

# Year Ahead 2023

Global | Chief Investment Office GWM | Investment Research



A Year of Inflections



### **Year Ahead 2023 – UBS House View**

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# Foreword

Welcome to the *Year Ahead 2023*.

After one of the most challenging years in history for investors, we're entering what we think will be "A Year of Inflections."

As the year opens, inflation is high, interest rates are still rising, and growth expectations are falling, with geopolitical tensions, financial stresses, and the legacy of COVID-19 adding to uncertainty. Against this backdrop, we favor defensive sectors, income opportunities, "safe havens," and alternatives.

At a time when calamitous events are in the headlines on an all-too-regular basis, investors will enter 2023 with many questions about the strength and purpose of the political and financial institutions that support global markets. Yet, provided the world can avoid another geopolitical, financial, or epidemiological accident, we do see a more favorable backdrop for markets emerging as the year evolves. We think inflationary pressures will start to abate, central banks will shift from tightening to loosening policy, and economies, currently slowing, will trough and start to revive.

Navigating inflection points will be key to investment success in the year ahead. It will be our challenge and privilege to help guide you through them. For investors who are able to look through short-term noise, the challenges of 2022 should give way to longer-term opportunity in the years ahead.

We hope that this *Year Ahead 2023* brings you the perspective, insight, and ideas to navigate a Year of Inflections. We thank you for your trust and look forward to helping you realize your financial goals.



A stylized, handwritten signature in black ink, consisting of several fluid, connected loops.

Iqbal Khan

President, UBS Global Wealth Management,  
and President, UBS EMEA

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# A Year of Inflections

In 2022, inflation stayed high, interest rates rose, growth expectations fell, and both equity and bond markets suffered. 2023 will be a year of inflections as investors try to identify turning points for inflation, interest rates, economic growth, and financial markets against a complex geopolitical backdrop.



**Mark Haefele**  
Chief Investment Officer  
Global Wealth Management

## **Inflation inflection**

We think that year-over-year rates of inflation have peaked in the United States and are in the process of peaking in Europe. In both regions, we expect inflation to decline through 2023, but the pace and magnitude of the path lower will contribute to volatility, reflecting investor fears that even higher interest rates may be needed for longer.





Marcin Jucha | Shutterstock

### From hikes to cuts

Although incoming data will be key, we expect the Federal Reserve, the European Central Bank, the Swiss National Bank, and the Bank of England to conduct their final rate hikes in the first quarter of 2023, or the second quarter at the latest. Dependent on how sticky inflation proves, the Fed could be in a position to cut interest rates by the end of the year.

### From recession to growth

As higher interest rates begin to affect the economy, we expect growth and earnings expectations to fall through the first half of the year. Overall, we are looking for a 4% earnings contraction in the

US, a 10% decline in Europe, and 2% growth in Asia for the full year. But we expect global growth to trough in 2023, and growth forecasts should improve later in the year as investors begin to look forward to 2024.

### From lockdown to reopening

China's economic cycle has been distinct from the rest of the world's, due to the country's approach to managing COVID-19. Developments from here will hinge on policy decisions, and President Xi Jinping's consolidation of power has added to investor unease. But the outlook could start to improve if a full reopening, which may be likely around

the middle of the year, supports consumption, and if higher infrastructure spending helps offset weakness in the property sector.

### Shocks to navigate

Geopolitical events often spark volatility in financial markets but rarely change the broad trajectory of economic growth. Yet as we enter 2023, there is an elevated risk that politics could shape growth outcomes. Russia's war in Ukraine poses energy and security threats to

Europe and raises the risk of NATO involvement. US-China tensions are unlikely to lessen given Beijing's increased focus on self-sufficiency, the Biden administration's moves to restrict trade on security grounds, and the potential for discord over Taiwan. And, at an individual country level, the increased politicization of economic issues like inflation and interest rates broadens the scope for radical policy interventions and market dislocations.



## What does it mean for investors?

History tells us that durable turning points for markets tend to arrive once investors begin to anticipate interest rate cuts and a trough in economic activity and corporate earnings. As we enter 2023, high inflation and rising interest rates alongside elevated earnings expectations and geopolitical risks inform our investment themes of defensives, value, income, and safety.

But we think the backdrop for risky assets should become more positive as the year progresses. This means investors with the patience and discipline to stay invested should be rewarded with time. Investors currently sheltering from volatility will need to plan when, and how, to rotate back into riskier assets over the course of 2023.

## Investing in 2023

### **Add defensives and value**

Defensive sectors such as consumer staples and healthcare should prove relatively insulated from lower economic growth expectations, while value stocks tend to perform well in environments of high inflation. More attractive opportunities to buy cyclicals and growth stocks may emerge later in the year as markets start to anticipate lower inflation and stronger economic growth.

› [Read more on page 26](#)

### **Seek income opportunities**

The opportunity to earn more predictable returns from income strategies is appealing against an uncertain backdrop, while high market volatility can itself also offer a means of generating income. We start the new year with a focus on higher-quality credit issuers, but note that lower-rated issuers could present an opportunity once interest rates and growth stabilize.

