UBS House View

Monthly Extended March 2024

Chief Investment Office GWM
Investment Research

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

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

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

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UBS

Section 1

Investment views

UBS

Section 1.1

Asset class outlook

Asset class outlook

Global asset allocation
In our global strategy, we keep our preference for bonds over equities.

Within equities, we retain our preference for quality. Our most preferred region is Emerging Markets (EM) and, within EM, we prefer 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 the CHF as least preferred and the AUD as most preferred currencies. The remaining major currencies remain neutral.

Equities
Our base case is for mid single-digit returns for global equities over the next 6–12 months as earnings keep inflecting upward and lofty valuations decompress.

The recent slew of inflation data in the US has cast a pall on the disinflation narrative, putting into question the timing of central banks' cutting cycles.

Amid a still subdued economic backdrop outside the US, global earnings still beat expectations, particularly in the higher-quality segment of the equity market.

We continue to like emerging market over UK equities.

Bonds
We have a most preferred stance on the higher-quality segments of fixed income given the all-in yields on offer and as central banks transition from a rate-hiking to a rate-cutting cycle. Specifically, we maintain a preference for high grade (government) and investment grade bonds, and are neutral on high yield and emerging market credit.

The tightening of lending standards and higher official policy rates over the last two years will continue to transmit into the real economy and apply downward pressure on growth and inflation, and by derivation nominal interest rates. This is a positive driver for the performance of high-quality bonds. The prospects of rate cuts has been priced into market expectations and hence resulted in some easing of financial conditions already. This should offset downside risks to growth to some extent; however, higher-beta credit segments are trading tight and not offering much spread compensation in the event of a worsening growth backdrop.

Foreign exchange
The US dollar has rebounded solidly from December lows in response to surprisingly solid US data and reduced expectations for Fed rate cuts. Our most preferred currency with upside potential against the USD remains the AUD.

The USD rebound in January and February hurt emerging market currencies broadly. Still, we think high-yielding currencies are still worth the carry. We see good opportunities in the Brazilian real and the South African rand.

This month, we view the **Swiss Franc as least preferred**. Swiss interest rates are very low, inflation has reached the central bank's target band, and the need to promote CHF appreciation to defend against imported inflation has faded.

Commodities
Our return outlook for commodities remains positive, and we expect broadly diversified commodity indexes to appreciate by mid- to high-single-digit rates, with a total return of around 10% for the full year.

All sectors should contribute to the likely decent performance. As spot moves are unlikely to be synchronous, broad asset class exposure is advised. This should come with an expected volatility of only 10–15% in 2024. Within this context, our preference for oil remains in place.

The underlying risk skew to our view looks largely balanced. While the macroeconomic picture suggests downside risks, structural demand drivers, supply-related risks, and low inventories will likely act as counterweights.

We also continue to recommend actively managing commodity exposure.

Section 1.2

Risk scenarios

Key scenarios – June 2024

	Upside: Goldilocks	Base case: Soft landing	Downside: Hard landing	*Things to watch*
Probability	20%	60%	20%	
Market path	**Bonds slightly up, equities up** Equity markets and other risk assets rally as bonds remain supported by lower policy rates.	**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 above the trend rate of about 2% as labor markets, household balance sheets, and corporate earnings prove resilient. China opts for large-scale fiscal stimulus. European growth improves.	The US economy slows to roughly trend growth 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. Sticky US inflation pushes bond yields higher in the near term, but yields later move sharply lower as the economy enters recession. China continues to decelerate amid underwhelming fiscal support.	*US, China: PMI data* *US, Europe: Industrial prod.* *Global: Consumer spending* *US: Housing starts* *US: Savings rates, depletion* *US, Europe: Delinquency ratios* *Europe: gas prices*
Inflation	Reaches central bank targets earlier than expected.	Continues to slow in the US and in Europe, normalizing by 2H24.	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: Chg in nonfarm payrolls* *US: JOLTS openings and hires* *Eurozone: HICP inflation*
Central banks	Cut policy rates more than current market expectations. The Fed cuts at least 100bps.	Start cutting policy rates by mid-2024 as inflation normalizes. The Fed cuts rates by 75bps.	Cut interest rates after seeing evidence of a deep recession. The Fed cuts rates down to 1–1.25%.	
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* *Bank lending surveys*
Geopolitics	The Middle East crisis de-escalates. The war in Ukraine also de-escalates, e.g., via a ceasefire agreement. Progress is made in bilateral relations between the US and China.	The Middle East crisis results in a contained regional confrontation. The war in Ukraine drags on as ceasefire negotiations remain elusive. The US-China strategic rivalry continues.	The Israel-Hamas war turns into a regional conflict with potential for greater disruption to oil supply. The war in Ukraine escalates, and US-China tensions intensify.	*Middle East crisis and oil supply* *Territorial gains by Russia* *Weapons shipments to Ukraine* *US sanctions on Chinese companies* *US election season*

Asset class targets - December 2024

Key targets for December 2024	spot*	Upside	Base case	Downside
MSCI AC World	903	995 (+10%)	940 (+4%)	700 (-22%)
S&P 500	4,982	5,500 (+10%)	5,200 (+4%)	3,700 (-26%)
EuroStoxx 50	4,775	5,400 (+13%)	4,900 (+3%)	3,800 (-20%)
SMI	11,429	12,300 (+8%)	11,640 (+2%)	9,800 (-14%)
MSCI EM	1,021	1,200 (+18%)	1,100 (+8%)	820 (-20%)
Fed funds rate (upper bound)	5.50	4.00	4.75	1.25
US 10y Treasury yield (%)	4.32	4.00	3.50	2.50
US high yield spread**	334bps	325bps	400bps	800bps
Euro high yield spread**	359bps	350bps	400bps	800bps
US IG spread**	81bps	80bps	100bps	200bps
Euro IG spread**	123bps	120bps	140bps	200bps
EURUSD	1.08	1.15 (+6%)	1.12 (+4%)	1.03 (-5%)
Commodities (CMCI Composite)	1,751	2,000 (+14%)	1,890 (+8%)	1,550 (-11%)
Gold***	USD 2,022/oz	USD 2,000/oz (-1%)	USD 2,250/oz (+11%)	USD 2,500/oz (+24%)

* Spot prices as of market close of 21 Feb 2024. 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

UBS

Global asset class preferences

	Least preferred		Most preferred
Liquidity		=	
Equities		=	
United States		=	
Eurozone		=	
Switzerland		=	
Emerging markets			+
Japan		=	
United Kingdom	−		
Bonds			+
High grade			+
Investment grade			+
High yield		=	
Emerging markets		=	

	Least preferred		Most preferred
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	−		
US Growth Equity		=	
US Value Equity		=	
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	US	MP	LP	Eurozone	MP
Communication services		=		−		
Consumer discretionary		=				+
Consumer staples		= ←	(+)			+
Energy		= ←	(+)		=	
Financials		=			=	
Healthcare		(=) →	+	−		
Industrials		(=) →	+	(−) →	=	
Information technology			+		=	
Materials		=				+
Real estate	−				=	
Utilities	−				=	

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

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

Messages in Focus

Manage liquidity*

We expect interest rates to fall in 2024. This means that cash will progressively deliver lower returns, creating a risk for investors who do not lock in returns today. Investors should diversify a liquidity strategy beyond cash and money market funds, with a combination of fixed term deposits, bond ladders, and structured investment strategies to cover expected portfolio withdrawals over the next five years.

Fixed term deposits
Bond ladders
Structured investment strategies with capital preservation features

Source of funds
- Cash
- Maturing investments

Buy quality

Quality is key. In fixed income, quality bonds offer attractive yields and should deliver capital appreciation if economic growth slows and inflation falls further, as we expect. Active and diversified bond exposure can help mitigate specific risks and enable investors to realize the full return potential of the asset class. In equities, we believe that quality companies with strong balance sheets, high profitability, and exposure to resilient earnings streams remain well positioned to deliver performance, especially if growth slows.

Quality stocks (including US IT and Europe's Magnificent 7)
Quality bonds (HG and IG)
Active and diversified bond exposure
Sustainable equivalents (ESG leader equities, sustainable bonds, MDB bonds)

Source of funds
- Cash
- Excess EM / high yield bonds
- Excess equity exposure

Optimize tech exposure

The AI revolution is here, and investors' future performance will rest heavily on their level of exposure to the technology sector. We believe investors cannot afford to be underinvested—we expect rapid earnings growth and think that the big will get bigger. Equally, investors need to be wary of concentration and overexposure. As a guideline, the Magnificent 7 and information technology represent 18% and 24% of the MSCI All-Country World Index, respectively. Structured and diversified solutions can help investors grow exposure while mitigating downside risks, and we also see various diversification opportunities for investors managing US tech concentration risks.

Structured solutions on technology stocks
Diversified technology
Technology disruption EPL
Europe's Magnificent 7
Energy and healthcare disruption

Source of funds
- Excess cash / money market / bond exposure
- Address portfolio biases
- Excess US technology exposure

Anticipate a "Goldilocks" scenario

Investors should prepare for a potential broadening of the equity market rally, which could materialize with a combination of Fed interest rate cuts, still-robust growth, and falling inflation. We would expect US and European small-caps, select Swiss mid-caps, and emerging and frontier market equities to be particular beneficiaries in this scenario, given their interest rate sensitivity and low valuations. High small-cap exposure in ESG engagement strategies and in select long-term investment themes could also prove supportive of these areas.

US small-caps
European small- and mid-caps
Select Swiss mid-caps
Emerging markets (incl. India and frontier markets)
ESG engagement strategies

Source of funds
- Cash
- Maturing investments

*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.

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

Messages in Focus

Capture upside and protect downside

A mix of low equity market volatility and high bond yields makes this an attractive time to consider strategies that can allow investors to capture market upside while protecting against downside. These can be particularly effective ways to invest in markets that have downside risks but also high potential upside, including technology and China. More generally, we believe investors can mitigate portfolio downside risks by adding exposure to gold and oil (which could rally in the event of geopolitical turmoil) and macro hedge funds (which have historically delivered consistent performance in times of bond market turbulence).

Capital preservation strategies (including on technology and China)
Gold
Oil and energy stocks
Macro and multistrategy hedge funds

Source of funds
- Cash
- Excess equity exposure

Trade the range in currencies and commodities

We expect most major currency pairings to continue to trade in established ranges in the months ahead, creating opportunities for investors to earn additional income by "trading the range." Some exceptions include the Swiss franc, where we expect near-term weakness stemming from lower-than-expected inflation, and the Australian dollar and Japanese yen, where we expect appreciation driven by relative policy tightening. Meanwhile, we expect oil prices to fluctuate in the USD 80–90/bbl range in 2024, creating opportunities for investors to navigate the range.

