

UBS House View

Monthly Letter | 21 March 2024 | Chief Investment Office GWM, Investment Research

Optimize tech exposure

Investors should hold diversified, strategic exposure to the technology sector, while remaining mindful of the risks of overconcentration.

Seek durable income

With the Fed and other major central banks on track to cut interest rates this year, investors should ensure their portfolio income streams are sustainable.

A balanced approach

We believe that diversifying across asset classes, regions, and sectors is the best way to navigate short-term market dynamics and grow long-term wealth.

Asset allocation

Within equities, we favor quality stocks and hold a constructive view on the US technology sector. In fixed income, we also prefer quality.



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The next stage

As we approach the end of the first quarter, equity markets are buoyant, and a strong US economy has diminished expectations for rate cuts. Despite geopolitical uncertainties, cross-asset volatility has remained low. Looking ahead to the second quarter, we see the next stage of two primary market drivers playing out: the start of rate-cutting cycles by major central banks, and the broadening-out of AI adoption and implementation across a wider range of companies.

Against this backdrop, we believe investors' key focus should be on: 1) getting their exposure to the technology sector right; 2) ensuring that portfolio income streams are sustainable; and 3) employing effective portfolio risk management techniques.

What does that look like in practice?

First, it's important to hold a diversified strategic exposure to the technology sector and to some of the likely winners from tech disruption. We foresee 18% earnings growth for the global technology sector this year and 72% annualized growth in AI revenues over the next five years. The rising excitement over artificial intelligence and its implications could lead to a scenario in which future gains are frontloaded. Investors looking to grow wealth should ensure they have exposure to this space.

But equally, after such a strong run in AI-related stocks, the risk of overconcentrating portfolios has risen. Structured strategies can play a role in helping investors manage downside risks in tech. For those looking to diversify, we see opportunities beyond technology—in quality stocks across regions; in alternative growth themes like the energy transition, healthcare disruption, and water scarcity; and in small- and mid-cap stocks.

Investors should ensure they have exposure to durable income streams.

Second, although the US economy has remained strong and inflation has surprised to the upside, we still expect the Federal Reserve to cut interest rates in the coming months, likely starting in June. The Swiss National Bank announced a 25-basis-point rate cut in March, and other major central banks are also on track to start easing policy. To prepare portfolios, investors need to be proactive and shift their cash and money market holdings toward more durable sources of income, including fixed-term deposits, short-term bond ladders, and medium-duration high-quality bonds. We expect major currency pairings to continue to trade in their recent ranges, presenting opportunities for investors to generate added income through tactical currency trades.

Third, effective risk management is key. The temptation to manage risk by simply cashing in on gains or retreating to the sidelines may be strong, but history favors those who pursue a more balanced approach. We believe that only by diversifying across asset classes, regions, and sectors can investors effectively manage the tension between navigating short-term market dynamics and growing long-term wealth.

For more on these ideas, please refer to the *UBS House View Quarterly*, also published alongside this Monthly Letter. In the rest of this letter, I will discuss three of the big questions investors are asking today: 1) Is tech in a bubble, and what to do now?; 2) Soft landing or no landing, and where next for the Fed?; and 3) How to manage risks with markets at all-time highs?

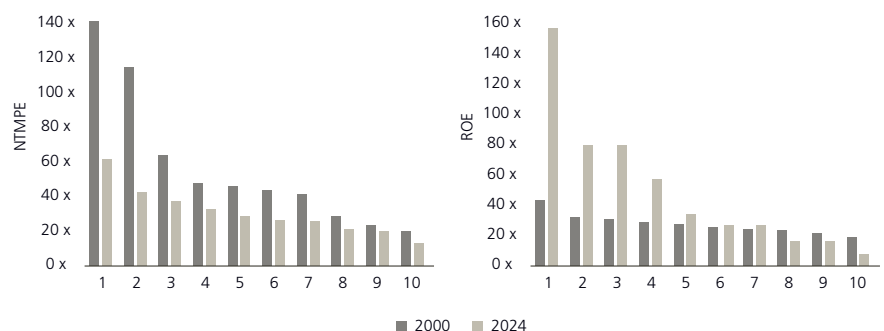
Tech stocks have continued to rally in 2024.

