UBS House View

Monthly Extended November 2023

Chief Investment Office GWM
Investment Research

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

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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 retain our preference for bonds over equities.

Within equities, we retain our preference for value and quality income versus growth. We also like the consumer staples, utilities, energy and industrials sectors. Our most preferred regions are EM and China.

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

Within commodities, we hold a preference for oil.

Within foreign exchange, we have a neutral stance in all major currencies.

Equities

We see better value in bonds than equities, and retain our preference for high-quality bonds to stocks.

Across regions, we keep US equities as least preferred and emerging market equities as most preferred.

By sector, consumer staples, utilities, energy, and industrials stay as most preferred, and materials and healthcare as least preferred.

Across styles, we prefer value (most preferred) and quality income (most preferred) to growth (neutral). Value stocks remain historically very cheap compared to growth stocks, in our view.

Bonds

We maintain our preference for the 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 and emerging market credit.

The tightening of lending standards and higher official policy rates continue to weigh on growth and inflation, and should apply downward pressure on nominal interest rates. This is a positive driver for the performance of high-quality bonds. For higher-beta credit segments, we are beginning to see rising defaults and a gradual deterioration in corporate fundamentals. These dynamics and rising liquidity risk premiums are likely to have a greater impact on the lower quality segments of the asset class, such as high yield and loans.

Foreign exchange

The USD is finding support from the latest September FOMC meeting, which signaled it intends to keep policy rates higher for longer. In contrast, major central banks in Europe have mostly disappointed market expectations.

We now think that the greenback will stay well-bid till end-2023, and we accordingly changed our forecasts across key currency pairs.

Short term, we like to use option markets for yield pickup when it comes to the USD, while investors should consider beneficiaries of higher energy prices (NOK, the AUD, or the CAD) in the crosses.

Commodities

Our UBS CMCI broad commodity index trended sideways in September, delivering a total return of 0.3% and is up 2.7% year-to-date. Energy has been a key driver behind the performance of the asset class. The UBS CMCI energy index gained 2.5% during the month. Therefore within the asset class, we retain our preference for oil.

We see further gains for commodities as a whole into year-end and target low-teens total returns on a 12-month basis.

We also continue to recommend actively managing commodity exposure.

Section 1.2

Risk scenarios

Key scenarios – June 2024

	Upside: Lift-off	Base case: Soft landing	Downside: Hard landing	*Things to watch*
Probability	*20%*	*60%*	*20%*	
Market path	**Bonds flat to down, equities up** Equity markets and other risk assets rally, while high quality bonds will be confronted with high(er)-for-longer interest rates environment.	**Bonds up, equities 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 at or above 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. Rising fiscal deficit and treasury supply in the US can push bond yields higher in the near term, raising the likelihood of a recession in 2024.	*US, China: PMI data* *US, Europe: industrial production* *US: capital goods orders* *US, China Europe: consumer spending* *US: housing starts* *Europe: gas prices*
Inflation	Remains above central bank target throughout next year.	Continues to slow in the US and in Europe, but ends the year above central bank targets before normalizing by mid-2024.	Falls quickly as demand for goods and services collapses.	*Global: Oil price* *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	Monetary policy stays in restrictive territory. Major central banks keep interest rates "high for longer", i.e., do not start cutting policy rates in 2024 as inflation stays above target.	Central bank policy rates reach peak level in 2023. Major central banks start cutting policy rates in 2024 as inflation normalizes. The Fed lowers its policy rate in line with market expectations during H2 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 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	Middle East crisis de-escalates. The war in Ukraine deescalates, e.g., via a ceasefire agreement. Progress is made in bilateral relations between the US and China.	Middle East crisis results in a contained regional confrontation. The war in Ukraine drags on as ceasefire negotiations remain elusive. US-China strategic rivalry continues.	Middle East crisis escalates, with potential for greater disruption to oil supply. The war in Ukraine escalates and/or US-China tensions intensify.	*Middle East crisis and oil supply* *Territorial gains by Russia* *Weapon shipments to Ukraine* *US sanctions on Chinese companies*

Asset class targets – June 2024

Key targets for June 2024	spot*	Upside	Base case	Downside
MSCI AC World	808	940 (+16%)	870 (+8%)	680 (-16%)
S&P 500	4,377	5,000 (+14%)	4,500 (+3%)	3,500 (-20%)
EuroStoxx 50	4,201	5,100 (+21%)	4,600 (+10%)	3,700 (-12%)
SMI	11,038	12,600 (+14%)	12,000 (+9%)	9,800 (-11%)
MSCI EM	957	1,150 (+20%)	1,050 (+10%)	820 (-14%)
US 10y Treasury yield	4.56	5.00	3.50	2.75
US 10y breakeven yield	2.31	2.50	2.25	1.50
US high yield spread**	425bps	370bps	500bps	850bps
Euro high yield spread**	469bps	370bps	500bps	850bps
US IG spread**	118bps	80bps	120bps	200bps
Euro IG spread**	161bps	110bps	170bps	220bps
EURUSD	1.06	1.15 (+8%)	1.10 (+4%)	1.00 (-6%)
Commodities (CMCI Composite)	1,797	2,100 (+17%)	1,950 (+9%)	1,600 (-11%)
Gold***	USD 1,873/oz	USD 1650-1,750/oz (-9%)	USD 1,950/oz (+4%)	USD 2,150-2,250/oz (+17%)

* Spot prices as of market close of 11 October 2023. Developed market constituents of the MSCI All Country (AC) World index display in the local currency. The MSCI EM index displays in US dollar. Values in brackets are expected percentage changes from the quoted spot levels. Dividends, share buybacks and other sources of carry are not included.

** During periods of market stress, credit bid-offer spreads tend to widen and result in larger ranges.

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

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

Analysts: Dirk Effenberger, Daniil Bargman

Section 1.3

Asset class preferences and themes

Global asset class preferences

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

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

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

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

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

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

Get in balance

Equity and bond markets have weakened in recent weeks, but with economic growth still resilient and bond yields high, in our base case we expect cash, bonds, stocks, and alternatives all to deliver good returns over the next 6–12 months and over the longer term. We believe that investors who review their portfolios and ensure an effective balance across asset classes will be well positioned to manage potential risks and earn durable long-term returns.

Balanced asset allocation incl. alternatives
Balanced sustainable asset allocation incl. alternatives

Source of funds
- Cash
- Maturing investments

Manage liquidity*

Cash rates are currently attractive, but we believe the central bank tightening cycle is close to completion and high rates are likely to prove short-lived. We therefore 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. Within Liquidity portfolios, we believe investors can optimize and future-proof yields by using a combination of deposit vehicles, bond ladders, and select structured solutions.

Bond ladders
Certificates of deposit
Capital preservation structured investments
Money market funds
Bond funds

Source of funds
- Cash
- Maturing investments

Buy quality bonds

Within fixed income, we are focused on quality bonds—at current yield levels, we see it as unlikely that they will deliver negative returns over the next 12 months. Our preferred duration stance is the 5–10-year range, where we see the combination of income durability and greater scope for capital appreciation as attractive. We are less positive on emerging market and high yield bonds given that the extra yield in these asset classes seems limited for the additional risks borne.

High grade (government) bonds
Investment grade bonds
Sustainable bonds
Actively managed fixed income strategies

Source of funds
- Cash
- Excess EM / high yield

Look for equity laggards

With stock market gains this year concentrated in a few companies, an economic soft landing looking more likely, and more investors actively 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 ones. In Europe, we like small- and mid-caps. And within emerging markets, which have lagged global markets this year, we favor India and Indonesia.

US equal-weight indexes vs. cap-weight indexes
Select Swiss / European opportunities
Quality income and value
Invest in EM (incl. India and Indonesia)

Source of funds
- Cash
- Least preferred stocks

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, which should benefit as the impact of artificial intelligence (AI) broadens. In energy, we see a variety of opportunities in the transition to renewables. We also like education services companies as both beneficiaries of, and providers of training in, AI.

Technology disruption
Energy transition
Education innovation

Source of funds
- Cash
- Least preferred stocks

Navigate volatility

Volatility across asset classes has increased, creating opportunities for investors to earn income and benefit from asymmetric payoffs. In equities, we see opportunities to stay exposed to market upside while mitigating downside risks. In commodities and currencies, we focus on strategies that enable investors to take advantage of range-bound market movements. Elevated fixed income volatility creates opportunities for cash and bond yield enhancement.