Range-trading in USD, EUR, GBP, and CNY
Expect near-term CHF weakness
Upside for AUD and JPY
Trade the range in crude oil

Source of funds
- Cash
- Maturing investments
- Available collateral (for OTC range trading strategies)

Diversify with alternative credit

High dispersion within the high yield credit universe is creating opportunities for specialized credit hedge fund managers to generate performance. This is a supportive backdrop for various credit strategies, including credit arbitrage and distressed debt. We also see opportunities in convertible arbitrage, a strategy which we expect to see more opportunities as companies refinance maturing debt.

Credit arbitrage
Distressed debt
Convertible arbitrage

Source of funds
- Cash
- Maturing investments

Capture growth with private markets

A new world will see significant investments in healthcare, digitalization, and energy. This will create significant opportunities for private market managers to provide equity or debt capital to companies at different lifecycle stages. For investors, private markets offer attractive return potential and differentiated opportunities, in exchange for lower liquidity. They can also be an effective vehicle for investors focused on driving positive change through impact and sustainability.

Secondaries
Value and middle market buyout
Thematic growth
Private infrastructure
Private credit

Source of funds
- Excess bonds / equities
- Concentrated equities

Key investment ideas by asset class

	We like	Source of funds
Equities	• Quality stocks (including US IT) • Emerging market equities incl. China, India • Diversified technology - Technology disruption EPL • Europe's Magnificent 7 • Energy and healthcare disruption • US small-caps • European small- and mid-caps • ESG leader	CIO least preferred equities, excess cash
Bonds	• Quality bonds (investment grade and high grade) • Sustainable bonds • Fixed term deposits • Bond ladders	Excess cash, excess EM/HY bonds
Foreign exchange	• AUD • Range-trading in USD, EUR, GBP, and CNY	CHF
Commodities	• Active commodity exposure • Oil	Excess cash
Hedge funds, private markets	• Hedge funds (credit, discretionary macro, equity low-net, multi-strategy) • Private markets (value and middle market buyout, secondaries, private infrastructure, thematic growth, private credit)	Excess bonds and equities, excess cash

Section 2

Macro economic outlook

Global economy – Sense from central bankers?

Base case (60%)

Growth

Economic data does not give a precise picture of economic activity in real time. The broad trends that can be discerned across a range of statistics still point to a soft economic landing, but the noise in unrevised data is adding some volatility to market expectations. Middle income consumers still seem willing to spend, which is an important support for overall economic growth. Spending on goods underperforms spending on having fun. Unemployment remains low, although people are less inclined to move between employers. There has also been some increase in the number of people taking more than one job – reflecting a mix of structural change in labor markets and economic necessity after a period of weak real wage growth.

Inflation

Underlying inflation data continues to moderate in most major economies. Inflation inequality and peculiarities in calculation mean that some consumers face notably lower inflation rates than the headlines suggest – meaning that their spending power is correspondingly stronger.

Positive case (20%)

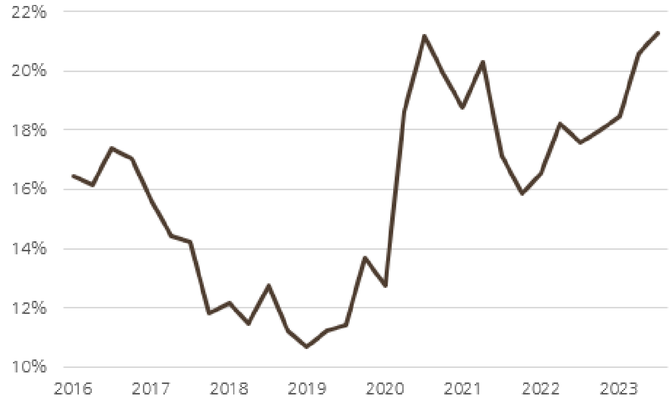
The positive scenario is enhanced version of existing trends. Real wage growth is supported by a faster inflation slowdown. Low unemployment gives advanced economy consumers confidence to accelerate spending. Investment spending increases more rapidly in new technologies and areas of labor shortage. Fiscal policy remains a drag on developed economy growth, but China implements a more effective fiscal boost.

Negative case (20%)

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. Consumer concerns about the cost of credit slows borrowing for middle income consumers as well as lower income groups. Fear of unemployment starts to increase, leading to a rise in precautionary saving. This compounds the risks to growth.

Profit-led inflation

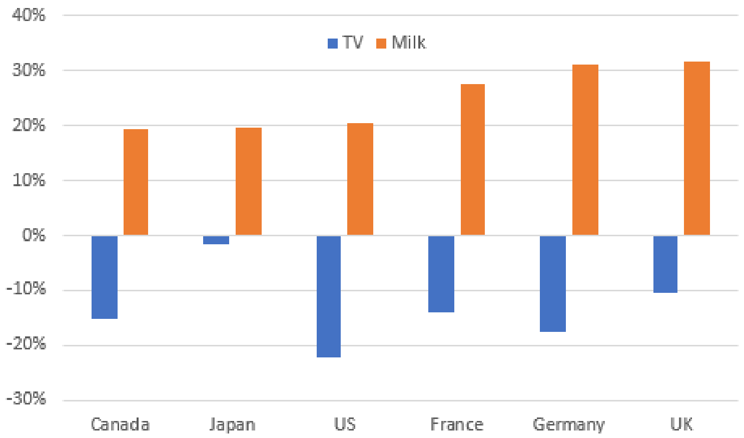
US retail profits as a share of US retail GDP (to Q3 2023)



Source: Haver, UBS as of 19 February, 2024

Price inflation or deflation, depending on the product

Change in price levels since January 2020



Source: Haver, UBS, as of 19 February, 2024

US economy – On a path toward a soft landing

Base case (60%)

Growth

Growth has remained above-trend since 3Q22, including a strong 3.3% growth rate in 4Q23. Recent data has been mixed, with the January labor report surprising to the upside but retail sales coming in weaker than expected. In the months ahead, consumer spending should be supported by robust growth in real disposable income. However, monetary policy is in restrictive territory, and we expect this to eventually restrain growth. Fiscal policy will also provide less support than in 2023. Our base case remains a soft landing, with the Fed starting to trim rates in 2Q as the growth data turns softer.

Inflation

Inflation surprised to the upside in January, breaking a string of more favorable data in recent months. Inflation is being driven by service prices, which are more sensitive to the still-strong pace of wage growth. Meanwhile, core goods inflation has turned negative. In our view, some transitory factors were helping to bring inflation down in 2H23, and wage growth will have to slow further in order for the Fed to sustainably hit its 2% target.

Positive case (20%)

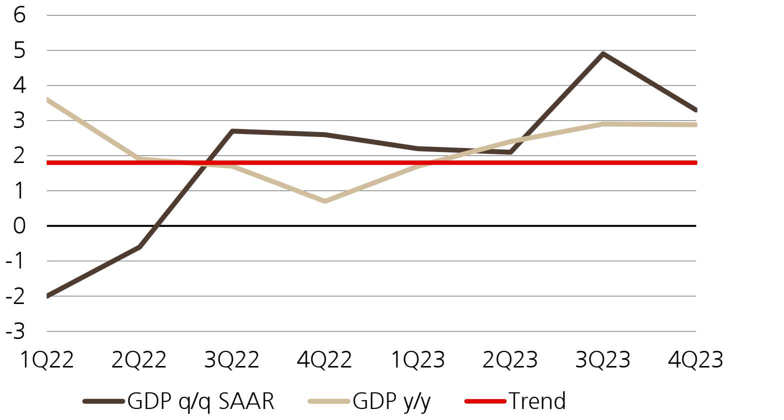
Better labor supply allows businesses to fill their open job positions. Wage growth slows to a more moderate pace, helping bring inflation down while growth remains robust. New industrial policies continue to promote business investment. The Fed sees enough progress toward its mandates to start cutting rates even as the economy continues to expand and the unemployment rate stays low.

Negative case (20%)

Household spending finally takes a breather after an extended period of strong growth, and the savings rate moves higher. Seeing weakening consumer demand, businesses increase the pace of layoffs and reduce hiring, re-enforcing the consumption slowdown. A spike in energy prices could lead to stagflation, but otherwise inflation should fall quickly, allowing the Fed to cut rates aggressively and helping to prevent a severe downtown.

GDP growth has been above-trend

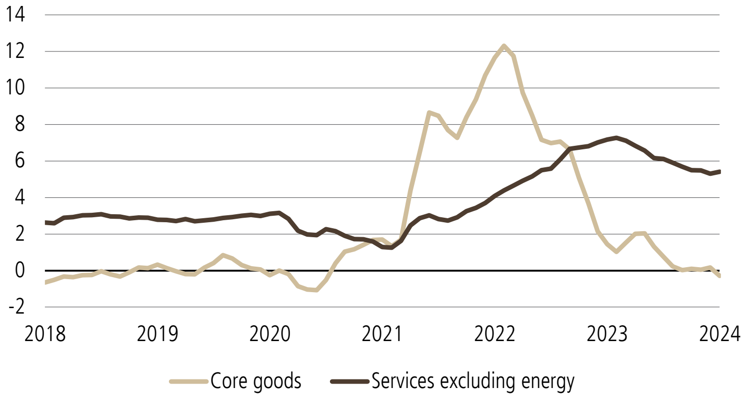
GDP, q/q seasonally-adjusted annualized rate and y/y change, in %



Source: Bloomberg, UBS, as of 16 February 2024

Inflation is being driven by services

Core CPI goods and services, y/y change, in %



Source: Bloomberg, UBS, as of 16 February 2024

Eurozone economy – Waiting for improvement

Base case (60%)

Growth

Sentiment surveys are stabilizing, with some signs of mild improvement, but they remain at low levels. Likewise, hard data remain weak. In our view, the economy is set to remain on its current sideways trend in the coming months, with activity starting to show a modest pickup later in the year as real incomes improve and the drag from tight monetary policy eases.

Inflation

We expect inflation to fall back to target over the coming quarters, faster than the ECB projects. Some modest volatility in inflation could persist early in the year as governments phase out remaining fiscal support measures and the disinflationary impulse from energy base effects fades. Still, coupled with a moderation in wage growth, the ECB should gain the confidence to start lowering interest rates, most likely from June. In total, we expect 100bps of cuts from the ECB this year

Positive case (20%)

Economic activity normalizes sooner, supported by a sharp fall in inflation, a pickup in consumer sentiment, earlier than expected monetary policy easing, and ongoing labor market strength.

