UBS House View

Monthly Letter | 14 September 2023 | Chief Investment Office GWM, Investment Research

Better balance

Inflation has receded, the US labor market has cooled, and the corporate earnings outlook has improved.

Opportune moment

Against a supportive backdrop for stocks and with bond yields high, we expect decent returns across asset classes.

Why invest?

Current high returns make cash look appealing. But returns on bonds and equities should be more durable.

Asset allocation

Bonds remain our preferred asset class. We move the technology sector to neutral and see opportunities to tap into disruptive growth trends.

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Back in balance?

In our second-half outlook, published in June, we characterized global markets as facing a balancing act. Our view was that for markets to rally further, the Federal Reserve would need no more than two additional rate hikes, the US recession would need to be averted, and the rally in stocks linked to artificial intelligence would need to be sustained.

In the three months since, inflation has receded, meaning the Fed and other major central banks are closer to the end of their tightening cycles. The US labor market has cooled, but not so much as to push the economy into a recession. Earnings have improved, with US-listed company profit expectations now back at all-time highs. Yet global equities are little changed over this period, and bond yields remain elevated.

In our view, this creates an opportune moment for investors. Against a supportive backdrop for stocks and with bond yields high, we expect decent returns across asset classes: 8–10% for major global stock market benchmarks and 10–15% for major high-quality bond indexes in US dollars, sterling, Swiss franc, and euro by June 2024. And by diversifying, investors can also earn these returns while reducing exposure to potential risks.

Of course, cash offers good current yields. But while we expect bond and stock returns to prove durable, the high interest rates on cash today are likely to drop in the next 12 months. Taking a longer-term view, we expect cumulative cash returns of just 5–14% depending on currency over the next five years, versus cumulative returns of 15–25% in bonds, 40–55% in stocks, and 25–65% in alternatives, based on our Capital Market Assumptions.

Risks remain. Inflation is still above official targets, and rising oil prices threaten to keep it elevated over a longer period. It is unclear if or when the interest rate hikes that central bank have enacted will begin to have a larger effect. China's economy has disappointed. And yet another US government shutdown is possible in October.

Investors can tap into attractive opportunities and mitigate risks.

But for investors who carefully construct multi-asset portfolios, these risks are navigable. By reviewing and balancing exposures, investors can tap into today's attractive opportunity set across asset classes, position for durable returns for years to come, and mitigate the effect of potential risks.

In the remainder of this letter, I will review the macro backdrop as we see it today, outline our tactical views on key asset classes, address the question of why invest now when cash rates are so attractive, and review our preferred areas within each asset class.

Back in balance – the macro backdrop

While a soft landing is not yet assured, the economy looks much closer to being in balance.

A few months ago, achieving an economic "soft landing" in the US seemed a challenging task. Inflation was well above target, the US labor market was extraordinarily tight, and the financial system was straining under the pressure of higher interest rates. Today, while a soft landing is not yet assured, the economy looks much closer to being in balance.

Most critically, inflation measures and indicators of future inflation are pointing down. PCE goods prices are in deflation, coming in at –0.5% year-over-year in July. The declining trend in housing rents has started to be reflected in the official housing inflation gauge. And the number of employees leaving their existing jobs—often to seek equivalent jobs with higher pay—has fallen.

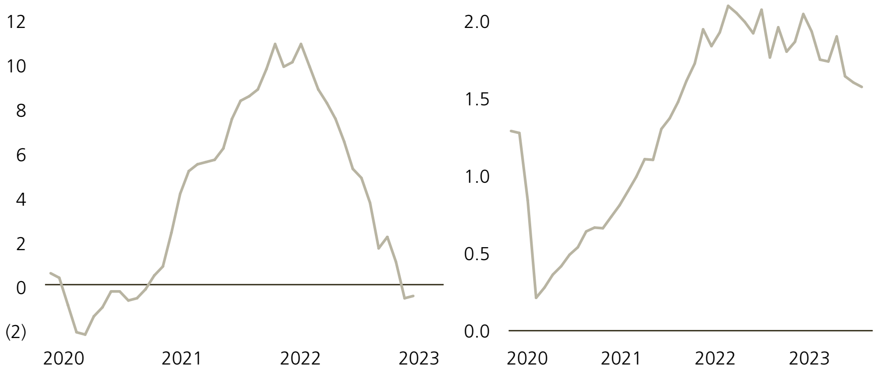
Figure 1

Goods prices in deflation

US PCE goods price inflation, y/y, in %

Labor market tightness has eased

US job openings to unemployed ratio



Source: Bloomberg, UBS, as of September 2023

Source: Bloomberg, UBS, as of September 2023

Recent activity data have also indicated resilience. The labor market has cooled enough to reduce upward pressure on inflation, but not so much as to provoke fears of recession. Job vacancies were double the number of unemployed in April; that ratio has now fallen to 1.5x. Nonfarm payroll growth has slowed to the 100,000–200,000 range in recent months, a level closer to the growth in the labor force.

