire negotiations remain elusive. US-China strategic rivalry continues following the outbound investment restrictions by the US.	The war in Ukraine escalates and/or US-China tensions intensify.	*Territorial gains by Russia* *Weapon shipments to Ukraine* *Further coup attempts in Russia* *US sanctions on Chinese companies*

Asset class targets – June 2024

Key targets for June 2024	spot*	Upside	Base case	Downside
MSCI AC World	823	950 (+15%)	870 (+6%)	680 (-17%)
S&P 500	4,490	5,200 (+16%)	4,700 (+5%)	3,500 (-22%)
EuroStoxx 50	4,330	5,100 (+18%)	4,700 (+9%)	3,700 (-15%)
SMI	11,110	12,800 (+15%)	12,400 (+12%)	9,800 (-12%)
MSCI EM	986	1,200 (+22%)	1,100 (+12%)	820 (-17%)
US 10y Treasury yield	4.19	3.50	3.00	2.25
US 10y breakeven yield	2.35	2.50	2.25	1.50
US high yield spread**	379bps	370bps	500bps	850bps
Euro high yield spread**	438bps	370bps	500bps	850bps
US IG spread**	108bps	80bps	120bps	200bps
Euro IG spread**	150bps	110bps	170bps	220bps
EURUSD	1.09	1.20 (+10%)	1.16 (+6%)	1.05 (-4%)
Commodities (CMCI Composite)	1,825	2,000 (+10%)	1,950 (+7%)	1,600 (-12%)
Gold***	USD 1,907/oz	USD 1,800-1,900/oz (-3%)	USD 2,100/oz (+10%)	USD 2,300-2,400/oz (+23%)

* Spot prices as of market close of 14 August 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.

Section 1.3

Asset class preferences and themes

Global asset class preferences

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

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

Note: The global asset class preferences reflect the high-level UBS House View. The tactical asset allocation (TAA) positioning of our different investment strategies may differ from this view because our strategies seek specific investment objectives and can frequently adjust portfolio allocation to achieve them. Also, these preferences may vary in different regions for various reasons such as currency considerations.

Least preferred
We expect this asset class to deliver the least attractive risk-adjusted returns over the next 12 months within our asset class universe.

Most preferred
We expect this asset class to deliver the most attractive risk-adjusted returns over the next 12 months within our asset class universe.

Asia ex-Japan asset class preferences

	Least preferred		Most preferred
Equities			
Asia ex-Japan		=	
China			+
Hong Kong		=	
India			+
Indonesia			+
South Korea		=	
Malaysia	−		
Philippines		=	
Singapore	−		
Taiwan		=	
Thailand		=	
Bonds			
Asian investment grade bonds		=	
Asian high yield bonds		=	
Chinese government bonds		=	

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

Least preferred
We expect this asset class to deliver the least attractive risk-adjusted returns over the next 12 months within our asset class universe.

Most preferred
We expect this asset class to deliver the most attractive risk-adjusted returns over the next 12 months within our asset class universe.

US asset class preferences

	Least preferred		Most preferred
Cash		=	
Fixed Income			+
US Gov't FI		=	
US Gov't Short		=	
US Gov't Intermediate		=	
US Gov't Long		=	
TIPS		=	
US Agency MBS			+
US Municipal		=	
US IG Corp FI			+
US HY Corp FI		=	
Senior Loans		=	
Preferreds			+
CMBS		=	
EM Hard Currency FI		= ←	⊕
EM Local Currency FI		=	

	Least preferred		Most preferred
Equity	⊖ →	=	
US Equity	−		
US Large Cap Growth	−		
US Large Cap Value		=	
US Mid Cap		=	
US Small Cap		=	
Int'l Developed Markets		=	
UK		=	
Eurozone		=	
Japan		=	
Australia		= ←	⊕
Emerging Markets			+
Other			
Commodities		=	
Gold		= ←	⊕
Oil			+
MLPs		=	
US REITs		=	

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

Least preferred
We expect this asset class to deliver the least attractive risk-adjusted returns over the next 12 months within our asset class universe.

Most preferred
We expect this asset class to deliver the most attractive risk-adjusted returns over the next 12 months within our asset class universe.

Global and regional sector preferences

Sectors	LP	Global	MP	LP	US	MP	LP	Eurozone	MP
Communication services	− →	=			=		−		
Consumer discretionary		=			=				+
Consumer staples			+			+			+
Energy		= →	+			+	−		
Financials		=		− →	=			=	
Healthcare	−				=		−		
Industrials			+			+			+
Information technology	−			−				=	
Materials	− ←	=			=				+
Real estate		=		− ←	=			=	
Utilities			+	−				=	

Least preferred (LP)
We expect this sector to deliver the least attractive risk-adjusted returns over the next 12 months within our sector universe.

Most preferred (MP)
We expect this sector to deliver the most attractive risk-adjusted returns over the next 12 months within our sector universe.

Messages in Focus

Manage liquidity as rates peak

Interest rates are peaking in developed markets as inflation falls closer to central bank targets. Investors should therefore actively consider how to optimize yields on cash holdings, while attractive interest rates are still available. We typically recommend that investors hold a liquidity portfolio worth 2–5 years of expected net portfolio withdrawals. A combination of fixed term deposits, a bond ladder, and select structured investment strategies can also help optimize yields and manage liquidity considerations. Assets in excess of 2–5 years of expected withdrawals should be invested in a diversified range of longer-duration financial assets.

Fixed term deposits
Short-term bond ladder
Select structured investment strategies

Source of funds
- Low yielding cash

Invest in quality bonds and diverse income

Surprisingly robust economic data has boosted bond yields, providing investors with a good opportunity to lock in currently elevated rates for an extended period. In fixed income, we like opportunities in the 5–10-year duration segment; in high grade (government), investment grade (incl. select senior financial debt), and sustainable bonds. Exposure to actively managed income strategies and yield-generating structured investments can help investors take advantage of the breadth of opportunities.

Lock in quality bond yields (high grade, investment grade, sustainable)
Actively managed income strategies
Yield-generating structured investments
Quality dividend paying equities incl. Switzerland

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

Look for equity laggards

We have a balanced overall outlook on global equities. Valuations are elevated, but developed market economic data has proven better than expected, and AI offers long-term optimism. Since stock market gains have been relatively concentrated this year, we see opportunity in stocks, markets, and sectors that have lagged. In US equities, we prefer equal-weighted indexes to cap-weighted indexes. Regionally, we like emerging market equities, and India in particular. By style, we continue to prefer value over growth.

US equal-weight indexes vs. cap-weight indexes
Invest in EM (incl. India)
Value vs. growth
Capital preservation structured investments
Select Swiss / European opportunities (vs. US)

Source of funds
- Excess liquidity
- Excess EM or HY bonds
- Excess US equities
- Excess IT equities
- Excess growth equities

Position for dollar weakness

The US dollar has regained ground in recent weeks, but we see limited upside from here, given high valuations and the Fed approaching an interest rate peak. Investors with excess dollar holdings should therefore consider selling the currency's upside in exchange for income. We have a preference for the euro and recommend structured strategies to take advantage of the elevated volatility versus the Norwegian krone, the Japanese yen, and the Australian dollar.

Diversify USD holdings
Structured strategies on select currencies (EUR, NOK, JPY, AUD)

Source of funds
- Excess USD cash holdings

Diversify with alternatives

We recommend complementing traditional bond-equity portfolios with an allocation to alternatives, which can help diversify portfolios and potentially boost returns. Hedge funds can generate returns even in flattish markets. Meanwhile, 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

Businesses and governments have been focusing their spending plans on 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. We think that 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
- 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	• Global value • Quality income • Emerging market equities • Sectors: utilities, consumer staples, industrials, energy • Select Swiss / European opportunities (vs. US) • Sustainable equities: ESG leaders, renewables, and water scarcity • Infrastructure including Greentech • Industrials incl automation and robotics	CIO least preferred equities, excess US equities, excess IT equities, excess growth equities, excess healthcare equities, concentrated stocks, excess cash
Bonds	• Lock in quality bond yields (high grade, investment grade, sustainable) • Short-term bond ladder • Actively managed fixed income strategies	Excess cash, sell/expensive-rated bonds, excess equities, excess EM/HY bonds
Foreign exchange	• EUR	USD
Commodities	• Active commodity exposure • Oil	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 – Watching middle income consumers

Base case (60%)

Growth

Middle income households continue to limit the slowdown of consumer spending in developed economies. Real household incomes for middle income families are helpful, and there are fewer credit constraints than are hitting lower income households. Labor markets are seeing less "job hopping," but generally have low unemployment, which supports job security. The shift in favor of spending on services remains intact, creating relative demand shifts away from spending on goods. This is very likely to reduce the trade share of the global economy in 2023.