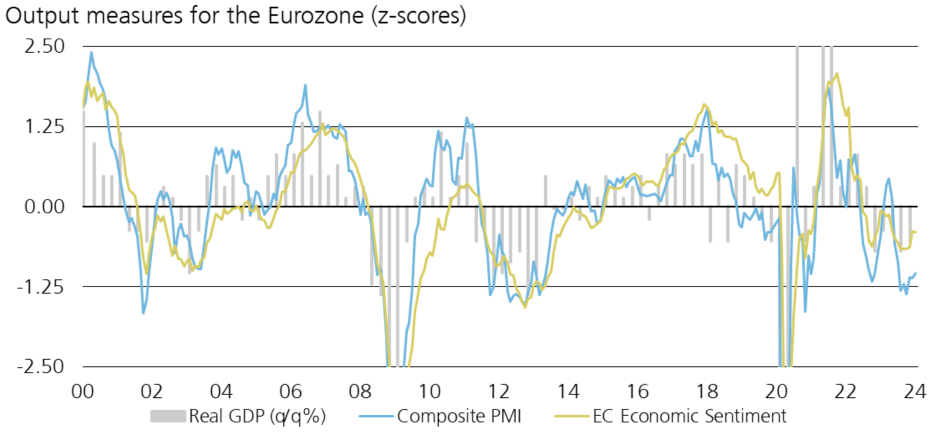
Economic growth in Asia and the US accelerates, with the latter avoiding a recession, boosting demand for Eurozone exports.

Negative case (20%)

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

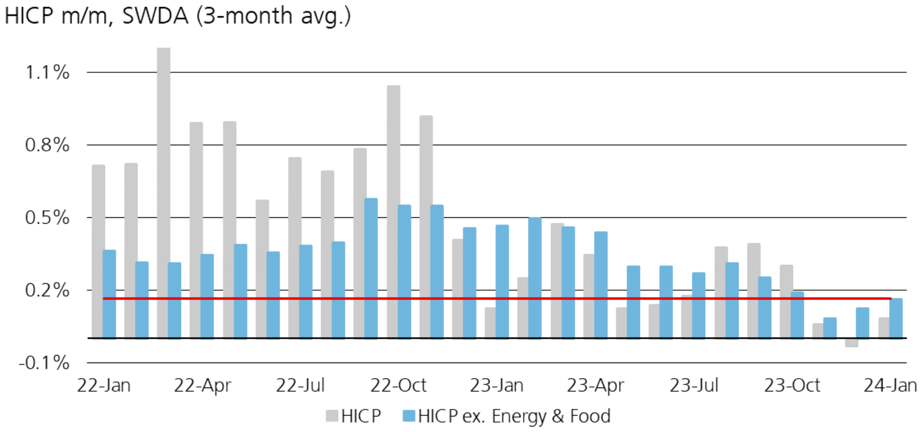
Geopolitical tensions force energy prices materially higher, leading to renewed supply-push inflation that induces a real income loss and a tighter monetary stance.

Growth is likely to remain anemic, as sentiment measures stabilize at a low level



Source: Haver Analytics, UBS, as of 19 February 2024

Sequential inflation is broadly consistent with the ECB's target



Source: Haver Analytics, UBS, as of 19 February 2024

Swiss economy – Inflation falls to two-year low

Base case (70%)

Growth

Switzerland has grown 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, GDP growth is expected to improve on the back of global sport events. Furthermore, a decline in inflation and the end of interest rate hikes should support European growth and help Swiss exports to recover.

Inflation

In January 2024, inflation dropped to 1.3% year on year from 1.7% in December 2023, the lowest value since October 2021. Due to the surprise in January, we lower our forecasts for 2024 from 1.6% to 1.4%. Yet, inflation risks remain due to the renewed rise in the reference interest rate, the increase in VAT and geopolitical turbulence. Therefore, a rate cut by the SNB in March would be premature, but low inflation should pave the way for a rate cut in June. We still expect the SNB to cut rates three times this year to a level of 1%.

Positive case (15%)

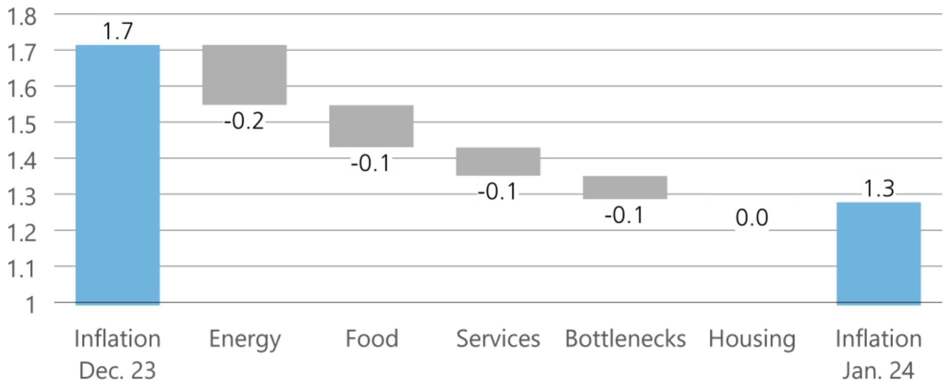
Better global growth momentum: Growth in the U.S. remains strong. Meanwhile, lower than expected inflation allows central banks to cut rates earlier. Switzerland benefits from the stronger global backdrop and a weakening of the safe-haven Swiss franc.

Negative case (15%)

US downturn pushes Switzerland into a recession: If the global economy falls into recession, Switzerland would suffer strongly from the slump in global export demand and from a strong appreciation of the Swiss franc.

Inflation falls to two-year low in Switzerland

Swiss inflation yoy contribution, in %



Source: Macrobond, UBS, as of 13 February 2024

Swiss forecasts (in %; *UBS forecasts)

Source: Macrobond, UBS, as of 13 February 2024

Chinese economy – More green shoots emerging

Base case (70%)

Growth

Both travel and spending during Chinese New Year holiday beat 2019 levels, signaling resilient consumption. Macau and HK visitations also went back to 2019 levels. The data is encouraging for our 6% consumption growth forecast for 2024 versus 7% in 2023. January new credit reached a record high with a better-than-expected growth of 9.5% y/y.

Intensive policy measures were rolled out in the past weeks, including 50bps RRR cut, market bail-out by "National Team," 3,218+ property projects whitelisted for bank loan support, and tier-1 city home purchase easing. We expect continuous policy support to ensure growth meets the potential ~5% target. March's "Two Sessions" is the next key event to watch

Inflation

Deflation continued. January CPI inflation reached -0.8% y/y and may pick up mildly to average about 0.8% y/y in 2024. PPI also stayed in (-2.5% y/y in Jan) and may turn mildly positive by 3Q24.

Positive case (15%)

More policy measures are announced to revive confidence in the economy's medium outlook.

Geopolitical risks ease on more communications between China and US post Xi-Biden talk at APEC summit.

The US economy achieves a soft landing.

Negative case (15%)

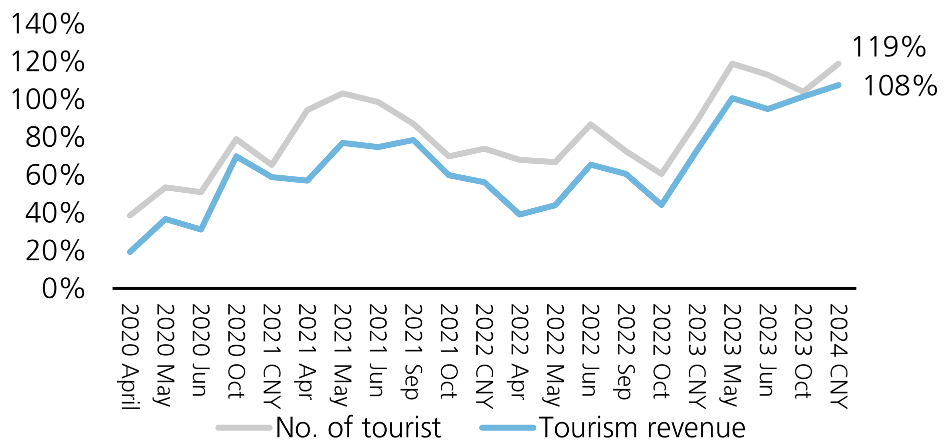
Property activity continues to deteriorate despite supportive policies.

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.

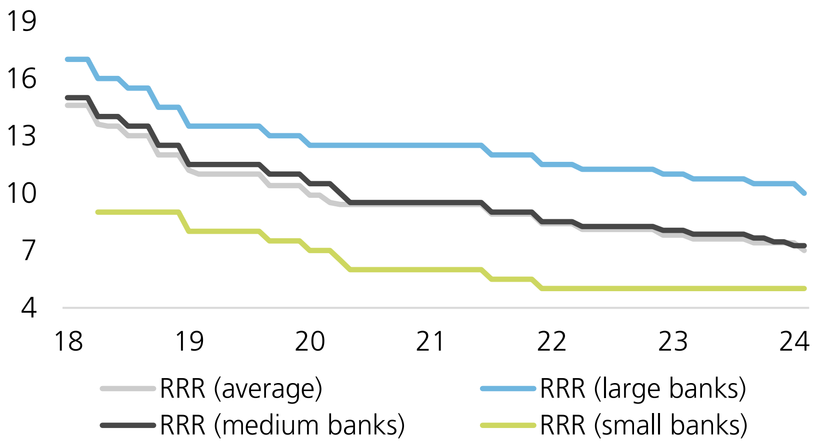
The strongest travel and spending during 2024 CNY holiday

% versus 2019 level



Source: CEIC, UBS, as of 19 February 2024

50bps RRR cut delivered on 5 February releasing CNY 1tr liquidity



Source: CEIC, UBS, as of 19 February 2024

UBS

Analysts: Yifan Hu, Kathy Li

Section 3

Asset class views

Section 3.1

Summary of major asset classes

Equities

Central scenario

MSCI AC World December 2024 target: 940

We maintain a neutral view on global equities. Global equities have posted solid gains in the first stages of 2024, following robust results from big cap and high-quality companies. Despite early signs of a resurgence in US inflation and soaring yields, stock markets have stayed resilient. All in all, we still expect global equities to deliver mid-single-digit returns by end-2024.