Capital preservation strategies
Invest in the ranges in currencies and commodities
Yield generation through rates volatility

Source of funds
- Cash
- Maturing investments

Diversify with alternatives

Alternative asset classes are a key part of long-term portfolio diversification, particularly during market environments when stocks and bonds move together. We currently see particular opportunity 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 private debt.

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

Source of funds
- Excess bonds / equities
- Concentrated equities

Invest in infrastructure

Infrastructure benefits from powerful structural tailwinds including digitalization, deglobalization, and decarbonization. Government support is likely to spur capacity expansion and improve project economics, 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 developments and market fluctuations.

Infrastructure
US industrials

Source of funds
- Cash

Go sustainable

Sustainability is a key fundamental trend that will continue to shape markets, in our view. Investors focused on sustainability can put each of our investment ideas into practice in a sustainable way. This includes through sustainable multi-asset class portfolios, thematic sustainable and multilateral development bank bonds, ESG leader and thematic equities, and a growing universe of sustainable private markets and hedge funds.

Sustainable bonds
Sustainable equities
Sustainable hedge funds
Private market impact investing

Source of funds
- Cash
- Traditional equivalents

Analysts: Kiran Ganesh, Sagar Khandelwal, Wayne Gordon, Jason Draho, Michael Gourd

*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.

Key investment ideas by asset class

	We like	Source of funds
Equities	• Global value and quality income • Emerging market equities incl. China, India, Indonesia • Sectors: utilities, consumer staples, industrials, energy • Select Swiss / European opportunities • US equal-weight indexes vs. cap-weight indexes • Technology disruption • Energy transition and education innovation • Infrastructure • Sustainable equities	CIO least preferred equities, excess cash
Bonds	• High grade (government) bonds • Investment grade bonds • Sustainable bonds • Actively managed fixed income strategies	Excess cash, excess EM/HY bonds
Foreign exchange	• NOK	SEK
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, thematic) • Private real estate/private credit	Excess bonds and equities, concentrated equities

Section 2

Macro economic outlook

Global economy – Consumers cushioning the slowdown

Base case (60%)

Growth

While sentiment data has tended to be pessimistic this year, actual production of goods has been stable. Consumer demand, especially from middle income households, has switched to favor service spending, but goods demand has not collapsed. While labor market turnover continues to normalize, job security appears relatively good. Consumer credit demand appears to be slowing in several economies. This supports the idea of an episode of below trend growth, without too negative an outcome.

Inflation

Energy prices may also raise survey-based consumer inflation expectations (as the two measures are strongly correlated), but this is only a policy concern if it impacts wage demands. Goods price disinflation or deflation remains intact. Local peculiarities generate regional variations in service inflation.

Positive case (15%)

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

Negative case (25%)

A more rapid tightening of credit standards and higher cost of borrowing for existing debtors produces a sharper slowdown in consumer demand as spending power is eroded. Fear of unemployment starts to increase, leading to a rise in precautionary spending. This compounds the risks to growth.

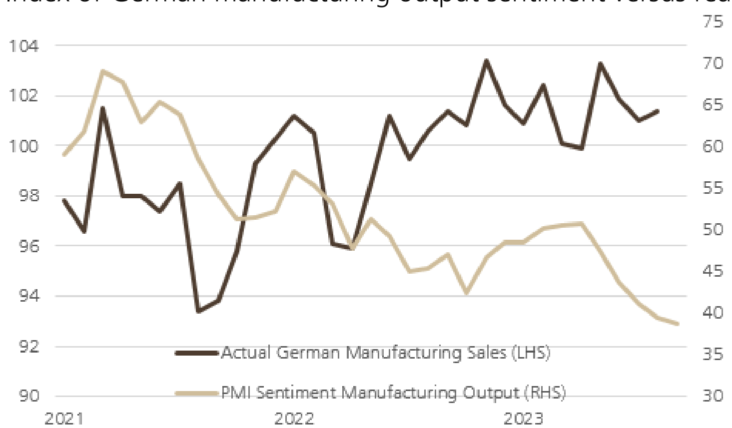
US price discounts are growing in number

Share of PCE deflator with falling prices

Source: Haver, UBS as of 9 October 2023

Sentiment is not always the same thing as reality

Index of German manufacturing output sentiment versus reality



Source: Haver, UBS, as of 9 October 2023

US economy – On a path toward a soft landing

Base case (60%)

Growth

Growth has remained above-trend since 3Q22 despite aggressive rate hikes by the Federal Reserve and stress in the banking system. Recently revised data suggests that households have more excess savings than previously believed, and the strong labor market is providing rising income from wages. This should help to offset the negative impact of higher interest rates and the resumption of student loan payments.

Inflation

The recent increase in energy prices has pushed up headline inflation, but core inflation continues to moderate. 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, with shelter inflation trending lower. Recent data has been in a range that should allow the Fed to end its rate hiking cycle, although one additional hike is possible.

Positive case (15%)

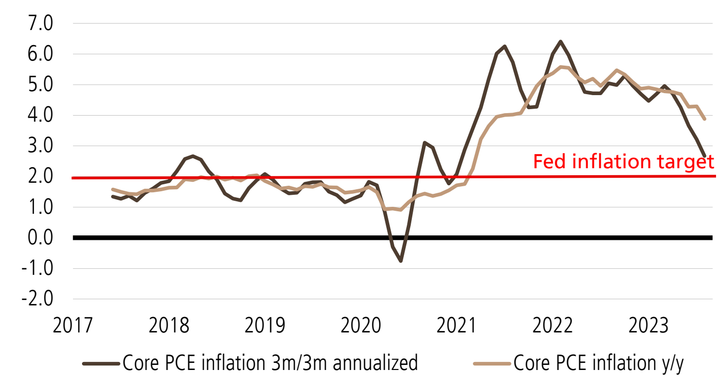
Better labor supply allows businesses to fill their open job positions. Wage growth slows to a more moderate pace and energy prices retreat, helping bring inflation down while growth remains robust. New industrial policies promote business investment. The Fed sees enough progress toward its mandates to stop raising rates and begins to trim rates in 2024.

Negative case (25%)

Progress on inflation stalls, forcing the Fed to maintain tight monetary policy. Banks continue to tighten their lending standards, pushing up borrowing costs. 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 pushes the economy into a recession.

Core inflation still above the Fed's target

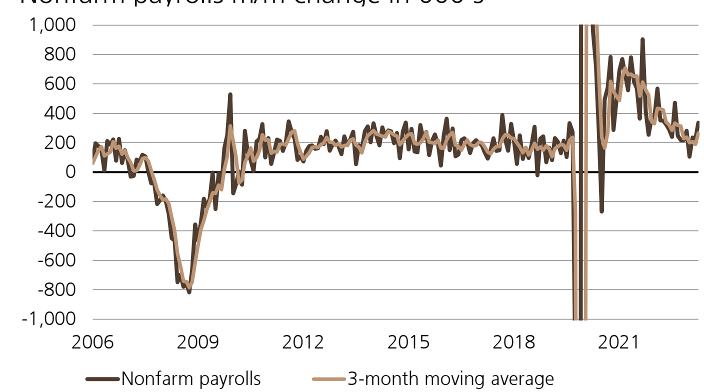
Core PCE, 3m/3m annualized and y/y change, in %



Source: Bloomberg, UBS, as of 9 October 2023

September payroll report surprised to the upside

Nonfarm payrolls m/m change in 000's



Source: Bloomberg, UBS, as of 9 October 2023

Eurozone economy – Little relief in sight

Base case (60%)

Growth

Sentiment surveys, and industrial production data for the Eurozone's largest economy, Germany, suggest that the risks to economic growth in the near term remain firmly skewed to the downside. The softening in activity has, for now, prompted the ECB to signal a pause in the pace of monetary tightening, which should ease pressures, as will a strong labor market. However, in the absence of fiscal headroom, it will likely take lower interest rates to stimulate a meaningful recovery.

Inflation

Rising oil prices could place upward pressure on headline inflation in the short term, but elsewhere the disinflationary process seems well established. We expect core and headline inflation to fall back to the ECB's 2% target over the coming quarters, which should give the central bank the confidence to lower interest rates, most likely from the summer of next year.

Positive case (15%)

Economic activity normalizes sooner, supported by a sharp fall in inflation and ongoing labor market strength.