Inflation

Disinflation trends continue in developed economies. While local quirks in calculation do provide occasional distortions or delays to disinflation, fewer and fewer items are experiencing high inflation. Localized instances of very rapid slowdowns in inflation argue against structural price stickiness—inflation can move to 2%, if the appropriate policies are in place.

Positive case (15%)

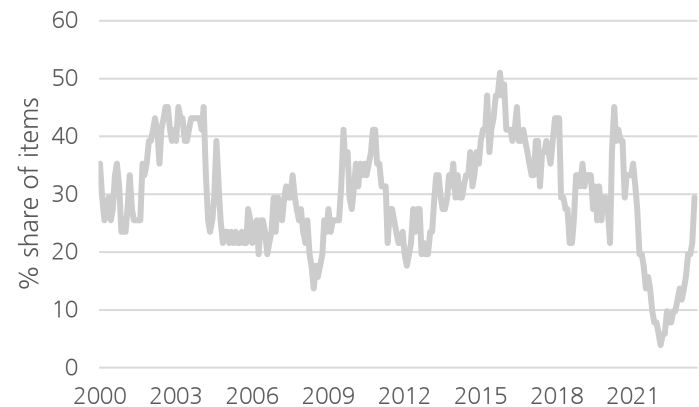
Although nominal wage growth slows, a faster decline in inflation restores stability in real wage growth more quickly, stabilizing consumer demand earlier than anticipated. Middle-income consumers experience below-reported inflation, which helps spending power in an important demographic. Unemployment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

Negative case (25%)

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.

More and more prices are falling into deflation

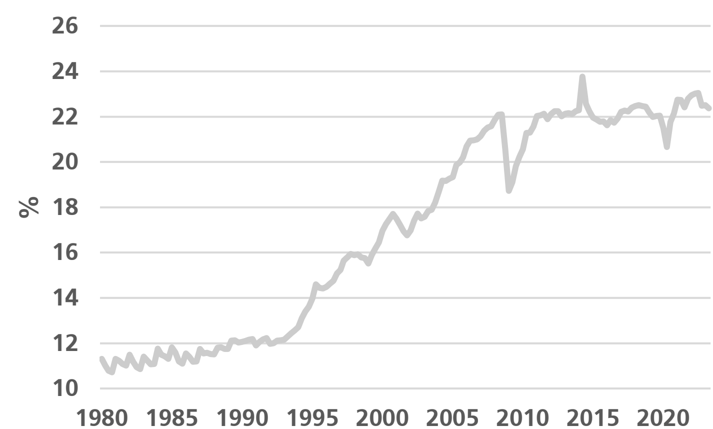
Share of items in US PCE deflator that are declining, 3mma



Source: BEA, Haver, UBS, as of 15 August 2023

Globalization stagnates, may decline

Global trade volumes (ex intra-EU trade) as share of real global GDP



Source: Oxford Economic Forecasting, UBS, as of 15 August 2023

US economy – Slower growth ahead

Base case (60%)

Growth

Growth has remained above-trend over the past 12 months despite aggressive rate hikes by the Federal Reserve and stress in the banking system. But we expect growth to slow from here. Households have used up a lot of the excess savings built up during the pandemic, and loan delinquencies are rising. New industrial policies related to computer chips and green energy have promoted economic activity, but the rapid pace of growth cannot be sustained for much longer.

Inflation

Resilient growth has made it more difficult for the Fed to get inflation down toward its 2% target. However, supply chain issues have mostly been resolved, reducing inflationary pressure at the producer level, and this is now feeding through to retail prices. Broad disinflation has taken hold, while shelter is the main factor keeping inflation high. Recent data has been in a range that could allow the Fed to end its rate hiking cycle.

Positive case (15%)

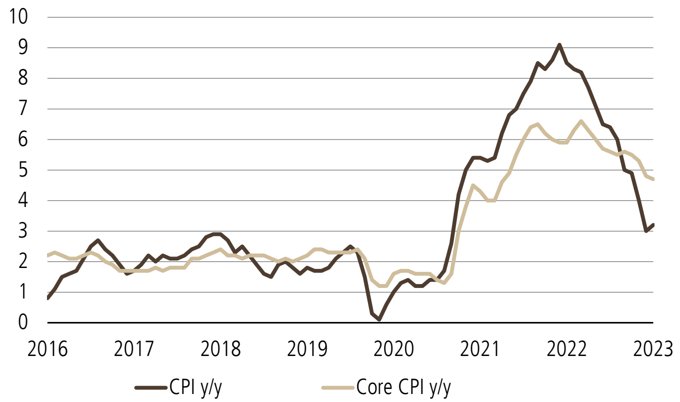
Better labor supply allows businesses to fill in their open job positions. Wage growth slows to a more moderate pace and energy prices stay low, helping bring inflation down while growth remains robust. The Fed sees enough progress toward its mandates to stop raising rates and begins to cut rates toward neutral in 2024.

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.

Core inflation now clearly trending lower

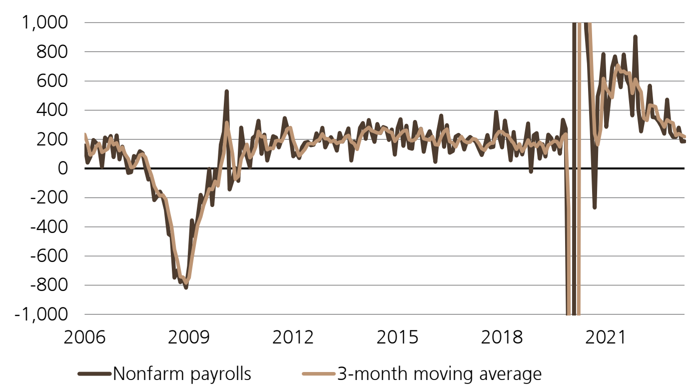
CPI and core CPI, y/y change in %



Source: Bloomberg, UBS, as of 14 August 2023

Payroll growth back to pre-pandemic trend

Nonfarm payrolls m/m change in 000's



Source: Bloomberg, UBS, as of 14 August 2023

Eurozone economy – More to do for the ECB

Base case (60%)

Growth

Economic growth rebounded in 2Q23 following six months of stagnation. We look for growth to remain positive through the end of the year, albeit at a below trend pace. A strong summer for tourism should continue to support divergence between the industrial heavy core relative to the south. Nevertheless, the full impact monetary tightening will likely be increasingly felt over the coming year, with rate cuts unlikely before 2H24.

Inflation

Headline inflation continued its sharp retreat in July, primarily thanks to energy prices, but other categories are also moderating. 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 tightening monetary policy. We look for another rate increase in September to what we expect will be a peak of 4%. Quantitative tightening is set to continue, with discussions around the next phase could begin before year-end.

Positive case (15%)

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

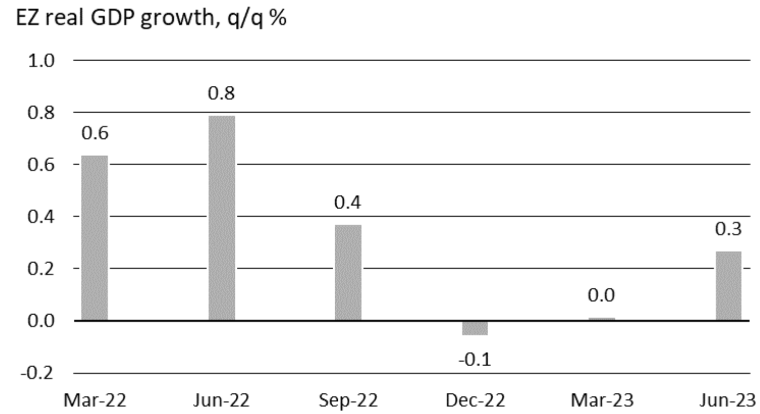
Economic growth in Asia and the US accelerates, with the latter avoiding a recession, boosting demand for Eurozone exports.

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.

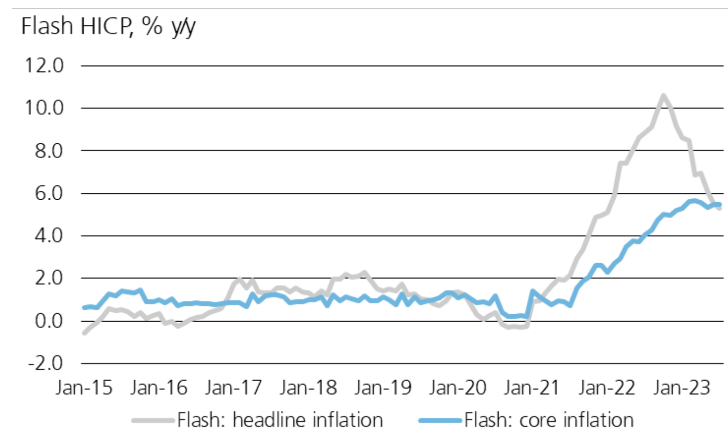
Geopolitical tensions force energy prices materially higher. Fiscal policy is too slow to respond or is tightened too early.