Equities face pressure from interest rates volatility. The higher-than-expected US CPI and PPI readings were a reminder that the last mile of the inflation fight may prove tricky, causing some sharp moves in yields to which long-duration equites are sensitive.

The earnings outlook looks promising. 2023 earnings likely narrowly avoided a contraction, and we expect a rebound in 2024. In contrast to the US where the Q4 earnings season has marked the second straight quarter of growth, earnings in the EU are surprising to the downside, while in Japan upbeat results have been supported by the weak yen. All things considered, we find the current consensus forecast for 2024 earnings per share increase quite aggressive (around 10% for MSCI ACWI); whether companies deliver or beat this forecast will depend on their ability to defend margins, the resilience of the labor market, and the magnitude of the restocking cycle.

Valuations are above 10-year averages. Global equities are currently trading at a 12-month forward price-to-earnings (P/E) ratio of 17.4x (MSCI ACWI). This is ahead of their 10-year average and supports our neutral stance. Moreover, the equity risk premiums remain low in a historical context, especially against fixed income markets.

Positioning is getting stretched. One element that could constrain further upside from here is the elevated allocation into global equities by money managers. Recent retail flows are looking quite stretched, too, with equity allocations globally approaching historical highs as active managers are forced to match passive peers' allocations as a result of record high concentrations in a few high-quality market-leading companies.

We prefer EM to UK equities. EM and China earnings appear to have bottomed, are being revised higher, and should grow faster than in any other major region in 2024. In addition, multiples remain attractive both in absolute and relative terms (forward P/E below 12x for EM, below 9x for China based on MSCI EM and MSCI China data). We see value in EM equities that could be unlocked when the Fed starts its easing cycle. Conversely, the UK has entered a technical recession which doesn't in itself mean downside for stocks, however, corporate profits remain on a downtrend which is why we keep a negative stance on the UK.

Equities

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Upside scenario

MSCI ACWI December 2024 target: 995

Inflation cools quickly and the US and European economies grow above trend: Inflationary pressures quickly dissipate, but growth turns out stronger than expected.

Geopolitical de-escalation: Ceasefires end the wars in Ukraine and between Israel and Hamas, and reduce the risk of further sanctions against Russian or Iranian commodities.

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

Downside scenario

MSCI ACWI December 2024 target: 700

Inflation runs hot: Inflation surprises again on the upside and central banks are forced to hike more than expected.

Geopolitical escalation: Increased escalation between Russia and Ukraine or between Israel and Hamas leads to a further disruption of Russia's or Iran's energy supplies. Oil and natural gas prices rise sharply and remain elevated.

Economic growth shrinks sharply as a result of the lagged impact of tighter monetary policy, driving earnings growth and valuation multiples lower.

Regional/Country preferences

Most preferred: Emerging markets

Least preferred: UK

Bonds

Preference: Most preferred

Bond yields rose over the past month, in particular after the US January consumer price data showed an unexpected rise in monthly headline and core inflation. A jump in services inflation contributed the most to the stronger-than-expected release, adding to concerns that the Federal Reserve may need to wait longer before it begins to cut rates in 2024. Fed funds futures markets have moved to price in fewer than four 25-basis-point rate cuts in 2024, up from as much as 170 basis points of cuts earlier this year. Given our outlook for continued inflation moderation, we expect the Fed to begin cutting policy rates in June, and our base case scenario is for three 25-basis-point rate cuts this year.

Nonetheless, once central banks begin their rate-cutting cycle, a momentum is often established, and this time the bond market, in addition to attempting to price the near term, would also attempt to price the end point given that "higher for longer" is no longer a consensus view. Mixed in with market pricing is some probability of recession. Although central banks, such as the Fed, endeavor to avoid causing a recession, it is challenging given that the transmission of policy has long and variable lags.

Given the uncertainty associated with the timing of policy rate cuts, volatility remains elevated. An additional element emanates from the supply side. Following the pandemic, governments have been left with significant debt loads and large deficits. The size of deficits at present is unprecedented outside of a recession. By virtue of these fiscal dynamics and the fact that central banks are reducing their stock of government bonds, there is significant bond supply coming to the market and required to be absorbed by the private sector. In October last year, we observed a pickup in term premium as the market began to focus on this supply backdrop. Historically, a widening of fiscal deficits has coincided with a deteriorating economic backdrop and hence a pickup in demand for high-quality bonds. With rate cuts coming back onto the agenda, this has trumped these technicals for now. Our preferred approach is to take exposure in the 1- to 10-year part of the curve, which has a stronger link to growth, inflation, and policy, rather than the ultra-long end of the curve, which is more sensitive to these technical elements. We have gained some comfort with Fed speakers beginning to discuss the conditions necessary to slow the pace of balance sheet runoff (quantitative tightening, or QT). This would alleviate the need for the private sector to absorb the net additional supply and a sharp run down of excess reserves, which could generate instability in the banking system.

Within the fixed income asset class, we are maintaining an up-in-quality bias expressed through high grade (HG) and investment grade (IG) bonds. There are select opportunities in the more growth-sensitive areas of high yield (HY) and emerging market (EM) credit. The prospects of rate cuts has been priced into market expectations and hence resulted in some easing of financial conditions already. This should offset downside risks to growth to some extent. However, higher-beta credit segments are trading tight and not offering much spread compensation in the event of a worsening growth backdrop, while also being vulnerable to a further repricing of Fed rate cut expectations. Furthermore, current spreads also appear to be discounting a below-average credit risk premium. As a result, we see HY and EM spreads as being more vulnerable to spread widening relative to IG and HG. Read more

High grade bonds: We keep HG bonds as most preferred. Inflationary pressures are abating and, as a result, major central banks are now in discussions on when rate cuts may be appropriate. This is a favorable backdrop for duration risk. To see structurally higher interest rates across the curve from here, we believe economic growth needs to step up. As excess savings have been run down and fiscal policy is already loose, we see growth more likely to slow than accelerate going forward. High grade bonds are rated AA- or better, and therefore have minimal default risk. Given that the outright level of rates is high due to high policy rates, we see an attractive asymmetric absolute return profile in light of the inflation and growth mix. Read more

Investment grade bonds: Like HG bonds, we keep IG bonds as most preferred. Looking ahead, we see returns in the high-single-digit range over the coming 12 months supported by both elevated yields and price upside on prospects for falling interest rates. Within EUR IG, the average yield is around 4%. On US IG, yields for all maturity and intermediate profiles are around 5.3%. Credit fundamentals on the US IG corporate side remain solid, and we expect limited credit quality deterioration in our base case. Any widening of spreads should be more than offset by falling interest rates as the focus turns toward rate cuts. Read more

High yield bonds: We are neutral on the asset class as, relative to the higher-quality segments, we see more pronounced risks of spread widening and decompression given risks around continued credit quality deterioration and corporate defaults among the more leveraged, lower-rated companies. Spread levels appear to discount a very low expected default level of 1–2% and a below-average credit risk premium. 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 around 8% and 6.5%, respectively, which has attracted capital flows and supported performance, hence our neutral stance. Read more

Bonds

Emerging market bonds: We maintain a neutral stance on the asset class. We think EM bonds can deliver high-single-digit returns in 2024, not least thanks to the elevated yield level. Current yields are around 8% and 7% for sovereign and corporate bonds, respectively. High nominal yields and prospects for a weaker US dollar and US policy rate cuts should support the asset class. But following the strong compression in spreads, the room for error is small with spreads at the tight end of their historical range, leaving the asset class vulnerable to temporary setbacks. These could occur due to various reasons, including the risks arising from negative growth and inflation shocks, escalating geopolitical tensions, or rising defaults. Read more

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 consider this positioning over shorter-dated bonds with higher credit risk.

FX

Price action and economic conditions suggest EURUSD is likely to stay in a 1.05 to 1.10 range. We believe the pairing may test the lower edge of that trading band in the coming weeks, as surprisingly good US data pave the way for the dollar to appreciate. Still, we see limits to dollar strength. Markets are expecting most G10 central banks to cut interest rates by 150 to 200 basis points over the next two years. This should provide very solid support for risk-on currencies like the EUR, the GBP, and the commodity bloc (AUD, CAD, and NZD). In light of that long-term expectation, most investors are likely to shy away from buying US dollars below EURUSD 1.05.

Still, the upside for the euro and other risk-on currencies is also limited for the time being, in our view. A necessary condition for a sharp and large appreciation of the common currency would be a strong rebound in both Eurozone and global growth. Over the next couple of months, we see some support for the common currency from the fact that the European Central Bank (ECB) is usually slow to react to changing trends, and does not seem to be in any hurry to cut interest rates. This implies higher real interest rates that would support the euro around current levels and even more strongly around 1.05.

The pound is also steady against the EUR. The UK and the Eurozone are at a very similar stage in the economic and monetary policy cycle. Just like the euro, the GBP would need a stronger global growth backdrop and a more stable geopolitical outlook to rally sustainably. A rebound of GPBUSD to 1.30 cannot be ruled out in light of easing global monetary conditions and improving risk sentiment.

The Swiss franc is on a weakening trend in response to Swiss inflation dropping into the Swiss National Bank's (SNB) target band, reducing the need to shield Switzerland from imported inflation. This backdrop suggests to us the CHF should decline a bit further from here, and we are now least preferred on the franc. We think the currency is well suited to finance carry trades in the coming months. In contrast to this short-term least preferred view, we continue to see long-term value in CHF positions. The last two years have demonstrated that the Swiss franc has strong appreciation potential when the global economy is hit by high inflation or rising geopolitical concerns.

USDJPY has been rocked by significant moves in the past few months, falling from around 152 last November to nearly 140 in late December, before rebounding quickly to around 150 currently. The sharp rise this year has been driven by a rebounding USD (thanks to the repricing of Fed rate-cut expectations) and weaker-than-expected Japan GDP growth data, showing the economy fell into a technical recession in the last two quarters of 2023. We see current USDJPY levels as toppish, as Fed rate cut expectations have been trimmed and speculative net-short JPY positions have fallen back to extreme levels. So, we still favor selling yen downside risks for yield pickup.

For the CAD, NOK, AUD, and NZD, we anticipate only benign changes in the crosses. However, the AUD is likely to profit the most as the Reserve Bank of Australia will likely join the rate cut cycle only in 4Q in view of its stronger domestic economy. The pullback in oil prices should be transitory and any rebound may support the CAD and NOK. We expect EURCAD to move lower and the NOK to outperform the SEK again.