› [Read more on page 29](#)

### **Shelter in safe-haven currencies**

We like the US dollar and the Swiss franc. Relatively high US rates and slowing global growth should help keep the dollar strong in the coming months, and the Swiss franc's safe-haven appeal is likely to attract inflows. Over the next year, investors will need to prepare for dollar weakness as expectations for Fed policy shift.

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### **Seek uncorrelated hedge fund strategies**

Swings in monetary policy expectations are likely to remain an important market driver in 2023, meaning that equity-bond correlations will be periodically elevated. In this context, uncorrelated hedge fund strategies such as macro, equity market neutral, and multi-strategy funds should continue to help diversify portfolios.

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# What might derail a market inflection point?

The past year has demonstrated how policy choices not only add to volatility, but also have the potential to change the trajectory of asset markets. Russia's invasion of Ukraine, China's approach to managing COVID-19, and even the financial instability spurred by the UK's "mini-budget" all

affected global economies through multiple channels. In 2023, the key policy risks include an escalation in the Russia-Ukraine war, economic policy missteps in China, heightened geopolitical tensions, and monetary or fiscal policy errors.





Ivica Dzambo | pexels

### **Escalation in the Russia-Ukraine war**

As well as being a humanitarian and environmental disaster, Russia's invasion of Ukraine in 2022 had a significant impact on the global economic trajectory—adding an inflationary shock to a world already navigating resurgent demand, tight labor markets, and supply chain disruption.

As we enter 2023, Russia's annexation of occupied territories in Ukraine poses a threat to global markets. The annexation brings these areas under Russia's nuclear doctrine, meaning that if Ukraine continues its efforts to reclaim these regions, a retaliation by Russia beyond conventional warfare cannot be ruled out. In turn, this would increase the risk of a direct confrontation between NATO and Russia.

### **Economic policy missteps in China**

After many years in which China's policy measures were oriented toward driving economic growth, the country's leadership is now focused on achieving a broader range of objectives—including self-sufficiency, national security, and common prosperity. In the near term, the greater consolidation of power under President Xi following the 20<sup>th</sup> Party Congress has prompted concerns about a continuation of pandemic controls.

If China extends its zero-COVID policy through all of next year, it would make it less likely that global growth will trough in 2023.

Separately, the consolidation of power has also led to investor concern over less support for the private sector, a heightened risk of policy mistakes, and lower long-term rates of economic growth.

### **What to do with China exposure?**

China's stock market suffered a 44% loss in the first 10 months of 2022, in part because stricter COVID-related mobility restrictions hampered consumption and new business investment. At the time of writing, China's weight in the MSCI All Country World Index is close to 3%. We think this level of holdings of Chinese stocks in global equity portfolios is adequate given the near-term risks from the country's ongoing zero-COVID policy and

challenges in the property sector. We recommend overexposed investors diversify into global defensives and value. That said, China's economy may offer long-term opportunity for investors who have no allocation to the country, particularly in the supply chains of electric vehicles and renewable energy, and in consumer services and durables.

55%  
of investors rank geopolitical risk as  
a top concern.

Source: UBS Investor Sentiment survey, November 2022



### Heightened geopolitical tensions

Antagonism between the US and China continued to rise in 2022. China's refusal to condemn Russia in its war with Ukraine, US House Speaker Nancy Pelosi's visit to Taiwan, and military drills around the island heightened tensions. Meanwhile, the US CHIPS Act and White House directives to restrict China's access to advanced technologies have added to the trend of technological divergence between the two nations.

In 2023, Taiwan will remain a potential geopolitical flashpoint. President Xi remains committed to reunification while President Biden has repeatedly stated that US forces would come to Taiwan's defense in the event of an "attack." Although attempts to reunify mainland China and Taiwan are unlikely to materialize next year, tensions surrounding national security are likely to mean a continuation of technological and supply chain localization, with implications for sectors across Asia.

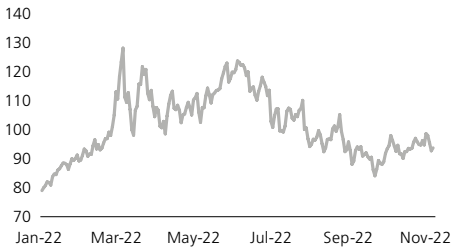
Geopolitical tensions are not limited to those between the US and China.

In October, President Biden warned Saudi Arabia that “there will be consequences” after it joined with Russia and other OPEC+ producers to cut oil output. A risk for the market in 2023 would be if Biden’s “consequences” prompt a further output cut by Saudi Arabia, sending oil prices higher and weighing further on the growth outlook.

Figure 1

### Oil transmits geopolitical tension into economic outcomes

Brent crude oil prices, in USD/bbl



Source: Refinitiv, UBS, as of 10 November 2022

### Monetary and fiscal policy errors

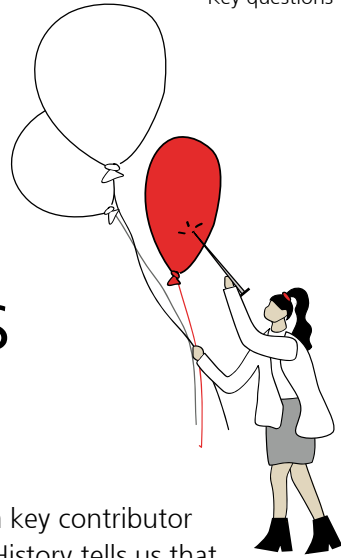
Disruption in the UK gilt market in 2022 illustrated the challenges facing governments that try to increase borrowing while central banks sell government bond holdings to reduce inflation. While events in the UK had idiosyncratic aspects, a risk for next year is that the UK might be a forerunner of financial instability in other markets.