Economic growth recovering after a weak winter. The outlook points to low, but positive growth this year



Source: Haver Analytics, UBS, as of 14 August 2023

Eurozone inflation pressures continue to moderate, but the ECB still has more to do



Source: Haver Analytics, UBS, as of 14 August 2023

Swiss economy – Inflation to rise above 2% again

Base case (70%)

Growth

We expect Swiss GDP to grow at a below-average pace in 2023. Inflation, rising interest rates, and a sluggish Eurozone economy are likely to weigh on growth. Several risks to the Swiss economy have diminished thanks to greater energy security in Europe, China's reopening, and more resilient growth in the US. However, we still expect growth in the US to slow below trend.

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%. Interest rate cuts are unlikely before 2H24.

Positive case (15%)

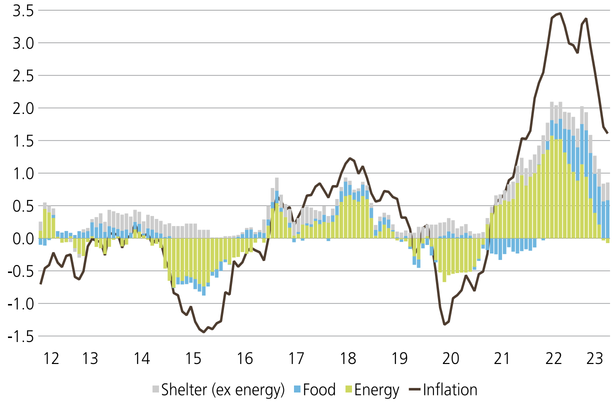
Better global growth momentum: Global inflation further retracts allowing central banks to refrain from additional rate hikes. Switzerland benefits from the stronger global backdrop and a weakening of the safe-haven Swiss franc.

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 further in July

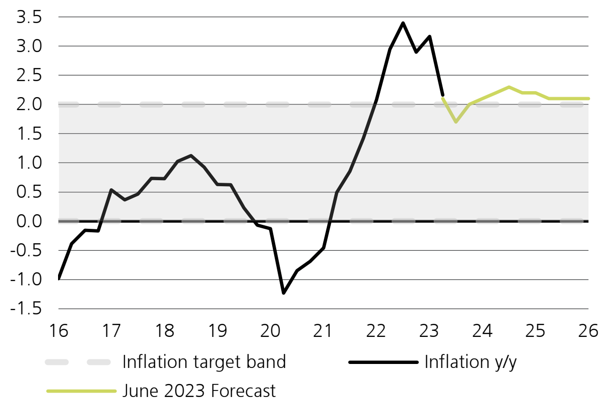
Year-over-year change in Swiss CPI and contribution of selected components, in %



Source: Macrobond, UBS, as of 11 August 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 11 August 2023

Analysts: Alessandro Bee, Florian Germanier

Chinese economy – Concrete policy support awaited

Base case (70%)

Growth

July data came in broadly weaker than expected, raising the need for concrete policy support. Retail sales weakened to 2.5% y/y, dragged down by durable goods. Investment growth slowed to 3.4% y/y in Jan–Jul, mainly dragged by property. Credit growth fell to 8.9% y/y on household deleveraging. More supportive measures are needed following the positive signals from the Politburo meeting in order to support a recovery in 2H.

Inflation

July CPI inflation turned negative at –0.3% y/y, mainly due to a high base for food prices. We expect a mild pickup to near 1% by year-end. PPI deflation is likely to persist through year end.

The PBoC cut the 1-year MLF by 15bps on 15 August. We expect another one to two cuts to banks' required reserves and 10–20bps cut to the MLF rate by year-end.

Positive case (15%)

Concrete policy measures are announced to stabilize the property market, boost consumption, and revive confidence.

Geopolitical risks remain contained without dramatic spillovers.

The US economy manages to achieve a soft landing.

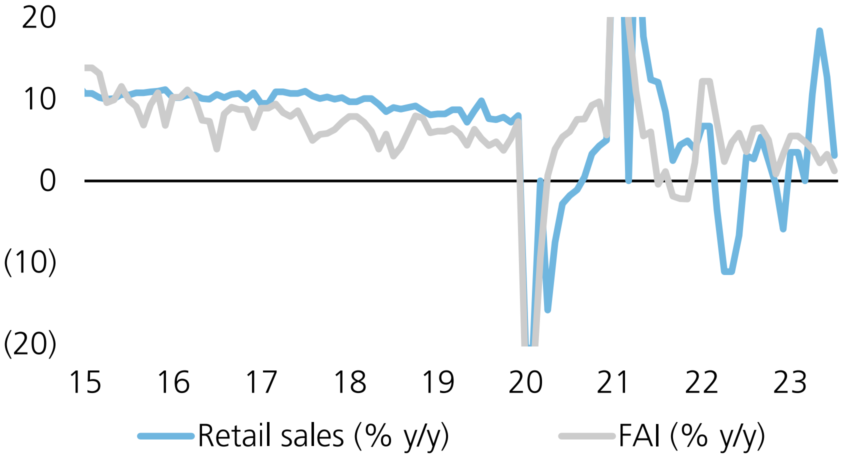
Negative case (15%)

Property activity slumps more than expected, and consumption registers a weak recovery.

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

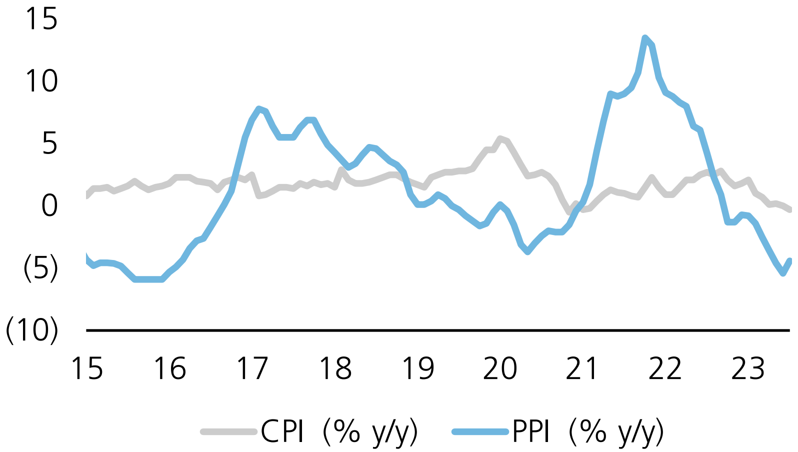
The US imposes much stricter restrictions on China's tech sectors.

Consumption and investment both weakened in July



Source: CEIC, UBS, as of 15 August 2023

CPI inflation to stay low; PPI deflation to persist



Source: CEIC, UBS, as of 15 August 2023

Section 3

Asset class views

UBS

Section 3.1

Summary of major asset classes

Equities

Central scenario

MSCI AC World June 2024 target: 870

In our global tactical strategy, we upgrade equities to neutral. The latest economic and inflation data have come in ahead of expectations, with the US economy growing above trend in the second quarter and the disinflationary path remaining on track. Moreover, the 2Q reporting season likely marked the end of the earnings recession and profitability now appears set to inflect upward in the coming quarters. We now consider a recession in the US less likely, while earnings look likely to rebound. On balance, going into the second half of the year we see the risk-reward for equites as more favorable.

The earnings outlook has improved. At the beginning of the year, we were concerned the weakness in leading economic indicators and tightening credit conditions would spark a mild earnings recession in 2023. Instead, strong consumer spending coupled with high inflation has sustained nominal earnings. With the risk of a recession receding and the end of the hiking cycle getting closer, we no longer expect a contraction in global and US earnings for 2023, and see flat global earnings this year versus 2022, and earnings to grow by single digits in 2024.

Equity valuations remain stretched. On a P/E basis, the MSCI All Country World Index is currently trading at 16.1x—11% above its long-term average of 14.6x. Meanwhile, the cost of equity is around 8.3% (back to 10-year highs), consistent with historical episodes of investor exuberance.

US equities are least preferred. While we are revising higher our expectations for earnings in 2023 (from 215 to 220, 0% growth y/y) and 2024 (235 to 240, 9% growth y/y), we believe the market has mostly priced such an improvement in, and we only expect single-digit upside by June 2024 (S&P 500 to end the year at 4500 and reach 4700 by June 2024). The MSCI USA forward P/E multiple is now 19.5x, a more than 20% 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 rerating follows the repricing of the soft landing scenario and speculative fever around AI-leveraged market segments that sent valuations soaring.