Emerging market currencies first came under pressure in mid-January as markets digested the higher-than-expected US inflation release, but have fared better going through the Fed outlook repricing period in February so far. Positioning indicators for many currencies moved away from the rather stretched levels, and we think this and a more sanguine assessment of the speed of impending Fed cuts make selective engagement in higher carry currencies attractive again—we like the Brazilian real. Aside from that, we are still looking for opportunistic yield enhancement for short tenors, first and foremost in pairings including the South African rand. Even after a change to the central bank governor in Türkiye, we expect the move toward policy orthodoxy to persist and see exposure to the Turkish lira as attractive. The high interest rate carry should compensate for expected spot losses, in our view. Emerging market currencies remain exposed to more hawkish-than-expected Fed policy, which could lead to a global growth slump, geopolitical flashpoints, and impacted commodity markets and risk sentiment, as well as idiosyncratic risks for individual currencies stemming from local monetary policy, fiscal policy, and politics.

For China, we expect limited upside potential for the yuan, because of weakening Chinese growth momentum, which speaks for further easing measures. Our end-2024 forecast of 7.15 shows a sideways profile for USDCNY, which reflects our view that the yuan is unlikely to benefit materially from medium-term dollar weakness. In this context, we reiterate our view that investors should continue to hedge their CNY long exposure.

FX

The biggest risk to our short-term USD view is a rapid fall 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 economy doesn't slow because consumer demand or fiscal spending comes in strong ahead of the presidential elections, current market expectations for lower US rates could still be revised higher.

Conversely, a hard landing with risk assets under downward pressure could support the USD beyond the ranges that we currently promote. The USD tends to perform positively in a risk-off environment, while risk-on currencies (the EUR, GBP, commodity dollars, and emerging market currencies) tend to depreciate. Still, a hard landing would likely lead to a strong reaction from the Fed. Therefore, we think any major USD rally could be sharp initially, but would be watered down eventually by expansive central bank action.

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, there would also be a point where higher rates would 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 any signs of this scenario for the US economy and the USD.

Read more about our foreign exchange views:

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

Commodities

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

Sideways so far in 2024. Our benchmark UBS CMCI total return index is flat this year, but there is dispersion within the sector. Livestock and energy have risen by more than 5%, while industrial metals are down by more than 4% this year. Our return outlook for commodities remains positive, and we expect broadly diversified commodity indexes to appreciate by mid- to high-single digit rates with a total return of around 10% for the full year.

Large drop in visible oil inventories. January saw visible crude and refined product inventories falling by 60 million barrels, according to the International Energy Agency. With oil demand holding up and lower supply from OPEC+ countries, we see the oil market staying undersupplied and lifting Brent crude oil to USD 86/bbl by mid-year.

Silver linings emerge in base metals. We see further supply disappointments and structurally low exchange inventories providing conditions for higher prices in industrial metals this year. While prices will likely remain volatile in the near term on global growth concerns, structural demand drivers for the sector are still in place, which we think should drive a recovery over the coming quarters.

Gold – a hedge with benefits. Gold prices temporarily dropped below the USD 2,000/oz level as US CPI data beat to the upside. With a mid-year Fed cut our base case, we think a revival in gold ETF demand remains the main catalyst, boosting gold to USD 2,250 by end-2024. We continue to see gold as a portfolio hedge against risk events. We recommend an allocation of around 5% in diversified and balanced USD-based portfolios.

Agricultural markets remain split. Easing weather-related risks saw the CMCI Grains sub-index decline by 10% while the soft commodities sub-index, led by cocoa ad cotton, moved higher by a similar magnitude. Meanwhile, market positioning has reflected these price dynamics with short positions held by hedge funds at a more-than three-year high. Adding to the bearish sentiment was industry wheat estimates that signaled Russia may produce another 100 million metric tons this year alongside the first estimate from the USDA for the 2024-25 US planted areas—US corn area is forecast to contract by 3.6 million acres while soybean areas are projected to rise by nearly 4 million acres. Within softs, cocoa has been the standout as El Nino-related damage means deficits will likely persist over 2024–25. Livestock, in aggregate, has risen by around 10% this year; we hold a moderate overweight to the sector.

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 the global asset allocation—within a balanced USD portfolio our analysis shows around a mid-single digit percentage is most optimal.

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

Analysts: Dominic Schnider, Giovanni Staunovo, Wayne Gordon

Section 3.2

Details per asset class

Eurozone equities

Central scenario

DJ Euro Stoxx 50 December 2024 target: 4,900

We maintain our neutral stance on Eurozone equities and see modest upside into the year-end. The potential start of a monetary easing cycle in combination with bottoming manufacturing activity is supportive, but equities have performed well in anticipation of some of this, so further gains from here should be modest, in our view.

We believe the earnings backdrop remains broadly supportive. Weakening prices are driving slowing revenue growth, but growth is bottoming in real terms and lower input costs are supporting profit margins, which have surpassed consensus expectations again in the 4Q results. 2023 overall looks better than we had expected, driving a 5% upgrade to our earnings and index target this month. But our forward-looking earnings growth forecasts for 2024 and 2025 remain unchanged, and we continue to expect relatively slow growth ahead due to sub-trend economic growth and softening prices. We forecast 3% earnings growth this year (consensus 3%) and 4% in 2025 (consensus 10%).

Falling inflation, easing financial conditions, bottoming manufacturing activity, light investor positioning, and reasonable equity valuations (12.6x forward P/E, versus average since 1988 of 13.4x) present a relatively favorable backdrop for equities. But after the strong run, we see only modest further gains from here in the absence of a faster economic recovery or bigger interest rate cuts.

We favor beneficiaries of disinflation, interest rate cuts, and bottoming manufacturing activity, where valuations are attractive. We expect consumer sentiment to improve as real incomes turn positive and rate hikes end, boosting consumer sectors. Eurozone small- and mid-caps should get a boost from easing credit conditions and bottoming activity, with relative valuations at 20-year lows. We think the materials sector also offers attractive relative value with upside from bottoming manufacturing activity and the end of destocking. We also see select opportunities in greentech.

CIO themes

Eurozone small- and mid-caps

We see attractive value in small and midsize companies, and believe that supportive inflections are starting to emerge in the macroeconomic backdrop.

Consumer recovery

We like European consumer stocks that are poised to benefit from an improving consumer outlook as real household income growth turns positive, inflation pressures ease, and central banks stop hiking.

Greentech goes global

This theme recommends companies that will likely play a key role in the global energy transition.

Sector Preferences:

Most preferred: Consumer discretionary, consumer staples, and materials

Least preferred: Communication services and healthcare

Eurozone equities

Upside scenario

DJ Euro Stoxx 50 December 2024 target: 5,400

Inflation falls quickly, allowing central banks to ease policy at a faster pace, supporting valuations.

The economy recovers. In this scenario, earnings could surprise to the upside if US and European economic growth is better than expected or China's economic outlook brightens.

Companies keep pricing power. If companies can maintain pricing power, margins could expand more than we expect and revenues could stay resilient, leading to upside risks to our earnings forecasts.

Lower European gas prices could support the outlook for households and manufacturers in the region.

Downside scenario

DJ Euro Stoxx 50 December 2024 target: 3,800

Growth disappoints, triggering weaker earnings growth and lower valuation multiples in anticipation of it.

Inflation starts to turn back up, which could mean rates stay at high levels, weighing on valuations and raising the risk of a deeper growth downturn in the future.

Political risks or fiscal tightening emerge at a fragile time given high government debt levels.

Loss of European competitiveness due to structurally higher energy prices, more innovation from the US and China, and the rise of new industrial competitors.

US equities

Central scenario

S&P 500 December 2024 target: 5,200

Over the last several months, US equities have been buoyed by: 1) better-than-expected economic growth; 2) improving inflation; 3) the end of Fed rate hikes and a likely pivot to rate cuts; and 4) surging investment in AI infrastructure and applications. Despite some recent economic data that suggests a slowdown in growth and hotter-than-expected inflation, we continue to believe that the four key equity market drivers remain largely in place.

Crucially, consumer spending should continue to be supported by healthy labor market dynamics. Initial claims for unemployment insurance remain low, jobs continue to be added in the most cyclical segments of the labor market (manufacturing and construction), there are 1.4 open jobs for every unemployed worker, and real wages are rising. In addition, access to capital is improving with high yield markets open and the banks backing away from their tightening bias.

While inflation readings for January were a bit hotter than expected, the data could have been impacted by seasonal adjustment issues. More broadly, corporate America continues to suggest disinflationary trends remain in place, commodity prices are near multi-year lows, and consumer inflation expectations remain well contained. This should enable the Fed to start cutting interest rates later this year. We expect three rate cuts in 2024 with the first one starting in June. With the Fed now in a position to cut rates in case growth falters, this should limit the scope of potential downside risks for stocks.

It's been over a year since ChatGPT first burst on the scene, which has unleashed an AI arms race that shows no signs of letting up. Key semiconductor manufacturing companies expect AI chips to be supply constrained into next year. At the same time, software companies are racing to deploy applications to take advantage of the new capabilities, with many starting to gain some early traction. While expectations in this segment are elevated, we think the underlying demand will remain robust in the near term.

So even though US equities have performed very well in recent months, we think the key market drivers will remain supportive. And on the heels of a substantially better-than-expected 4Q earnings season, we are raising our S&P 500 EPS estimates by USD 5 each for this year and next. Our 2024 estimate goes from USD 240 to USD 245 (9% y/y) and 2025 goes from USD 255 to USD 260 (6% y/y). Not only were the fourth quarter results themselves better than we had expected, but the guidance was also solid. This prompts us to raise our June and December S&P 500 price targets to 5,100 and 5,200.

Our revised price targets suggest modest upside through the end of the year and we retain a neutral allocation to US equities in our tactical asset allocation. With some sentiment and positioning indicators looking elevated, we do now see a higher risk of a modest pullback in the coming months. That could offer investors a better opportunity to add to equity positions.

Sector preferences

Most preferred

Healthcare: This is our preferred defensive sector due to faster earnings growth relative to the other defensives and the potential for certain segments—managed care and life sciences tools—to benefit from a pick-up in earnings growth as the year progresses.

Industrials: The sector should benefit from resilient economic growth, an improvement in manufacturing business sentiment, a bottoming in cyclical areas such as transports, secular growth in infrastructure, re-industrialization of the US economy, and aerospace demand.

Information technology: The sector should benefit from a bottoming in PC and smartphone end-markets. AI investment spending remains robust and key components will likely remain supply constrained into next year. Investors will likely continue to gravitate to high-quality companies that have good secular growth. That all being said, the sector has performed well recently and pullbacks are possible.