In the Eurozone, we are monitoring the risk that the unwinding of quantitative easing could prompt stress in bond markets. The European Central Bank’s Transmission Protection Instrument is designed to mitigate these challenges, but it remains unclear how it would work in practice, and it is unlikely to be deployed proactively.

In the US, as the Fed conducts quantitative tightening, we are monitoring for the risk of a funding squeeze similar to 2019, when the Fed’s balance sheet run-down caused undue tightening in dollar funding conditions. Meanwhile, a divided US government could presage potential battles over the federal budget and debt ceiling, which could affect markets.



# When will central banks cut rates?



Higher interest rate expectations were a key contributor to weak market performance in 2022. History tells us that, prior to market bottoms, investors usually begin to anticipate Fed rate cuts. We think inflation should be close enough to target by the end of the year for the Fed to consider rate cuts.

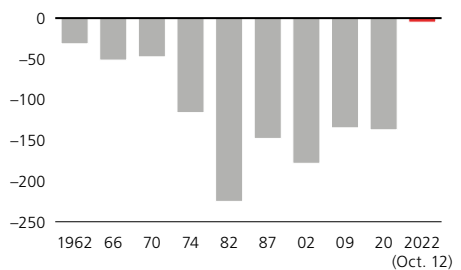
At the time of writing, interest rate cuts seem a distant prospect. Inflation is far higher than official targets, and with central banks seeing their credibility at stake, rates are likely to be hiked further still. We expect interest rates to peak around 5%, 2.5%, and 1.5% in the US, the Eurozone, and Switzerland, respectively.

That said, we do think that year-over-year rates of inflation have topped out in the US. Real-time indicators of future inflation, including new rents, wage growth, import prices, and price-paid indexes, are almost all pointing down; durable goods prices are falling; and services inflation is largely being driven by profits—an unusual and likely temporary phenomenon.

Figure 2

## Two-year Treasury yields usually fall prior to market bottoms

Fall in 2-year US Treasury yield from peak in the six months prior to bear market bottom, in basis points



Source: Bloomberg, UBS, as of November 2022

Inflation is also likely to peak in Europe soon, as the impact of higher energy prices begins to fade and as higher rates discourage consumer and business spending. Falling rates of inflation should allow the Fed, the ECB, the SNB, and the BoE to complete their hiking cycles in the first quarter of 2023, or the second quarter at the latest.

How quickly central banks and investors then turn their attention to potential rate cuts will depend on the data, as they

both seek evidence that inflation is heading sustainably back to target before contemplating lower rates.

In our base case, we think year-over-year rates of inflation in the US and Europe will be close enough to central banks' 2% target toward the end of 2023 for policymakers to refocus their attention on economic growth and employment, and consider rate cuts.



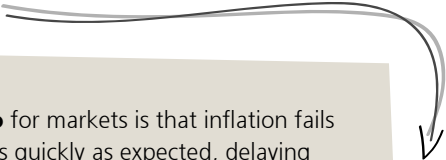
## What does it mean for investors?

We think that high inflation and still-rising interest rates are likely to mean continued volatility for risky assets in the near term.

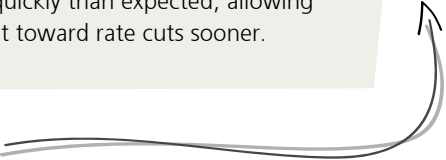
But evidence that inflation is falling sustainably, an end to Fed rate hikes, and anticipation of potential rate cuts should present a more supportive backdrop for markets as 2023 progresses. So while

we advocate a defensive posture as we enter the new year, it is also important for investors to stay invested in line with longer-term plans, and retain upside exposure so that portfolios do not get left behind as markets attempt to anticipate a turning point.


## Inflation and rates – risk scenarios



A **downside scenario** for markets is that inflation fails to fall back to target as quickly as expected, delaying rate cuts or forcing further rate hikes. Central banks will be particularly watchful for the risk that, by pausing rate hikes, they may reignite inflationary forces.



An **upside scenario** is that a combination of easing supply chains, a more balanced US labor market, and improvements in commodity supplies means that inflation falls more quickly than expected, allowing central banks to tilt toward rate cuts sooner.



62%  
of investors think inflation will increase further,  
while 48% are planning to reduce spending.

Source: UBS Investor Sentiment survey, November 2022

# When will growth reaccelerate?

Tight US monetary policy, the energy crisis in Europe, and ongoing COVID-19 and property market challenges in China are likely to contribute to lower economic growth and earnings declines in 2023. But we think global growth should trough during the year.