We downgrade Australian equites to neutral. The regional earnings outlook has failed to improve with next year's profit growth expected to be negative in the low-single digits and downgrades seen outpacing upgrades. Slowing domestic growth and the high exposure of the index to basic materials, metals, and mining in particular make us less confident about the potential for the region to outperform versus the global benchmark (i.e., MSCI AC World index). The index does not look particularly expensive, at 15.4x forward earnings it trades in line with historical multiples.

Emerging market equities stay most preferred. We expect emerging market stocks to outperform their developed market peers thanks to better earnings growth prospects, undemanding relative valuations, and central banks' easing bias in 2H. The approaching end of the US rate-hike cycle also provides a tailwind for emerging market stocks. Valuations look appealing to us: The region is trading at 11.9x—in line with the long-term average, a 28% discount to global equities, and a 40% discount to US stocks. Besides, following the Politburo meeting in China we have observed a pickup in the number of policy support announcements and their respective rollouts. The market has reacted positively to these interventions, and we believe this positive momentum will continue. In order to revive demand, we think the most effective policy measures at this junction would be to embark on a central government-backed consumption stimulus campaign. China is also entering a rate-cutting cycle.

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, energy

Least preferred: IT, healthcare, materials

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

Equities

Materials move to least preferred, and energy to most preferred. The materials sector exhibits the worst momentum both in terms of trailing and forward earnings on the back of weak global manufacturing demand and a still depressed property market in China. Within the sector, we are particularly concerned about mining companies, which remain highly driven by Chinese demand. In addition, mining companies' capex is expected to rise, putting shareholder returns at risk.

We upgrade energy stocks to most preferred, as reduced recession risk is supportive of value sectors. Energy specifically looks very attractive on a number of metrics (12-month forward P/E at 9.6x, a 40% discount to the global benchmark and a 35% discount to history), with supportive return-on-equity and free-cash-flow yield. While earnings momentum may stay negative to the end of the year, the recent rise in the energy prices may help next year's profit growth while consensus expectations are very depressed (–0.3% earnings growth expected in 2024).

We upgrade communication services to neutral. Both price and earnings momentum are well oriented making us more confident on the sector going forward. The sector has performed well this year thanks to a better tone on digital advertising, investor enthusiasm about opportunities in AI, and aggressive cost-cutting at some mega-caps. However, the integration of AI into internet search queries will likely usher in a heavier investment cycle for incumbents and could lead to competitive threats and margin pressure.

Consumer staples, utilities, and industrials are most preferred. We like the defensive profile of consumer staples companies. While we are not expecting the global economy to enter a recession, below-trend economic growth should cap upside potential for some cyclical parts of the market. After the recent underperformance of consumer staples stocks versus the benchmark, valuations looks more appealing to us as the sector now trades in line with historical standards. Utilities' defensive profile and earnings resilience in an economic slowdown should help in a volatile environment. Utilities are a traditional safe-haven during downturns. When uncertainty rises, utilities should 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; automotives (EV transition); and the reshoring of operations (e.g., more automation).

Healthcare and information technology are least preferred. The expected softening USD would be a headwind for pharmaceutical companies outside the US. Trading at 17.8x 12-month forward earnings versus other defensive sectors such as utilities (15x 12-month forward P/E), valuations now look expensive to us.

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 a 61% premium to the market).

Prefer value and quality-income stocks over growth stocks. In an environment of higher-for-longer bond yields, 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 focus on is defensive value (high free cash flow generation or high return on equity), which requires 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.

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

Equities

Upside scenario

MSCI ACWI June 2024 target: 950

Inflation cools quickly, and the US and European economies grow above trend: Inflationary pressures quickly dissipate, and the Fed and other central banks become more accommodative.

Geopolitical de-escalation: A ceasefire ends the war in Ukraine and reduces the risk of further sanctions against Russian commodities.

Economic growth reaccelerates: Solid economic growth in the US and emerging markets drive a sharper improvement in corporate profits in 2023 and 2024.

Downside scenario

MSCI ACWI June 2024 target: 680

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. As the rate-hiking cycle has progressed, financial instability risks have begun to surface. This first started 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 inverted yield curves as the front end continues to grapple with where and for how long central banks are likely to take terminal policy rates, whereas the long end is looking to price 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. Following the strong recent performance on emerging market credit due to positive developments across a number of distressed issuers, we now see valuations as no longer cheap but broadly fair, and therefore downgrade our most preferred stance to neutral. Read more

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 in 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. Read more

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

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

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. Read more

Emerging market (EM) sovereign bonds: The asset class has been supported in the last few months by signs of resilient US economic growth and moderating inflation as well as positive developments across a number of distressed sovereign issuers. We have seen strong spread compression across the credit rating spectrum, particularly in the low-rated issuers. As a result, we think valuations of EM bonds are no longer cheap and look broadly fair, in our view. We downgrade the asset class to neutral. 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 8.3% (EMBIG Diversified), while the yield on the corporate index (CEMBI Diversified) is about 7.2%. We expect mid- to high-single-digit total returns (non-annualized) for the asset class in a baseline scenario over the next six months, supported by carry and lower US rates. Read more

FX

The US dollar remains least preferred in our global strategy, although we acknowledge current bouts of strength in the greenback may signal that further weakness may be more benign. Strong economic data out of the US keeps the Federal Reserve on its toes, while the timing for rate cuts has been pushed further down the road. Still, we believe that the strong tightening since March 2022 should be soon putting the economy under pressure.

The Fed is approaching the inflection point we have been looking for in 2023, although uncertainty has been mounting given upside surprises in the data. The August liquidity worries have added upward pressure on US yields while spooking the equity markets—an environment favorable to the greenback. As disinflation seems to be well in place, markets are still waiting for the Fed to signal a clearer shift in its policy stance. Still, the general direction of a weakening USD seems clear. But for this, we need to see a softer labor market and signs of stabilization of economic activity outside the US. As excess savings run out, monetary policy should weigh more sizably on spending activity. And with lower inflation, this should leave enough room for US rates to fall back. In that phase, international investors will have strong incentives to move funds out of the US into higher-yielding emerging market or formerly negative-yielding G10 currencies.

We keep the euro at most preferred in spite of disappointments in China and lackluster growth in Europe. We still expect investors moving away from the US dollar to look for a liquid alternative asset market, and the euro is an obvious option, in our view. Inflation in Europe remains well above target, and the healing of the current account balance has helped the euro to recover and should continue improving. We still expect to see yield decompression from the Fed and that the European Central Bank (ECB) will keep rates on hold. The delta of relative growth and rates should come from the US and not Europe, and the euro's current levels remain attractive for long-term investors who have been looking to diversify considerable USD long positions. The expected shift in US monetary policy would be a good time to do so, in our view.

We shift the Japanese yen from most preferred to neutral. Given that relative US economic strength and Japanese yield curve control have already been softly removed, we see limited catalysts that will outweigh the negative 5% carry that a long yen, short dollar position entails. Near-term, US-Japan yield differentials could also remain wide due to US Treasury refunding, as well as the Bank of Japan managing the speed of Japanese government bond yield increases. Nonetheless, we continue to see a long yen position as an effective downside hedge, particularly if implemented using optionality.

We keep a neutral position on the British pound and Swiss franc, which have been stellar outperformers this year. The pound still has room to outperform the USD, but we think the CHF may move sideways as inflation differentials wane. We still believe that the euro would be a better choice here, as it would be advantageous for a Swiss franc-based investor to hold euro bonds when the exchange rate is expected to trade sideways and the yield is higher on the euro, providing more carry. We see EURGBP as close to the bottom of our expected trading range.

The rise in longer-term US yields and linked risk-off sentiment has hurt emerging market currencies, with bigger corrections for some of those that had enjoyed support in prior months, especially the South African rand. But lower US recession risks are not a roadblock per se for emerging market currencies to perform again: We expect US activity to slow and inflation to trend down further. Paired with a still sizable yield advantage for emerging market currencies, this should allow high carry currencies, for example the Mexican peso or Czech koruna, to perform well against the US dollar over the coming months. A few emerging market central banks have started their easing cycles, but on aggregate large-scale monetary easing still looks unlikely in the short run. A key risk remains inflation proving more persistent than expected and the Federal Reserve seeing the need to deliver more interest rate hikes.

FX

In Asia Pacific, we reset our expectations for the CNY, following a significant deterioration in Chinese data in recent weeks, which stood in stark contrast to the resilience of the US economy. We now expect USDCNY to trade at 7.40 by December (from 6.90) and 7.20 by June 2024 (from 6.70). Sluggish Chinese growth and a subdued CNY also keep a lid on the upside potential for Asian currencies for the remainder of this year. Within APAC, we maintain our preference for domestic-demand-oriented, high-yielding currencies such as the Indonesian rupiah and the Indian rupee, against a backdrop where the Fed is largely done with its rate-hike cycle.