US equities

Upside scenario

S&P 500 December 2024 target: 5,500

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

Stronger-than-expected 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 cuts rates even more than we expect. This lifts expectations for economic growth and corporate earnings.

Downside scenario

S&P 500 December 2024 target: 3,700

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 and as household cash cushions dwindle.

Inflation stays hot: Inflation pressures reaccelerate. Central banks are forced to raise interest rates even more 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: The sector seems to be pricing in lower interest rates. Estimates are still high in some areas that over-earned during the pandemic. Growth in adjusted 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 healthcare which offers better earnings growth.

UK equities

Preference: Least preferred

Central scenario

FTSE 100 December 2024 target: 7,780

We expect easing monetary policy in 2024 as inflation cools, which, in combination with reasonable valuations and earnings that should be close to bottoming, should support UK equities around current levels. We rate UK equities as least preferred in our global asset class preferences, as we see more upside for emerging markets where valuations are relatively attractive, and we anticipate double-digit earnings growth this year—versus around 2% earnings growth for the FTSE 100. Looking ahead to 2025, the picture should brighten: We forecast 6–7% earnings growth next year, driven by fading headwinds to energy and banks' profits alongside an improving economy.

The FTSE 100 trades at 10.6x forward P/E with a 4.4% dividend yield. We think valuations are attractive relative to a long-run average forward P/E for the FTSE 100 of 12.8x since 1987. However, much of that value is in the energy (7.4x P/E) and financials (7.1x P/E) sectors, reflecting market concerns about the sustainability of their profits given current oil prices and expectations for rate cuts. Excluding these sectors, we estimate the UK market trades around 13.9x forward P/E.

We believe quality stocks with strong returns on invested capital, resilient operating margins, and relatively low debt on their balance sheets will be best positioned to continue generating profits in an environment of sub-trend global growth. We also expect household disposable income growth to improve in 2024 as inflation pressures fade and interest rates come down, supporting our preference for consumer stocks across Europe.

Upside scenario

FTSE 100 December 2024 target: 8,400

Valuations rerate: A reduction of the UK's discount versus global equities offers upside risk to valuations.

Higher commodity prices: Higher commodity prices, especially oil, 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.

CIO themes

Consumer recovery

We like European consumer stocks that are poised to benefit from an improving consumer outlook as real household income growth turns positive, inflation pressures ease, and central banks stop hiking.

Downside scenario

FTSE 100 December 2024 target: 6,000

Lower oil prices: If the price of Brent crude oil falls, earnings growth could be hurt as the energy sector contributes around 25% of FTSE 100 earnings.

Weaker economic growth: Should global economic growth slow more than anticipated, this would be negative for earnings and equity valuations.

Sticky inflation: Persistently high inflation could keep Bank of England rates higher for longer and put downward pressure on equity valuations and the economic growth outlook.

Stronger sterling: Sterling strength would be a drag on the FTSE 100, which generates close to 75% of its revenues outside the UK, although stronger sterling likely comes alongside a better economic growth backdrop.

Swiss equities

Central scenario

SMI December 2024 target: 11,640

After a strong 2021, we estimate corporate profits to have dropped 7% over the 2021–23 period due to the global economic slowdown and significant currency losses. This year, we expect 7% earnings growth, supported by robust organic sales growth; margin improvements, particularly in the healthcare, consumer staples, and financials sectors; cost-cutting measures; and more moderate currency losses. Although we are working on the basis of a significant economic slowdown, the greatest risk to our 2024 earnings expectations lies in an even weaker global economy than currently forecast. This would probably cause the Swiss franc to appreciate even more.

From June 2022 to June 2023, the Swiss National Bank (SNB) hiked its prime interest rate five times to mitigate inflation pressures despite a recent slowdown in Swiss and global growth. Higher interest rates support the Swiss franc. This, in turn, has weighed on Swiss profits, of which 90% of are generated in foreign currencies. We expect negative currency effects to moderate significantly from 2Q24. Moreover, we currently forecast the SNB to begin cutting its prime rate in June 2024.

Swiss equity valuation multiples are slightly above their 25-year average, which we think is fair given normalized interest rates. Dividend yields remain attractive, in our view, despite the now higher bond yields. 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 robust 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 cash flow yields are particularly appealing to us.

Key risks include protectionism, international trade disputes, a significant economic downturn, currency losses, and Swiss-EU negotiations.

Swiss equities

Upside scenario

SMI December 2024 target: 12,300

Robust Swiss profits: If there is only a modest global economic downturn ahead, corporate profits could expand by low teens in 2024.

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 this 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. They then increased a bit in 2022 and significantly in 2023. In 2024, we expect currency losses to moderate.

Downside scenario

SMI December 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 flat in 2024, leaving the SMI trading at an unjustified premium to its 25-year forward P/E average.

Sector composition: The SMI has a high exposure to defensive industries and quality companies that tend to underperform when bond yields increase strongly or economic growth expands.

Emerging market equities

Preference: Most preferred

Central scenario

MSCI EM December 2024 target: 1,100

We view emerging market (EM) equities as most preferred. The macroeconomic picture in emerging markets remains healthy. Economic activity continues to expand, with aggregate manufacturing PMIs remaining strong, while inflation continues to normalize. In our view, emerging market companies look set to deliver solid mid-teens earnings growth in 2024.

Valuations for the MSCI EM index are largely in line with their 10-year average, yet stand at an above-average discount to US and developed market stocks. In our view, this gap does not factor in the better earnings growth prospects we see for emerging markets relative to global peers. A strong US dollar, sharply higher US rates, an uptick in geopolitical tensions, a pronounced US recession, and policy and growth disappointments in China are risks to the outlook for EM equities.

From a geographic standpoint, we have India, Indonesia, and China as most preferred. We believe India's valuations should be well supported by solid corporate fundamentals. We expect positive macroeconomic and corporate dynamics to take the driver's seat in Indonesia, with US real yields likely having peaked and as local election-related uncertainty has diminished. Finally, we think markets have priced in a lot of the negatives around both the cyclical slowdown and structural issues in China. Policy support will likely continue, which should translate into a tailwind for equity valuations from current levels. We closely watch for further policy signals potentially from the upcoming "Two Sessions" in March.

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.

Upside scenario

MSCI EM December 2024 target: 1,200

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

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

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

Downside scenario

MSCI EM December 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.

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

Singapore, Malaysia

Japanese equities

Central scenario

TOPIX December 2024 target: 2,620

We are neutral on Japanese equities in our global portfolio. TOPIX is off to a good start with a +10% gain ytd, supported by better sentiment in particularly the US equity market. Both the TOPIX and S&P 500 are up 10% since the beginning of December 2023. A weaker yen has also supported the rally, with USDJPY rebounding to over 150 from 141 at year-end. The top 30 large-cap stocks, especially beneficiaries of the weaker yen and AI-related stocks, have contributed more than 60% of the ytd rally.

Corporate governance reforms accelerate. Recent comments from non-life insurers that they will reduce cross-shareholdings to zero or significantly accelerate the pace mark important milestones in Japan's corporate governance push. They are some of the largest cross-shareholders, with over 500 holdings across different sectors. Unwinding these mean share buybacks as a countermeasure are likely to broaden to other sectors, representing an EPS growth driver for Japanese equities over the medium term.

Corporate earnings remain strong, but valuations are no longer cheap. After solid December quarter results, we revised up our FY23 (year-end March 2024) to +12% from +9%. For FY24, we expect +5% growth. Forward P/E is trading at 15.5x, close to last year's high and above the historical average of 13.7x. But it still looks fair compared to the MSCI ACWI (17.3x) or S&P 500 (20.6x), with the P/E discount to the both markets still below the long-term average.

Focus on fundamentals and quality given a potential JPY appreciation due to the Fed's potential easing from mid-2024. Stock selection will be important to capture further upside. We continue to prefer large cap banks and real estate, as they are key beneficiaries of the BoJ's policy normalization, which we expect in 2Q24, a solid domestic economy and corporate governance reform. We also see opportunities in laggard cyclical stocks with an above-average earnings growth outlook in FY24.

Upside scenario

TOPIX December 2024 target: 2,840

Higher ROE: Potential increases in unwinding of cross-shareholdings and share buybacks. Potential business portfolio restructuring or increased investment to increase return on equity (an aim of the Tokyo Stock Exchange) and profit margins become a rerating catalyst for Japanese equities in the longer term.

Global economic growth remains resilient: A strong Chinese economic recovery and a resilient US economy lead to stronger topline growth for Japanese corporate earnings.

Sustainable inflation and wage growth: Solid 2024 Shunto wage negotiations results provide confidence to investors that Japan's moderate wage growth and inflation could be sustained in 2024, and that there could be structural changes in the economy.

Downside scenario

TOPIX December 2024 target: 2,000

Recession: The US slips into a recession, and increased tensions between the US and China put downward pressure on Japan's economic and earnings growth outlook.

Global economic growth remains resilient: A strong Chinese economic recovery and a resilient US economy lead to stronger topline growth for Japanese corporate earnings.

US inflation remains elevated: Inflation stays hot and the Federal Reserve is forced to raise interest rates even more than expected or keep them high for longer than expected, leading to a correction in valuations.

Asian ex-Japan equities

Central scenario

MSCI Asia ex-Japan December 2024 target: 685

Asia's macro environment remains stable. Regional inflation has been trending down to around 3%, opening the door for Asian central banks to cut policy rates starting in 2Q24, following the Federal Reserve. With the help of recovering global orders, growth in Asia is returning to trend, favoring North Asia for now. PMIs, however, are mixed, with no decisive trend yet. As a result, we believe it's still too early for a directional trend in the Asia ex-Japan equity market to take shape. We remain focused on relative opportunities, and keep our most preferred view on China, India, and Indonesia, and our least preferred view on Singapore and Malaysia.

After upgrading Indonesia last month, we continue to keep it as most preferred. Quick counts of Indonesia's 2024 presidential election point to a one-round victory, which largely removes the political overhang and should boost market sentiment. Elsewhere, Indonesia's macro environment remains supportive—its PMI is consistently above 50 (indicating expansion), and some key factors we track are showing an improvement trend, such as construction and consumer spending. Given the high policy rates as well as moderated inflation and healthy FX reserves, Indonesia could be one of the first markets in the region to deliver rate cuts, in our view. In terms of fundamentals, 60% of the Indonesian index is made up of financials, which should benefit from the high net interest margin (NIM) guidance and healthy loan growth in the country.