Meanwhile, consumer dollars are coming less out of excess savings built up during the pandemic and more out of real wage growth. Rising spending and flat income had caused the savings rate to fall to an unsustainably low 3.5%, but with real wage growth turning positive in March and increasing 0.2% month-over-month in July, the average consumer should be able to maintain real spending without having to draw down savings.

Risks

Risks to the soft landing remain, including slowing progress on inflation.

Risks to the soft landing do remain, of course. The steady rise in oil prices in recent weeks will lead to higher headline inflation, and being a highly visible price to consumers, may undo some of the progress made in reducing inflation expectations. In our base case, however, we don't expect oil prices to move past USD 100/bbl on a sustained basis over the next 12 months, as that would likely induce strong US supply growth and hurt demand growth in 2024.

An exogenous shock is also possible. Disappointing growth in China has raised concerns about possible spillover effects into the global economy. However, even for a trade-oriented region like the Eurozone, China accounts for only around 8% of exports; for the US, that figure is 7.5%.

Separately, the start of a new federal fiscal year in October challenges the US Congress to avoid a government shutdown. But unlike the recent debt ceiling debate, which posed an existential threat to financial markets, the risk of long-term adverse consequences from a temporary closure of US government offices is minimal, in our view.

Overall, we think the macro backdrop suggests a combination of higher growth and lower inflation than had seemed possible a few months ago. The Fed now faces less pressure to hike rates further, and rising real wages are reducing the economic pain from earlier rate hikes.

The market outlook

Range-bound equity and bond markets create an opportunity for investors.

The macroeconomic backdrop has improved, and we see an increasing likelihood of a "softish" landing being achieved. But both equities and bonds have been broadly range-bound for the past three months. We think this creates an opportunity for investors, and we expect positive returns across both markets over the next six to 12 months.

Bonds
Bond performance has been muted so far this year, as resilient US economic growth and steadily increasing oil prices have led to expectations that interest rates will stay higher for longer. Year-to-date returns through the end of August for US and European high grade bonds have been just 0.7% and 2.8%, respectively.

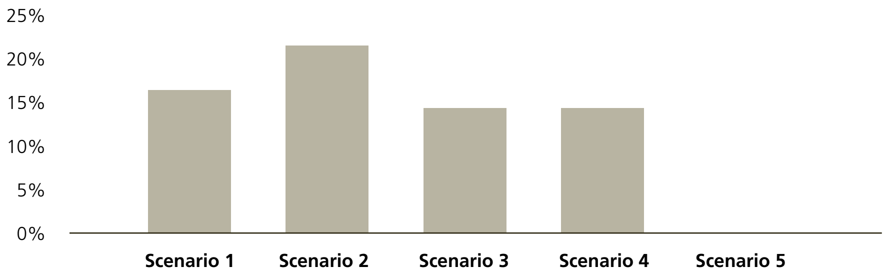
Still-high bond yields provide investors with an opportunity to lock in attractive interest rates.

The good news is that still-high bond yields provide investors with an opportunity to lock in attractive interest rates. In most scenarios, we expect bonds to outperform cash over both 12-month and five-year time horizons. We also see the risk of absolute mark-to-market losses in quality bonds as limited; for investors in 5-year US Treasuries (currently yielding 4.4%) to lose money over a one-year horizon, we would have to assume a further increase in yields of 100 basis points.

Figure 2

We expect high returns for Treasuries across most interest rate scenarios

Estimates for 1-year total returns (in %) for 10-year US Treasuries under different scenarios



Scenario 1: Hike to terminal rate of 5.25%, hold for 6mths, then cut back to 2.5%
Scenario 2: Hike to terminal rate of 5.25%, hold for 6mths, then cut back to 0%, hold for 12mths, hike back to 2.5%
Scenario 3: Hike to terminal rate of 5.5%, hold for 12mths, then cut back to 2.5%
Scenario 4: Hike to terminal rate of 6%, hold for 6mths, then cut back to 2.5%
Scenario 5: Hike to terminal rate of 5.5%, hold for 12 mths, then cut back to 3.5% (new inflation target of 3%)

Source: Bloomberg, UBS, as of September 2023

Furthermore, in our base case, we expect quality bonds to deliver front-loaded capital appreciation, as economic growth decelerates and inflation falls closer to target. Considering the long and variable lags of monetary policy transmission, we expect US growth to slow down into early 2024 as various measures of inflation are falling. PCE goods prices are in deflation; housing inflation has likely peaked; and while core services inflation ex-housing is elevated, US labor markets are now cooling in response to monetary tightening.