Read more about our foreign exchange views:

- Currencies
- EURUSD
- EURCHF
- USDCHF
- GBPUSD
- EURGBP
- GBPCHF
- USDJPY
- USDCAD
- AUDUSD
- NZDUSD
- EURSEK
- EURNOK
- USDCNY
- USDSGD
- EURPLN
- USDPLN
- EURCZK
- USDRUB
- USDZAR
- USDBRL
- USDMXN

Commodities

We hold a neutral view on commodities overall but remain most preferred on crude oil. Read more

Oil rally reinforces our long-held positive energy view. Brent crude oil hit its highest level since January at more than USD 87/bbl after Saudi Arabia and Russia announced plans to extend their supply reductions. Saudi Arabia will continue its extra voluntary 1mbpd production cut for another month into September, while Russia indicated it will cut crude exports by 0.3mbpd next month. These mean additional barrels will not be available, and as such, oil inventories are expected to decline further over the coming months. We see risks of Brent trading more quickly towards the upper end of our USD 85–95/bbl range. Read more

Industrial metals pressured by weak China data. Industrial metal prices have declined by 6% so far in August amid a stream of disappointing Chinese activity and credit data. Rising default risks at Country Garden have also weighed on expectations for a stabilization in confidence across the housing sector. The tug-of-war between a weak macro environment and hopes of a step-up in the pace of policy delivery continues, but worsening supply-side fundamentals should mitigate downside risk. Therefore, we like to sell the price downside for yield pickup, particularly in copper and nickel.

Gold requires a clearer Fed signal. We have downgraded gold from most preferred to neutral due to the rising chance of a "soft landing" for the US economy, and subsequently higher nominal and real US yields into year-end. Near-term, government refunding activities and a stronger US dollar add to the downside risks on the gold price. As such, we have cut our year-end forecast to USD 1,950/oz (from 2,100/oz), but we maintain our more positive outlook for 2024. Read more

Climate and geopolitical risks in agriculture persist. Record-breaking global temperatures, renewed attacks on Black Sea grain infrastructure, and easing US grain production risks fueled significant price volatility in July. Wheat prices, for example, rallied and fell by around 15–20% in just a few weeks. But, if Russian grain exports are restricted, this would reverse the current downtrend. Likewise, a worsening El Niño would have greater impact on soft commodities. But short-term profit taking is a risk as speculators' net-long positions sit above historical norms. For livestock, we await stronger seasonals in 4Q.

Where to invest

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. We also raise global energy equities to most preferred (from neutral).

Gold as a hedge. A peak in global rates (and associated weakness in the USD), and subsequent cuts by the Fed in 2024 should drive a rebound in ETF demand for gold. Meanwhile, we see a tug-of-war between ongoing uncertainties over the global growth outlook, equity market dynamics and geopolitics, and recent USD strength and higher US real yields. As such, despite the downgrade, we maintain our recommendation that investors should hold gold as a hedge within a portfolio context.

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

Section 3.2

Details per asset class

Eurozone equities

Central scenario

DJ Euro Stoxx 50 June 2024 target: 4,700

We maintain our neutral stance on Eurozone equities. Valuations look fair to us given modest downside risks to consensus earnings estimates and above-average interest rates.

After another solid set of company results for 2Q, we have upgraded our earnings forecasts for Eurozone equities. Profit margins are now surprising to the upside and support a small upgrade to this year's earnings forecast from -5% to 0% (consensus +3%). The stronger numbers this year imply less margin expansion next year and therefore we adjust lower our growth forecast for 2024 from 5% to 3% (consensus +8%).

At 11.9x forward P/E, Eurozone equity valuations are relatively attractive, at a 10% discount to their long run average. We see some upside to P/E valuations to around 13x, supporting further modest gains to Eurozone equities, but see valuations capped in the near-term by the relatively slow earnings recovery that we are anticipating and the above-average interest rate environment.

We favor sectors and themes that can benefit from improving trends and potential inflections in the coming months. 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, a China economic recovery, or lower gas prices. German equities should also benefit if these drivers turn more favorable, and Eurozone small- and mid-caps offer material upside at current valuations should the macro outlook improve.

CIO themes

Eurozone small- and mid-caps

We see attractive value in small- and mid-sized companies, and expect inflections in the macroeconomic outlook to emerge in 2H23, supporting these companies more than large caps.

Consumer recovery

We like European consumer stocks that are poised to benefit from an improving consumer outlook as wages rise, inflation pressures ease, central banks stop hiking, and China reopens.

German equities – attractively priced quality

We like German equities given attractive relative valuations and improving sentiment indicators as energy crisis fears subside and the outlook for growth begins to improve.

European medtech

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

Investing in Europe's digital leaders

In this theme, we employ a framework that identifies European companies poised to benefit from the accelerated transition to a more digital world.

Investing in Europe's greentech leaders

This theme recommends companies that will likely play a key role in Europe's energy transition and stand to benefit from the Green Deal—the biggest green stimulus program the world has ever seen.

For an up-to-date view refer to links on slides 32 and 33.

Analysts: Matthew Gilman, Rolf Ganter

Eurozone equities

Upside scenario

DJ Euro Stoxx 50 June 2024 target: 5,100

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 economy begins to recover.

Companies keep pricing power. If companies can maintain some pricing power, margins could expand more than we expect, 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 June 2024 target: 3,700

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.

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.

For an up-to-date view refer to links on slides 32 and 33.

Analysts: Matthew Gilman, Rolf Ganter

US equities

Preference: Least preferred

Central scenario

S&P 500 June 2024 target: 4,700

US equity market performance has been strong this year driven by resilient economic data, the winding down of Fed rate hikes, better-than-expected corporate profits, and AI-driven enthusiasm for a handful of mega-cap tech stocks. While there is still some debate regarding the length of time it takes for Fed rate hikes to impact the economy, it is looking more likely that the economy may have already absorbed a good portion of the headwind. As a result, recession probabilities seem to have receded and the market gains appear reasonable. Excess household savings and fiscal stimulus related to infrastructure and manufacturing have likely helped cushion the headwind from Fed rate hikes. This has kept demand for labor fairly resilient.

Additionally, progress continues to be made on inflation. Through July, the year-over-year change in headline inflation had fallen for twelve consecutive months, with core inflation following a similar trend. Wage pressures have been a bit more sticky, but they are also easing. And longer-term inflation expectations are at the lower-end of their recent range. While the Fed may ultimately deliver one more rate hike, that shouldn't have a material impact on economic activity. If inflation continues to move in the right direction, the Fed could be in a position to reduce interest rates in 2024.

An improving earnings picture. The more resilient economic activity is having a favorable impact on corporate profits. With second quarter earnings season largely complete, the results give us conviction that S&P 500 EPS growth has likely troughed. The index will likely return to positive growth in the third quarter and looks poised to gain momentum into 2024. Specifically, guidance for the third quarter has been better than expected across a wide swath of companies. In addition, there are signs that some key end markets that had been a drag are beginning to stabilize or improve, such as digital advertising, cloud, PCs, smartphones, and capital markets businesses.

Looking out to 2024, healthcare should return to growth as difficult comparisons from COVID-related gains start to ease. Energy is weighing on S&P 500 EPS growth by 4% this year and this drag should also fade in 2024 as oil prices stabilize. While there has been some concern about corporate profit margins, they are already beginning to recover as costs fall faster than the deceleration in revenues. As a result, we are lifting our 2023 and 2024 EPS estimates by USD 5 each. Our new estimates are USD 220 (0% growth, +4% ex-energy) and USD 240 (+9% growth).

Making sense of valuations. In conjunction with the higher earnings outlook, we are also raising our target valuation multiple to about 19x. While this valuation is high in absolute terms, it is consistent with prior periods of low unemployment and low inflation. The simple addition of the unemployment rate and the inflation rate is called the Misery Index. Valuations tend to be high when the Misery Index is low. In fact, the improvement in the Misery Index (falling inflation and durable growth—sometimes described as "goldilocks" in the financial media) has likely been a key driver of the increase in equity market valuations this year. At the market low in October last year, the Misery Index was nearly 12% compared to 6.7% right now.

Within the market, over the next several months we expect some de-rating of elevated valuations for some mega-cap growth companies. But this should be offset by higher valuations for the rest of the market driven by an improvement in business sentiment—as measured by the ISM Manufacturing index—and a decline in real interest rates. For context, excluding the seven largest growth companies (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla) the S&P 500 is trading at a more reasonable 16.5x P/E.

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 rebounded in recent months driving outperformance for the sector. OPEC+ supply cuts, increases in the US strategic petroleum reserve, and better global economic growth have led to oil inventory declines resulting in higher prices. We think there is further to go. Valuations are pricing in a somewhat cautious outlook. The sector should also be 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.