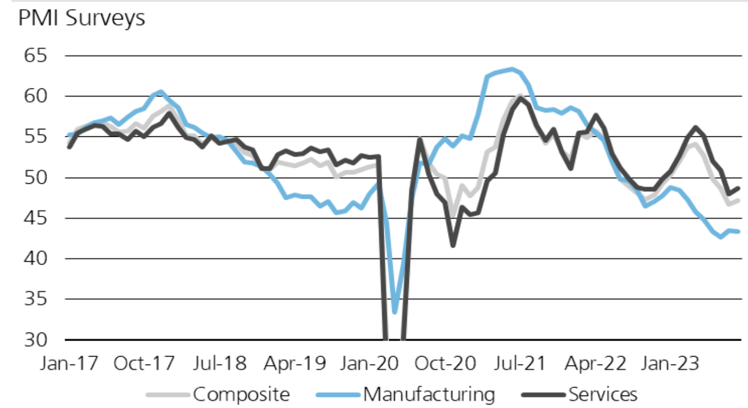
Economic growth in Asia and the US accelerates, with the latter avoiding a recession, boosting demand for Eurozone exports.

Negative case (25%)

The ECB overtightens monetary policy by placing too much weight on near-term inflation. Tighter financial conditions see demand for credit to collapse further, hurting consumption and investment.

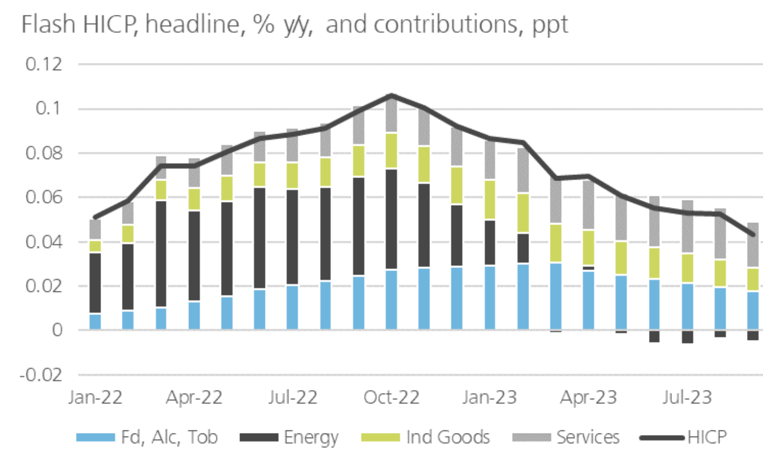
Geopolitical tensions force energy prices materially higher. Fiscal policy is too slow to respond or is tightened too early.

Sentiment indicators highlight the challenges to growth



Source: Haver Analytics, UBS, as of 9 October 2023

Headline inflation fell sharply in September



Source: Haver Analytics, UBS, as of 9 October 2023

Swiss economy – SNB to keep policy rate on hold

Base case (70%)

Growth

Switzerland is expected to grow at a below-average rate in 2023. The weakness in the Eurozone's economy is weighing on manufacturing sentiment. Domestic demand is likely to stay solid and cushion the slowdown in manufacturing.

In 2024, activity is expected to improve over the course of the year. A decline in inflation and the end of interest rate hikes should help European growth and boost Swiss exports.

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 a rebound in inflation.

We expect a stable SNB policy rate at the end of the year and in 1H24 as inflation risks still exist. Interest rate cuts are unlikely before 2H24.

Positive case (15%)

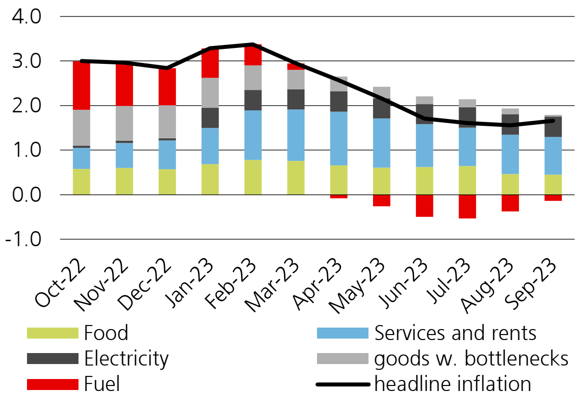
Better global growth momentum: Global inflation further softens, allowing central banks to support GDP growth more than expected. Switzerland benefits from the stronger global backdrop and a weakening of the safe-haven Swiss franc.

Negative case (15%)

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

Swiss inflation bottoming out

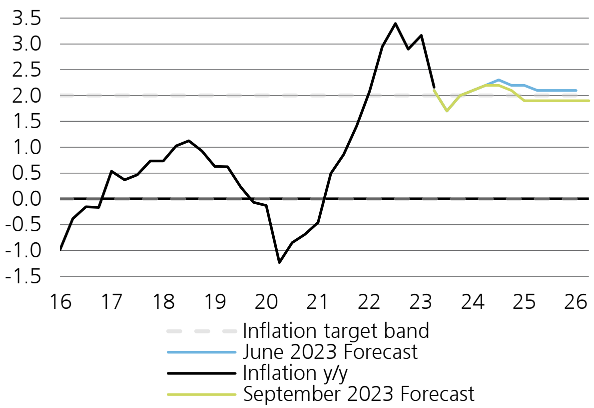
Swiss inflation y/y with contribution from different components, in %



Source: Macrobond, UBS, as of 10 October 2023

SNB now sees inflation inside the comfort zone

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



Source: Macrobond, SNB, UBS, as of 10 October 2023

Analysts: Alessandro Bee, Florian Germanier

Chinese economy – Bottoming out on policy support

Base case (70%)

Growth

Recent data showed more signs of bottoming out from July. Domestic tourism revenue and revenue per capita during October Golden Week returned to 2019 levels, the highest since reopening. September manufacturing PMI returned to expansion (50.2) after five months of contraction. August retail sales rebounded to 4.6% y/y led by services and auto. Credit growth edged up to 9% y/y ytd. Though, investment slowed further to 3.2% y/y ytd dragged down by property. We expect 2023 full-year GDP growth of ~4.8% y/y backed by policy support.

Inflation

August CPI inflation turned positive at 0.1% y/y. We expect a mild pickup by year-end, with full-year average at 0.5%. PPI deflation is likely to persist, but to ease further through year end.

PBoC cut RRR by 25bps on 15 September, after a 15bps MLF rate cut on 15 August. We expect a further 25-50bps of RRR cut(s) and 10-20bps MLF cut(s) by year end.

Positive case (15%)

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

Geopolitical risks remain contained without dramatic spillovers.

The US economy achieves a soft landing.

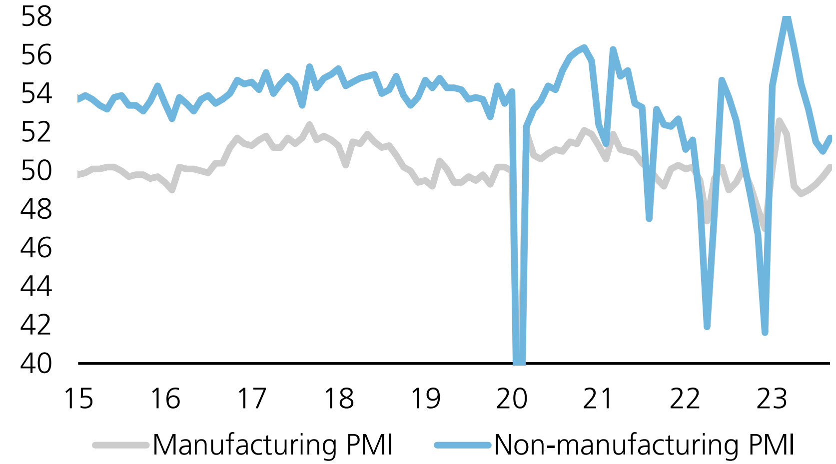
Negative case (15%)

Property activity continues deteriorating despite supportive policies.

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

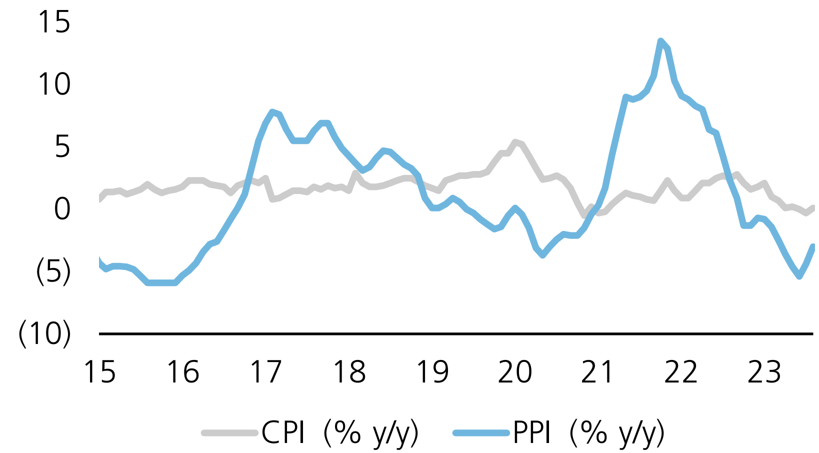
The US imposes much stricter restrictions on China's tech sectors.