Overall, we expect total returns of 10–15% for both high grade and investment grade bonds* over the next six to 12 months, and bonds are our most preferred asset class.

Equities

In the US, while most of this year's S&P 500 gains have been driven by valuation expansion, profit dynamics are now more supportive.

After a strong first half of 2023, largely driven by expanding valuation multiples, global equity indexes have delivered muted performance over the past three months. In our base case, we expect 8–10% total returns across MSCI developed and emerging market indexes over the next six to 12 months, potentially reaching 17–19% in an upside scenario where AI-driven optimism drives further upside in earnings expectations.

In the US, while most of this year's S&P 500 gains have been driven by valuation expansion, profit dynamics are now more supportive. Bottom-up 12-month forward earnings per share (EPS) expectations have staged a notable rebound and are now back to all-time highs. We expect flat S&P 500 earnings for 2023 and 9% growth in 2024.

* Bond expectations are based on indexes from Bloomberg, ICE BofA, JP Morgan, Bloomberg Barclays, Solactive, and S&P LCD. For more details on how we derive these returns estimates, please consult our Capital Market Assumptions or speak to your advisor.

In the Eurozone, companies have benefited from higher inflation, with greater pricing power supporting earnings. After earnings growth of 20% in 2022, this tailwind is fading as inflation recedes. We expect flat EuroStoxx 50 earnings for 2023 and 3% growth next year. That said, valuations are cheap, with the EuroStoxx index trading at 11.5x 12-month forward earnings, compared with a 10-year average of around 14x.

And in emerging markets, while we now expect earnings to decline 6% this year (in USD terms), we see a potential recovery in 2024, led by Asia ex-Japan as domestic demand improves, industrial production gets a boost from the tech sector, and easing input costs allow an expansion in profit margins. We expect 16% growth overall—18% in Asia ex-Japan—compared to 7% growth for developed markets. Valuations are also cheap. The MSCI Emerging Markets index is trading on a 11.8x 12-month forward P/E, largely in line with its 10-year average and at a 30% discount to the MSCI World index. On a price-to-book basis, the discount is even deeper at 49% versus its 10-year average of 36%.

There are, however, more significant downside risks to stocks than to bonds, in our view, and we have a neutral overall stance on equities. In the event of a sharp economic slowdown, we would expect 22% downside for the S&P 500, 13% for MSCI Europe, and 16% for MSCI Emerging Markets.

Why invest at all?

We expect returns from stocks and bonds to prove durable over the long term, while returns on cash are likely to fall from current high levels.

A question we frequently get from clients in the current interest rate environment is, "Why invest at all?" Even if the macro backdrop is decent, overall risks are lower, and the base-case outlook for markets is favorable, why take any downside or mark-to-market risk, when the returns available on cash look good?

The short answer is durability. While returns from stocks and bonds may be uncertain over the short term, we expect them to prove durable over the long term. By contrast, cash may pay a certain and high return in the near term, but today's high interest rates are likely to drop in 12 months, presenting reinvestment risk. Overall, we expect cumulative cash returns of just 5–14% over the next five years, versus cumulative returns of 15–25% from high grade bonds, 40–55% from global stocks, and 25–65% from alternatives, based on our Capital Market Assumptions.

In addition, investors often underestimate how well a combination of stocks, bonds, and alternatives can reduce the volatility inherent in holding any of those asset classes individually. For example, in our downside scenario, global stocks would fall by 17%, but 10-year US Treasury bonds would rally by 21%. Equally, in our upside scenario of positive growth surprises, bond markets might return a modest 7% compared with equities' 17–19%.

