UBS House View

Monthly Extended May 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 "

Please see the important disclaimer at the end of the document.

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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Section 1

Investment views

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 the United Kingdom.

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. We stay neutral on the remaining major currencies.

Equities
We maintain a neutral view on global equities. Solid macroeconomic data and improving earnings lifted global equities to fresh all-time highs in late March. The flip side is that inflation pressures did not abate as quickly as anticipated and even started to tick marginally higher again in the US, which weighed on the asset class in April. Inflation is a near-term risk but should keep falling in the medium-term in our view.

We also believe 2024 earnings will rebound further. AI beneficiaries should continue to lead, but we expect other sectors to increasingly contribute as well. That said, the equity risk premium remains low, while rate and geopolitical uncertainty is high.

We stay neutral in all major regions but introduce a most preferred view on the UK.

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

Although inflation has printed higher in recent months, we continue to see it on a downward path as the drivers of lower inflation on the goods, rent, and labor market side remain encouraging. Additionally, the recent rise in longer-term rates and expectation that rate cuts are only likely later in the year will transmit into the real economy through tighter financial conditions. This should put downward pressure on growth and inflation, and hence add to the appeal of high-quality bonds.

Foreign exchange
Surprisingly, solid US economic data and reduced expectations for Federal Reserve rate cuts are supporting the US dollar, which has strengthened marginally within well-established ranges. Our most preferred G10 currency with upside potential against the USD remains the Australian dollar.

We view the Swiss franc as least preferred. Swiss interest rates are very low and motivated the Swiss National Bank's to cut rates preemptively. The need for CHF appreciation to defend against imported inflation has faded.

The backdrop for high-yielding currencies remains in place, mainly in the crosses. Our favorite is the Brazilian real. In frontier markets, exposure to the Egyptian pound looks attractive for investors with a high risk tolerance.

Commodities
Our benchmark UBS CMCI total return index is up by around 8% this year, supported by a strong contribution across all sectors.

We expect total returns of 8-10% for broad commodity indexes over the next 6 to 12 months, with all subsectors contributing to performance. This outlook is supported by a recovery in global industrial activity, the prospect of lower interest rates, and commodity-specific supply-side constraints, which should combine to push prices higher.

A likely undersupplied market—given solid demand and OPEC+ supply discipline—underpins our positive view on oil, and we see Brent crude prices trading in a range of USD 85–95/bbl over our forecast horizon. We also see scope for gold prices to rise further by the end of the year, with a December price target of USD 2,500/oz. We believe both oil and gold have value in a portfolio context, particularly to help hedge geopolitical risks.

Section 1.2

Risk scenarios

Key scenarios – December 2024

	Upside: Roaring 20s	Base case: Soft landing	Downside: Overheating	*Things to watch*
Probability	20%	60%	20%	
Market path	**Bonds flat, equities up** Equity markets rally amid strong US growth, moderating inflation, and optimism about the impact of AI on earnings. Bond yields trade close to current levels by year end.	**Bonds up, equities slightly up** Bond markets rally by the end of the year as a renewed fall in US inflation contributes to lower interest rate expectations. Equity markets move moderately higher by year end.	**Bonds down, equities down** A mix of US growth staying "too good," fiscal policy concerns, and a commodity price spike drives the US 10-year yield to rise to 6%. Fears about the impact of tighter monetary policy lead global equities to post double-digit losses.	
Economic growth	The US grows above the trend rate of about 2% as labor markets, household balance sheets, and corporate earnings prove resilient. Elsewhere, improving European growth and fiscal stimulus in China could contribute to a strong global growth picture.	US economic growth moderates to a level close to trend growth over the next 12 months. Other Western economies experience sub-trend growth, in line with market expectations. China announces targeted measures to support economic activity.	Continued above-trend near-term growth in the US and sticky inflation push bond yields higher, increasing the risk of weaker growth in future. Economic growth elsewhere in the world underwhelms expectations.	*Global: Consumer spending* *US: Savings rates* *US: Housing starts* *US, Europe: Delinquency ratios* *US, China: PMI data* *US, Europe: Industrial production*
Inflation	Resumes decline in the US and continues to fall in Europe, reaching central bank targets earlier than expected.	Resumes decline in the US and continues to fall in Europe, normalizing by 2H24.	Inflation stays sticky (or reaccelerates). Robust near-term US growth or a commodity price shock are potential drivers.	*Global: Oil price* *US: CPI and PCE inflation* *US: ISM prices-paid subindex* *US: Average hourly earnings* *US: Change in nonfarm payrolls* *US: JOLTS openings and hires* *Eurozone: HICP inflation*
Central banks	Start cutting policy rates in mid-2024 as inflation normalizes. The Fed cuts rates by 50bps in 2024, with cuts in September and December. Strong growth may limit expectations for cuts thereafter.	Start cutting policy rates in mid-2024 as inflation normalizes. The Fed cuts rates by 50bps in 2024, with cuts in September and December. Markets expect deeper cuts in 2025 and 2026 amid slowing growth and inflation.	Fed hikes interest rates towards 6-6.5%. Other central banks potentially slow down their rate cutting cycle. Markets fear rates remaining 'higher-for-longer'.	
Financial conditions	Ease thanks to increased risk appetite in financial markets, as a favorable growth-inflation mix is priced in.	Ease gradually amid building expectations of upcoming monetary easing.	Tighten, increasing the risk of financial system stress and systemic events.	*Global financial conditions* *Bank lending surveys*
Geopolitics	A de-escalation in the Middle East crisis and in the Russia-Ukraine war, and/or an improvement in bilateral relations between the US and China could contribute to this scenario.	The Middle East crisis remains geographically contained. The Russia-Ukraine war continues. The US election contributes to volatility, particularly at a sector level, but the net effect on broader markets is limited.	The Israel-Hamas war turns into a regional conflict with potential for greater disruption to oil supply. Fears about US fiscal policy contribute to higher bond yields. An escalation in the Russia-Ukraine war or heightened US-China tensions could also contribute to this scenario.	*Middle East crisis and oil supply* *US election season* *US fiscal policy* *Territorial moves by Russia* *Weapon shipments to Ukraine* *US sanctions on Chinese companies*

Asset class targets - December 2024

Key targets for December 2024	spot*	Upside	Base case	Downside
MSCI AC World	921	995 (+8%)	940 (+2%)	800 (-13%)
S&P 500	5,071	5,500 (+8%)	5,200 (+3%)	4,400 (-13%)
EuroStoxx 50	5,008	5,400 (+8%)	4,900 (-2%)	4,200 (-16%)
SMI	11,469	12,300 (+7%)	11,640 (+1%)	10,000 (-13%)
MSCI EM	1,019	1,150 (+13%)	1,060 (+4%)	880 (-14%)
Fed funds rate (upper bound)	5.50	4.50	4.88	6.25
US 10y Treasury yield (%)	4.60	5.00	3.85	6.00
US high yield spread**	320bps	300bps	400bps	500bps
Euro high yield spread**	359bps	325bps	400bps	550bps
US IG spread**	80bps	70bps	100bps	130bps
Euro IG spread**	110bps	100bps	120bps	160bps
EURUSD	1.10	1.12 (+2%)	1.09 (-1%)	1.02 (-7%)
Commodities (CMCI Composite)	1,875	2,100 (+12%)	1,960 (+5%)	1,500 (-20%)
Gold***	USD 2,328/oz	USD 2,250/oz (-3%)	USD 2,500/oz (+7%)	USD 2,750/oz (+18%)

* Spot prices as of market close of 23 Apr 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.

Section 1.3

Asset class preferences and themes

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.

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.

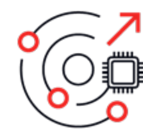
Messages in Focus

Take advantage of tech volatility

The recent sell-off in technology stocks provides a potential opportunity for investors who are underinvested in the technology sector and the AI revolution. We advocate diverse strategic exposure to the sector and hold a most preferred view on tech, balancing the beneficiaries of tech disruption (incl. AI) with sector leaders including "Asia's Super 8." Structured strategies can help investors position for further upside while protecting against downside, or earn income while awaiting a potentially better entry point.

- *Global technology stocks*
- *Technology disruption (incl. AI)*
- *"Asia's Super 8"*
- *Structured strategies on technology stocks*

Source of funds
- Cash and money markets
- Address equity portfolio biases
- Excess US technology exposure
- Excess individual tech stock exposure



Opportunities beyond technology

Beyond the technology sector, we advocate a focus on quality stocks, including Europe's Magnificent 7, alternative growth themes (including the low carbon transition, healthtech, and ocean economy), and small and mid caps. We expect the quality style and select growth themes to deliver resilient earnings growth. Meanwhile, better-than-expected economic performance should support small and mid cap earnings, where relative valuations are close to multi-decade lows.

- *Quality stocks (including 'Europe's Magnificent 7')*
- *Alternative growth themes (low-carbon transition, healthtech, blue economy)*
- *Small- and mid-caps (including US small-caps, European small- and mid-caps, ESG engagement)*
- *Structured investments (yield-generating and capital preservation)*

Source of funds
- Cash and money markets
- Excess US technology exposure

Manage liquidity*

Interest rates look likely to stay higher-for-longer in the US, but not forever. We expect cash to deliver progressively lower returns over the coming two years, creating a reinvestment risk for investors who do not proactively manage cash holdings. We believe investors should build a liquidity strategy beyond cash and money market funds, including 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 and money markets
- Maturing investments

Buy quality bonds

We keep a preference for quality bonds. Robust economic growth and elevated inflation have driven bond yields higher in recent months, improving potential returns for investors in quality fixed income. Investors can benefit from attractive yields and potential capital gains if yields fall (as we expect), and diversify portfolios against equity market risks. Beyond individual bonds, active and diversified fixed income exposure can provide investors with a convenient way to realize the full return potential of the asset class while managing global interest rate, credit, and concentration risks.