Is tech in a bubble, and what to do now?

The global tech sector (MSCI ACWI Information Technology Index) has gained 12% year-to-date after rallying 50% in 2023. Mega-caps Meta and Nvidia are up 43% and 82%, respectively, this year. Are we in a bubble?

On a simple one-year earnings horizon, the tech sector does look expensive relative to its own history. Its 12-month forward price-to-earnings (P/E) ratio of 26.8x sits at a roughly 37% premium to its long-term average. Yet that still compares favorably to the Nasdaq 100's peak of around 60x at the height of the dotcom bubble in 2000. We also believe the rally is on a firmer foundation this time around, with profitability higher and valuations lower at the market's largest companies, many of which also enjoy dominant market positions. With many of the largest companies in the industry already present across multiple stages of the AI value chain, we think the big firms have a good opportunity to get even bigger as AI deployment continues.

Figure 1
The top 10 stocks in the S&P 500 have lower valuations and higher profitability than in 2000
Left: Top 10 stocks in the S&P 500 by market cap, ranked by valuation (NTMPE*), in 2024 vs. 2000.
Right: Same comparison based on profitability (return on equity).



*NTMPE = Next-12-months P/E ratio
Source: Factset, UBS, as of March 2024

We expect AI demand to grow at a 72% annual rate over the next five years.

Ultimately, whether or not tech is overvalued rests on your view of the sector's prospective growth. At the start of the year, we increased our forecast for global AI revenue by 40%. We currently expect a 72% annual growth rate in AI demand—a fifteenfold cumulative increase—over the next five years. To put that in context, it took the smart device industry more than 10 years to grow its revenues by 15 times. AI should take only five years, and if our estimates prove accurate, then the valuation of AI infrastructure companies (based on the MSCI ACWI IT index) is only 20x 2027 P/E.

Is that reasonable? Well, consider the following:

In the market for GPUs—the graphics processing units that power technologies like gaming and AI applications—we expect the imminent launches of new AI chip products to command higher pricing and buoy margins given the expansion in demand. We can see a parallel development to when Apple raised iPhone prices above USD 1,000 in 2017 from the USD 600–800 range of the previous five years. This move underpinned a breakout in Apple's share price from a five-year range of USD 20–40 to ever higher levels in a sustained manner.

With broadening AI demand and rising trends in monetization, we expect strong growth for AI applications and models. Microsoft, for example, is charging businesses USD 30 per month per user for its Copilot generative AI application. If half of the 400 million Office 365 users today adopted Copilot, it would increase Microsoft's revenue by 30% compared to a year ago. Our estimates for the applications and models segment (using lower 30% penetration rates for copilots) point to revenues for the industry increasing from USD 2.2 billion to USD 225 billion in the five-year period from 2022–27—a 152% annual growth rate or a hundredfold increase over the period.

In short, the earnings growth potential in AI is real, could be very large, and could make today's valuations look reasonable. But with growth expectations high, so is the scope for disappointment.

We recommend holding diversified exposure to the tech sector.

Against this backdrop, how should you position? In our view, investors should hold some diversified strategic exposure to the technology sector and the likely winners from tech disruption. In the latter category, we like AI infrastructure companies that have strong pricing power and competitive market positions, as well as platform and application beneficiaries that are well placed for AI-related use cases.

For investors overexposed to tech—i.e., those with a higher-than-benchmark market-cap allocation to the global technology sector—we see opportunities to diversify, focusing on three key areas. First, we think that quality companies—including regional champions in Europe and Asia—with strong balance sheets, high profitability, and exposure to resilient earnings streams will continue to deliver strong results in the months ahead. Second, we recommend seeking companies exposed to other major structural growth themes, including the energy

transition, healthcare disruption, and addressing water scarcity. Third, we have a constructive view on US small-cap stocks given their discounted valuations and potential catalysts such as Fed rate cuts, increased M&A, and stronger earnings growth. We also see opportunities in select European small- and mid-cap stocks.

Recent US economic data have remained resilient.

Soft landing or no landing, and where next for the Fed?