For an up-to-date view refer to links on slides 32 and 33.

Analysts: David Lefkowitz, Nadia Lovell, Matthew Tormey

US equities

Range-bound for now. At current valuations we think a lot of good news is priced into equity markets. And now that there has been a pronounced increase in investor sentiment there seems to be less dry powder on the sidelines to propel markets higher in the near term. In addition, the durable growth and improving inflation narrative seems well understood, which should also limit further valuation expansion.

We therefore expect equity markets to be largely range-bound in the near term. But stocks should be able to climb a bit higher in 2024 as earnings growth improves and the market begins to anticipate eventual Fed rate cuts if inflation continues to trend to the Fed’s target. Investor sentiment around AI could also be a key upside or downside driver in the months ahead. Our December 2023 and June 2024 S&P 500 price targets are 4,500 and 4,700 respectively.

Upside scenario

S&P 500 June 2024 target: 5,200

Artificial intelligence is a game-changer: The impact of artificial intelligence on productivity and earnings growth is larger and comes sooner than investor expectations.

Resilient economic growth: High wages attract even more workers into the labor force, and demand for labor stays strong. Real incomes continue to grow and household cash cushions remain.

Inflation cools quickly: Inflationary pressures dissipate faster than expected and the Fed quickly pivots to rate cuts. This lifts expectations for economic growth and corporate earnings.

Downside scenario

S&P 500 June 2024 target: 3,500

Recession: The US slips into a full-blown recession in the next 6–12 months, primarily driven by the lagged effects of Fed rate hikes, perhaps as household cash cushions dwindle.

Inflation stays hot: Inflation pressures re-accelerate. 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 the 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

- 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.
- Real estate: Higher rates and poor sentiment may continue to weigh on the sector. Although valuations appear fair, we think estimates are still high in some areas that over-earned during the pandemic. Growth in funds from operations will likely lag S&P 500 profit growth.
- Utilities: Increased regulatory risks and resilient economic data may lead to underperformance. We prefer to have defensive exposure through consumer staples, which continues to exhibit pricing power and benefits from resilient consumer spending.

For an up-to-date view refer to links on slides 32 and 33.

Analysts: David Lefkowitz, Nadia Lovell, Matthew Tormey

UK equities

Central scenario

FTSE 100 June 2024 target: 8,200

We expect the global economy to slow further, as developed market economies absorb the impact of monetary tightening. Economic growth in China is also disappointing relative to expectations of strong reopening rebound. We 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 falling sharply, but remains too high for comfort for policymakers, 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 should weigh on the international earnings of FTSE 100 companies. However, much of this outlook is already priced into the UK equity market, in our view.

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 June 2024 target: 8,500

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 June 2024 target: 6,700

Oil price: If the price of Brent crude 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 global economic growth slows more than anticipated, this would be negative for earnings and equity valuations.

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

For an up-to-date view refer to links on slides 32 and 33.

Swiss equities

Central scenario

SMI June 2024 target: 12,400

After a strong 2021, we expect corporate profits to drop 4% over the 2021–23 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 marginally 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 3.3%, 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.

Key risks include protectionism, international trade disputes, an economic downturn, currency losses, and Switzerland-EU negotiations.

CIO themes

Swiss high-quality dividends

Swiss dividend-paying equities are attractive, in our view. The average yield of the Swiss equity market, at over 3%, is higher than that of Swiss franc-denominated corporate and government bonds. Historically, dividend yields have tended to be similar to or lower than bond yields. Balance sheets and profitability are generally robust, suggesting that market-wide distributions are sustainable despite risks to corporate profits on the back of weaker economic prospects. For the SMI, the total cash distribution amount only moderated slightly in 2021 versus 2020, and rebounded by around 6% in spring 2022 as well as in 2023, achieving a new all-time high. We expect another low-single digit percentage increase in spring 2024 as well as in 2025.

For an up-to-date view refer to links on slides 32 and 33.

Analyst: Stefan R Meyer, Claudia Panseri

Swiss equities

Upside scenario

SMI June 2024 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 2021–23 period.

Sustainable dividends: Swiss dividends have generally grown every year since 2009. In 2021, however, total SMI dividends fell by 3%. In 2022 and 2023, they recovered by 6% each. In our upside scenario, we would expect mid-single digit percentage rises next year (i.e., for the business year 2023) and in 2025.

Manageable currency impact: In 2020, currency effects were clearly negative, while those in 2021 were insignificant. In 2022, they increased a bit. In 2023, we expect currency losses to be significantly negative again.

Downside scenario

SMI June 2024 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, leaving the SMI 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.

For an up-to-date view refer to links on slides 32 and 33.

Emerging market equities

Preference: Most preferred

Central scenario

MSCI EM June 2024 target: 1,100

We keep emerging market equities as most preferred. Aggregate manufacturing PMIs in emerging economies have fallen slightly, due mostly to China's faltering recovery, but are still in expansion territory, and the growth gap with developed economies has widened amid weakening momentum there, especially in the Eurozone. And in contrast to developed market peers, many emerging market central banks have started or are expected to ease policy in 2H23 thanks to declining inflation. This should be positive for local stocks.

The MSCI Emerging Markets Index 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 63% versus its 10-year average of 54%. In our view, the gap does not factor in better earnings growth prospects for emerging markets relative to developed markets in 2024. By contrast, we expect US equities to derate from close to 20x 12-month forward P/E, which we think has priced in much of the good prospects for the US economy and corporate earnings.

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

Within emerging markets, environmental, social, and governance (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 have upgraded Brazil and Chile to most preferred. Both countries have kicked off monetary easing cycles, which have historically been supportive of stocks. In addition, they both exhibit undemanding valuations. In Brazil, higher productivity in agricultural production should lift GDP growth in 2023 past 2%, well above consensus estimates at the beginning of the year. Against this backdrop, we expect earnings revisions to improve in 2H23. As for Chile, political risk has pushed stock valuations well below historical averages for the last few years. Some of this should unwind on the back of a more stable backdrop moving forward.

Elsewhere, China remains most preferred. As markets are pricing in a dire picture around China's real estate sector and weak growth momentum, further stimulus measures should stabilize sentiment. With the policy tone set at the July Politburo meeting being more supportive than expected, we would watch for specific announcements from both central and local governments. Finally, we keep Indonesia and India as most preferred. Domestic growth in Indonesia remains relatively strong, and we believe India's valuation remains reasonable while the corporate outlook looks healthy.

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

Brazil (new), Chile (new), China, India, Indonesia

Least preferred

Malaysia, Singapore

For an up-to-date view refer to links on slides 32 and 33.

Analysts: Alejo Czerwonko, Xingchen Yu.

Emerging market equities

Upside scenario

MSCI EM June 2024 target: 1,200

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 June 2024 target: 820

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.

For an up-to-date view refer to links on slides 32 and 33.

Analysts: Alejo Czerwonko, Xingchen Yu.

Japanese equities

Central scenario

TOPIX June 2024 target: 2,400

We are neutral on Japanese equities in our global portfolio. After rising 22% from January to June and touching a three-decade high, TOPIX's performance has been flattish. We remain selective in the short term, given: 1) valuations are still unattractive versus their historical average (TOPIX P/E 14.4x vs. 10-year average of 13.7x); 2) international investors' trading value has started to slow in recent weeks; 3) 1Q results (June quarter) are unlikely to be a major catalyst and could create volatility after the year-to-date rally; and 4) seasonality, as August and September tend to be quiet months for both Japanese and US equities.

The Federal Reserve's and the Bank of Japan's policies could support Japanese equities by keeping the JPY weaker than we expect against the USD in the coming months. While the Fed is unlikely to cut rates in 2023, the BoJ is likely to control the pace of rising 10-year Japanese government bond (JGB) yields through its fixed-rate purchase operations. As a result, the US-Japan yield gap will likely stay wide, leaving the JPY weaker for longer. The BoJ left its 10-year JGB yield target band unchanged at its July monetary policy meeting, but said it would buy the JGBs at 1% in fixed-rate operations versus 0.5% previously. Due to a weaker-than-anticipated JPY against the USD, we have revised up our corporate earnings growth forecasts to 6% from 3% for FY2023 (end-March 2024), and to 3% from 0% for FY2024.

In the near term, we continue to recommend being selective and diversifying into laggards. As such, we focus on quality value names, including banks, that can capture potential structural changes such as the Tokyo Stock Exchange's push to increase corporate value. Domestic-oriented sectors, such as consumer discretionary and service-based names, should benefit from Japan's economic reopening. These sectors are also key beneficiaries of the moderate wage growth and inflation we expect in the coming years.