- *Quality bonds (HG and IG)*
- *Sustainable bonds including MDB bonds*
- *Active and diversified bond exposure*

Source of funds
- Cash and money markets

*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.

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Messages in Focus

Generate income from currencies and commodities

Cross-asset volatility has increased in recent weeks. That provides investors an opportunity to boost portfolio income via volatility selling strategies. In currencies, with uncertainty around rate cut timings, we see value in income-generating strategies in the USD, British pound, and the euro. The Australian dollar also looks poised to make gains vs. the USD. We also like strategies that take advantage of the trading ranges within commodities, with gold and crude oil particularly interesting.

- *Generate income from USD, EUR, GBP, and CNY*
- *Structured solutions on oil and gold*

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

Get in balance

Investors 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.

- *Balanced portfolios*

Source of funds
- Cash
- Maturing investments

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, particularly when equity-bond correlations are positive as they are today. 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).

- *Infrastructure*
- *Hedge funds (specialist credit, equity long-short, macro, and multistrategy)*
- *Private equity (secondaries, buyout, and thematic growth) and credit*

Source of funds
- Cash
- Maturing investments

Key investment ideas by asset class

Asset class	We like	Source of funds
Equities	• Global technology stocks • Technology disruption • "Asia's Super 8” • Quality stocks (incl. Europe’s Magnificent 7) • Alternative growth themes (Energy transition, healthcare disruption, blue economy) • Small- and mid-caps (including US small-caps, European small- and mid-caps, ESG engagement)	CIO least preferred equities, excess cash
Bonds	• Quality bonds (investment grade and high grade) • Sustainable bonds including MDB bonds • Fixed term deposits • Bond ladders • Active and diversified bond exposure	Excess cash, excess EM/HY bonds
Foreign exchange	• AUD • Generate income from USD, EUR, GBP, and CNY	CHF
Commodities	• Active commodity exposure • Oil • Generate income from oil and precious metals	Excess cash
Hedge funds, private markets	• Infrastructure • Hedge funds (specialist credit, equity long-short, macro and multistrategy) • Private equity (secondaries, buyout, and thematic growth) and credit	Excess bonds and equities, excess cash

Section 2

Macro economic outlook

Global economy – Moving slowly toward cuts

Base case (60%)

Growth

Economic growth is likely to slow from current levels as fiscal drag and the lagged effect of past interest rate increases reduce activity. The resilience of middle income consumers and the relative stability of the labor market prevents a severe economic slowdown from occurring. Consumption patterns continue to be biased towards fun rather than goods spending, which means that economic growth is likely to remain unevenly distributed within economies. Monetary policy is likely to follow inflation lower – the restrictive nature of monetary policy is not consistent with slowing inflation and some growth moderation.

Inflation

Market forces continue to push inflation lower across the major economies. Technical measurement issues and administered prices are the main props to inflation at the moment. This suggests that monetary tightening has had sufficient impact (because market-derived prices have fallen) and further declines in inflation will have less of an impact on consumer spending power (because they represent declines in prices consumers do not actually pay).

Positive case (20%)

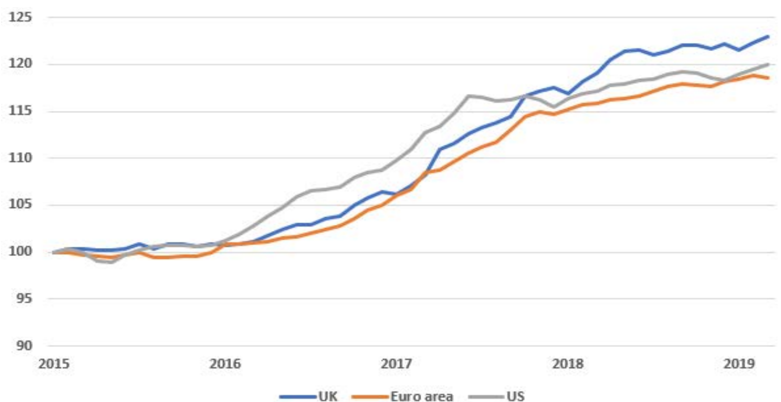
The positive scenario is an enhanced version of existing trends. Real wage growth is supported by a sharper slowdown in inflation. Low unemployment gives consumers in advanced economies confidence to accelerate rather than stabilize spending. Investment increases more rapidly in new technologies and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

Negative case (20%)

A more rapid tightening of credit standards and higher costs of borrowing for existing debtors lead to a sharper slowdown in consumer demand as spending power is eroded. Concerns about the cost of credit slows borrowing for middle-income consumers as well as lower-income groups. Fear of unemployment starts to increase, resulting in higher precautionary savings. This compounds the risks to growth.

Developed economy inflation followed a similar path

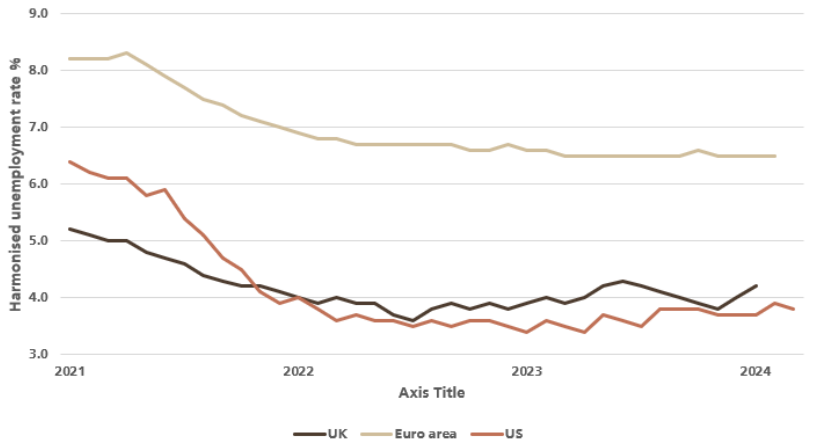
Harmonised index of consumer prices, January 2020 = 100



Source: Haver, UBS, as of 21 April 2024. The harmonized measure treats components (especially housing) in a similar way. The US measure includes some price discounting not included in UK or Euro area measures

Inflation fell without unemployment rising

Harmonized unemployment rates



Source: OECD via Haver, as of 21 April 2024

US economy – Consumer spending remains strong

Base case (60%)

Growth

Growth has remained above-trend since 3Q22, led by consumer spending. More households have used up the excess savings built during the pandemic, while credit card balances have risen rapidly despite high interest rates. We expect consumer spending to moderate, although rising real disposable income, driven by labor income, should continue to provide support. Our base case remains a soft landing, but we have pushed back the timing of the first Fed rate cut from June to September.

Inflation

Monthly inflation prints were low in 2H23 but have been higher so far in 2024. Inflation is being driven by service prices, which are more sensitive than goods prices to rising labor costs. Wage growth has been trending lower, which should help to ease inflationary pressure over the medium term. Businesses report that consumers are pushing back against further price increases, and we still expect to see better news on inflation in the months ahead.

Positive case (20%)

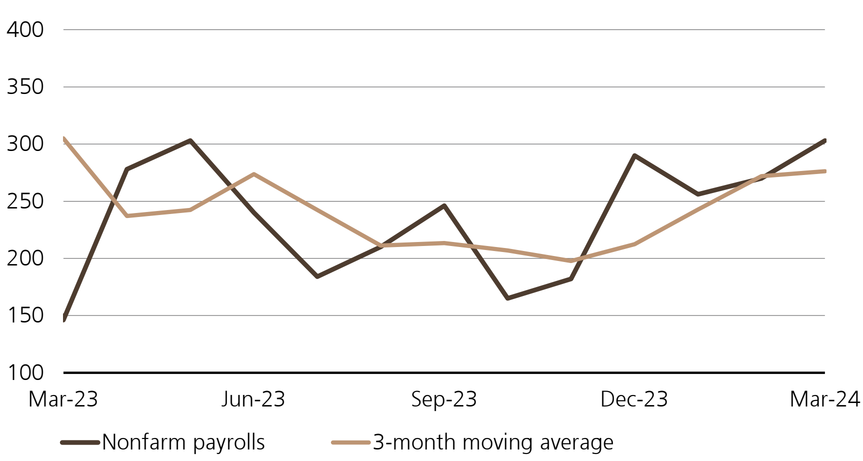
Better labor supply allows businesses to fill their open job positions while wage growth continues to moderate. Consumer spending remains robust, encouraging business to keep investing in new capacity and to continue hiring more workers. The Fed sees enough progress toward its mandates to start cutting 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, reinforcing 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.