India remains as most preferred. Its macro backdrop is still supportive—domestically, GDP has been strong, and its PMI has consistently stayed above 50. Although vehicle sales have recently been a bit softer, we think the overall macro environment is still healthy. Externally, the country's FX reserves are rebuilding, and the balance of payment condition doesn't seem to be a headwind for the INR. Since inflation is still high at 5.1%, we don't expect policy rate cuts to be imminent in 1H24. In terms of fundamentals, we see Indian earnings continuing their upward trend. The general election in April will be a potential risk to watch, particularly as market valuations are slightly expensive, with the forward P/E multiple at 0.9 standard deviation above the five-year average. But overall, we believe the downside risks for India are manageable for now.

Elsewhere, China also remains as most preferred. Chinese equities have rebounded since late January, triggered by multiple media reports and announcements—authorities planning to buy CNY 2tr of equities, a 50bps reserve requirement ratio cut, and stronger regulatory actions. Despite the positive policy news flow, the macro data showed an uneven recovery. PMI and CPI prints tilted toward the weaker side, while credit data and Lunar New Year activities grew at a higher pace than market estimations. Given the low valuation of the market and the supportive policy stance from the government, we maintain our most preferred view on the market, and will closely monitor the upcoming March "Two Sessions" for growth targets and potential stimulus announcements.

On the flip side, Singapore is kept as least preferred. Its market has been recovering, but fundamentals continue to face headwinds. Financials make up half of the market, with NIMs expected to fall in 2024. Earnings across the market have shown initial signs of a stabilizing trend, but the market valuation isn't particularly cheap, with P/B at 0.1 standard deviation above the five-year average. Despite weak domestic activity, upside risks could come from faster-than-expected recovering global orders. Overall, we maintain our negative view on Singapore until more upside catalysts emerge in the future.

Malaysia is also kept as least preferred. Its market has weak macro dynamics, as its PMI data is consistently below the 50 level that indicates contraction. Manufacturing exports are decent, but not strong. With a relatively weak balance of payment and a relatively low policy rate of 3%, we see some room for rate cuts, but it is limited. Fundamentally, financials account for 40% of the market, which should see a NIM of just around 2% in 2024. As a result, despite cheap valuations (with P/B at 1.6 standard deviation below the five-year average), we believe the near-term upside for the market is limited from both a macro and a fundamental perspective.

Asian ex-Japan equities

Upside scenario

MSCI Asia ex-Japan December 2024 target: 741

Fed starts rate cuts earlier than expected

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

Strong Chinese housing demand recovery

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

Strong demand recovery in tech

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

Downside scenario

MSCI Asia ex-Japan December 2024 target: 493

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 likely weaken if the US adds secondary sanctions on Chinese firms or financial institutions.

Stronger US dollar

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

Market preferences

Most preferred: India, China, Indonesia

Least preferred: Singapore, Malaysia

High grade

Preference: Most preferred

Central scenario

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

With indications that inflationary pressures continue to abate, major central banks have ended their rate hikes and are assessing when it may be appropriate to ease policy. 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 although a fair amount is priced into curves in terms of rate cut expectations, there is often downward momentum on term rates once central banks start rate cutting. Additionally, although there are high expectations that the US can avoid a recession, the lagged transmission of all the policy rate tightening over the last two years continues to present downside risks to growth and financial stability. Interest rate volatility is likely to remain elevated, particularly in the long end of the curve, as government bond supply is large given existing deficits and maturity profiles. Accordingly, our preferred approach is to take rate risk in the 1–10yr part of the curve where the link to growth, inflation, and policy is stronger, as opposed to the ultra-long end of the curve, which has sensitivity to technical dynamics.

Upside scenario

10-year US Treasury yield December 2024 target: 2.50%

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 exogenous shocks such as geopolitical tail risks. 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 ends and QE restarts.

Downside scenario

10-year US Treasury yield December 2024 target: 4.00%

In the downside scenario for high grade bonds, US activity grows above its trend rate of 2% as labor markets and household balance sheets prove resilient to monetary policy tightening. Inflation continues to fall toward price targets, paving the way for central banks to trim policy rates down from currently restrictive levels.

Investment grade

Preference: Most preferred

Central scenario

December 2024 spread targets: 100bps (USD IG) / 140bps (EUR IG)

Investment grade credit spreads have further tightened over the past month with indications of strong investor demand for high-quality credit despite elevated supply and a significant repricing of Federal Reserve rate cut expectations this year. While supply has strongly ramped up as per the typical trend of higher issuance levels at the start of the year, this has so far has been very well absorbed with investors demonstrating strong appetite to meet the increased bond supply. We also note that the share of M&A-related issuance has remained below the long-term average and use of proceeds for refinancing remains at above average levels, suggesting that use of proceeds remain overall relatively creditor-friendly at this stage.

With yields remaining elevated and major central banks in developed markets likely having ended their hiking cycles, we think total return prospects in higher-quality fixed income remain appealing over the coming quarters. US investment grade (IG) yields are at 5.3% and EUR IG yields are at 3.8%. While these levels are off their recent peaks, they remain historically elevated. The elevated outright yields and the fact that spreads are a much smaller proportion of all-in yields than in the recent past are positives for forward-looking returns.

We think the total returns outlook for US IG remains supported by elevated yield levels, expected lower government bond yields over the coming quarters and our outlook of relatively resilient spreads in our base case of a soft landing. We expect lower government bond yields as inflation and growth continue to moderate, and markets look to price both the upcoming rate-cutting cycle and the expected longer-term neutral policy rate in the coming quarters.

In addition, 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 last year, when 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.

US IG fundamentals remain relatively solid. While median net leverage (excluding financials and utilities) remained broadly stable at 2.0x in 3Q (compared to 2.2x in 4Q19, just prior to the pandemic), preliminary leverage figures on reported 1Q earnings suggest a moderate decline in leverage on a continued recovery in earnings to 1.9x. Furthermore, while the median interest coverage ratio has declined from the highs reached in 2022 given rising interest expenses; as of 3Q, it was still at a solid level of 10.6x, compared to 10.4x in 4Q19. In our base case of a soft landing, the pace of nominal growth is likely to moderate yet remain overall relatively resilient this year, and we expect decent earnings growth, which is supportive of fundamentals. So, while ratings migrations have become less supportive over time, they are not expected to turn significantly negative in our base case scenario. We also note that debt growth for the median issuer has remained very muted as companies have continued to exhibit a conservative balance sheet management approach overall. We view the near-term risk of rising downgrades and upward pressure on spreads as limited outside a deep recession. We continue to believe IG bonds stand to deliver attractive risk-adjusted returns, given all-in yields, resilient fundamentals and upside from falling interest rates.

Key risks to our view include a recession (though in our view spread widening would be to a good extent offset by falling interest rates in this scenario), sustained evidence of stalling progress on inflation, which could put further upward pressure on both yields and spreads as the market further reprices expectations of Fed cuts this year, as well as a material rise in creditor-unfriendly actions such as debt-funded M&A and share buybacks that would lead to rising net supply and a deterioration in credit quality over time.

Investment grade

Preference: Most preferred

Upside scenario

Bloomberg Barclays US Int. Corp. December 2024 target: 80bps/ Bloomberg Barclays Euro-Agg. Corp. December 2024 target: 120bps

Goldilocks

Growth remains robust, inflation declines more rapidly than expected, and the Fed cuts interest rates pre-emptively.

Downside scenario

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

Hard landing

Growth falls sharply on a global scale, owing to the delayed impact of monetary tightening.

High yield

Central scenario

December 2024 spread targets: 400bps (USD HY) / 400bps (EUR HY)

Valuations significantly compressed late last year amid prospects for Federal Reserve easing and a resilient growth environment. A significant upward repricing of the near-term path of interest rates this year given upward surprises to inflation, labor markets, and hawkish Fedspeak has done little to materially dent sentiment thus far. HY spreads have tightened further over the last month and credit availability has improved, with lower-rated borrowers accessing primary markets to a greater extent this year than seen in past quarters.

The January CPI report shows the disinflation process may not proceed as rapidly as expected and while further rate hikes seem unlikely, the risk of a further repricing of Fed rate cut expectations remains. While HY has thus far weathered the recent repricing in Fed cut expectations well, a further repricing may be more problematic and could lead to widening spreads, an overall tightening of financial conditions, and ultimately weigh on the growth outlook if sustained. At the same time, we note that central banks have shown a willingness to actively use their balance sheets temporarily when market conditions turn dysfunctional, and we also note that the last Fed minutes indicate discussions about reducing the pace of quantitative tightening are likely to increasingly come into focus.

At current valuations, US HY appears to be discounting a below-average default rate in the year ahead of 1–2% and a strong nominal growth rate in excess of 5%. While less tight than in the prior quarter, lending standards remain somewhat restricted, pointing to some downside risks to growth and upside risks to defaults over the coming 12 months, though considerably less than before.

We still view the risk of a sharp rise in defaults as low. 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 earnings growth has declined and debt levels have ticked up. The energy sector in the US, which has historically been a source of defaults in downturns, is in a relatively healthy state having deleveraged since the last default cycle.

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. Lower-rated, highly leveraged issuers are at particular risk if rates remain high for longer given the large associated step up in interest expenses. Such issuers could struggle to meet their refinancing needs. However, easing financial conditions recently on the back of expectations of Fed easing have enabled lower-rated borrowers to access primary markets to a greater degree this year.

Our updated estimate is for defaults to reach around 4% (on an issuer-weighted basis) this year, which would equate to around 3% on a par-weighted basis. While this is relatively low, it is still slightly above what credit spreads appear to be implying.

Furthermore, current spreads also appear to be discounting a below-average credit risk premium. This is the compensation credit investors require over and above expected credit losses. One explanation for this is the fact that the market has shrunk from USD 1.5tr in 2021 to USD 1.3tr. This is due to net 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 while the scope for further net rising stars has diminished.

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 remains historically elevated at around 8% 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.

Analysts: Carolina Corvalan, Antoine Geiller, Frederick Mellors

High yield

Upside scenario

ICE BofA US high yield spread December 2024 target: 325bps / ICE BofA Euro high yield spread December 2024 target: 350bps

Goldilocks

Growth remains robust, inflation declines more rapidly than expected, and the Fed cuts interest rates pre-emptively.

Downside scenario

ICE BofA US high yield spread December 2024 target: 800bps / ICE BofA Euro high yield spread December 2024 target: 800bps

Hard landing

A slowdown in growth, possibly resulting from the cumulative effect of interest rate hikes so far, results in a recession.