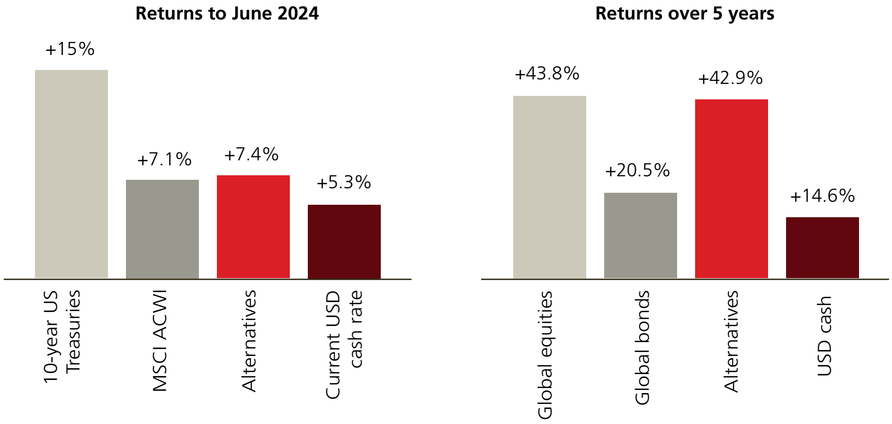
Last year's simultaneous annual losses for equities and bonds were unusual.

Last year's simultaneous annual losses for equities and bonds were unusual; since 1926, this has only occurred three times. But if it were to occur again, we think a healthy allocation to alternatives can mitigate portfolio downside: In 2022, diversified alternatives indexes delivered performance between –6% and +17%.

Figure 3

We expect cash to underperform other asset classes

Expected total returns to June 2024 and over 5 years for cash vs. equities, bonds, and alternatives



Note: 1-year equity and bond estimates based on CIO's base case June 2024 forecasts. 1-year alternatives forecast based on long-term capital market assumptions. 5-year forecasts based on long-term capital market assumptions

Source: UBS, as of September 2023

We believe that by developing a core allocation of investments carefully balanced across asset classes, investors can both position to earn attractive returns over the short and longer term, and effectively protect themselves against potential market risks. This approach can also provide them with the freedom to pursue opportunistic or satellite strategies, or passion investments, while staying on track to grow wealth steadily over time.

Investment ideas

The prospect of decent returns across asset classes makes it an opportune time to invest in a balanced portfolio.

Alongside this *Monthly letter*, we have also published our *Quarterly outlook*, also entitled "Back in balance?" In that publication, we have detailed some of our key investment ideas that we believe investors should consider today. I encourage you to read it for a more comprehensive view. Below is a summary of our key ideas:

First, get in balance. We are at a rare moment when earning returns can be relatively simple. In our base case, we expect bonds, stocks, and alternatives all to deliver reasonable returns over the next six to 12 months and over the longer term. Investors need to review portfolios to ensure an effective balance across asset classes to manage potential risks and ensure that returns are durable.

Cash is not an attractive long-term investment.

Second, manage liquidity. Part of getting in balance means not overallocating to cash. Cash rates are attractive. But we expect such high rates to be short-lived as the central bank tightening cycle ends. We recommend that investors hold no more than two to five years of expected net portfolio withdrawals in a Liquidity* strategy. The remainder should be put to work in a balanced portfolio of equities, bonds, and alternatives, which can offer more durable returns than cash. Within Liquidity portfolios, investors can optimize and future-proof yields by using a combination of certificates of deposit, bond ladders, and select structured solutions.

* Time frames may vary. Strategies are subject to individual client goals, objectives and suitability. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved.

Figure 4

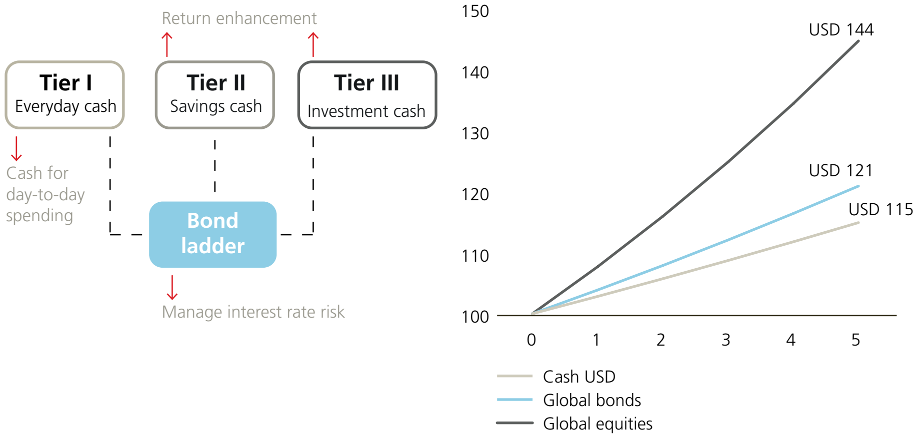
There's a place for cash, but not as a long-term investment

Cash has a role to play as part of a Liquidity strategy…

It is used to meet expenses and avoid selling assets at a loss to meet spending needs

…but it won't improve portfolio returns

Expected 5-year returns of cash vs. equities and bonds, based on CIO's Capital Market Assumptions



Source: UBS, as of September 2023
Strategies are subject to individual client goals, objectives, and suitability.