September manufacturing PMI returned to expansion



Source: CEIC, UBS, as of 10 October 2023

Both CPI and PPI inflation bottoming



Source: CEIC, UBS, as of 10 October 2023

Section 3

Asset class views

Section 3.1

Summary of major asset classes

Equities

Central scenario

MSCI AC World June 2024 target: 870

In our global tactical strategy, we have a neutral rating on equities. Over the last month, lofty equity valuations have been pressured by surging real rates. Apart from higher US rates, other near-term headwinds to global equities have been the risk of a US government shutdown and economic weakness in China and Europe. Nevertheless, while it may be challenging to see where the economy is headed, the recent moderation in job growth has yet to dent the labor market. The latest new-orders and inventories readings in the US support the view that corporate earnings are back on the rise.

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 rate-hiking cycle getting closer, we no longer expect a contraction in global and US earnings for 2023. Instead, we see flat global earnings this year versus 2022 and expect earnings to grow by high single digits in 2024.

Equity valuations remain stretched versus bonds but improve in absolute terms. On a price-to-earnings (P/E) basis, the MSCI All Country World Index is currently trading at 15.4x, or 5% above its long-term average of 14.5x. Meanwhile, the cost of equity is around 8.3% (back to 10-year highs), consistent with historical episodes of investor exuberance. The equity risk premium continues to deteriorate and now stands below the long-term average, meaning that equities are less appealing than bonds.

US equities are least preferred. While we do not expect an earnings recession in the next 6–12 months, we believe the market has mostly priced in such an improvement. After the recent market correction, the MSCI USA forward P/E multiple is now more attractive than a month ago, but at 18.2x still trades at 13% 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).

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. The approaching end of the US rate-hike cycle also provides a tailwind for emerging market stocks. Valuations look appealing to us: MSCI Emerging Markets is trading at 11.4x P/E—in line with the long-term average, a 30% discount to global equities, and a 38% discount to US stocks. Importantly, since the summer, China has announced more policy support measures and their respective rollouts.

We continue to prefer energy (most preferred) to materials (least preferred). The materials sector exhibits the worst momentum in terms of both 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, we expect capital spending at mining companies to rise, putting shareholder returns at risk.

We keep energy stocks at most preferred as reduced recession risks benefit value sectors. Energy specifically looks very attractive to us on a number of metrics (12-month forward P/E at 10x, a 35% discount to the global benchmark, and a 32% discount to history), with supportive return on equity and free cash flow yield. While earnings momentum may stay negative until the end of the year, the 0.8% consensus earnings growth expectations for 2024 seem a bit too pessimistic.

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.

Sector preferences

Most preferred: Utilities, consumer staples, industrials, energy

Least preferred: Healthcare, materials

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

Equities

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 growth should cap the 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 stays least preferred. Trading at 17.4x 12-month forward P/E versus other defensive sectors such as utilities (13.4x), valuations do not look particularly attractive to us. Among defensive sectors, we prefer consumer staples and utilities.

Prefer value (most preferred) and quality-income (most preferred) stocks over growth stocks (neutral). In an environment of higher-for-longer bond yields, we maintain our preference for value and high-quality stocks. Amid market and economic uncertainty, we suggest investors keep a balanced approach between defensive and cyclical sectors. 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.

Upside scenario

MSCI ACWI June 2024 target: 940

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 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

Preference: Most preferred

Interest rate volatility remains elevated as bond markets continue to look to price the end of policy tightening. More recently, better-than-expected growth in the US has recalibrated expectations of rate cuts for next year. This was further validated by the most recent FOMC where it was communicated that the Fed is looking to maintain restrictive policy for a number of years in order to get inflation back down to target. Although the market did not reprice aggressively terminal policy rate expectations, the removal of rate cuts next year and repricing to a more prolonged restrictive policy stance saw the entire term structure of rates shift higher globally. In recent weeks, rate volatility has centered on the long end of the curve. Given that fiscal deficits continue to widen across most major economies, this is resulting in a pick-up in bond supply as treasuries look to refinance existing debt and issue new debt to fund the growing deficits. As central banks are reducing their stock of government bonds in their pursuit of tightening financial conditions, this is creating a supply-demand imbalance with private sector end investors required to absorb the additional supply. As a consequence, the long end of the curve which carries the most risk has repriced higher through an increase in term premia. This is the extra compensation investors demand to hold long-dated bonds above short-term policy rate expectations.

As financial conditions continue to tighten and rate volatility remains elevated, financial instability risks have begun to resurface. Central banks in the last year have elected 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 troubles. Within this context, we see the recent volatility as presenting opportunities in high quality bonds. Given the higher level of rates, there is a substantial cushion to mark to market volatility and as such, appealing risk-adjusted returns relative to other asset classes, particularly if downside risks on growth and financial stability increase.

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 rising 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 have the asset class also on a neutral recommendation.

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 remains high and we can envisage periodic spikes higher as it remains too early to declare victory in the inflation fight. Given our view that the objective of restrictive monetary policy is to exert downward pressure on growth and inflation, and the fact that rates are close to multidecade highs now, we see 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.

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.

Analysts: Frederick Mellors

Bonds

Investment grade 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 6%. Credit fundamentals on the US IG corporate side remain solid and should provide protection in a slowing earnings environment.

High yield 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 9% and 8%, respectively, which has attracted capital flows more recently and supported performance, hence our neutral stance.

Emerging market 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. Although we have seen spread compression across the credit rating spectrum, spreads remain highly bifurcated with EM IG near post-crisis tightness and EM HY still historically wide. Despite this dynamic, we are not forecasting spreads at the index level to tighten much further, until there is evidence that global growth is accelerating and the Federal Reserve is shifting its policy stance. The sovereign index yield is currently around 9% (EMBIG Diversified), while the yield on the corporate index (CEMBI Diversified) is about 8%. We expect mid- to high-single-digit total returns (non-annualized) for the asset class in a baseline scenario over the next six months and have a neutral asset class recommendation.

FX

Elevated interest rates and robust economic growth in the US relative to the rest of the world have provided broad USD support over the past two months. Considering the latest data, the US appears to be the only major economy that can still handle higher interest rates for now. We think this will keep the USD well bid across all currencies into year-end.

Our big question for the EUR is whether the European Central Bank or the Federal Reserve will cut rates first. Some weeks ago, our answer would have been the Fed. But the ECB may now be one that acts first, with European activity data coming in on the soft side and recession risks increasing. Hence, we think EURUSD faces near-term downside risks, potentially trading deeper into the 1.0–1.05 range.

As for the GBP, the dovish turn from the Bank of England has left its mark. Housing market data is starting to become a greater concern as monetary policy works its way through the economy—with more data to be released next week—and labor market leading indicators are pointing at a downturn. Falling relative real rates between the UK and the US could push GBPUSD to 1.19 and EURGBP to 0.88 temporarily, in our view.

While the Swiss franc is a safe-haven currency, a disappointing Swiss National Bank and lower-than-expected inflation in Switzerland are taking the steam out of the CHF in the absence of a material recession in Europe. For now, we like to sell the CHF upside risks for yield pickup versus the EUR or GBP. As for USDCHF, we are looking for a top at 0.94.

The rise in US yields continues to drive USDJPY upwards, even though markets have gotten more wary of the 150 level given the prospect of FX intervention. We think FX intervention should cap USDJPY but is not yet a sufficiently strong reason to believe in JPY strength or chase a lower USDJPY. This should come once US economic data steps down and US yields finally retreat.

For the CAD, NOK, AUD, or NZD, we see room for relative outperformance in the crosses. Chinese data should stabilize further with room to grind higher, in our view. The pullback in oil prices should also be transitory, which should ultimately support the CAD and NOK. We expect EURCAD to move lower and the NOK to outperform the SEK again.