Emerging market bonds

Central scenario

December 2024 spread targets: 425bps (EM sovereign bonds) /350bps (EM corporate bonds)

Year-to-date, yields on emerging market bonds have moderately widened to 8.2% for sovereign bonds and to 7.1% for corporate bonds (JPMorgan EMBIG Diversified and CEMBI Diversified indexes, respectively). This was mainly driven by higher benchmark rates after the US January consumer price data showed an unexpected rise in monthly headline and core inflation. A jump in services inflation contributed the most to the stronger-than-expected release, adding to concerns that the Federal Reserve may need to wait longer before it begins to cut rates in 2024. Fed funds futures markets have moved to price in fewer than four 25-basis-point rate cuts in 2024, up from as much as 170 basis points of cuts earlier this year.

We maintain a neutral stance on EM USD-denominated bonds. We think the asset class can deliver high-single digit returns in 2024. High nominal yields, the prospects of a weaker US dollar, and US policy rate cuts should support the asset class. Given our outlook for a soft-landing continued inflation moderation in the US, we expect the Fed to cut policy rates towards the second half of the year, and our base case scenario is for three 25-basis-point rate cuts this year.

But following the strong compression in spreads, the room for error is small with spreads at the tight end of their historical range. This leaves the asset class vulnerable to temporary setbacks, in our view. These could occur due to various reasons, including negative growth and inflation shocks, escalating geopolitical tensions and rising defaults. As such, we advise investors to err on the side of caution within the asset class, especially when it comes to holding exposure to lower-rated names.

Emerging market bonds

Upside scenario

EMBIG Diversified / CEMBI Diversified spread December 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 December 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 remains on hold: Fed could be forced to stay on hold for longer if the labor and inflation data continues to run hot, which could tighten financial conditions and weigh on growth.

Geopolitical tensions escalate: Heightened friction, emanating from either the war in Ukraine, the conflict in the Middle East of US-China relations, 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.

Asian bonds

Central scenario

JACI composite spread December 2024 target: 250bps

US Treasury yields recently drifted higher to 4.3% (as of 19 February) on the back of stronger-than-expected US inflation data. But going forward, we believe yields will fall in 2024 as US growth moderates. As US inflation fades, growth slows, and the Federal Reserve cuts rates, we continue to believe bonds—especially high-quality segments like high grade (HG) and investment grade (IG) bonds—will be attractive in terms of risk-reward in this year.

Asian credits delivered a positive performance in the past month and credit spreads have tightened. Within the asset class, we continue to believe Asian IG bonds present solid risk-reward potential. The current yield level (5.7% as of 19 February) is attractive to us, considering the high credit quality (average rating of A-), supportive technical factors (e.g., negative net issuance), and stable fundamentals for most issuers. While from a valuation perspective, JACI IG spread is at one of the tightest levels historically (135bps), we expect spreads to stay resilient.

Asian high yields (HY) bonds had a strong start this year, especially as distressed names in China, India, and Indonesia recovered. We retain a relative cautious and selective approach given ongoing stress in the Chinese property space and tight spreads elsewhere. For China, while policy has been supportive, such as the approval of a "white list" of property projects and the recent 25bps cut to the 5-year loan prime rates, it has not been enough to alleviate credit concerns in the distressed developers so far. Property sales in January were down 36% y/y and developers are still under liquidity pressure. In the non-China HY space, we saw improving fundamentals for issuers in countries such as Macau, India, and the Philippines. We believe there are some cherry-picking opportunities from a bottom-up perspective.

Asian bonds

Upside scenario

JACI composite spread December 2024target: 220bps

Much faster recovery: If China's recovery is faster and stronger than expected in the coming months, Asian credits would likely see upside.

Sharp property rebound: Policy has been focused on demand-side measures so far, but the housing sales recovery remains uneven and mixed. A rebound in housing sales or more details on supporting developer liquidity needs would offer fundamental support to the credit metrics of this sector.

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

Downside scenario

JACI composite spread December 2024 target: 320bps

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

Increased China-US tensions: Heightened friction emanating from upcoming US elections next year could hurt risk 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 would be impacted.

Gold

Central scenario

Gold December 2024 target: USD 2,250/oz

The gold price has risen back above the psychological support level of USD 2,000/oz, but should remain in the USD 2,000–2,050/oz trading range established since mid-January in the short term. While we and the market expect the first 25-basis-point Federal Reserve rate cut by mid-year, sticky US inflation has made an earlier move unlikely. This has also kept the US dollar on a stronger footing, while outflows from exchange-traded funds has continued.

Alongside ETFs, we see ongoing demand for the physical metal as highlighted by recent Swiss gold export data. Shipments for January nearly doubled month-over-month to 207 metric tons, with around half these volumes exported to mainland China and Hong Kong. The persistent Shanghai price premium over London prices signals solid domestic demand, with the turning of the year allowing a reset of quota volumes and stronger demand. As we highlighted in our previous report, we see Chinese demand as an underappreciated factor in global gold markets. We have also seen central bank demand recovering over recent weeks. Central banks have purchased in excess of 1,000 metric tons in each of the last two years.

We maintain gold as an attractive standalone investment, and can be used as a portfolio hedge against risk events. We recommend an allocation of around 5% in diversified and balanced USD-based portfolios. We also like select gold miners, with attractive valuations versus gold.

Crude oil

Preference: Most preferred

Central scenario

Brent crude oil December 2024 target: USD 82/bbl

The futures curve in crude oil prices has become even more strongly downward sloped (backwardation). Normally, a premium for immediate delivery versus later delivery indicates market tightness. Part of this explanation might be due to cold weather-related production shut-ins in North America in January and OPEC+ production cuts, which caused a drop in global oil production of 1.4mbpd m/m according to the International Energy Agency (IEA). At the same time, India's oil demand (the third global largest consumer), rose by 8.2% y/y in January. The IEA estimates that visible crude and refined products fell by 60 million barrels in January, which would correspond to a deficit of nearly 2mbpd.

Preliminary data for the month of February (until 18 February) indicates that the compliance of OPEC to the production cuts has further increased. The January laggard, Iraq, has reduced its crude exports further, which are now down more than 300kbpd versus December, according to Petro-Logistics. Total OPEC crude exports are at around 18.7mbpd, which are down around 900kbpd versus December and the lowest level since August. If exports are maintained at current levels, we expect the oil markets to stay tight.

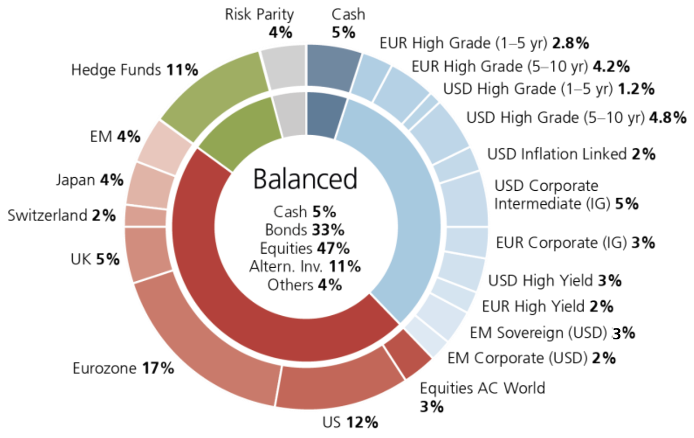
We retain a modestly positive outlook as we expect the oil market to remain slightly undersupplied this year. Hence, we continue to advise investors with a high risk-tolerance to sell Brent's downside price risks or to add exposure to longer-dated Brent oil contracts.

Section 4

Appendix

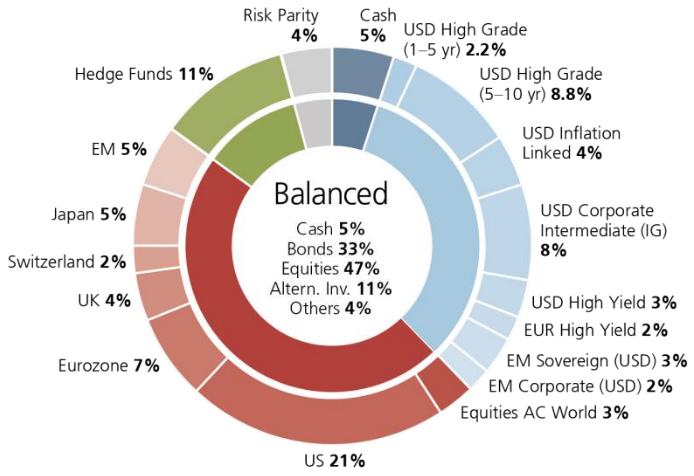
Strategic Asset Allocations (SAAs)

EUR (local portfolio)



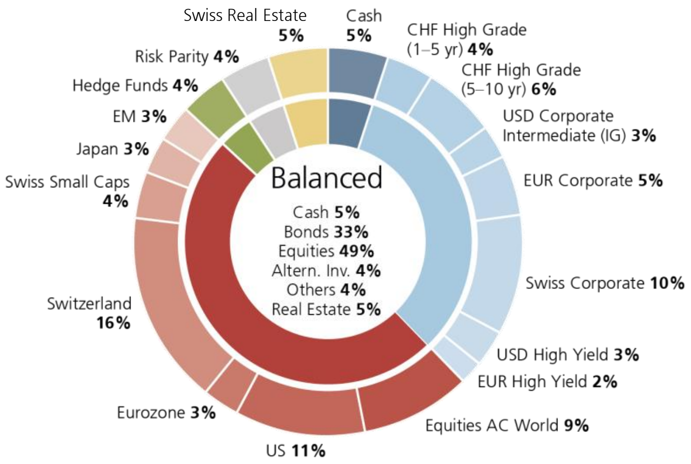
Note: Portfolio weightings are for EUR SAA with a home bias and a balanced risk profile. We expect a balanced EUR SAA to have an average total return of 5.7% p.a. and a volatility of 8.7% p.a. over the next 15 years.

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 6.4% p.a. and a volatility of 8.8% p.a. over the next 15 years.

CHF (local portfolio)



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 8.6% p.a. over the next 15 years.

Source: SAA as of January 2024

For illustrative purposes only. The above asset classes and allocations are indicative only and can be changed at any time at UBS's discretion without informing the client. All expected returns are p.a. and reflect the arithmetic mean of the estimated return distribution. Risk is measured as annualized volatility of monthly log-returns. Annualized expected risk and return figures are forward-looking and not a reliable indicator of future performance. Forecasts are not a reliable indicator of future performance / results. Please always read in conjunction with the glossary and the risk information at the end of the document.

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Risk information

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