It is highly unlikely that quality bonds will deliver negative returns over the next 12 months.

Third, buy quality bonds. We expect high-quality bonds to deliver total returns of 10–15% over the next six to 12 months, as economic growth gradually decelerates, inflation falls closer to target, and investors begin to expect future interest rate cuts. Within fixed income, we focus on quality bonds. At current yield levels, we see it as unlikely that quality bonds will deliver negative returns over the next 12 months. Our preferred duration stance is in the 5–10-year range; although yields are lower than at the short end, we see the income durability and greater scope for capital appreciation as attractive. We are less positive on emerging market and high yield bonds given that the additional yield in these asset classes is limited for the additional risks borne.

We see opportunity in the parts of the market that have lagged global indexes this year.

Fourth, look for equity laggards. With stock market gains this year concentrated in a few individual companies, an economic "soft landing" looking more likely, and more investors seeking cheaper stocks, we see opportunity in the parts of the market that have lagged global indexes this year. In US equities, we prefer equal-weighted indexes to cap-weighted indexes. In Europe, we like small- and mid-caps. And within emerging markets, which have lagged global markets, we focus on India and Indonesia. We also like value stocks.

Technological disruption across industries is creating compelling opportunities for investors.

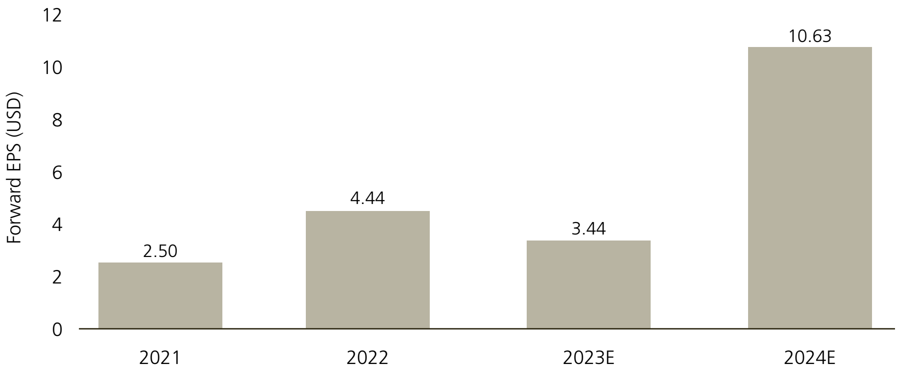
Fifth, pick leaders from disruption. Technological disruption across industries is creating compelling opportunities for investors looking for longer-term portfolio growth potential. In the technology sector, among disruptors, we like platform companies with network effects in industries like internet and software, as the impact of artificial intelligence broadens. We also like enablers exposed to trends like cloud, big data, and AI, including software and solution providers. In energy, we see opportunity in the transition to renewable energy, including carbon reduction and energy efficiency.

This month, we move the global and US information technology sectors to neutral from least preferred. The surge in AI applications and investments has created a powerful new narrative for the broader tech sector. We forecast a 61% compound annual growth rate (CAGR) for AI end-demand during 2022–27.

Figure 5

Demand for AI expected to rise

Consensus earnings forecasts for AI chipmaker Nvidia illustrate unabated demand for AI technology



Source: Bloomberg, UBS, as of September 2023

Alongside these AI developments, we are more constructive on the tech sector due to improving earnings revisions as key end-markets appear to trough; the strength of US tech company balance sheets, a positive driver in a period of high interest rates and slowing economic activity; and the fact that quality growth stocks typically perform well during the later stages of the business cycle.

Implied and realized volatility across equities and commodities has fallen to the lowest level since the start of the pandemic in 2020.

Sixth, benefit from low volatility. Implied and realized volatility across equities and commodities has fallen to the lowest level since the start of the pandemic in 2020. If sustained, this should improve the stability of overall portfolio returns and present opportunities for investors. In equities, investors can now cheaply mitigate downside risks. In commodities and currencies, investors have opportunities to take advantage of market ranges. Fixed income volatility remains elevated compared with prepandemic levels, creating opportunities for cash and bond yield enhancement.