Pressure on emerging market currencies has intensified as global rates continue to march up. Carry currencies—including some of the market’s most preferred picks like the Mexican peso and Brazilian real—have suffered the most, with investors clearing out high-yielding positions. We have little conviction on the near-term direction for carry currencies, and therefore closed our “Collect carry in currencies” theme on 4 October. The current environment is more suitable for yield-enhancement strategies than outright carry positions in emerging market currencies, in our view, especially against the US dollar.

The biggest risk to our short-term USD view is a step down in US growth, which would put investor focus on structural USD negatives and the greenback’s elevated valuation. The speed at which the US economy slows matters. If the US economy fails to slow because consumer demand or fiscal spending comes in strongly ahead of the US elections, current market expectations for lower US rates could still be revised higher.

Conversely, a hard landing, with risk assets under downward pressure, could temporarily support the USD. The USD tends to perform positively in a risk-off environment. However, for this to happen, the starting point matters as well. A richly valued USD on the back of US exceptionalism is unlikely to benefit greatly from risk-off forces if the same narrative goes into reverse gear. This would change if the weakness in US accelerates an already weak growth backdrop outside the US.

Lastly, we are also watching the US bond market at the long end of the yield curve. The US fiscal deficit seems to be too high without the market commanding a higher term premium. A further rise in the 10-year US Treasury yield north of 5% could keep the USD on a path of further strength. That being said, it will also reach a point where higher rates provide little support for the currency as investors begin to worry about the economic knockdown effect at a later stage. However, we have yet to see this point emerging for the US economy and the USD.

Commodities

We hold a neutral view on commodities overall and gold, but remain most preferred on crude oil.

Crude oil: Geopolitical tensions in focus. Oil prices have been very volatile so far in October. Recession fears saw oil prices falling sharply at the start of the month, then later rose following the Hamas attack on Israel. That said, geopolitical risk premiums tend to fade quickly if oil supplies are not impacted. We still look for higher prices driven by an undersupplied oil market and expect Brent to move back into the USD 90–100/bbl range.

Base metals: Stay focused on the long term. Industrial metal prices are likely to be volatile in the near term on global growth concerns. However, supply disappointments and structural demand drivers have been offsetting forces to weaker global manufacturing and disappointing China data. Our supply and demand estimates still point to an undersupplied market for most metals, which favors higher prices in the coming quarters.

Gold: Boosted by geopolitics. Gold has reacted to headline geopolitical events as expected. With investors looking for safe-haven assets, the yellow metal has benefited from the spike in tensions. That said, high US interest rates will remain a headwind for gold. We expect only higher gold prices once the Fed starts to sound more dovish in 2024.

Agriculture: Supply-side risks are key. Agriculture ended 3Q23 lower overall, although differences between each sector over the quarter were stark, e.g., grains declined by 6.5%, while softs including cocoa, coffee, cotton, and sugar rose by above 10%. Livestock eked out a small gain of 2%. Most significant to grains prices were the USDA's surprise upgrades to the US planted area for corn, as well as higher-than-expected quarter-end domestic grain inventory data. Wheat led the decline (–12.5%) as speculators added to their short positioning following the USDA report alongside improved export flows from Ukrainian Black Sea ports (despite no UN-sponsored grain initiative) and as Russian shipments set new seasonal record highs. However, El Nino and other weather risks loom large. Local analysts suggest further production downgrades are likely in Argentina, Australia, Brazil, and Canada over the coming weeks. In soft commodities, gains in cotton, cocoa, and sugar were notable due to disappointments around the monsoon season in India, the world's second-largest sugar producer, and a slower-than-expected harvest in Brazil. For India, some analysts put production as low as 28–29mn tons, below the Indian Sugar Mills Association forecast of 31.7mn. In livestock, live cattle should continue to support the sector as herd reductions in 2022 due to drought and higher feed costs will likely keep the US market tight until 2025.

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, as a rule, don't hold much predictive power. So, vanishing available spare capacity should support longer-dated contracts, in our view.

Gold still a good hedge. We continue to recommend investors use gold as a hedge despite being neutral in our global strategy. Within a balanced USD portfolio, our analysis shows exposure of around a mid-single-digit percentage is most optimal.

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

Long select critical metal miners. We believe recent share price setbacks in producers of metals and materials vital to the low-carbon transition offer opportunities to buy select companies on a five-year view. We prefer quality companies with high revenue exposure to commodities like aluminum, copper, lithium, rare earths, etc.

Section 3.2

Details per asset class

Eurozone equities

Central scenario

DJ Euro Stoxx 50 June 2024 target: 4,600

We maintain our neutral stance on Eurozone equities. Valuations are now relatively attractive and already reflect higher bond yields and our below-consensus earnings estimates, in our view.

Concerns over higher-for-longer interest rates and weak economic growth have led to an 8% correction for Eurozone equities (MSCI EMU), or a 13% correction in USD terms. After this sell-off we view current valuations as attractive and see double-digit upside to Eurozone equities over the next 12 months. MSCI EMU trades on a 11.2x forward price-to-earnings (P/E) multiple, a 16% discount to its long-run average of 13.4x (since 1988) and a deep 27% discount to global equities.

We believe current valuations more than reflect our weak earnings outlook. We forecast 0% earnings growth this year (consensus 4%), 3% in 2024 (consensus 7%), and 4% in 2025 (consensus 9%). The main downside risks to our earnings view come from a weaker-than-expected global economy (our base case assumes a "softish" landing) or falling prices, which would weigh on revenues and profit margins. But both would likely come alongside easier monetary policy, which could help support valuations and limit the downside risk to Eurozone equities from here.

We favor laggards and segments that can benefit from improving trends or potential inflections in the coming months. We expect consumer sentiment to improve as real incomes turn positive (wage growth exceeds consumer price inflation) and central bank rate hikes come to an end, boosting consumer sectors. We like materials, given attractive valuations with potential upside from an end to destocking, an improvement in China's outlook, 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. In the medium term, we like Europe's greentech and digital leaders as they should receive a boost from government investment plans.

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, and central banks stop hiking.

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.

Greentech goes global

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

Eurozone equities

Upside scenario

DJ Euro Stoxx 50 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 with a risk of oversupply in the coming months as European gas storage levels reach full capacity.

Downside scenario

DJ Euro Stoxx 50 June 2024 target: 3,700

Growth disappoints, with the US entering a recession in the coming quarters, triggering weaker earnings growth and lower valuation multiples in anticipation of it.

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.

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, and materials.

Least preferred: communication services, energy, and healthcare.

US equities

Preference: Least preferred

Central scenario

S&P 500 June 2024 target: 4,500

After the recent pullback, we believe the risk-reward for US equities is more attractive on a 12-month time horizon. Higher rates have been a key driver of the pullback, but if the move is due to more resilient economic growth, stocks should rebound once rates begin to stabilize, especially if the Fed is all but done raising rates. However, forward returns are a bit lower than normal, on average, after large upward moves in rates. This is a key reason we are trimming our June 2024 S&P 500 price target from 4,700 to 4,500. We now see the market reaching 4,700 by year-end 2024.

Solid growth and falling inflation have supported stocks this year, and we continue to believe the US economy is on track for a "softish" landing. With that said, we are likely to see economic growth slow in the months ahead. The resumption of student loan repayments, higher oil prices, and a tick up in mortgage rates could prompt a bit of a slowdown in consumer spending. Geopolitical and government shutdown risks are additional potential headwinds. However, despite a cooling labor market, consumers remain in good shape. There are still more job openings than there are unemployed workers, recent revisions to household savings show consumer balance sheets are in better shape than previously thought, and jobless claims and the unemployment rate remain near historically low levels. In addition, households and businesses (especially the largest businesses) have some protection from higher interest rates due to a high proportion of fixed-rate debt or maturities that are quite lengthy. Lastly, business inventories are now somewhat lean, there are no obvious areas of over-investment in the economy, and the imperative to invest in AI remains. So, in our base case, we expect the US economy to avoid a hard landing.

Third-quarter earnings season is kicking off and we expect S&P 500 profits to increase at a low-single-digit pace versus the year-ago period, driven by earnings beats of around 3% (consistent with early reporters). If results play out as we expect, this would be the first quarter of positive profit growth since the third quarter of last year. While lower inflation is weighing on revenue growth, many corporate costs are cooling at a faster pace, suggesting that profit margins should hold up. We believe investors will be keenly interested in the durability of consumer spending. While it will likely be mixed by company, the still-resilient job market suggests that consumer spending shouldn't disappoint in aggregate. There will also be close scrutiny of AI adoption and monetization. Overall, we expect a generally good earnings season, especially relative to the pullback in stocks from the summer highs.