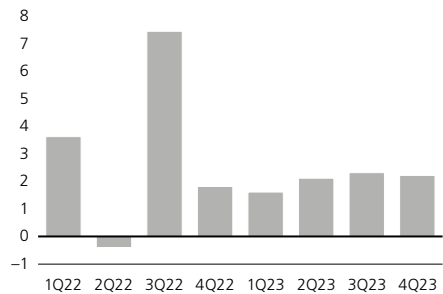
As we enter 2023, the world economy is decelerating. The US is still in expansion, but higher interest rates, tighter financial conditions, and weakening property and labor markets will have a lagged, negative impact in the months ahead. The Eurozone and the UK are likely already in contraction given the combined impact of the energy crisis, inflation, and monetary tightening. And China's recovery continues to be delayed by issues relating to COVID-19 and the property market.

Given the likelihood of a near-term deterioration in economic growth, we think further downward earnings revisions can also be expected in the months ahead.

Figure 3

## Global GDP growth to decelerate but improve in the second half

Real GDP growth including UBS forecasts starting 3Q22, q/q, in %



Source: CEIC, Haver, National statistics, UBS, as of November 2022



Overall, we are looking for a 4% earnings contraction in the US, a 10% decline in Europe, and 2% growth in Asia, below consensus expectations of growth of 4%, 3%, and 7%, respectively.

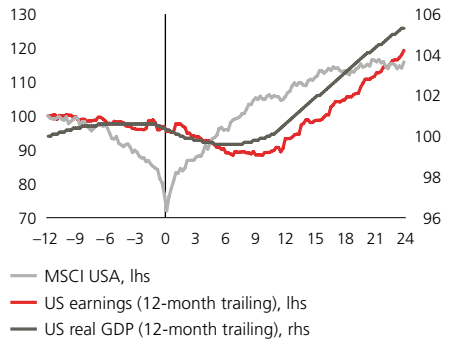
But while the near-term outlook is challenging, we also think world economies will trough in 2023.

In Europe, growth should start to improve midyear as the continent's energy crisis begins to ease after the winter, even if next winter may also pose challenges. In China, contingent upon a reopening in the middle of the year, economic growth should also improve, potentially with the help of higher infrastructure spending. In the US, a trough is likely to come later, given the strength in the economy thus far and the lagged impact of tighter monetary policy. But consumption and investment could be supported in the second half provided inflation is lower and financial conditions are looser.

Figure 4

## Markets tend to trough ahead of the economy

US stocks, earnings, and GDP months before and after equity market low, indexed



Note: Average around bear market troughs in 1974, 1982, 1990, 2002, 2009, and 2020.

Source: Refinitiv, UBS, as of October 2022

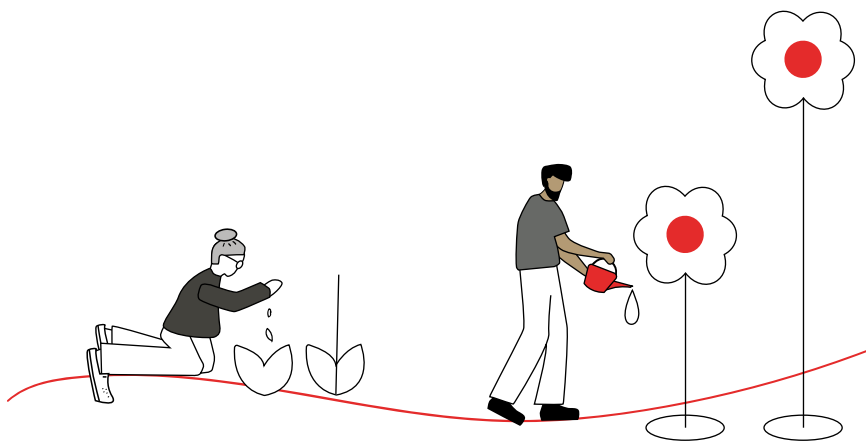
## What does it mean for investors?

Downward revisions to company earnings estimates mean the risk-reward is unfavorable for risky assets over the coming months. But we note that historically markets start to turn between three and nine months prior to a trough in economic activity and corporate profits.

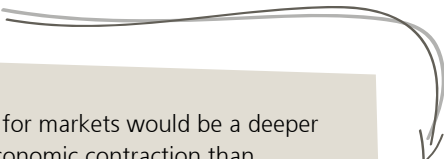
With this in mind, a more constructive environment for risky assets should start to emerge during the year, as markets anticipate potential turning points in economic and earnings growth rates.

History also tells us that trying to anticipate a precise turning point for the market can often result in failure, and the best way for most investors to position for more favorable markets ahead is to keep a diversified portfolio, consistent with long-term investment plans.

Once a turning point arrives, markets that have already priced in most bad news and where valuations are lowest have the greatest potential for a rebound, which currently look like European and emerging market equities.

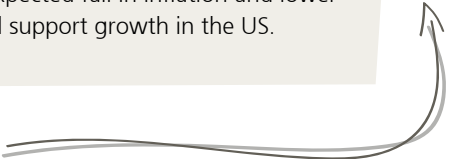


## Growth – risk scenarios



A **downside scenario** for markets would be a deeper and more prolonged economic contraction than expected. The Fed's own labor market projections are consistent with a recession, and US recessions have historically had global spillover effects. In Europe, a colder-than-average winter could strain the provision of energy supplies, deepening the economic downturn. And in China, a longer-than-expected adherence to strict zero-COVID policies could further delay the recovery.