The current market environment also offers compelling individual hedge fund and private markets opportunities.

Seventh, diversify with alternatives. Alternative asset classes are a key part of long-term portfolios, for both risk-adjusted performance and potential diversification when stocks and bonds move together. The current market environment also offers compelling individual hedge fund and private markets opportunities, particularly in specialist credit hedge fund strategies and secondaries in private equity. Higher interest rates can also support return potential for alternative asset managers, given higher yields and returns on offer in underlying assets, including in private debt. Investors should be aware of the unique drawbacks involved in investing in alternatives, like illiquidity.

Infrastructure benefits from digitalization, deglobalization, and decarbonization

Finally, invest in infrastructure. The theme benefits from powerful structural tailwinds driven by digitalization, deglobalization, and decarbonization trends. Government support is likely to spur capacity expansions and enhance current and future project economics and competitiveness, more notably for renewables. In a portfolio context, we think the asset class is a valuable source of steady and inflation-linked income with lower sensitivity to economic growth and broad market movements.

For investors focused on sustainability, each of these investment ideas can be implemented in a sustainable way, including through sustainable multi-asset class portfolios, sustainable bonds, sustainable equities, sustainable themes including in education and biotechnology, and a growing universe of sustainable hedge funds and private market funds.

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Global forecasts

Economy

Real GDP y/y, in %

	2022	2023E	2024E
US	2.1	2.1	0.4
Canada	3.4	1.4	0.5
Japan	1.0	2.0	0.8
Eurozone	3.5	0.5	0.7
UK	4.1	0.2	0.6
Switzerland	2.7	0.7	0.9
Australia	3.7	2.0	1.7
China	3.0	4.8	4.2
India	7.2	6.2	6.0
World*	3.4	2.8	2.5

Inflation (average CPI), y/y, in %

	2022	2023E	2024E
US	8.0	4.1	2.2
Canada	6.8	3.5	2.3
Japan	2.5	3.0	1.9
Eurozone	8.4	5.5	2.4
UK	9.0	7.4	2.4
Switzerland	2.8	2.2	1.8
Australia	6.6	5.5	3.0
China	2.0	0.5	1.2
India	6.7	5.6	5.0
World*	8.4	6.1	4.8

* Excludes Venezuela

Source: Bloomberg, UBS, as of 14 September 2023. Latest forecasts available in the Global forecasts publication, published weekly.

Asset classes

	Spot	Dec-23	Jun-24
Equities			
S&P 500	4,467	4,500	4,700
Eurostoxx 50	4,223	4,500	4,700
FTSE 100	7,526	8,000	8,200
SMI	10,976	12,000	12,400
MSCI Asia ex-Japan	618	680	700
MSCI China	60	68	71
Topix	2,379	2,300	2,400
MSCI AC World	680	840	870
Currencies			
EURUSD	1.07	1.12	1.16
GBPUSD	1.25	1.29	1.35
USDCAD	1.35	1.32	1.30
AUDUSD	0.64	0.66	0.70
EURCHF	0.96	0.97	0.97
USDCHF	0.89	0.87	0.84
USDJPY	147	142	138
USDCNY	7.27	7.40	7.20

	Spot	Dec-23	Jun-24
2-year yields, in %			
USD 2y Treas.	4.97	3.75	2.75
EUR 2y Bund	3.17	2.50	2.00
GBP 2y Gilts	4.97	4.50	3.50
CHF 2y Eidg.	1.25	1.10	0.75
JPY 2y JGB	0.02	0.05	0.05
10-year yields, in %			
USD 10y Treas.	4.25	3.50	3.00
EUR 10y Bund	2.65	2.00	2.00
GBP 10y Gilts	4.34	3.75	3.25
CHF 10y Eidg.	1.04	1.10	0.90
JPY 10y JGB	0.71	0.80	0.80
Commodities			
Brent crude, USD/bbl	91.9	95	95
WTI, USD/bbl	88.5	91	91
Gold, USD/oz	1,914	1,950	2,100

Source: Bloomberg, UBS, as of 14 September 2023. Latest forecasts available in the *Global forecasts* publication, updated weekly.

Disclaimer

Non-Traditional Assets

Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

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In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, “junk bonds,” derivatives, distressed securities, non-US securities and illiquid investments.
- Managed Futures: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
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- Private Equity: There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- Foreign Exchange/Currency Risk: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer’s “home” currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a US investor.

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