A few months ago, much of the debate about the next phase for the US economy was whether it would stage a hard landing or a soft landing after an impressive run of growth and resilience. Most recent data have not only dispelled fears of a hard landing, but they have also added credence to the prospect of “no landing.”

As a result, markets have scaled back their expectations for Fed rate cuts this year, to about 83 basis points at the time of writing from as much as 170 basis points earlier in the year. The 10-year US Treasury yield has thus risen to 4.3% from 3.86% at the start of the year.

What does that mean from here? A no-landing scenario is plausible, in our view, particularly if the combination of a tight labor market, increased capital spending, and AI deployment supports a continued surge in productivity. We note that US labor productivity has risen over the past year, growing 3.2% in the fourth quarter, with the five-year rolling average now at 2.1%—its highest in over a decade, excluding pandemic-related data distortions in 2020.

That said, such a secular improvement in productivity, while plausible, is likely to take more than a few months to evolve. So despite the recent strength in US headline data—nonfarm payrolls expanded by 275,000 in February and inflation edged up to 3.2% from 3.1% in January—we still think it makes sense to position for a soft landing, factoring in moderating growth, receding inflation, and declining interest rates.

Economic growth appears to be moderating from an unsustainable pace.

The US economy appears to be moderating back toward trend growth from an unsustainable pace. It was running at an annualized 4% rate in the second half of 2023, while the Atlanta Fed’s GDPNow model is tracking growth of a much lower 2.1% for the first quarter of 2024. This is positive news for the disinflation outlook.

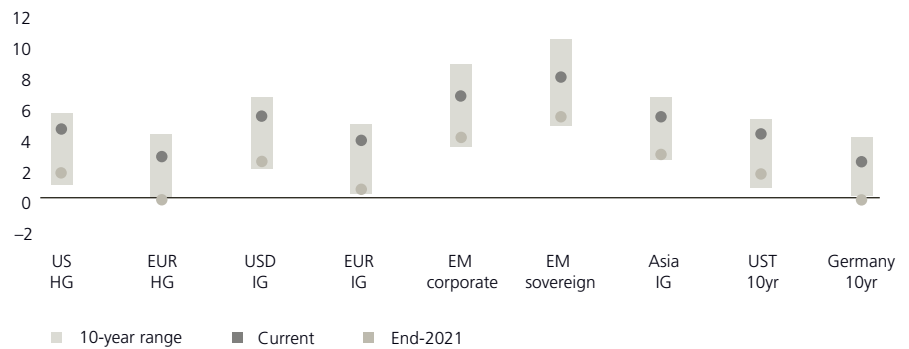
Meanwhile, the February jobs report, although strong, also showed signs that the labor market is cooling: The unemployment rate rose to 3.9%, the highest in two years, and growth in average hourly earnings slowed to just 0.1% month-over-month. The Atlanta Fed’s wage growth tracker shows that increases for job switchers moderated to 5.3% in February (based on the three-month moving average) from 5.6% in January (versus 4.7% in both months for workers who remained in their jobs).

We think a softer labor market and more muted shelter inflation will help turn the overall CPI inflation trend lower in the coming months. Fed Chair Jerome Powell has stressed that the US central bank is “not far” from having sufficient confidence to cut rates. In our base case, we expect 75 basis points of cuts this year, starting in June, with further reductions in 2025.

Figure 2

Yields are still attractive

10-year range (gray columns) vs. current yields and their end-of-2021 low, in %



Source: Bloomberg, UBS, as of March 2024

We expect bond yields to fall through the balance of the year.

As the market shifts its focus back toward a soft landing and the Fed starts cutting rates, we would expect bond yields to fall, and we forecast the US 10-year yield to decline to 3.5% by year-end from 4.3% today, implying a total return of 9.3%. Bond markets could rally even more if US economic growth starts to disappoint. At the time of writing, markets are implying that the federal funds rate will trough at roughly 3.5%, though we would expect it to be potentially much lower if growth slows below trend.