Payroll growth has been strong

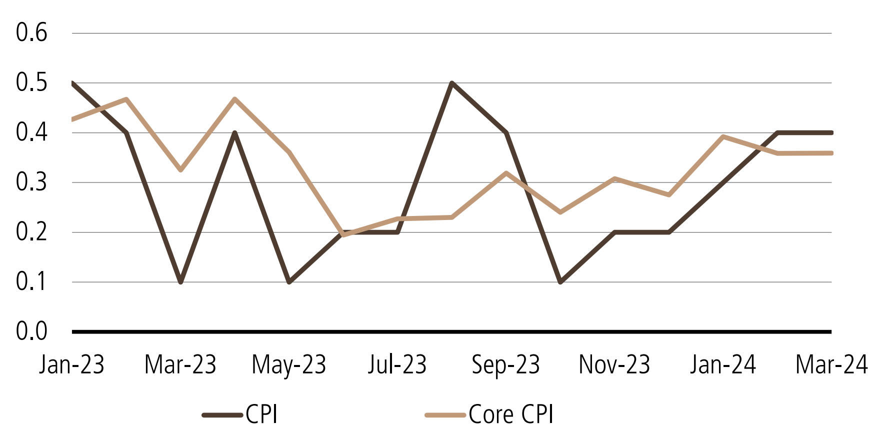
Nonfarm payrolls, month-over-month change, in thousands



Source: Bloomberg, UBS, as of 22 April 2024

Higher inflation prints so far in 2024

CPI and core CPI, month-over-month change, in %



Source: Bloomberg, UBS, as of 22 April 2024

Eurozone economy – Set for the cutting cycle

Base case (60%)

Growth

Sentiment surveys are showing mild improvement, but they remain at low levels. Likewise, hard data might have experienced further contraction in Q1. In our view, the economy is set to remain on its current sideways trend in the coming months, then start 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 European Central Bank (ECB) projects. Some modest volatility in inflation could persist 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 starting 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.

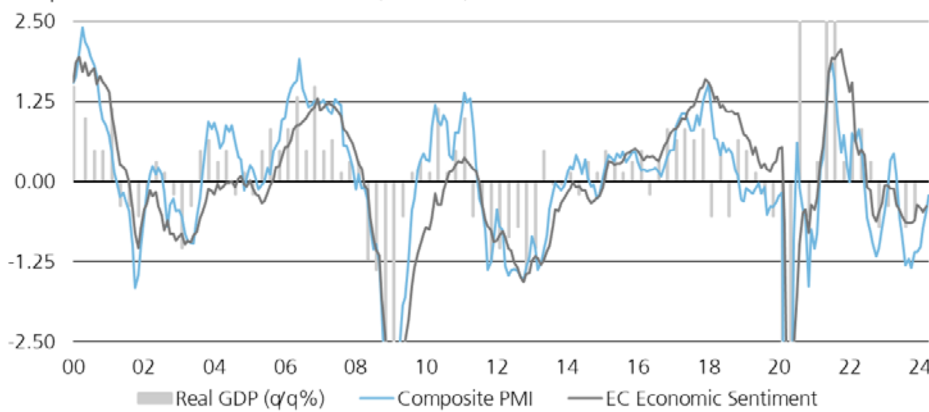
Economic growth in Asia and the US accelerates, with the latter avoiding a recession, boosting demand for Eurozone exports.

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.

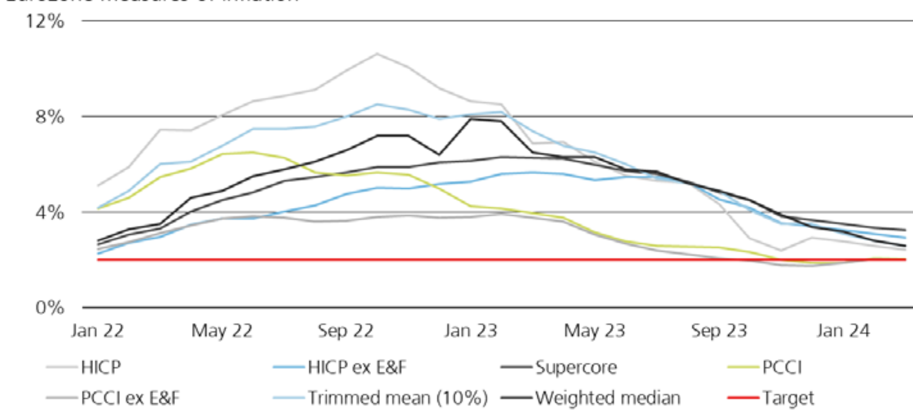
Geopolitical tensions force energy prices materially higher, leading to renewed supply-push inflation that induces a real income loss and a tighter monetary stance.

Recent sentiment data support expectations for a modest improvement in activity, but hard data has been mixed



Source: Haver Analytics, UBS, as of 23 April 2024

Measures of underlying inflation continued to ease in March, despite the inflationary impulse from the early Easter season



Source: Haver Analytics, UBS, as of 23 April 2024

Swiss economy – SNB kicks off rate-cut cycle

Base case (70%)

Growth

Swiss GDP grew 0.8% in 2023 and we expect it to grow a still-below-average 1.3% in 2024. A gloomy economic outlook for the Eurozone is weighing on industrial sentiment. External demand improved recently, but our export barometer is still in negative territory, pointing to below-trend growth in the months ahead. Domestic demand looks more solid on the back of robust employment growth and declining inflation.

Inflation

Inflation averaged 1.2% in 1Q24, well below the SNB's forecast of 1.8%. Lower-than-expected inflation allowed the SNB to cut rates in March by 25bp to 1.5%. With muted inflation risks and other central banks starting to cut rates in the coming months, we expect two further rate cuts of 25bp each, in June and September. After that, the SNB is likely to leave its policy rate unchanged at 1%.

Positive case (15%)

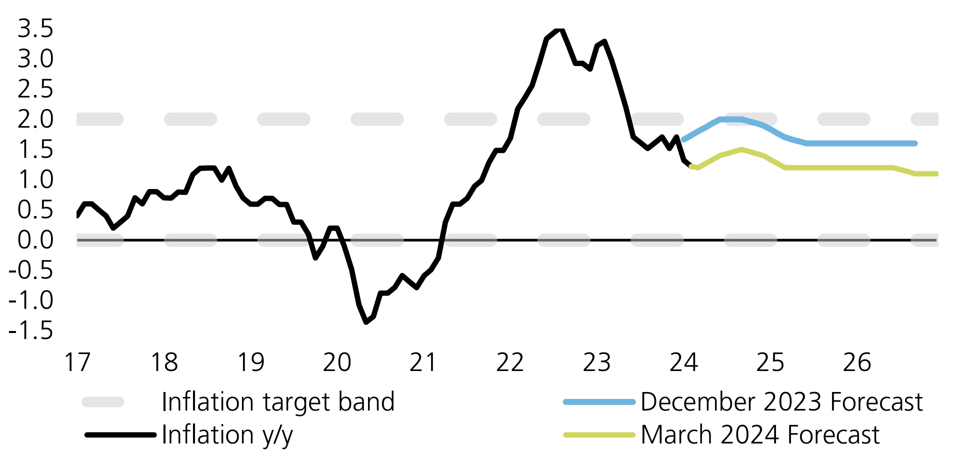
Better global growth momentum: Growth in the US remains strong. Lower-than-expected inflation allows global central banks to cut rates early. Switzerland benefits from the stronger global backdrop and a weakening of the safe-haven Swiss franc.

Negative case (15%)

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

Inflation much lower than expected

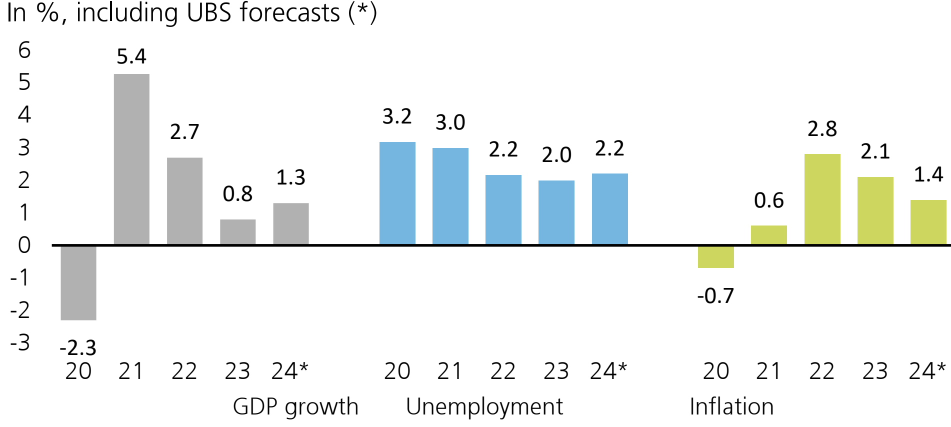
Inflation, y/y, and conditional SNB inflation forecast (conditional on stable policy rate), in %



Source: Macrobond, UBS, as of 23 April 2024

Swiss economic data

In %, including UBS forecasts (*)



Source: Macrobond, UBS, as of 23 April 2024

Analysts: Alessandro Bee, Florian Germanier, Maxime Botteron

Chinese economy – A strong start on manufacturing strength

Base case (70%)

Growth

1Q GDP beat expectation at 5.3% y/y, mainly driven by manufacturing strength. Fixed asset investment growth edged up to 4.5%y/y, led by manufacturing and infrastructure. Retail sales eased to 4.7% y/y against a high base, but likely to pick up in 2Q given recent robust holiday spending. Export growth improved to 1.5% y/y on tech upcycle and better external demand. Credit growth dipped to 8.7% y/y on a high base but could pick up from 2Q with stronger government bond issuance.

Full-year GDP growth is tracking closer to "around 5%" target. Policy support will likely focus on implementation of announced measures, preluding new major stimulus unless we have much worse data.

Inflation

CPI inflation retreated to 0.1% y/y in March with soft goods demand and may reach a full-year average of about 0.5%. PPI stayed in deflation(–2.8%) and may stay negative through 1H24.