Overall, our view is that the risk-reward in equities is getting more attractive. Valuations have pulled back and sentiment has turned somewhat cautious, which means there is now some dry powder on the sidelines to propel stocks higher if our outlook for corporate profits is correct. It's nearly impossible to pick the bottom in sell-offs, but in our soft landing base case, stocks could rise close to double digits over the next year.

Sector preferences

Most preferred

- Consumer staples: While this defensive sector has lagged as the soft-landing scenario has become a consensus view, 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. Recent concerns about the negative impact of obesity drugs seems overblown.
- Energy: After a fall in oil prices over the past few weeks amid falling inventories, the sector looks more appealing. OPEC+ supply cuts and better global economic growth have driven the oil inventory declines, resulting in higher prices since the summer. 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. We are starting to see a bit of an improvement in the ISM manufacturing index, which has historically been correlated with performance.

US equities

Upside scenario

S&P 500 June 2024 target: 5,000

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 and unemployment rises.

Inflation stays hot: Inflation pressures reaccelerate. 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.

Geopolitical turmoil: Geopolitical flashpoints spiral further out of control, potentially disrupting energy supplies or dragging more countries into hostilities.

Sector preferences

Least preferred

- 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.

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 a 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. Into 2024, earnings should start to recover as the drag from commodities fades and global growth recovers. UK inflation is falling but remains above target; however, given the weak economic growth backdrop, the Bank of England is likely at the end of its rate-hiking cycle. A decline in interest rates next year, combined with a recovery in earnings, should drive the FTSE 100 higher.

The FTSE 100 trades on a 12-month forward P/E of 10.2x—around 20% below its long-run average—and more than a third lower than global equities (MSCI All Country World Index). 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.

Swiss equities

Central scenario

SMI June 2024 target: 12,000

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 weighed on Swiss profits since 90% of them are generated in foreign currencies. We expect negative currency effects to moderate significantly from 4Q23.

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, a significant 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 moderated only slightly in 2021 versus 2020, and rebounded by around 6% in spring 2022 as well as in 2023, achieving a new all-time high. We expect another low-single digit percentage increase in spring 2024 as well as in 2025.

Swiss equities

Upside scenario

SMI June 2024 target: 12,600

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. Starting from 4Q23, we expect negative currency effects to moderate.

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.

Emerging market equities

Preference: Most preferred

Central scenario

MSCI EM June 2024 target: 1,050

We rate emerging market (EM) equities as most preferred. Aggregate manufacturing PMIs in emerging economies have slightly improved, and economic surprises have been positive. Over the past month, EM assets have suffered from surging US Treasury yields. Historically, a sharp rise in US rates poses major headwinds for risk assets in emerging markets. That said, we expect US Treasury rates to stabilize in the coming weeks.

Valuations for the MSCI EM index, at 11.6x 12-month forward P/E, are largely in line with the 10-year average and stand at a 36% discount to the S&P 500. On a price-to-book basis, the discount is even deeper at 65% 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 next year.

A strong US dollar, higher US rates, an uptick in geopolitical tensions, a pronounced US recession, and growth disappointments in China are risks to the outlook for EM equities.

From a geographic standpoint, we are changing our most preferred stance on Brazil and Chile to neutral. Brazil has outperformed EM peers in recent weeks. Looking ahead, we think higher-for-longer US rates pose a risk to the country's monetary policy easing path, which is a key driver for our thesis. For Chile, currency depreciation led by a combination of lower copper price, aggressive central bank easing, and surging US rates explains more than two-thirds of the underperformance versus EM peers of recent weeks. Looking ahead, we think the risk-reward balance is no longer attractive as the external backdrop has worsened meaningfully.

Elsewhere, China remains most preferred on the ongoing policy support. We think markets have priced in a lot of the negatives around China's real estate sector and weak growth. Overall economic dynamics seem to have found a floor. The Golden Week holiday spending data have come in at decent levels. Further stimulus measures should help stabilize sentiment. Finally, we keep Indonesia and India as most preferred. Growth in Indonesia remains relatively strong, and we believe India's valuation is reasonable while the corporate outlook looks healthy.

From a thematic angle, we like environmental, social, and governance (ESG) leaders in emerging markets, which can help mitigate downside risks and present attractive valuations, 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.

CIO themes

ESG matters in emerging markets

This theme offers investors an opportunity to add value to their portfolios by incorporating ESG considerations into their investment decisions. The wide disparity in ESG performance among emerging market companies tells us investors should focus on those with strong management to reduce the risk of tail-risk events, particularly in relation to governance (e.g., accounting and audit issues) as well as severe environmental accidents.

Market preferences

Most preferred

China, India, Indonesia

Least preferred

Malaysia, Singapore

Emerging market equities

Upside scenario

MSCI EM June 2024 target: 1,150

Sizable GDP growth recovery: A continued economic recovery would benefit corporate earnings and lift valuation multiples.

Global monetary policy: A less hawkish policy stance would bring about a more benign external environment.

China policy support: Stronger-than-expected policy easing and faster demand recovery in China would support emerging market stocks.

Downside scenario

MSCI EM 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.

Japanese equities

Central scenario

TOPIX June 2024 target: 2,500

We are neutral on Japanese equities in our global portfolio. The TOPIX underperformed in late September against MSCI ACWI, falling to mid-August levels after the recent FOMC meeting turned global sentiment risk off. The 10-year US yield climbed higher in the month, while the S&P 500 also fell. In addition, after the TOPIX hit a 33-year high in mid-September, profit-taking occurred before the end of the month's ex-dividend date. However, these drivers were all either non-domestic or one-time events.

Looking into 2024, we continue to think the Japanese equity market will offer relative safety, supported by a more favorable macro environment. We expect Japan's economic growth to be stronger than that of major developed markets next year, with higher inflation and wage growth than in the last few decades. Nominal wage growth should also support corporate earnings growth in 2024. Despite higher inflation, we expect the Bank of Japan to maintain a prudent monetary policy stance, providing a favorable investment environment for risk assets in Japan. Given the stronger-than-expected US and domestic economy and the weaker-than-expected USDJPY, we have revised our corporate earnings forecasts to +9% for FY2023 (end-March 2024) and +7% for FY2024 from +6% and +3%, based on a mild strengthening of the yen in 2024.

September quarter results are the next catalyst. We believe upward revisions of full-year corporate guidance are likely given the better-than-expected US economy, solid domestic consumption thanks to the post-COVID reopening, the increase in international visitors, and the weaker-than-expected JPY versus the USD. Consensus earnings forecasts should follow suit as well after the results season in November and December. We also expect share buybacks to regain momentum in the September quarter results, along with positive guidance revisions.

We continue to prefer quality value stocks, including banks as beneficiaries of higher yields and improving shareholder returns, as well as domestic-oriented sectors like consumer discretionary and service sectors to benefit from moderate inflation and wage growth. However, we are more selective and focus on laggards and stocks with pricing power considering the potential inflationary environment.

Japanese equities

Upside scenario

TOPIX June 2024 target: 2,700

Global economic growth remains resilient: A strong Chinese economic recovery and a resilient US economy would likely 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 given the Tokyo Stock Exchange's push 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 has 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: A full-blown recession in the US and increased tensions between the US and China would put downward pressure on Japan's economic and earnings growth outlook.

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

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

Asian ex-Japan equities

Central scenario

MSCI Asia ex-Japan June 2024 target: 670

The macro environment in Asia remains stable overall. Food and energy inflation has been stubborn in the region, but we maintain our view that core inflation will continue to fall through the rest of the year to about 2–3% on average. With the US Federal Reserve likely on extended hold, Asian central banks may delay any rate cuts to 1Q or 2Q next year. On the exports front, we believe the slow recovery should continue into the end of year. As a result, we focus on relative opportunities in the region, instead of taking directional beta exposure.

Within Asian equities, we continue to like India. India has a strong domestic economy and foreign investment interest. In terms of macro, while food inflation has bounced, the Reserve Bank of India (RBI) has stayed on pause because of slowing core inflation. There is healthy consumption and construction demand, funded by ample bank credit. As for fundamentals, India's y/y EPS (forward 12-months) has recovered further over the past month. Looking ahead, we expect earnings should be the main driver of the market, fueling a potential rerating if deposit rates peak from here.

Indonesia remains most preferred in our regional strategy. Its manufacturing PMI remained strong at 52.3 in September, marking the 25th straight month of activity expansion since late 2021. The high policy rate (5.75%) in Indonesia provides a healthy net interest margin (NIM) environment for its financial sector, which accounts for around 60% of the equity index. We expect its domestic economic activity to remain strong, foreign direct investment solid, and market earnings to continue to benefit from the NIM environment.