An **upside scenario** would be a faster and stronger re-acceleration in economic growth than expected. A détente between Europe and Russia or warmer winter temperatures could alleviate the energy crisis and boost growth expectations for the region. We could see upside to China's growth prospects if Beijing were to more quickly reopen, or roll out additional stimulus. Meanwhile, a faster-than-expected fall in inflation and lower borrowing costs could support growth in the US.



## Scenario analysis

<b>Upside</b> <b>Probability 20%</b>	<b>Base case</b> <b>Probability 50%</b>	<b>Downside</b> <b>Probability 30%</b>
<i>Key drivers</i>		
<b>Central banks</b> Inflation falls faster than expected, allowing a tilt toward rate cuts sooner. The lagged effect of monetary policy could support inflation surprising to the downside.	Falling inflation allows the Fed, the ECB, the SNB, and the BoE to complete their hiking cycles in 1Q23, or 2Q23 at the latest.  Inflation in the US and Europe is likely to be close enough to the 2% year-over-year targets toward end-2023 for rate cuts to be considered.	Inflation fails to fall back to target, delaying rate cuts or forcing further rate hikes.  Central banks pause rate hikes too early, stimulating near-term growth and reigniting inflationary forces, in turn requiring further hikes.
<b>Economic growth</b> Economic activity reaccelerates due to one or more key drivers, including: A détente between Europe and Russia or a warmer winter, alleviating the energy crisis; A revision of the zero-COVID policy or additional stimulus in China; or A faster-than-expected decline in inflation and lower borrowing costs in the US.	The US is still in expansion, but slowing, while the Eurozone and the UK are already in recession. China's recovery continues to be delayed.  Growth in Europe should improve as the energy crisis begins to ease after the winter. In China, provided zero-COVID policies are at least partially relaxed by midyear, economic growth should also improve. In the US, a trough in economic activity is likely to come later given the strong momentum at present and the lagged impact of monetary policy.	Growth falls more sharply than expected due to tight monetary policy and inflation continuing to outpace wage growth.  In Europe, a colder-than-expected winter strains energy supplies, deepening the economic downturn.  China's reopening is delayed to 2024.  The economic downturn prompts lower corporate earnings, rising default rates, and falling commodity prices.
<b>Geopolitics and others</b> The war in Ukraine de-escalates or is resolved.	The war in Ukraine drags on and keeps markets volatile.  Financial conditions tighten and increase the market's vulnerability to external shocks.	The war in Ukraine escalates or US-China tensions intensify.  Financial conditions tighten even further, causing stress in the financial system.
<i>Market path</i>		
The backdrop for riskier assets brightens as investors see rate cuts and a trough in economic growth on the horizon.	Markets remain volatile and under pressure from inflation and rate fears, and amid weaker growth expectations.  The risk-reward balance remains unfavorable, with stocks ending June 2023 around current levels.	The market experiences a severe downturn, with riskier asset classes such as equities posting double-digit losses. Credit spreads widen, while safe havens benefit.

## Scenario targets

<b>Key targets for June 2023</b>	<b>Spot*</b>	<b>Upside</b>	<b>Base case</b>	<b>Downside</b>
<b>MSCI AC World</b>	748	820	720	590
<b>S&amp;P 500</b>	3,957	4,400	3,700	3,300
<b>EuroStoxx 50</b>	3,888	4,400	3,550	3,100
<b>US 10y Treasury yield</b>	3.85%	4.50%	3.25%	1.50%
<b>US 10y breakeven yield</b>	2.38%	3.00%	2.25%	1.50%
<b>US high yield spread**</b>	467bps	300bps	600bps	850bps
<b>US investment grade spread**</b>	128bps	60bps	150bps	200bps
<b>EURUSD</b>	1.03	1.05	0.98	0.92
<b>Commodities (CMCI Composite)</b>	1,909	2,200	2,000	1,600
<b>Gold</b>	USD 1,777/oz	USD 1,400–1,500/oz	USD 1,600/oz	USD 1,800–2,100/oz

\* Spot prices as of market close of 14 November 2022.

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

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

Source: UBS, as of November 2022

An aerial photograph of a dark asphalt road that winds through a dense forest. The road has a white dashed line on its left side. Patches of snow are scattered across the forest floor, particularly in the open areas between the trees. Some trees have yellow leaves, suggesting an autumn or early winter setting. The road curves in an S-shape, starting from the bottom left, curving right, then left, and finally right again towards the top right.

# Investing in 2023

Joshua Welch | pexels



# Add defensives and value



Defensive sectors should prove relatively insulated from a weakening economy, while value stocks tend to perform well when inflation is high. More attractive opportunities to buy cyclical and growth stocks may emerge later in the year as investors start to anticipate a trough in economic activity and a decline in interest rates.

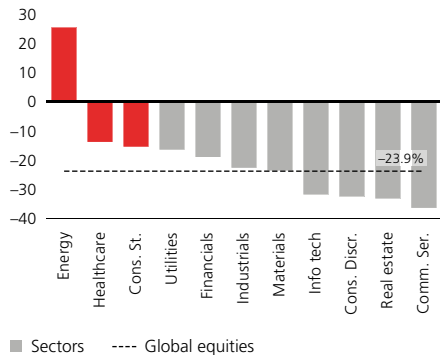
## Consumer staples and healthcare.