Positive case (15%)

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

Geopolitical risks ease with improved communications between China and the US post Xi-Biden talk at the APEC summit.

The US economy achieves a soft landing.

Negative case (15%)

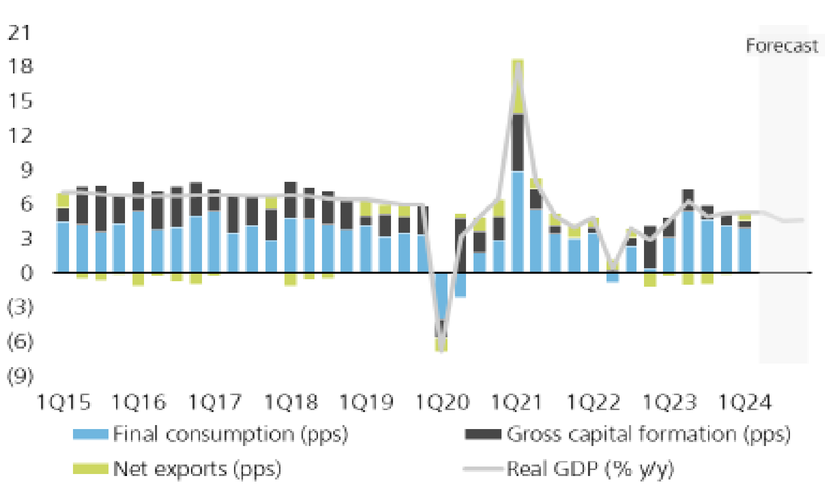
Property activity continues to deteriorate despite supportive policies.

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.

A strong start on manufacturing and export recovery

GDP growth breakdown



Source: CEIC, UBS, as of April 2024

Recent travel spending per capita finally exceeded 2019 level

Domestic tourism travelers and spending during holidays

Source: Ministry of Culture and Tourism, UBS, as of April 2024

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. Solid macroeconomic data and improving earnings lifted global equities to fresh all-time highs in late March. The flip side is that inflation pressures did not abate as quickly as anticipated and even started to tick marginally higher again in the US. Against this backdrop, markets began questioning the potential for rate cuts this year, which led to higher interest rates and lower equity prices so far in April. The moves were exacerbated by technical factors (equities looked short-term overbought late March) and by rising geopolitical tensions in the Middle East. Despite near-term risks, we remain confident a soft landing can be achieved and expect global equities to deliver mid-single digits returns by the end of the year. We maintain a neutral allocation in our portfolios.

The earnings outlook continues to improve. Robust nominal growth supports our base case that a soft landing is the most likely outcome. Against this backdrop, earnings likely troughed in 2023, and we expect them to reaccelerate in 2024. Tech sectors should lead the growth as they harvest the fruits of their cost cutting measures from 2023 and also benefit from rapid developments in the AI space. That said, contribution should broaden, with all sectors but energy expected to deliver positive earnings growth in 2024. The ongoing Q1 earnings season is still early stage but started on a solid footing. For 2024 as a whole, consensus earnings per share (EPS) growth is at 9% for MSCI ACWI, broadly in line with our own estimates.

Equities no longer welcome rising yields. For most of 2H23, equities and interest rates have been negatively correlated. This relationship temporarily flipped in 1Q24 as inflation concerns somewhat fell in the background and equity markets essentially focused on the improved growth/earnings outlook. However, after three consecutive upside surprises in US CPI, inflation concerns resurfaced and equities again reacted negatively to rising yields in April. Further inflationary pressure that would derail the expected central bank easing cycle is the main risk to the asset class in our view. That said, the hawkish repricing of the Fed appears advanced and we expect yields to edge lower from here. Medium-term inflation risks are skewed lower in our view amid moderating demand, slowing wage growth and easing supply conditions.

Valuations high but not extreme. MSCI ACWI's 12-month forward price-to-earnings ratio currently trades at 17.0x, roughly 0.7 standard deviation above its 10-year average. While not extreme in a historical context, it remains on the high side and could reduce the potential for rerating that may come from lower yields. Looking at other metrics, the equity risk premium remains low in a historical context, especially against fixed income markets.

Mixed tactical indicators, stretched positioning. Despite the recent pullback, global equities are trading comfortably above their 200-day moving average, highlighting a solid price momentum picture. Investor positioning plateaued at elevated levels while short-term tactical indicators such as the 30-day relative-strength index have normalized from stretched levels seen at the end of March to roughly average readings.

UK equities from least to most preferred. UK equities trailed their global peers by 14% in 2023 and another 1% year-to-date, dragged by lower commodity prices, high policy rates and weak economic growth. But we believe the tide is turning and expect EPS growth to recover from -11% in 2023 to +4% and +7% in 2024 and 2025 respectively. With the improving global manufacturing outlook, we have positive views on oil and industrial metals, which should boost profit of under-owned commodity sectors. In addition, the outlook for domestic consumption is likely to improve amid a resilient labor market and normalizing inflation. The latter should allow the BoE to start cutting rates from August onwards, which should help equity valuation rebound from currently low levels (12m forward P/E is currently at 11.0x, almost 1 standard deviation cheaper than its 10-year average).

Emerging markets back to neutral. Emerging markets gained 5% in the past three months, showing signs of recovery. But the potential for outperformance has weakened as sticky inflation led to a hawkish repricing of the Fed and a stronger USD. Trade friction between EM countries and the US could also flare up as we get closer to the US election. As a result, we decide to move the region back to neutral

Equities

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: Cease-fires 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: 800

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

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: UK

Bonds

Preference: Most preferred

Developed market bond yields broke higher over the last month by 20–30bps, weighting on total returns. The catalyst was another hotter US CPI print, indicating that the disinflationary progress has now stalled. This as a consequence has seen Fed rate cut expectations paired back and now the market is only expecting between one and two cuts this year. Contrary to the US, other key developed markets have seen ongoing progress on inflation and rate cuts continue to be expected around the middle of the year. This is seeing some divergence build between different rate markets.

Despite the performance setback, we continue to expect the Federal Reserve to cut rates later this year. Key items in the CPI basket that have remained elevated, such as shelter, we expect to begin to roll over. Additionally, the number of items in the CPI basket where prices are growing less than 3% is increasing, the PCE measure of inflation is much lower than CPI, and wage growth is steadily slowing. These are all arguments to ease the currently restrictive policy, particularly if the Fed wants to avoid a sharper economic slowdown. We are constructive on fixed income as the starting yields provide an ample buffer against ongoing volatility, and in the event of a growth shock, there is scope for significant capital appreciation.

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 to be absorbed by the private sector. In October last year, we observed a pickup in term premiums 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 some of the need for the private sector to absorb the net additional supply and a sharp rundown of excess reserves, which could generate instability in the banking system.

Within the fixed income asset class, we maintain 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 and emerging market (EM) credit. Higher-beta credit segments have seen some widening in spreads after the repricing of Fed rate-cut expectations. This has reopened some value; however, at this stage, we remain neutral tactically as spreads remain relatively tight. Read more

High grade bonds: We keep HG bonds as most preferred. Inflation is well off its peak, but the disinflation process appears to have stalled and weighted on returns in recent weeks as rate cut expectations have been pushed out. Despite this, we believe monetary policy is restrictive and continuing to transmit into the real economy. So, we believe the next move from central banks will be to lower rates, as we have already seeing in parts of Europe. This is a favorable backdrop for duration risk. Since the outright level of rates is high, we see an attractive asymmetric absolute return profile in light of the current inflation and growth mix. High grade bonds are rated AA- or better, and therefore have minimal default risk, as such we expect them to perform well in the event of a sharper economic slowdown. 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 5.5%. 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 eventually the focus will return towards 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 6.8%, 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 yields. 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. However, EM bond spreads appear moderately expensive, which makes the asset class vulnerable to setbacks, including risks arising from inflation and fiscal outlooks. Rising geopolitical uncertainty could dent risk sentiment further. 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

Extrapolating US dollar strength is tempting: Solid economic growth in the US, higher Federal Reserve rates for longer, and geopolitical risks in Europe, the Middle East, and Asia all speak for US-linked assets and therefore robust USD demand. Upgrades to economic growth outside the US, if any, have been marginal. Most importantly, central banks in the developed world are ready to start cutting rates from 2Q or 3Q onward. As monetary policy diverges in the short run, the backdrop for a stronger greenback for longer is well-supported. So, we stick to our guidance to keep USD longs unhedged and look for incremental strength from here.

The follow-up question then revolves around the magnitude and the duration of this US dollar strength. On the former, we think gains should be incremental. First, the currency's starting position is already rich. In real trade-weighted terms, the USD is not cheap and stands at levels comparable to the mid-1980s or the early 2000s, leaving little room for further upside, in our view. So, in the absence of extreme events—like the Ukraine-Russia war and the blowout in natural gas prices in 2022—we struggle to call for a further USD rise beyond the low-single digits.

Repricing the dollar meaningfully higher due to higher US yields would require larger interest rate shifts. In recent months, an increase in US yields led the dollar to marginal USD strength in trade-weighted terms. The real risk case for a materially stronger USD isn't the lack of rate cuts, but rather renewed rate hikes. We believe this scenario—of the Fed raising rates to 6% or higher—remains an unlikely outcome, with average financial conditions for US households and consumers still tightening and wage growth slowing.

In this context, it's worth highlighting that growth expectations for the US and its trading partners have diverged materially, yet USD strength has stayed within well-established ranges. The impact of positive US news is likely to be marginally negative. We would also argue that the reaction function of currency markets to relative growth dynamics is asymmetric. In other words, weaker US GDP growth or better growth outside the US should have a more material (negative) impact on the USD. Rather elevated speculative positions in dollar longs via the futures market also underpin this view.