We keep China as most preferred. The implementation of stimulus measures will continue to be the potential catalyst of China market in the near term. After the policy implementation of capital market and property easing policies in August, the improvement on the policy front in September has been relatively marginal—e.g., issuance of refinancing bonds from several local governments. We still believe if a holistic solution for local government debt issues is launched, the Chinese market will respond positively. On the macro front, we see initial signs of recovery in September, which could also support the Chinese market and potentially drive outperformance in the future, in our view. Earnings growth (MSCI China forward 12-month EPS) is continuing on a recovery path, while its valuation (MSCI China price-to-earnings multiple) is attractive at 1 standard deviation below the five-year average. Allocations to China in global mutual funds is currently also very low. So, we keep our most preferred view on China for tactical outperformance opportunities versus Asian peers.

Elsewhere, we keep Malaysia as least preferred. The September manufacturing PMI stood at 46.8, the 13th contraction in a row, as production remained subdued amid limited new orders inflow. Compared to other Southeast Asian peers, Malaysian banks have a less attractive NIM and loan growth outlook.

Singapore is also kept as least preferred. The country is sensitive to the global trade cycle, which is still weak. Its financial sector, accounting for 50% of the market, should have limited upside even in a higher-for-longer rate environment. The main upside risks to monitor are the potential turnaround of the global trade cycle or a rotation toward high-dividend Singaporean banks, but we think these risks are manageable for now.

Market preferences

Most preferred: Indonesia, India, China

Least preferred: Malaysia, Singapore

Analysts: Adrian Zuercher, Crystal Zhao, Vanny Wang,

Asian ex-Japan equities

Upside scenario

MSCI Asia ex-Japan June 2024 target: 742

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: 526

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.

Stronger US dollar

Asia ex-Japan regional equities tend to suffer in a strong US dollar environment.

High grade

Preference: Most preferred

Central scenario

10-year US Treasury yield June 2024 target: 3.50%

With indications that inflationary pressures are abating and growth is weakening, major central banks appear to be approaching a point where they are ready to pause and assess the full effects of aggressive policy 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, we believe economic growth needs to step up. We think growth will continue to slow because of tighter financial conditions, despite the recent resilience of the US economy. Accordingly, while interest rate volatility will likely remain elevated after declining from its October 2022 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 slowing growth.

Upside scenario

10-year US Treasury yield June 2024 target: 2.75%

In the upside scenario for high grade bonds, growth falls sharply on a global scale toward mid-2024 owing to the delayed impact of monetary tightening or additional tightening efforts to tame persistent core inflation. Once demand for goods and services weakens, inflation drops quickly with energy prices falling and the labor market losing momentum. As recession kicks in, major central banks cut rates aggressively. Balance sheet runoff goes on hold.

Downside scenario

10-year US Treasury yield June 2024 target: 5.00%

In the downside scenario for high grade bonds, US activity grows at its trend rate of around 2% as labor markets and household balance sheets prove resilient to monetary policy tightening. Inflation remains above central bank target throughout next year. Monetary policy stays in restrictive territory. Major central banks keep interest rates "high for longer," i.e. do not start cutting policy rates in 2024 as inflation stays above target.

Investment grade

Preference: Most preferred

Central scenario

June 2024 spread targets: 120bps (USD IG) / 170bps (EUR IG)

Investment grade spreads in the US and EU have widened by 10 basis points compared to their lowest levels in late September due to the recent jump in interest rate volatility. With yields remaining elevated and major central banks in developed markets nearing the end of their hiking cycle, we think total return prospects in higher-quality fixed income look appealing. US investment grade (IG) yields are now at 6%, while EUR IG yields are at 4%, both historically elevated levels. The higher outright yields and the fact that spreads are a much smaller proportion of total returns than in the recent past are positives for forward-looking returns.

High-quality bonds tend to be resilient in a growth slowdown as credit spread widening is usually offset to a good degree by falling interest rates. This was the case 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 of falling government bond yields as economic growth slows in the coming quarters to contribute nicely to total returns for the asset class. US IG tends to do particularly well at the end of a Federal Reserve hiking cycle, delivering double-digit returns on average over the following 12 months. We think total returns for US IG will similarly be supported by falling government bond yields in our base case over the coming quarters.

US IG fundamentals have started to modestly weaken in 2Q, though from a position of strength. Net leverage has edged up as debt growth increased, while earnings growth remained muted. That said, earnings remain resilient and are likely to limit material near-term deterioration, in our view, while issuers had been reducing debt until recently. We therefore view the risk of rising downgrades and upward pressure on spreads as limited outside 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

Lift-off

The US economy continues to grow around trend, while European growth is improving. Major central banks stay in restrictive territory as inflation remain above target.

Downside scenario

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

Hard landing

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.

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. In recent weeks, there has been a notable widening of high yield bond spreads, primarily influenced by the significant move in rates with spreads now reaching 425 basis point in USD HY. The resilience of spreads through much of the year may now be eroding as they factor in the risk of higher-for-longer rates and the implications on borrower financials.

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, rate cuts are 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 expect some moderate spread widening through the end of 2023.

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, are headwinds for credit. Lower-rated issuers are at particular risk if rates remain elevated given the large associated step up in interest expenses. For example, the current CCC bond coupon today is 7.5%, roughly half of the current CCC yield to maturity of 14.5%. Such issuers could struggle to meet their refinancing needs. Indeed, while primary markets appear to be open for many HY issuers this is mainly for those in the upper rating buckets, we note that CCC issuance of USD 7bn YTD is the lowest level in this period since 2009. We estimate corporate defaults could rise above their long-term average to around 4–5%, compared to the current level of 3.3% 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 has increased and earnings growth has declined. The energy sector in the US, which has historically been 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. One explanation for this is the fact that the market has been shrinking from just over USD 1.5tr in 2021 to around USD 1.3tr currently. This is due to combination of rising stars (issuers upgraded to investment grade and therefore leaving the high yield universe), while net issuance has remained low. These favorable technicals are likely to slowly diminish over time, as net issuance increases due to issuers addressing their maturity walls. We also note that 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 as rates remain higher for longer. Central banks have shown a willingness to actively use their balance sheets temporarily when market conditions turn dysfunctional, but this is reactive rather than proactive.

We remain neutral on HY bonds. Although we forecast scope for moderately wider spreads in HY in the coming quarters, the current level of outright yields in US HY are elevated at around 9.1% 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.

High yield

Upside scenario

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

Lift-off

The US economy continues to grow around trend, while European growth improves. Major central banks stay in restrictive territory as inflation remains above target.

Downside scenario

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

Hard landing

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.

Emerging market bonds

Central scenario

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

EM credit returns have turned negative for the year as US Treasury yields rose and geopolitical tensions flared in the Middle East. EM sovereign bond spreads have widened by roughly 35bps in the last month.

We view EM spreads as fair and expect them to trend largely sideways in coming months. We are moving closer to the end of the Federal Reserve's hiking cycle, which has historically corresponded with a decline in interest rate volatility. Rate cuts by the Fed do not appear imminent, however. Chinese authorities have accelerated support measures for the property sector. In the absence of large-scale fiscal stimulus, we expect the recovery to be gradual. Geopolitical tensions in the Middle East are now back in focus, with further escalation a possible risk. A sustained move tighter in EM credit spreads would require, for instance, a significant acceleration in global growth or easier Fed policy, none of which are part of our baseline assumptions.

Current yields are around 9.4% and 8.0% for sovereign and corporate bonds, respectively. The asset class should deliver healthy total returns in our base-case scenario over the next six to 12 months on the back of lower-trending US benchmark rates and sideways-trending EM spreads.

Investors need to be mindful that the range of possible outcomes remains wide. The possibility of a global recession or stubbornly high inflation, requiring tighter policy in the US and elsewhere, represent key risks to our views, in addition to China's real estate slump spilling beyond the country's borders and an escalation of tensions along geopolitical flashpoints.

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 tighter 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, hurts 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.

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

Asian bonds

Central scenario

JACI composite spread June 2024 target: 240bps

The moves in US rates are still the main factor affecting global fixed income assets. US Treasury yields have seen renewed upward pressure of late, with 10-year yields reaching another multi-year high of around 4.8% (as of 10 October). However, we think part of these moves could be technical in nature, and does not change our outlook that global growth and inflation are likely to moderate further from here. As such, the currently elevated yield levels present a good opportunity to lock in attractive carry, in our view. We therefore keep our most preferred view on bonds, especially high-quality segments like high grade and investment grade bonds. With rate volatility remaining elevated, these high-quality segments could be resilient given their defensive characteristics.