Upside scenario

TOPIX June 2024 target: 2,600

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 recent months (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 June 2024 target: 2,000

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

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

For an up-to-date view refer to links on slides 32 and 33.

Asian ex-Japan equities

Central scenario

MSCI Asia ex-Japan June 2024 target: 700

We continue to see early signs of stabilization across Asia ex-Japan in areas like export orders. Regional inflation also likely peaked in 4Q, and policy easing may begin in late 2H in some Asia ex-Japan markets. Within the region, we remain focused on relative opportunities rather than taking directional beta exposure. We keep India, Indonesia, and China as most preferred; and Malaysia and Singapore as least preferred.

We continue to like India. Domestic consumption remains on track, credit growth has been strong, and foreign direct investment (FDI) flows are solid. As headwinds from a strong dollar fade, India should benefit from a more stable and narrower external deficit, and moderating core inflation. In fact, we expect India to become one of the fastest-growing economies in the region this year. Earnings growth should continue to trough, and we think derating pressure will be manageable due to peaking deposit rates.

Indonesia also remains most preferred. With healthy external surpluses, strong credit growth, and strong FDI, Indonesia should continue to present one of the most robust growth rates in the region. A high policy rate also provides a favorable net interest margin (NIM) environment for its financial sector, which accounts for close to 60% of the equity market. We expect the market to deliver steady double-digit earnings growth this year.

In terms of China, the current allocation from global mutual funds is low (according to broker data), an earnings growth recovery is ongoing, and valuations are attractive, in our view. Although the latest macro and credit data came in weak, the Politburo meeting in late July provided some upside surprises—such as faster-than-expected government policy announcements, potential property easing in tier-1 cities, and an acknowledgement of the need to resolve local government debt issues. We continue to watch for the timing and details of policy support, and shifts in the US-China relationship.

On the flip side, we keep Malaysia and Singapore as least preferred. Malaysia is sensitive to weaker manufacturing exports, and the NIM environment for its financial sector is not as favorable compared to other Asian peers. Meanwhile, Singapore is sensitive to the global trade cycle, which is still weak. Singapore's financial sector, which makes up half of the market, is expected to see more NIM pressure.

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 supercycle, new lockdowns in Southeast Asia, and an escalation in Sino-US frictions.

Market preferences

Most preferred: Indonesia, India, China

Least preferred: Malaysia, Singapore

For an up-to-date view refer to links on slides 32 and 33.

Asian ex-Japan equities

Upside scenario

MSCI Asia ex-Japan June 2024 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 also less severe than feared and inflation drops faster than expected.

Strong China housing demand recovery

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

Strong demand recovery in tech

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

Downside scenario

MSCI Asia ex-Japan June 2024 target: 530

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 would 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 June 2024 target: 3.00%

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 pickup in financial instability earlier this year. We acknowledge there may be further upward pressure on short-end rates as central banks contend with the more persistent sources of inflationary strains 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, despite the recent resilience displayed by the US economy. 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 June 2024 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 June 2024 target: 3.50%

Economic growth: US GDP growth remains above trend in the face of Fed tightening. The job market is strong, and wages increase at a rapid pace. Inflation stays elevated, and the Fed is forced to hike more aggressively and to a higher level than currently priced in, and at the same time accelerates the shrinking of its balance sheet through active sales.

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

For an up-to-date view refer to links on slides 32 and 33.

Investment grade

Preference: Most preferred

Central scenario

June 2024 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.

Government bond yields further increased over the month, particularly at longer maturities on US Treasury supply concerns. This weighed on US IG total returns even as spreads were well-behaved, edging lower over the month. US IG yields are now at 5.8%, 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.

In addition, high-quality bonds tend to be resilient in a recession or a growth slowdown 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. We expect prospects for falling government bond yields as economic growth slows in the coming quarters to contribute nicely to total returns for the asset class.

On US IG fundamentals, we regard current credit metrics as solid. Rating trends have remained positive in past months, while we note that the median issuer (ex-financials and utilities) has been cutting debt until recently (based on data from BofA). In terms of the outlook, downside risks to earnings remain as global economic growth is slowing. This could lead to a potential degradation in metrics, in which case downgrades could increase and put upward pressure on spreads, though the extent of this is likely to be limited outside of a deep recession.

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.

Upside scenario

Bloomberg Barclays US Int. Corp. June 2024 target: 80bps/ Bloomberg Barclays Euro-Agg. Corp. June 2024 target: 110bps

Goldilocks

The US economy continues to grow around trend growth while European growth improves. Major central banks start cutting policy rates in early 2024 as inflation normalizes ahead of expectations, in order to avoid monetary policy becoming too restrictive in real terms.

Downside scenario

Bloomberg Barclays US Int. Corp. June 2024 target: 200bps/ Bloomberg Barclays Euro-Agg. Corp. June 2024 target: 220bps

Global recession

Growth falls sharply on a global scale toward mid-2024 owing to the delayed impact of monetary tightening or additional tightening efforts to tame persistently high core inflation in late 2023 or early 2024.

For an up-to-date view refer to links on slides 32 and 33.

High yield

Central scenario

June 2024 spread targets: 500bps (USD HY) / 500bps (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 recent months as the market has repriced the risk of recession in light of resilient US economic data. At current spreads of below 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 to slow as the lagged effect of all the policy tightening 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. Additionally, a policy pivot is unlikely in the near-term given current inflation rates and tight labor markets, in our view. This has implications for prospective defaults and credit risk premiums, which is why we forecast spreads widening over the coming quarters.

Many companies were fortunate to lock in lower funding costs prior to the sharp moves higher in rates. Over time, this benefit diminishes as maturities approach and refinancing needs increase. This, coupled with a potentially more challenging earnings backdrop as growth slows, is a nasty mix. We note that while new issuance has picked up this year as issuers seek to address their near-term maturities (65% of YTD issuance was for refinancing), lower-rated CCC issuers have been largely absent from the new issue market (only 6% of US HY issuance YTD was CCC-rated, compared to the long-term average of 15%). Our view is that credit metrics will likely deteriorate from here, and more levered companies without reasonably priced market access will be forced into aggressive balance sheet restructuring. As a consequence, we estimate corporate defaults could rise above their long-term average to around mid-single-digit rates, compared to the current level of 3.1% in the US.

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 remains low, although it has been trending higher as debt growth has picked up and earnings growth has declined. 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. While 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, the current level of outright yields in US HY are elevated at around 8.5% 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.

For an up-to-date view refer to links on slides 32 and 33.

Analysts: Frederick Mellors

High yield

Upside scenario

ICE BofA US high yield spread June 2024 target: 370bps / ICE BofA Euro high yield spread June 2024 target: 370bps

Goldilocks

US activity continues to expand around trend, while European growth improves. Major central banks start cutting policy rates in early 2024 as inflation normalizes ahead of expectations, in order to avoid monetary policy becoming too restrictive in real terms.

Downside scenario

ICE BofA US high yield spread June 2024 target: 850bps / ICE BofA Euro high yield spread June 2024 target: 850bps

Global recession

Growth falls sharply on a global scale toward mid-2024 owing to the delayed impact of monetary tightening and/or additional tightening efforts to tame persistent core inflation in late 2023 to early 2024.

For an up-to-date view refer to links on slides 32 and 33.

Emerging market bonds

Central scenario

June 2024 spread targets: 425bps (EM sovereign bonds) / 300bps (EM corporate bonds)

US economic growth has been more resilient than expected, and near-term recession risks have been repriced. 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 and US growth to moderate. Specifically, with regard to the Federal Reserve, we believe 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.

China is facing a loss of momentum in its economic recovery. Looking ahead, we think an increase in consumer confidence will be important in supporting growth. In this regard, we note that China's monetary policy has become more stimulative, while policy support is expected to ramp up on housing, consumption, and employment to boost private sector confidence, as signaled at the Politburo meeting in late July. Concrete measures are still needed in the weeks ahead, which will be crucial for economic recovery in 2H.

Emerging market (EM) bonds have been supported in the last few months by signs of resilient US economic growth and moderating inflation as well as positive developments across a number of distressed sovereign issuers. We have seen strong spread compression across the credit rating spectrum, particularly in the low-rated issuers. As a result, we think valuations of EM bonds are no longer cheap and look broadly fair, in our view. We downgrade the asset class to neutral. 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% (EMBIG Diversified), while the yield on the corporate index (CEMBI Diversified) is about 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 by carry and lower US rates.

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 sukuk

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

For an up-to-date view refer to links on slides 32 and 33.

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

Emerging market bonds

Upside scenario

EMBIG Diversified / CEMBI Diversified spread June 2024 targets: 340bps / 280bps

Goldilocks: China's economy recovers faster than expected as it opts for large scale fiscal stimulus measures, coupled with a global economy that exhibits resilience to the tightening of financial conditions. Major central banks start cutting policy rates in early 2024 as inflation normalizes ahead of expectations, in order to avoid monetary policy becoming too restrictive in real terms.