The relative growth aspect is an important factor to consider when gauging how long the US dollar's strength can last. In our base case, we still see relative growth dynamics converging—i.e., US growth moderates, while growth in the Eurozone picks up in 2H. The growth convergence should be modest, but sufficient to bring EURUSD back toward 1.09, the upper end of our guided trading range, if the Fed cuts rates toward year-end as inflation eases and growth slips below trend in the US.

This topping out of dollar strength into 3Q also allows USD investors to engage in volatility-selling strategies to pick up additional yield. The rise in option volatility across the asset class is clearly helpful in deploying such strategies. Still, the shifts higher have been rather modest so far. This leaves currency markets with a still-depressed volatility backdrop. So, where should investors sell volatility, then? We see scope for this strategy in AUDUSD, USDNOK, USDJPY, and XPTUSD.

As for other G10 currencies, we think that low yielders, like the CHF or the JPY, will continue to struggle to deliver performance in the short run. While CHF and JPY weakness looks extended from a longer-term perspective, the negative carry remains a total return drag. Once clarity emerges on the first rate cut by the Fed, we look for a trough in the CHF and the JPY. In that context, we expect better returns in the AUD and to some degree in the GBP, where rate cuts are likely to materialize toward year-end or should be more shallow.

For emerging market currencies, geopolitical worries and the general reassessment of the Fed outlook were negative. Currencies that had attracted investors' interest in recent months and were well positioned like the Mexican peso, the Brazilian real, and the Polish zloty were hard hit. The Israeli shekel, first and foremost, remains exposed to developments in the Middle East conflict. The highly managed status of the CNY has led to its strength in the crosses.

Because we expect the Fed rate-cutting cycle to be delayed, but not canceled, once it is approaching and then underway, it should relieve some pressure on emerging market currencies and benefit high-carry currencies again. We currently like the Brazilian real for its high nominal and real carry and supportive trade balance. And for investors willing to venture even further into the emerging and frontier market space, we think the Turkish lira and the Egyptian pound are good additions to diversified portfolios. The narrative for the CNY is different. With upside risks to USDCNY to 7.35 and the CNY offering a negative carry, we advise investors to hedge their long CNY exposure.

FX

The biggest risk to our short-term USD view is a rapid fall in US GDP growth, which would put investor focus on structural USD negatives and the currency's elevated valuation. The speed at which the US economy slows matters. If it doesn't slow because consumer demand or fiscal spending comes in strong ahead of the US presidential election, current market expectations for lower US rates could still be revised higher.

Conversely, a hard landing for the US economy 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-related currencies, 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 still watching longer-dated US yields and the US fiscal deficit, which seems to be too high without the market commanding a higher term premium. A further rise in the 10-year US Treasury yield above 5% could keep the USD on a path of further strength. However, 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. Still, we have yet to see any signs of this scenario for the US economy or the USD.

In emerging markets, we are concerned about the persistent downward pressure on the CNY. A larger devaluation of the CNY, while not expected, would have broader implications for the currency market, especially Asian currencies.

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.

Crude oil shows muted reaction to geopolitical tensions. Oil prices have been volatile in recent weeks due to geopolitical tensions in the Middle East, but the price reaction has been relatively muted compared to previous episodes, mostly due to high available spare capacity. As per history, geopolitical risk premiums have tended to be fleeting if there are no actual production losses or supply chain disruptions. With oil demand rising seasonally, we continue to see the oil market as being undersupplied, and we target a rise in Brent crude oil to USD 91/bbl by mid-year.

Macro tailwinds and tightening fundamentals should support industrial metals. With recent PMI data beating expectations and a modest rebuild cycle in inventories underway, we think the case for stronger 2H global manufacturing activity is taking shape. As such, we see scope for high-single-digit upside to industrial metal prices over coming months, supported by firmer demand and supply-side constraints. Copper remains our metal of choice, while we see a recovery in nickel much further out. The main risks to our positive industrial metal view continue to stem from China's struggling property sector.

We remain positive on the long-term outlook for gold. This year's rally in gold has evolved without the traditional support from ETF buying—something we expect to see once US rate cuts are more certain. We target a price of USD 2,500/oz at the end of this year and continue to see gold as a longer-term diversification asset. Investors should keep existing positions or add new ones on pullbacks.

La Nina risks return. Another year of elevated wheat production in Russia continues to weigh on the overall grains sector. However, elevated short positioning and rising prospects of a return of La Nina see us revise up our expectations for corn and soybean prices in 2024–25. Conversely, supply shortfalls in cocoa and coffee, while acute now, could ease in 2025. Livestock remains underpinned by further tightness in live cattle supply.

Where to invest

Benefit from optimized rolling of commodity futures. Our strategy aims to systematically generate returns by being long a second-generation commodity index while being short a first-generation commodity index. This allows investors to generate yield through the outperformance of the second-generation index. With little sensitivity to individual commodity spot moves, the strategy also provides investors with diversification benefits.

Diversify with gold. We continue to recommend investors use gold as a diversifier, despite being neutral in our global asset allocation. Within a balanced USD portfolio, our analysis shows around a mid-single-digit percentage as most optimal.

Volatility-selling strategies. On an individual commodity level, we see opportunities to engage in selling downside in crude oil, silver 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. An improving economic outlook coupled with expectations of easing interest rates provides a supportive backdrop for Eurozone equities. However, after strong performance, we expect further gains from here to be more modest.

We believe the earnings backdrop remains broadly supportive. It's early days, but the Eurozone results season has started reasonably well with corporate profits coming in ahead of consensus expectations so far. We believe earnings have bottomed and should improve from here (especially in real terms), supporting Eurozone equities. But we expect the earnings recovery to be relatively slow, in line with our economic growth assumptions, and lower inflation should weigh on growth rates in nominal terms. We forecast 3% earnings growth this year (consensus 3%) and 4% in 2025 (consensus 10%).

Falling inflation, easing financial conditions, bottoming manufacturing activity, and reasonable equity valuations (MSCI EMU trades at 13.0x forward P/E, versus the 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 given the robust labor market, falling inflation, and we expect the European Central Bank to cut interest rates in the near future. Eurozone small- and mid-caps should benefit from easing credit conditions and bottoming activity, with relative valuations at 20-year lows. 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 mid-sized 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 pivot from policy tightening to easing.

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: 4,200

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

After a very strong first quarter, the S&P 500 has reversed a bit in the first three weeks of April. We believe the pullback has been largely driven by the rapid move higher in interest rates, which tends to weigh on stocks. Elevated sentiment and positioning measures have likely amplified the selloff. The rate increases come on the heels of strong economic data and somewhat hotter inflation readings. Still, we think the environment for US stocks remains favorable driven by: 1) solid and broadening profit growth, 2) disinflation, 3) the end of Fed rate hikes and a likely pivot to rate cuts, and 4) surging investment in AI infrastructure and applications.

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 (e.g., 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. As a result, we expect earnings growth to start to broaden out beyond the Magnificent 7. First-quarter reporting season has gotten off to a good start. In the quarter, we look for 4–6% EPS growth for the S&P 500 (7–9% growth excluding a non-cash one-time charge from a pharmaceutical company). Our 2024 and 2025 S&P 500 EPS estimates remain USD 245 (+9% y/y) and USD 260 (+6% y/y), respectively.

While inflation readings in the first quarter were a bit hotter than expected, we think the disinflation trends remain in place. Pricing power for corporate America continues to moderate, wage pressures are easing, consumer inflation expectations remain well contained, and the shelter component of the government's inflation data should continue to ease. This should enable the Fed to start cutting interest rates later this year. We expect two rate cuts in 2024, with the first one in September. With the Fed now in a position to cut rates in case economic 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, unleashing 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 overall, we believe the environment remains supportive, and after the recent pullback, the risk-reward for US equities is looking more appealing. We retain our year-end S&P 500 price target of 5,200 and our neutral allocation to US equities in our tactical asset allocation.

Sector preferences

Most preferred

Healthcare: This is our preferred defensive sector driven by solid earnings growth. As the year progresses, certain segments should potentially benefit from a pickup in earnings growth. Drugmakers are facing patent expirations on several large products, but promising new drug therapies in large untapped end markets, such as obesity and Alzheimer's, offer an offset.

Industrials: The sector should benefit from resilient economic growth, an improvement in manufacturing business sentiment, a bottoming in cyclical areas such as transport, 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.

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: 4,400

Inflation stays sticky and tighter monetary policy: Robust near-term US growth or a commodity price shock potentially causes inflation to be stickier or to reaccelerate. This prompts the Fed to hike interest rates towards 6–6.5% and markets fear rates remain "higher-for-longer".

Higher rates weigh on economic growth: Solid near-term economic growth in the US and sticky inflation push bond yields higher, increasing the risk of weaker growth in the future. Consumer spending softens, pressuring corporate earnings growth.

Geopolitical turmoil: Escalation in geopolitical tensions—including the Israel-Hamas war potentially turning into a regional conflict, the Russia-Ukraine war, or heightened US-China tensions—leads to a risk-off environment and flight to quality.

Sector preferences

Least preferred

Real estate: The sector looks slightly expensive relative to real interest rates, which are a key driver of sector valuations. 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 exposure to some secular growth drivers.