The consumer staples and healthcare sectors outperformed the MSCI All Country World Index by 9 and 11 percentage points, respectively, in the first 10 months of 2022. We expect both sectors to continue to outperform in the months ahead as economic growth decelerates. Consensus expects earnings growth of 7% and 4% for the two sectors respectively next year, versus our expectation of a contraction of 3% for the broader equity market. Valuations—at 18.4 times 12-month forward price-to-earnings ratio for staples and 16.4 times for healthcare—are not cheap, but remain slightly below their 10-year average levels.

Figure 1

## Energy, healthcare, and consumer staples have been outperforming

MSCI ACWI and sectors, year-to-date through 31 October, in %



Source: Bloomberg, UBS, as of 31 October 2022

**Global value.** Value stocks outperformed growth stocks by 18 percentage points in the first 10 months of 2022, based on MSCI indexes. While peak inflation has likely passed in the US, inflation above 3% has historically favored value stocks relative to growth, and we only expect inflation to fall below 3% toward the end of 2023. Value also tends to outperform growth during periods of tight monetary policy. In the 12 months following the Fed's last rate hike in a cycle, value has historically outperformed growth by an average of 4 percentage points.

**Energy.** The energy sector was the best-performing global equity sector in the first 10 months of 2022, with returns of 33% versus a loss of 21% for the broader index. In isolation, slower global growth is negative for the energy sector, but we think that the oil market is sufficiently tight to support higher prices even if demand falls. Sector valuations are a mere 7.4 times 12-month forward earnings—a 50% discount to their 10-year average.

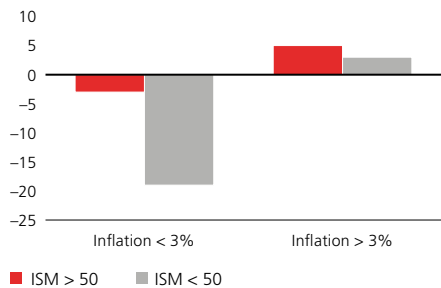
**59%**  
of investors consider energy stocks  
as highly attractive in the current environment.

Source: UBS Investor Sentiment survey, November 2022

Figure 2

### Value tends to outperform growth when inflation is high

Russell 1000 Value vs. Russell 1000 Growth  
annualized monthly relative return, in %



Source: Bloomberg, UBS, as of November 2022

To invest in our equity preferences in a diversified way, we also recommend our “23 for ‘23” stock list.

Outside of equities, we think that selling volatility in crude oil is an appealing strategy. Longer-dated oil contracts continue to underprice the potential for energy prices to stay higher for longer, in our view, and an actively managed exposure to commodities can provide diversification benefits to broad investment portfolios.

**Capital protection strategies.** Slower global growth, declining corporate earnings, and tight monetary policy are likely to pressure equity markets in the months ahead. But while we advocate a defensive posture as we enter the new year, we also think it is important to retain upside exposure so that portfolios do not get left behind as markets attempt to anticipate a turning point. Capital protection strategies can help investors stay in the market while limiting exposure to the downside.



## When to buy cyclical and growth?

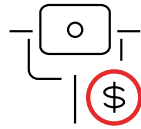
Precisely timing when a market will reach bottom is difficult, but a turning point will likely emerge in 2023 as investors begin to anticipate higher growth and lower interest rates. We continue to monitor signals such as the 2-year US Treasury yield and the ISM readings of business sentiment.

For investors looking toward a potential rally in cyclical stocks, we think select parts of the European and Asia Pacific markets are close to fully pricing in a downside scenario. This includes certain thematic picks and early-cycle opportunities in the broad German and Korean markets.

A turnaround for growth stocks will depend on lower inflation and an end to tighter monetary policy, so we start the year cautious on growth and global technology.

But investors looking to add long-term exposure in a disciplined way over the course of the year could make use of put-writing strategies, which can allow investors to be “paid to wait.”

# Seek income opportunities



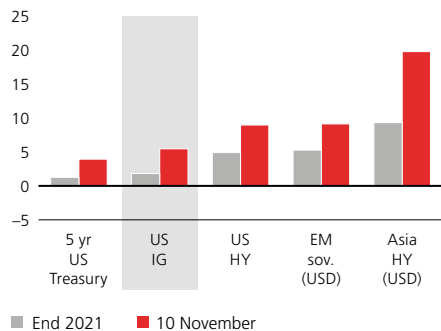
The opportunity to earn more predictable returns is appealing against an uncertain backdrop, while market volatility can itself offer investors a means of generating income. A slowing world economy means we are cautious on riskier credit, but we see potential opportunities emerging later in the new year.

**Investment grade bonds.** The high interest rate sensitivity of investment grade credit proved a detractor from total returns in 2022. Slowing earnings and tighter monetary policy could continue to drive volatility. But we now see the balance of risks as more favorable. In US investment grade, yields are around 5%—a level we find appealing and which should provide a buffer against volatility.