Similarly, within Asian credit, we believe Asia IG bonds still present solid risk-reward potential, given the attractive yields (6.4% as of 10 October) and high credit quality (average rating of A-). Valuation wise, while the JACI IG spread (168bps as of 10 October) remains tight, this has been anchored by strong fundamentals, a lack of bond supply, and resilient investor demand that is likely to continue going forward.

For Asia HY, we retain a relatively cautious and selective approach. Weakness in China's property sector continues. Country Garden stated on 9 October that it was unable to repay a loan and expected to miss upcoming overseas debt payments; on 10 October, it engaged advisors to pursue a holistic offshore debt restructuring as its liquidity remains pressured by much weaker property sales. Although the China property weighting in the Asia HY index has dropped to only 5%, the overall allocation to China is still sizable (24%), especially in sectors like industrials and financials. Therefore, if China's macro conditions continue to stay weak, we think it is likely that the China HY segment could still be a main drag on the performance of Asia HY. Elsewhere, the overall fundamentals for the Asia ex-mainland China segment appear relatively intact to us. For example, fundamentals for the Macau gaming sector are still improving, as increasing visitors to Macau during the Golden Week holiday further support gross gaming revenue growth.

Upside scenario

JACI composite spread June 2024 target: 210bps

Much faster recovery after full reopening: If China's recovery is faster and stronger than expected in the coming months, there will likely be upside for Asian credit.

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 inflation comes off faster than expected and the Fed becomes less aggressive with quantitative tightening.

Downside scenario

JACI composite spread June 2024 target: 310bps

Much higher default rates: The HY sector may see a selloff if default rates far exceed current market pricing.

Increased geopolitical tensions: Heightened frictions emanating from either the war in Ukraine, US-China relations, 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 credit will be impacted.

Gold

Central scenario

Gold June 2024 target: USD 1,950/oz

Rates up, gold down

Gold has demonstrated surprising resilience to the higher-for-longer Fed narrative, but the recent leg up in US real yields and broad USD strength have been the straws that broke the camel's back. In just seven days, the yellow metal lost more than USD 100/oz, falling to its lowest level since March at USD 1,820/oz and breaching technical support levels at USD 1,850–1,870/oz. Speculators' cuts to net positioning and further outflows from exchange-traded funds have weighed on demand, though central bank buying continues to help offset these.

In the short term, risks remain tilted to the downside amid mounting uncertainty over where US yields will peak (and the respective level of the USD). For example, if US 10-year real yields were to move above 3%, gold prices could fall to around USD 1,725–1,750/oz. That said, we see the recent moves as overdone, with our revised US 10-year yield forecast calling for 4% by year-end (from 3.5%) vs. the current 4.8%. To align, we trim our gold forecasts: End-2023 is now USD 1,850/oz (from 1,950), end-June 2024 is USD 1,950/oz (from 2,100/oz), and end-September 2024 is USD 2,050/oz (from 2,200).

From here, we look for confirmation of a peak in US real yields before adding new recommendations. But equally, those who are long gold should hold these positions in anticipation of a recovery over the next 6–12 months. We also highlight gold's long-term diversification benefits within a portfolio context.

Upside scenario

Gold June 2024 target: USD 2,150–2,250/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 1,650–1,750/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

Following a sharp drop in US crude oil prices last week, driven by rising US interest rates and re-emerging recession fears, Hamas' surprise attack on Israel has supported oil prices on Monday. While oil production in the Levant region is small (Syria: 41kbpd, Israel: 15kbpd) and that there has been no reported supply disruptions so far, concerns of a further escalation have lifted oil prices. Geopolitical risk premia tend to fade quickly if oil supplies are not impacted. So, market participants are likely to track Lebanon-based Hezbollah's actions closely, as well as any escalation in Israel's political response.

Despite US sanctions on Iran, its crude production has recovered above 3.1mbpd, a 5-year high. Market participants are likely to watch for whether the US administration enforces stronger sanctions on Iranian crude exports, where exports are fluctuating around 1.5mbpd. Additionally, the risks of the conflict dragging in Iran have increased, in our view.

Meanwhile, over the weekend, key OPEC+ energy ministers reiterated their commitment to support oil markets. Saudi energy minister Prince Abdulaziz has emphasized the precautionary approach of the group. He noted the group's preference to wait for guidance from real numbers before adjusting any policy. Lack of clarity on the outlook of the global economy supports a cautious policy, in our view.

Supported by an undersupplied market, we see Brent moving back into the USD 90–100/bbl range.

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

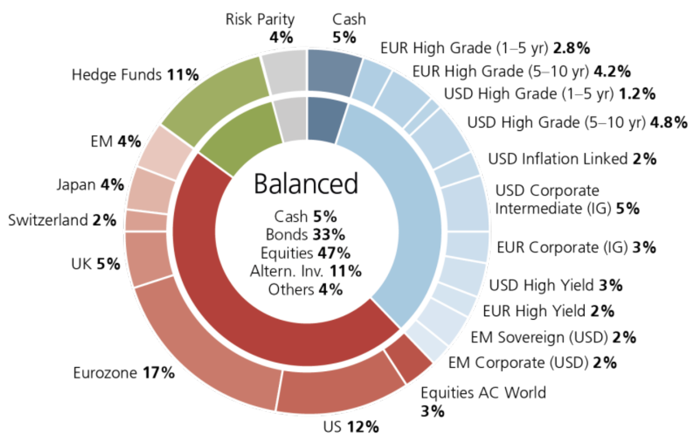
Downside risks include a deep recession or renewed extended mobility restrictions that weigh on the oil demand recovery. A hard landing for the Chinese economy in 2023 would also pose a downside risk, as emerging Asia is the engine of oil demand growth. Another concern is that capital discipline in the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

Section 4

Appendix

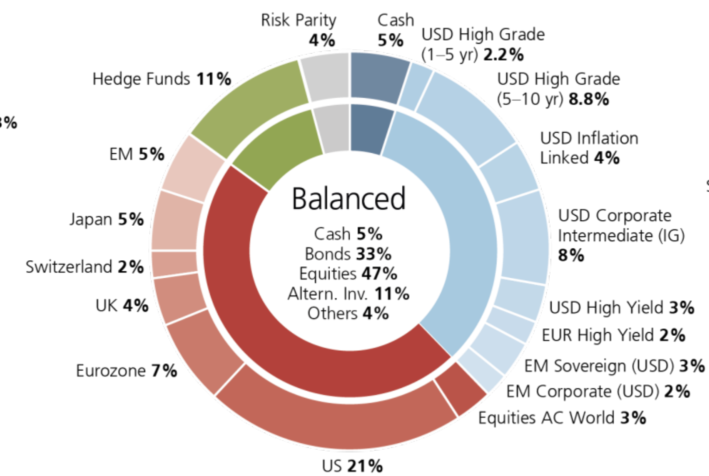
Strategic Asset Allocations (SAAs)

EUR (local portfolio with home bias)



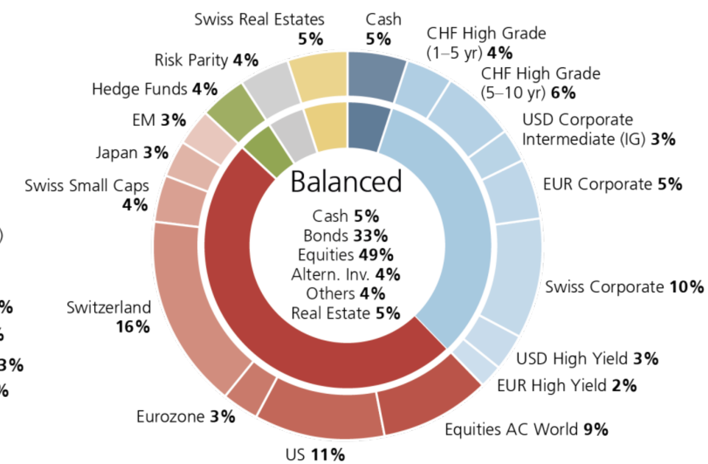
Note: Portfolio weightings are for EUR SAA with a home bias and a balanced risk profile. We expect a balanced EUR SAA to have an average total return of 5.3% p.a. and a volatility of 8.5% p.a. over the next 15 years.

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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