UK equities

Preference: Most preferred

Central scenario

FTSE 100 December 2024 target: 8,500

The outlook for UK equities is improving, and we have upgraded UK equities from least preferred to most preferred. With the improving global manufacturing outlook, we have positive views on oil and industrial metals, which should boost profits for the UK's commodity-linked sectors. In addition, the outlook for domestic consumption is likely to improve amid a resilient labor market and normalizing inflation. The latter should allow the Bank of England to start cutting rates from August on, which should help equity valuations rebound from currently low levels.

After an 11% fall in earnings last year, we expect UK earnings to return to growth this year. We have raised our earnings growth forecast for this year from +2% to +4% after the recent rise in oil and copper prices, and see a further acceleration to 7% growth in 2025 driven by improving profits for commodities and banks, alongside an improving UK economy.

The FTSE 100 trades at 11.0x forward P/E with a 4.1% dividend yield. Valuations are attractive relative to the long-run average forward P/E for the FTSE 100 of 12.8x since 1987. Much of that value is in the energy (8.1x P/E) and financials (7.6x P/E) sectors, on concerns about the sustainability of their profits. So, recovering oil prices and an improving outlook for bank profits should be supportive. The rest of the market trades at around 13.9x forward P/E—while this is not cheap, we view these businesses as high quality, and they look relatively attractive to other global quality stocks.

Three ways to invest in UK equities: We like broad-based exposure to the UK for its relatively attractive valuations, improving domestic outlook and commodity exposure. But there are three themes in particular that stand out to us: 1) position for a consumer-led recovery amid a resilient labor market and normalizing inflation—the latter should allow the Bank of England to start cutting rates from August; 2) we prefer UK banks to Eurozone banks with the outlook for net interest income improving as we go through 2024; 3) underappreciated UK quality stocks with high and stable returns, good free cash flow, solid balance sheets and reasonable growth prospects.

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.

Upside scenario

FTSE 100 December 2024 target: 9,000

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.

Downside scenario

FTSE 100 December 2024 target: 7,000

Lower oil prices: If oil prices fall, 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 around 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 11% over the 2021–23 period due to the global economic slowdown and significant currency losses. This year, we expect 7.5% earnings growth, supported by robust organic sales growth; margin improvements, particularly in the healthcare, consumer staples, and financials sectors; cost-cutting measures; and no major 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 as well, and consequently leading to currency losses for Swiss companies.

From June 2022 to June 2023, the Swiss National Bank (SNB) hiked its prime interest rate five times to mitigate inflation pressures. Higher interest rates supported the Swiss franc, which indeed was strong last year. On 21 March, the SNB cut its rate as a result of domestic inflation rates moderating significantly. This move has been softening the Swiss franc. As a result, this will support Swiss corporate profits (in CHF), of which 90% are generated in foreign currencies. We thus expect negative currency effects to moderate significantly from 2Q24. Moreover, we forecast further SNB rate cuts later this year.

Swiss equity valuation multiples trade at around a 10% premium to their 25-year average, which we think caps further upside potential for now. 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 still 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, exporters 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 significantly.

Downside scenario

SMI December 2024 target: 10,000

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

Central scenario

MSCI EM December 2024 target: 1,060

We rate emerging market equities as neutral in our global strategy. Although economic activity in emerging markets continues to surprise to the upside while inflation moderates, the delay in the Federal Reserve’s interest rate cutting cycle has clouded the near-term outlook. Higher US rates along with elevated geopolitical concerns are also weighing on emerging stocks’ risk premium.

We forecast low-single-digit returns from companies in the region in 2024, on the back of solid mid-teens earnings growth yet somewhat lower valuation multiples until we have more clarity on the timing of the Fed’s policy pivot. This means we expect emerging markets to perform in line with global peers.

At a sector level, we continue to like the EM tech space. The 1Q24 earnings season has so far beat expectations, especially on the strong revenue and profitability guidance around artificial intelligence, despite some cautiousness in the non-AI related tech segment. We think recent market weakness provides an attractive entry opportunity to key leaders in the emerging market tech space, especially in Taiwan and Korea.

From a geographic standpoint, we rate Indonesia and Hong Kong as most preferred. We continue to expect positive macroeconomic and corporate dynamics to take the driver's seat in Indonesia. In addition, we also like Hong Kong equities as the property sector appears on track to recover, and valuations are reaching levels close to those seen during the global financial crisis, which we don't see as justified.

From a thematic angle, we like environmental, social, and governance (ESG) leaders in emerging markets. We think these stocks can help mitigate downside risks and they present attractive valuations. For investors with a multiyear time horizon, we recommend exposure to three thematic opportunities: frontier markets, emerging market infrastructure, and emerging market healthcare.

CIO themes

ESG matters in emerging markets

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

Emerging market equities

Upside scenario

MSCI EM December 2024 target: 1,150

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

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

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

Downside scenario

MSCI EM December 2024 target: 880

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 and the Middle East would hurt emerging market assets.

Market preferences

Most preferred

Indonesia, Hong Kong, Information Technology

Least preferred

Malaysia, Thailand

Japanese equities

Central scenario

TOPIX December 2024 target: 2,800

We are neutral on Japanese equities in our global strategy. TOPIX has fallen 7% since its recent peak on 22 March, underperforming the MSCI ACWI after a strong rally of 18%. This is likely due to international investors pausing after two significant macro events in March: the labor union wage hike and the BoJ's historic shift to policy normalization. Additionally, a risk-off sentiment has emerged due to hotter-than-expected US inflation data and escalating geopolitical concerns. While international investors have taken profits in recent weeks, Japan is just beginning to experience inflation and rising wages after 30 years of deflation.

Fundamentals remain solid, with corporate governance reforms continuing to be a key driver. In the short term, they include deploying cash surpluses to enhance shareholder returns and unwinding cross-shareholdings. We anticipate an acceleration of such corporate actions during the announcements of full-year results and mid-term plans. Structural reforms aimed at achieving a higher ROE are expected to be a long-term catalyst, potentially leading to a sustained revaluation of Japanese equities.

Valuations have become more reasonable, in our view. Despite ongoing earnings revisions, the P/E ratio has adjusted to 15.2x from 16.4x. Although the current P/E remains above the historical average of 13.7x, the discount to the MSCI ACWI (17.7x) has widened, surpassing the long-term average.

Focus remains on fundamentals and quality. We continue to favor large-cap banks and real estate companies, which stand to benefit from Japan's inflation, a robust domestic economy, and corporate governance reforms. We are also optimistic about cyclical stocks that have not yet caught up. The domestic retail sector is likely to become more attractive in the second half of 2024 as real wages begin to increase.

Upside scenario

TOPIX December 2024 target: 2,900

Higher ROE: Greater increases in the unwinding of cross-shareholdings and share buybacks, business portfolio restructuring, or increased investments to raise the return on equity (one of the Tokyo Stock Exchange's aims) and profit margins prompt Japanese equities to rerate in the longer term.

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

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

Downside scenario

TOPIX December 2024 target: 2,300

Elevated inflation and 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.

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

Earlier- and higher-than-expected BoJ rate hike: While we expect policymakers to proceed with caution and keep policy rates at 0–0.1% throughout 2024, more aggressive hiking without sustainable wage and inflation is a downside risk.

Asian ex-Japan equities

Central scenario

MSCI Asia ex-Japan December 2024 target: 667

Asian central banks are likely to delay rate cuts to 3Q/4Q this year, following the Fed. Growth in Advanced Asia is off to a solid start to the year, while Emerging Asia has been relatively weaker. We anticipate that growth across the entire region will return to trend in the second half. Currently, regional PMIs are mixed, with no decisive trend yet. As a result, we believe it is still too early for a directional trend in the Asia ex-Japan equity market to form. We remain focused on relative opportunities, and keep Hong Kong and Indonesia as most preferred, and Thailand and Malaysia as least preferred.

Indonesia remains most preferred. We continue to see macro strength in Indonesia, where manufacturing PMIs are consistently above 50 and even edged higher to 54.2 in March. Earnings are strong too, with forward 12-month EPS maintaining a steady uptrend. The bank sector's loan growth remains strong, while net interest margins (NIM) may continue to see pressure given the prospect of a local rate cut from Indonesia central bank has been reduced amid a resilient US yield environment. Currency depreciation is a risk to watch, but the risk has reduced after the recent top-up hike, therefore does not change our positive macro outlook for now. Domestic micro loan development is also a risk to monitor. Key events to watch in the near term include the release of monthly bank results and a central bank decision in late April.

Hong Kong remains most preferred. Macroeconomic conditions remain stable, with PMIs rising higher to 50.9 in March. After the easing of housing measures in February, property transaction volumes have rebounded strongly from bottom, and property prices have shown initial signs of stabilization. Dividend yields offered by the market continue to be very attractive, reaching historic highs not seen since 2008. Although the market has been challenged by the delay in Fed rate cuts and investor concerns over the share buyback program of a heavyweight domestic insurer, we believe the bulk of the headwinds have been priced in at a forward price-to-earnings ratio close to global financial crisis levels. We are closely monitoring the major insurer's upcoming results in late April, which could provide a good opportunity for the firm to manage investors' expectations.

On the other hand, Thailand remains least preferred. The market underperformed Asian peers from both a currency and domestic equity perspective. Macro conditions continue to be weak, with PMIs stuck below the 50 level eight months in a row. Forward 12-month earnings estimates remain in a downtrend. Consumption is weak, and the digital wallet stimulus has been postponed to 4Q this year. The THB is one of the biggest currency laggards in Asia year-to-date, and Thailand's central bank has refrained from cutting policy rates to stimulate the economy. Although total tourism numbers have recovered steadily and the government has also stepped up easing in the property sector, we believe near-term upside risks are limited.