Figure 3

## Yields have risen across fixed income assets

Fixed income yields, end of 2021 vs. 10 November, in %



Source: Bloomberg, UBS, as of 10 November 2022

**Select short-duration bonds, resilient credit, sustainable bonds.** Within high-quality bonds, we particularly like select short-duration bonds and resilient credits. Short-duration bonds should prove relatively shielded from the risk of a further increase in benchmark yields, and, by focusing on more “resilient” issuers, investors can mitigate the risk of spread-widening.

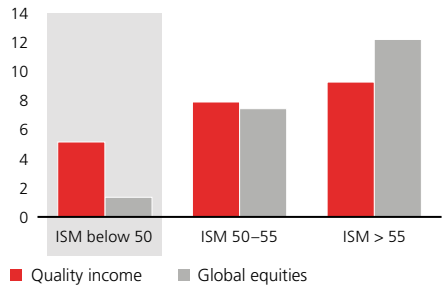
We also see opportunity in sustainable bonds with shorter tenors and somewhat higher credit risk than benchmark indexes. Positioning in such credits should result in lower volatility and higher total returns, in our view. The typically long-term investment horizon of sustainable investors may also lessen volatility in such exposures.

**Quality-income stocks.** We think that combining a filter of “quality”—high return on equity, low earnings variability, and low debt-to-equity—with income

Figure 4

Quality income stocks tend to outperform when the economy weakens

Quality income vs. MSCI ACWI, relative performance annualized, in %, ISM Manufacturing by level



Note: Data since 1988

Source: Bloomberg, UBS, as of October 2022



generation should help investors achieve more consistent returns in volatile markets. Over the past six largest market drawdowns, a quality-income strategy has outperformed the broader global equity market, including the 8.5-percent-age-point excess return in the first 10 months of 2022.

**Yield-generating structured investments.** We expect volatility to remain elevated over the coming months. But high volatility can create attractive opportunities, for example to earn a premium through structured investments or put-writing strategies.

In equities, we see opportunities to sell put options in select growth and cyclical stocks, allowing investors to build long-

term exposure if the market dips. In currencies, we see scope to generate yield by selling US dollar strength versus the Australian dollar, New Zealand dollar, Norwegian krone, and Canadian dollar. And in commodities, we see opportunities in selling downside price risks in Brent crude oil, copper, aluminum, and platinum given that we think supply constraints will put a floor under their prices.



## When to buy riskier credits?

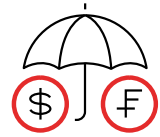
Tighter monetary policy and investor fears about global growth contributed to a sell-off in riskier credits in 2022.

But despite the higher yields on offer, we think the immediate outlook for high yield credit is unattractive. Spreads versus US Treasuries have widened to over 480 basis points, but these remain short of levels reached in prior downturns, such as the 1,087-basis-point spread in March 2020. Meanwhile, weaker corporate earnings and higher refinancing costs raise the risk of credit defaults. Lower market liquidity also means that credit risk premiums could expand significantly.

For us to take a more positive view on riskier credits, we would need to see wider credit risk premiums, more “normal” liquidity conditions, and clearer signs that interest rate cuts and a trough in economic activity are on the horizon.

For more risk-tolerant investors seeking to lock in current yields, we see an opportunity in select consumer, energy, and materials issuers with sound fundamentals.

# Shelter in safe-haven currencies



In currencies, we like the US dollar and the Swiss franc. Relatively high US rates and slowing global growth should help keep the dollar strong in the coming months, and the franc's safe-haven appeal is likely to attract inflows. Later in 2023, investors will need to prepare for dollar weakness as investors begin to anticipate Fed rate cuts.

**US dollar.** The dollar experienced unprecedented strength in 2022, with the US dollar index (DXY) rising 16% in the first 10 months of the year, on course for its biggest yearly gain ever. In the near term, we think this strength will persist. We expect broad market volatility to continue, leading investors to seek "safe havens" like the dollar, and the Fed remains more aggressive at raising rates than other major central banks. This should allow the dollar to maintain its premium valuation. We forecast EURUSD and GBPUSD at 0.98 and 1.13, respectively, by June 2023.

Figure 5

The USD has shown continued strength

DXY Index



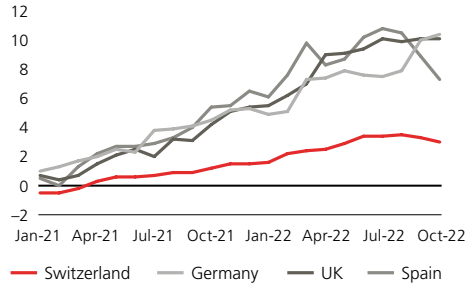
Source: Bloomberg, UBS, as of 10 November 2022

**Swiss franc.** A relatively early interest rate hike by the Swiss National Bank, on top of the considerably lower inflation in Switzerland than in its trading partners, helped the franc reach record highs on a trade-weighted basis in 2022. Over the coming months, we think it should continue to strengthen against the euro on the back of a European recession, concerns around the Russia-Ukraine war, fears about sustainability in European government debt, Switzerland's strong trade surplus, and the central bank's willingness to let the franc appreciate.