This backdrop means that now is an attractive time for investors to lock in still-elevated yields, benefit from potential capital gains if yields fall, and diversify portfolios against risks. We think it is important to take steps to prepare portfolios for lower interest rates—in particular, by ensuring they have exposure to durable income streams:

First, as interest rates decline, cash will progressively deliver lower returns, creating a risk for investors who do not proactively manage their liquidity. We therefore recommend diversifying liquidity holdings beyond cash and money market funds into a combination of fixed-term deposits, bond ladders, and certain structured investment strategies.

We continue to see an attractive risk-reward outlook for quality fixed income.

Second, we continue to see an attractive risk-reward outlook for quality bonds (including government and investment grade corporate bonds). The high level of outright interest rates on the asset class will be a key source of total return. As short-end policy rates look set to fall and downside risks to growth are nonnegligible, we also see potential for capital gains.

Third, we expect major central banks to cut rates broadly in tandem. The Swiss National Bank announced a 25-basis-point rate cut at its March meeting, while other central banks—including the European Central Bank, the Bank of England, and the Bank of Canada—are also expected to ease policy in the coming months. We therefore think major currency pairings will continue to trade in their recent ranges, and this provides investors with an opportunity to generate additional income in currency markets. For example, with the US dollar likely to remain caught between decent US growth and the prospect of Fed rate cuts, euro-based investors can consider using periods of EURUSD weakness to sell downside risks in the pairing.

We believe the fundamental backdrop remains supportive of markets.

How to manage risks with markets at all-time highs?

The fundamental backdrop is supportive of markets, in our view, and cross-asset volatility has remained low. But investor sentiment is still likely to be susceptible to a range of economic and market risks.

Inflation concerns are back in focus following higher-than-expected US inflation in February. The Russia-Ukraine and Israel-Hamas wars are ongoing. Meanwhile, US President Joe Biden and former President Donald Trump have the backing of enough delegates to clinch their parties' official nomination as candidates for November's presidential election, and headlines around the campaigns are likely to create market volatility.

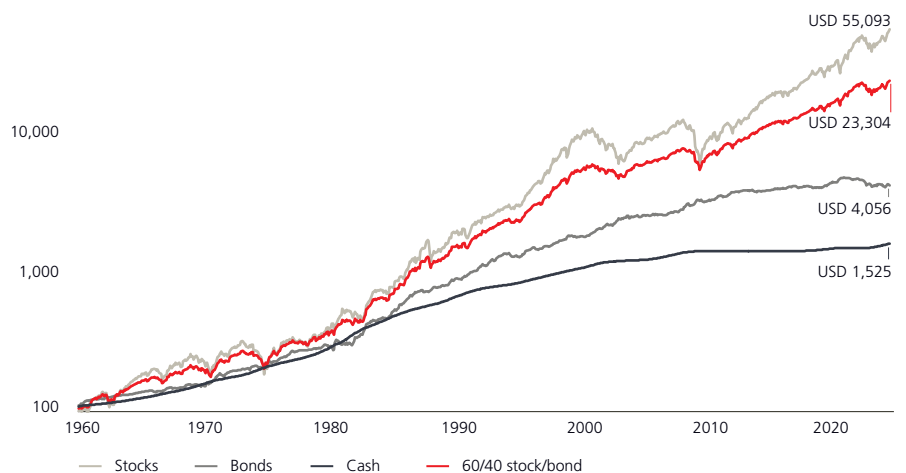
History favors being invested and hedging risks, rather than selling out or staying uninvested.

Against this backdrop, and with major equity indexes trading near all-time highs, it can be tempting for investors to manage risks by taking profits or staying on the sidelines. Yet history has shown that being invested and hedging risks is preferable to selling out or staying uninvested. Data since January 1960 show that a USD 100 investment in US stocks would have grown to USD 55,093 by February 2024. Adjusted for inflation, this represents a 52-fold increase in purchasing power, or an annual real return of 6.3% since then.

Figure 3

Staying invested leads to wealth creation over the long term

Growth of USD 1 invested in stocks (US large caps), bonds (Treasury's Intermediate), cash (1–3-month T-bills), and a 60/40 balanced portfolio since 1960, log scale



Source: Ibbotson, UBS, as of March 2024

Diversification across asset classes, regions, and sectors remains key.

Capital preservation strategies can help investors manage their equity exposure.