Finally, Malaysia also remains least preferred. Malaysia has been underperforming Asia peers. The market continues to be limited by a weak macroeconomy, with PMIs in March deteriorating to 48.4 from 49.5 in March. Similarly, forward 12-month EPS is also in a downtrend. The market usually outperforms during risk-off environments, but upside catalysts in the near term appear limited.

Asian ex-Japan equities

Upside scenario

MSCI Asia ex-Japan December 2024 target: 705

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 US 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 as tech is a key component of MSCI Asia ex-Japan.

Downside scenario

MSCI Asia ex-Japan December 2024 target: 550

US rates will stay higher for longer

If US rates cut process is slower than expected or even hike rates toward 6-6.5% by end 2024, Asian equities could be negatively impacted.

Escalation in geopolitical conflicts and US-China tension

A further escalation of the conflict between Iran and Israel will contribute to a risk-off move in equity markets. Risk sentiment would also weaken If US adds sanctions on Chinese firms or financial conditions.

Stronger US dollar

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

Market preferences

Most preferred: Hong Kong, Indonesia

Least preferred: Thailand, Malaysia

Analysts: Adrian Zuercher, Chun Lai Wu, Vanny Wang,

High grade

Preference: Most preferred

Central scenario

10-year US Treasury yield December 2024 target: 3.85%

With inflation and wage growth well off its peaks, major central banks ended their rate hikes last year 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 volatility is being generated as the market looks to price the timing and magnitude of near-term rate cuts, there is often downward momentum on term rates once central banks start rate cuts and the market looks to price the end point. Additionally, although there are high expectations that the US can avoid a recession given recent economic strength, 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 1–10-year 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: 5.00%

In the upside scenario, we see the overall global growth backdrop improving and inflation continuing to moderate. Central banks begin cutting rates in the middle of the year, however take a gradual approach given the strong growth backdrop. This keeps real yields in positive territory and nominal yields around current levels.

Downside scenario

10-year US Treasury yield December 2024 target: 6.00%

In the downside scenario inflation remains stubbornly high and growth in the US supported by fiscal policy. This prompts the Fed to resume the rate hiking cycle, taking the policy rate above 6%. Real yields move higher, taking nominal yields with them.

Investment grade

Preference: Most preferred

Central scenario

December 2024 spread targets: 100bps (USD IG) / 120bps (EUR IG)

Investment grade credit spreads have remained broadly rangebound over the past month, even as government bond yields saw renewed upward pressure following the higher-than-expected March US CPI print. We attribute this resilience in credit spreads to continued robust investor demand for high-quality credit, which offers historically attractive yields and where fundamentals remain relatively solid.

US investment grade (IG) yields are at 5.6% and EUR IG yields are at 3.8% (local currency). While these levels are off their October 2023 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 return 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. Given recent evidence of less progress on disinflation than anticipated, we have revised our expectations regarding the timing of the first Federal Reserve cut (from June to September) and moderated our expected US Treasury forecasts in the near term. However, we continue to believe the direction of US government bond yields is lower from here as inflation and growth are expected 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.

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 2023, 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. Median net leverage (excluding financials and utilities) edged lower to 1.9x in 4Q (compared to 2.2x in 4Q19, just prior to the pandemic) on improving earnings. Furthermore, while the median interest coverage ratio has declined from the highs reached in 2022 given rising interest expenses, as of 4Q, it was still at a solid level of 10.5x 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. We also 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 relatively 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.

While supply has strongly ramped up this year, this has been well absorbed with investors demonstrating good appetite to meet the increased bond supply. While the share of M&A-related bond issuance has increased this year, so far it is being mostly led by higher-rated issuers with relatively low leverage.

Key risks to our view include a recession (though we believe spread widening would be to a decent 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.

Analysts: Frederick Mellors, Carolina Corvalan, Antoine Geiller

Investment grade

Preference: Most preferred

Upside scenario

Bloomberg Barclays US Int. Corp. December 2024 target: 70bps/ Bloomberg Barclays Euro-Agg. Corp. December 2024 target: 100bps

Goldilocks

Growth remains robust, inflation declines more rapidly than expected, and the Fed cuts interest rates more than current market expectations.

Downside scenario

Bloomberg Barclays US Int. Corp. December 2024 target: 130bps/ Bloomberg Barclays Euro-Agg. Corp. December 2024 target: 160bps

Fed hikes rates further

The US Fed hikes interest rates toward 6–6.5% as inflation stays sticky (or reaccelerates). Other central banks potentially slow down their rate-cutting cycle. This causes financial conditions to tighten.

High yield

Central scenario

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

High yield spreads started to significantly compress late last year amid prospects for Federal Reserve easing and a resilient growth environment. Since then, credit availability has improved, with a broadening of HY primary issuance to lower-rated issuers amidst a continued issuer focus on refinancing upcoming maturities.

In the past month, however, we have seen a modest widening of HY spreads as prospects for near-term Fed easing have diminished following the third monthly hot US CPI in a row; and together with higher government bond yields, this has pushed overall yields higher.

We still think the risk of a sharp rise in defaults is 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 below the long-term average; and in particular, the energy sector in the US, which has historically been a source of defaults in downturns and remains the largest sector in the ICE BofA US HY index, is in a relatively healthy state having deleveraged since the last default cycle.

Many companies were fortunate to lock in lower funding costs before the sharp moves higher in rates. Over time, this benefit diminishes as maturities approach and refinancing needs increase. As such, we have seen a continued erosion of interest coverage in recent quarters. At an aggregate level, the US HY interest coverage ratio remains above the pre-pandemic level. However, lower-rated, highly leveraged issuers are at particular risk if rates stay high for longer, given the large associated step-up in interest expenses. Such issuers could struggle to meet their refinancing needs. Financial conditions have eased since late October 2023 mostly on the back of expectations of Fed easing, and this has enabled lower-rated borrowers to access primary markets to a greater degree this year, while we also note the role of private credit in providing financing to lower-rated borrowers. Despite the easing in financial conditions and the reopening of capital markets to lower-rated HY issuers, distress ratios remain elevated in certain sectors, including cable and telecom. These sectors have elevated leverage and could be the source of continued default activity ahead, particularly as rates stay elevated for longer.

At current valuations, US HY appears to be discounting a below-average default rate of 1–2% in the year ahead. While less tight than in the previous quarter, lending standards remain somewhat restrictive, pointing to some downside risks to growth and upside risks to defaults over the coming 12 months although considerably less than before, while we note that financial conditions have eased a lot since late October. 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.

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 reason could be technical factors. The market has shrunk from USD 1.5tr in 2021 to USD 1.3tr today due largely to net rising stars (issuers upgraded to investment grade and therefore leaving the high yield universe). Looking ahead, the scope for further net rising stars has diminished, and net supply has been trending higher although the use of proceeds overall remains heavily skewed to refinancing.

While rate hikes seem unlikely, the risk of a further repricing of Fed rate cut expectations remains. HY has so far weathered the recent repricing in Fed cut expectations relatively well, but a further repricing could lead to more spread widening and more tightening of financial conditions, which could ultimately weigh on the growth outlook if sustained. At the same time, we note that central banks seem willing to actively use their balance sheets temporarily when market conditions turn dysfunctional, and we also note that discussions at the Fed about reducing the pace of quantitative tightening are likely to increasingly come into focus.

We remain neutral on HY bonds. Although we think there is 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 a potential widening in credit spreads.

High yield

Upside scenario

ICE BofA US high yield spread December 2024 target: 300bps / ICE BofA Euro high yield spread December 2024 target: 325bps

Goldilocks scenario develops

Economic growth remains robust, inflation declines more rapidly than expected, and the Fed cuts interest rates more than current market expectations.

Downside scenario

ICE BofA US high yield spread December 2024 target: 500bps / ICE BofA Euro high yield spread December 2024 target: 550bps

Fed hikes rates further

The Fed hikes rates towards 6–6.5% as US inflation stays sticky (or reaccelerates). Other central banks potentially slow down their rate cutting cycle. This causes financial conditions to tighten, and increases the default risk of highly leveraged firms.

Emerging market bonds

Central scenario

December 2024 spread targets: 400bps (EM sovereign bonds) /325bps (EM corporate bonds)

US Treasury rate volatility has increased in recent weeks on the back of concerns about the stalling progress in the US disinflation process, particularly after headline CPI and core CPI (which excludes food and energy) came in above consensus expectations in March. We still expect US inflation to trend lower over time as the high level of interest rates weighs on economic growth. However, we have revised our Federal Reserve call down to two cuts in 2024, starting in September. And we still expect US Treasury yields to finish the year lower.

Intensifying tensions between Iran and Israel have triggered increased geopolitical angst. Even if the risks of escalation have increased, our base case is that a major direct confrontation between Israel and Iran can be avoided. Pressure on emerging market bonds and risk assets more broadly should therefore remain limited.

Primary market activity has been robust year-to-date, with EM sovereign issuing about USD 80bn of paper and EM corporations around USD 98bn. Encouragingly, EM high yield (HY) sovereign issuers have also staged a comeback to the market, accounting for over 40% of EM sovereign issuance in February. Given the spread tightening for various HY sovereign issuers driven by positive idiosyncratic developments, we wouldn't rule out capital market access to broaden over time, assuming global financial conditions do not tighten materially.