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 June 2024 targets: 600bps / 550bps

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

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

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

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

For an up-to-date view refer to links on slides 32 and 33.

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

Asian bonds

Central scenario

JACI composite spread June 2024 target: 240bps

US Treasury yields have recently seen renewed upward pressure on the back of resilient US economic data and rising bond supply, with the 10-year rate rising close to the highest levels since late 2022. That said, we continue to hold the view that the Fed is at the end of its rate hike cycle, presenting a good opportunity to lock in attractive yields now. We expect the 10-year US Treasury yield to gradually decline to 3.5% by year-end as inflation and growth continue to moderate. Against this backdrop, we believe high grade and investment grade bonds, which are more defensive, will better perform. In Asia, we also lean towards defensive segments.

Asia IG credits are likely to provide better risk-reward in the near term, given an attractive combination of high yields (5.9% as of Aug 15) and high quality. Current spreads for JACI IG are still tight (lower than historical levels), but we think the segment still looks resilient due to supportive technicals from negative net issuance and stable sovereign fundamentals.

For Asia HY, we believe short-term challenges still remain. China property continues to be the key challenge to watch. Property sales remain weak, with even SOE (state-owned enterprise) sales deteriorating in the past month. Country Garden, the largest outstanding issuer in the sector, missed a total of USD 22.5mn in coupons due on 6 August for two bonds. It further announced it would be suspending nearly a dozen onshore bonds on 12 August. We think the sentiment toward China property sector could stay weak and thus maintain a cautious view. In the high yield space, however, we hold a relatively positive view on the Macau gaming, underpinned by its reopening/recovery progress and potential deleveraging story.

Upside scenario

JACI composite spread June 2024 target: 210bps

Much faster recovery after full reopening: If the China recovery is faster and stronger than expected in the coming months, there will likely be 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 the housing sales recovery appears uneven and mixed. A quick rebound in housing sales later this year would offer fundamental support to credit metrics in this sector.

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

Downside scenario

JACI composite spread June 2024 target: 310bps

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 frictions emanating from either the war in Ukraine or broader geopolitical tensions hurt risk sentiment, strengthening the US dollar and curbing appetite for EM Asia assets.

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

For an up-to-date view refer to links on slides 32 and 33.

Gold

Central scenario

Gold June 2024 target: USD 2,100/oz

We have shifted our gold forecasts to align with changes to our views on US rates, the economic growth outlook, and the dollar. We initially anticipated a mild recession starting in late 2023, but now expect a soft landing. Likewise, we now see 2Q24 as a more likely time for the Federal Reserve to start cutting rates (vs. end-2023 before). As such, we see less downside to 10-year US yields by year-end and see less weakness for the USD (until we get closer to rate cuts).

Consequently, we are cutting our gold forecast to USD 1,950/oz (from 2,100/oz) by year-end. But we still see higher prices ahead in 2024, targeting USD 2,100/oz by end-June and USD 2,200/oz by end-September. Overall, we believe the next leg up in prices requires a revival in ETF demand (after outflows in 1H23), which typically occurs just ahead of a US easing cycle. So, as this is likely to be at least 3–4 months away, we expect gold to be relatively range-bound for the rest of this year.

Meanwhile, according to the World Gold Council, central banks purchased a net total 55 metric tons of gold in June after three months of net selling. We maintain a full-year forecast of 700 metric tons. If achieved, it would be the second highest amount of purchases for a year since the mid-1960s—following the 1,110 metric tons purchased in 2022. Despite the short-term headwinds outlined above, we reiterate gold's diversification benefits in a portfolio context.

Upside scenario

Gold June 2024 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 June 2024 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 June 2024 target: USD 95/bbl

Oil inventories are starting to fall in some Asian countries like China, and oil-on-water levels saw large drops in recent weeks. The market is tightening up: The futures curve has become more strongly downward-sloped (backwardation), while Asian and European refineries have had to find alternative barrels from non-OPEC+ producers. It's telling that despite weak Chinese economic activity, data from tanker trackers suggest that waterborne crude imports in China have been very strong so far in August.

With Saudi Arabia and Russia extending their production cuts into September, we expect the oil market to be undersupplied by around 2mbpd this month and more than 1.5mbpd in September. Also, due to the Saudi energy ministry's statement—that the Kingdom stands ready to deepen their production cut if market conditions deteriorate—we think Saudi Arabia will reduce its voluntary production cut only when it believes the oil market is stable enough to warrant it (i.e., when global oil inventories are lower than now, in our view). We therefore now expect Brent to hit USD 95/bbl and WTI USD 91/bbl by end-December, up from USD 90/bbl and USD 85/bbl respectively. But we don't expect oil prices to move above USD 100/bbl on a sustained basis over the next 12 months, as that would likely lead to strong US supply growth and hurt oil demand growth in 2024.

Upside scenario

Brent crude oil June 2024 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 June 2024 target: USD 40–70/bbl

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

For an up-to-date view refer to links on slides 32 and 33.

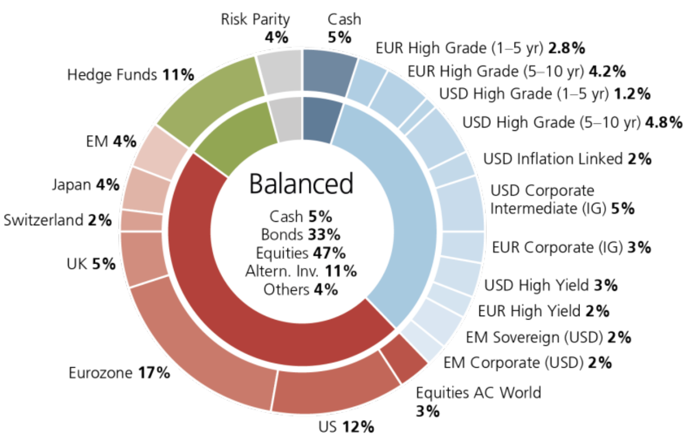
Analysts: Giovanni Staunovo, Dominic Schnider, Wayne Gordon

Section 4

Appendix

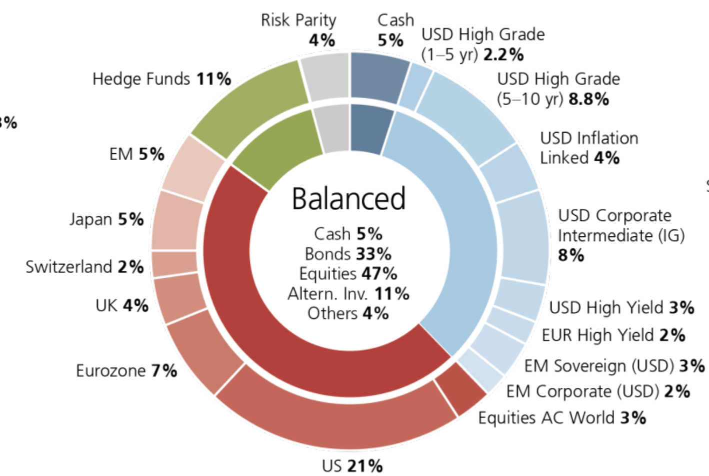
Strategic Asset Allocations (SAAs)

EUR (local portfolio with home bias)



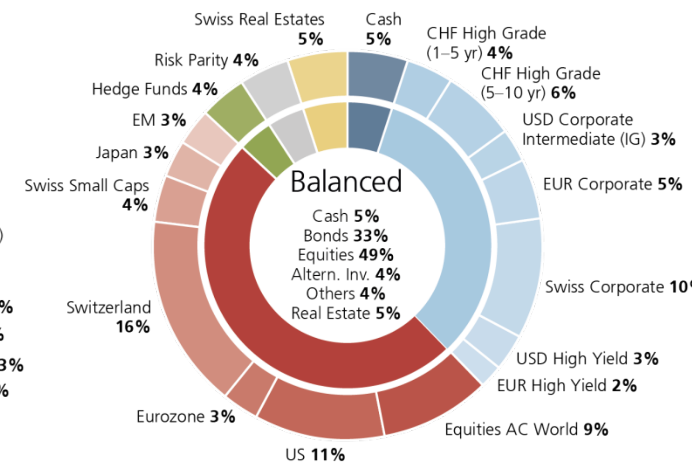
Note: Portfolio weightings are for EUR SAA with a home bias and a balanced risk profile. We expect a balanced EUR SAA to have an average total return of 5.3% p.a. and a volatility of 8.5% p.a. over the next 15 years.

USD



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

CHF (local portfolio with home bias)



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

Source: UBS, as of January 2023

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Version B/2023. CIO82652744