We see three broad ways that investors can manage the tension between navigating short-term market risks and growing long-term wealth.

The first and most fundamental principle is to diversify across asset classes, regions, and sectors. The UBS Global Investment Returns Yearbook, which analyzes financial markets going back to 1900, shows that an equity portfolio that is diversified across 21 countries would have 40% less risk than a single-country investment.

Similarly, a portfolio with a 60/40 split between stocks and bonds has historically been less volatile than one composed solely of stocks. Indeed, a 60/40 portfolio has only delivered a negative return over a five-year horizon on 5% of occasions, and never over a 10-year horizon (compared with 12% and 5% of the time for equity-only portfolios).

The second is to consider specific strategies that can help investors position for further upside while shielding against losses. For example, the current combination of low implied equity market volatility and high bond yields makes it more cost-effective to implement capital preservation strategies. We see this as particularly appealing for medium-term horizons in areas of the equity market where the upside potential may be strong but investors may also want to protect against downside risks (e.g., in technology stocks).

The third is to remember that diversification does not simply mean stocks and bonds. Alternative assets including hedge funds, private markets, and infrastructure can help smooth portfolio returns. We currently see opportunities in strategies that offer unique sources of return (credit hedge funds), provide access to fast-growing companies (private equity), and align with powerful long-term trends like digitalization and decarbonization (private infrastructure and thematic private equity funds).

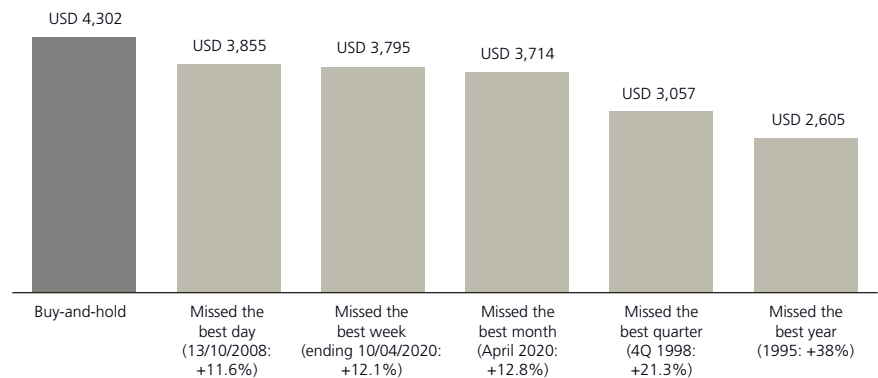
Investment ideas

As we navigate a year that promises to be historic for financial markets, our guiding principles remain steadfast: a commitment to long-term thinking, diversification, and the belief that time in the market trumps timing the market.

Figure 4

Trying to time the market has a cost

Growth of USD 100 invested in the S&P 500 (total return) in April 1988, buy-and-hold strategy vs. missing gains as a result of exiting the market.



Source: Bloomberg, UBS, as of March 2024

Our ideas for this month focus on: 1) getting exposure to the technology sector right; 2) ensuring that portfolio income streams are sustainable; and 3) employing effective portfolio risk management techniques.