In our view, selectivity is very important in the current climate. EM bond spreads appear moderately expensive, which makes the asset class vulnerable to setbacks, including risks arising from inflation and fiscal outlooks. Rising geopolitical uncertainty could dent risk sentiment further. In our base case, we think EM bonds will deliver mid- to high-single-digit total returns until year-end, supported by high nominal yields and the prospects for lower US Treasury bond yields.

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

Emerging market bonds

Upside scenario

EMBIG Diversified / CEMBI Diversified spread December 2024 targets: 340bps / 260bps

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 tight financial conditions. Major central banks start cutting policy rates earlier and to a greater extent than expected 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: 550bps / 500bps

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

Fed resumes rate hikes: The Fed could be forced to raise rates further if inflation data continues to run hot, which could tighten financial conditions and weigh on economic growth.

Geopolitical tensions escalate: Heightened friction, emanating from either the war in Ukraine, the conflict in the Middle East or US-China relations, hurts risk sentiment, strengthening the US dollar and curbing the 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

Markets have endured a bumpy ride over the past month due to investor concerns over hotter-than-expected US inflation, alongside strong job creation and retail sales numbers. Against this backdrop, we recently lowered our expectations on the timing and magnitude of Fed rate cuts. We now expect two rate cuts (50bps in total) this year, most likely starting in September. Therefore, we believe recent losses in fixed income markets are likely to be temporary as rates should still come down later this year, and we still think bonds—especially high-quality segments like high grade (HG) bonds and investment grade (IG) bonds—could be attractive in terms of risk-reward in this year.

In the past month, Asia IG bonds' performance was also dragged by sharp upward moves in US Treasury yields. Asia IG spreads, however, have remained resilient as fundamentals are solid and technicals have are still strong. Overall, we believe Asia IG still presents a solid risk-reward potential, considering its current yield level of around 5.9% (as of 22 April), its high credit quality (average rating of A-), supportive technical factors (net issuances still negative), and stable fundamentals for most issuers. Valuation of Asia IG is still on the tight end of the spectrum (124bps as of 22April), but we think that spreads may stay resilient in the absence of a sharp economic slowdown globally or in Asia. The recent negative rating actions for China sovereign have been well telegraphed and are unlikely to have much impact on overall spread movements.

Asia high yield (HY) bonds have had a slightly negative return in the past month, but it is still the best performing credit segment year-to-date. China HY developers still see pressure from weak property sales, and we remain cautious on this segment. China property sales have stayed weak, with a 18% y/y decline in March. Outside of China, we see relatively solid fundamentals, and we believe that there are still some bond selection opportunities from a bottom-up perspective. Macau gaming is a preferred sector in Asia HY, supported by Macau's visitation recovery, while the mass sector's gross gaming revenue has also fully recovered.

Asian bonds

Upside scenario

JACI composite spread December 2024 target: 220bps

Much faster macro recovery: If China's recovery is faster and stronger than expected in the coming months, there will be upside in Asia credits.

Sharp China property rebound: So far, policy has been focused on demand-side measures, but housing sales recovery still seems uneven and mixed. A rebound in housing sales or more details on supporting developer liquidity needs would offer fundamental support to the sector's credit metrics.

More dovish-than-expected central bank actions: Spreads would likely compress if the Fed becomes more dovish than expected and less aggressive with quantitative tightening if US 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 geopolitical tensions: Heightened friction emanating from the upcoming US presidential election or rising geopolitical tensions could hurt risk appetite for EM Asia assets.

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

Gold

Central scenario

Gold December 2024 target: USD 2,500/oz

We previously expected gold to rise, forecasting it to end the year at USD 2,250/oz. But it has rallied faster and more forcefully than our already bullish expectations. The rally thus far has been driven by buyers who haven't traditionally made material purchases, while the usual ETF buyers have remained net sellers. In fact, ETF holdings stand at a 4-year low. A combination of market concerns— including the sanctioning of USD-based assets, CNY devaluation fears, and renewed inflation risks—have supported solid demand from central banks and Asian investors. In January and February, preliminary data indicates central banks bought around 64 metric tons of gold and China imported 132 metric tons from Switzerland, a key gold refinery hub. We expect these buyers, who are less price sensitive, to continue accumulating gold in the months ahead.

Furthermore, despite record-high prices, we expect gold ETF holdings to increase once the Federal Reserve starts cutting rates around mid-year, as these buyers tend to move more in sync with interest rate adjustments. This event could trigger another step-up in demand via ETFs. So, with this catalyst still ahead, we lift all our forecasts by USD 250/oz, expecting gold to trade at USD 2,300/oz in June and at USD 2,500/oz at end-2024 and end-March 2025. Renewed price setbacks in the short term remain possible if US economic data delays Fed rate cuts, but so far these setbacks have been shallower than we had expected

Crude oil

Central scenario

Brent crude oil December 2024 target: USD 87/bbl

We continue to see the oil market as undersupplied, and expect inventories to point lower again over the coming weeks. As such, we reiterate our modestly positive crude outlook.

Despite elevated tensions in the Middle East, oil prices have reacted only modestly. Brent crude oil's peak was at USD 92.18/bbl on 12 April; prices now are trading at around USD 86.30/bbl, similar to levels at the start of the month. We believe three factors explain the modest price reaction.

In 2022, when the war in Ukraine began, there were forecasts for a sharp drop in Russian crude production, but this never materialized and long crude positions suffered as result. The second factor is high spare capacity, which is mostly in the hands of a few countries (Saudi Arabia, the UAE); this could compensate for any larger supply disruptions. And lastly, geopolitical risk premiums have tended not to last in the past if there are no actual supply disruptions. So, we still believe prices would react to geopolitical risk premiums, but this requires supply disruptions. We continue to assign a low probability to a closure of the Strait of Hormuz as Iran needs it as well to export its crude oil barrels. Attacks on tankers, pipelines, and other critical energy infrastructure in the region remain possible.

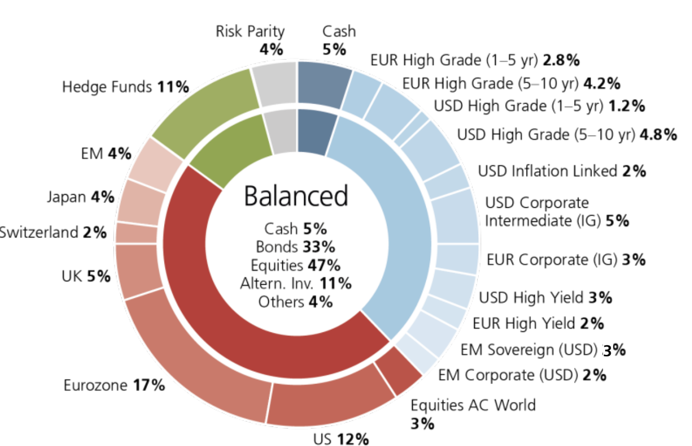
The past few weeks have seen rising oil inventories in the US, Europe, Japan, and Fujairah, while crude inventories in China have declined. We continue to see the oil market as undersupplied, and expect inventories to point lower again over the coming weeks. As such, we reiterate our modestly positive crude outlook

Section 4

Appendix

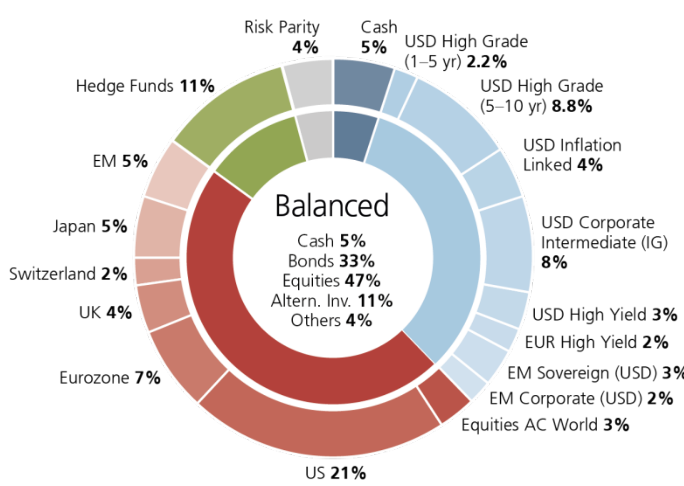
Strategic Asset Allocations (SAAs)

EUR (local portfolio)



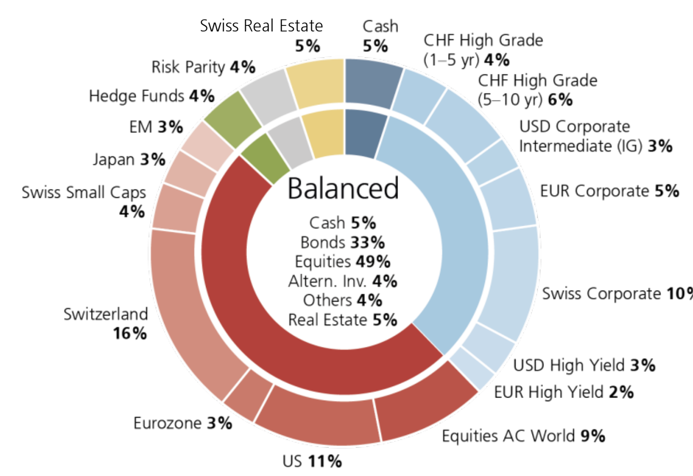
Note: Portfolio weightings are for EUR SAA with a home bias and a balanced risk profile. We expect a balanced EUR SAA to have an average total return of 5.7% p.a. and a volatility of 8.7% p.a. over the next 15 years.

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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Appendix

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

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

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

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