Messages in Focus

Optimize tech exposure	The AI revolution is here. Investors can't afford to be underinvested, and optimizing exposure to technology is key. We think this involves a diverse strategic exposure to the sector, balancing a focus between the beneficiaries of tech disruption and sector leaders including "Asia's Super 8." The current environment of high interest rates and low volatility also presents an opportunity to use structured solutions to position for further upside while protecting against downside.
Opportunities beyond technology	While we hold a constructive view on technology, investors need to be mindful of concentration risks and overexposure. For those diversifying beyond technology, we see opportunities in quality companies (including regional champions in Europe and Asia); the energy transition, healthcare disruption, and water scarcity; and small- and mid-cap stocks. Exposure to these ideas can also be built up through structured investments.
Manage liquidity	We expect interest rates to fall in 2024. This means cash will progressively deliver lower returns, creating a risk for investors who do not proactively manage cash holdings. We believe investors should build a liquidity strategy beyond cash and money market funds, in favor of a combination of fixed-term deposits, bond ladders, and structured investment strategies to cover expected portfolio withdrawals over the next five years.
Buy quality bonds	We keep a preference for quality bonds. Robust economic growth and elevated inflation have kept bond yields high in recent months. But we expect yields to fall over the balance of the year as growth and inflation moderate. That makes now an attractive time to lock in yields, benefit from potential capital gains if yields fall, and diversify portfolios against risks. Beyond individual bonds, active and diversified bond exposure can provide investors with a convenient way to realize the full return potential of the asset class while managing credit and concentration risks.
Generate income with currencies and commodities	We believe that major currency pairings are likely to continue to trade in established ranges as most major central banks are set to cut interest rates in tandem. This presents an opportunity for investors to generate added portfolio income by trading the range in currencies, as well as in select commodities.
Get in balance	Investors today are grappling with a complex financial environment. Some worry that the stock market has reached its peak, leading them to hold too much cash. Others may be overly focused on specific sectors, risking too much concentration in their portfolios. Against this backdrop, getting in balance is a key principle. We believe that only by diversifying across asset classes, regions, and sectors can investors effectively manage the tension between navigating short-term market dynamics and growing long-term wealth.
Diversify with alternatives	Alternative assets should be a key component of long-term portfolios, in our view. They can help diversify return sources and smooth portfolio returns. We currently see opportunities in strategies that offer unique return sources (credit hedge funds), provide access to fast-growing companies (private equity), and align with powerful long-term trends like digitalization and decarbonization (private infrastructure and thematic private equity funds).



Mark Haeefe
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Global forecasts

Economy

Real GDP y/y, in %

	2023E	2024E	2025E
US	2.5	2.2	1.4
Canada	1.1	0.2	1.3
Japan	1.9	0.5	1.2
Eurozone	0.5	0.6	1.2
UK	0.1	0.2	1.5
Switzerland	0.8	1.3	1.5
Australia	2.1	1.5	2.1
China	5.2	4.6	4.6
India	7.6	7.0	6.8
EM	4.5	4.1	4.4
World	3.3	3.0	3.1

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

	2023E	2024E	2025E
US	4.1	3.1	2.4
Canada	3.9	2.5	2.1
Japan	3.3	2.2	1.8
Eurozone	5.4	2.4	2.1
UK	7.3	2.3	2.0
Switzerland	2.1	1.4	1.2
Australia	5.6	3.3	3.1
China	0.2	0.8	1.6
India	5.1	4.5	4.5
EM	7.4	8.3	5.1
World	6.1	5.8	3.8

Source: Bloomberg, UBS, as of 21 March 2024. Latest forecasts available in the *Global forecasts* publication, published weekly.

Asset classes

	Spot	Dec-24
Equities		
S&P 500	5,225	5,200
Eurostoxx 50	5,000	4,900
FTSE 100	7,737	7,780
SMI	11,619	11,640
MSCI Asia ex-Japan	648	685
MSCI China	55	58
Topix	2,751	2,770
MSCI EM	1,032	1,100
MSCI AC World	940	940
Currencies		
EURUSD	1.09	1.12
GBPUSD	1.28	1.30
USDCHF	0.89	0.87
USDCAD	1.35	1.31
AUDUSD	0.66	0.71
EURCHF	0.97	0.97
NZDUSD	0.61	0.62
USDJPY	151	140
USDCNY	7.20	7.15

	Spot	Dec-24
2-year yields, in %		
USD 2y Treas.	4.60	3.25
EUR 2y Bund	2.92	2.00
GBP 2y Gilts	4.22	3.50
Swiss 2y Eidg.	0.97	0.70
JPY 2y JGB	0.18	0.25
10-year yields, in %		
USD 10y Treas.	4.27	3.50
EUR 10y Bund.	2.43	2.25
GBP 10y Gilts	4.01	3.50
Swiss 10y Eidg.	0.71	0.70
JPY 10y JGB	0.73	0.80
Commodities		
Brent crude, USD/bbl	86	82
Gold, USD/oz	2,161	2,250

Source: Bloomberg, UBS, as of 21 March 2024. Latest forecasts available in the *Global forecasts* publication, published weekly.

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

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