Figure 6

## Lower inflation supports Swiss competitiveness

CPI inflation, select countries, in %



Source: Bloomberg, UBS, as of 31 October 2022

**55%**  
of investors think the US dollar will appreciate in 2023.

Source: UBS Investor Sentiment survey, November 2022

**High-quality bonds.** One way to express our currency views in an investment portfolio is to hold bonds in our preferred currencies. In this regard, we currently see an attractive opportunity to hold high-quality USD bonds as a portfolio hedge. High-quality bonds tend to perform well during periods of weak global growth. And a slower global growth environment should

also help keep the US dollar strong. In our downside scenario, we see the 10-year US Treasury yield falling to 1.5% and the US dollar rising to 0.92 against the euro.

## What's the future of the UK?

Political turmoil and weak growth not only contributed to a weaker British pound in 2022, they also led to questions about the future of the UK as an investment destination. Currency valuations are low, and in the longer term we think the UK's large consumer base, education, skills, and flexible markets should continue to attract investment. Indeed, the

UK remains a major recipient of foreign direct investment. That said, after a prolonged period of instability, it is likely to take a number of years before the pound can regain more "normal" valuation levels. By the end of 2023, we expect the pound to trade at 1.21 versus the US dollar.



## When to sell the dollar?

We think the US dollar is likely to remain strong in the near term, at least while the Fed is still hiking interest rates and global growth expectations are being revised lower.

But we have to acknowledge that the dollar has already appreciated materially and that its current valuation is high. The US dollar index appreciated around 16% in the first 10 months of 2022 and reached levels last seen in the mid-1980s. We therefore think its record run will struggle to go much further. We expect it to peak once the Fed has hit its target rate and once investors start to anticipate a trough in global economic activity. We think these conditions will be met in the first half of 2023.

Thereafter, we would expect currencies in nations with relatively high real rates and a solid growth outlook to benefit. Within G10 currencies, this includes the Swiss franc, Australian dollar, and Canadian dollar as potential first gainers, while within emerging markets we think the Brazilian real, Mexican peso, and South African rand would appreciate.

Gold, which trades in US dollars, has declined over 8% in 2022, but given our view on the dollar and the Fed, we see the gold price softening to USD 1,600 per ounce or lower into the first quarter of next year before rebounding modestly to USD 1,650 by year-end. So we think now is not the time to buy gold, but an opportunity to add to gold positions is likely to emerge in 2023.



# Seek uncorrelated hedge fund strategies



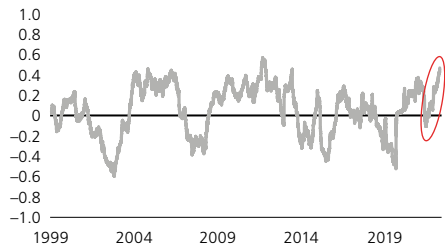
Equities and bonds failed to act as counterweights to each other's performance in 2022. In 2023, uncorrelated hedge fund strategies such as macro, equity market neutral, and multi-strategy funds should once again play an important role in diversifying portfolios.

**Macro.** Macro managers can take long or short positions across a range of asset classes, regions, and financial instruments to try to generate attractive returns through periods of deep and significant dislocations. These strategies have historically been uncorrelated to movements in the broader stock market, helping to diversify portfolios. Macro strategies delivered an average return of 11.5% in the first 10 months of 2022 as many managers successfully employed US dollar and short rates positions. We think a continuation of a tight monetary policy and high volatility regime should prove favorable for macro

Figure 7

## Bonds and equities have been highly correlated

Global equities, global bonds, 6-month correlation of daily returns, since 1998




Source: Bloomberg, UBS, as of October 2022

managers in 2023. Historically, when implied volatility has been elevated (VIX above 25), equities have generated an average loss of 11.3% while macro strategies were able to capitalize on market stress to produce 6.1% annualized returns.

**Equity market neutral.** Equity long-short managers buy stocks they expect to outperform and short those they expect to underperform. The net exposure of long-short managers can vary, but by focusing on those with a lower net exposure relative to the market, investors can reduce the sensitivity of their portfolios to broader market movements, while continuing to earn returns. As macro uncertainty increases, we expect this strategy to offer another source of relatively attractive, uncorrelated returns in 2023.

**Multi-strategy.** Multi-strategy funds combine different hedge fund strategies and allow investors to build a diversified hedge fund portfolio without investing in multiple individual funds. This can be particularly helpful for investors who wish to allocate to hedge funds but may struggle to build a high-quality, diversified portfolio, given the often high minimum investment requirements and high demand for individual funds. These strategies offer other key advantages including multiple sources of manager alpha; a quick reallocation to the best-performing hedge fund strategies and trading teams; and superior risk management. Since 1997, multi-strategy funds have offered annualized returns of 7.1% net of fees (Barclay-Hedge Multi Strategy Index) with a maximum drawdown of –20.7%, versus 5% and –31.3% for a 50-50 equity-bond portfolio (MSCI World Net TR, Barclays Global Aggregate TR).



53%  
of investors have already allocated to alternatives,  
while 33% are planning to increase their exposure  
over the next six months.

Source: UBS Investor Sentiment survey, November 2022



## How to build an alternatives allocation?

Building an allocation to alternatives requires investors to determine how much allocation to make, which assets to buy, and how best to combine them.

### *How much?*

This depends on the investor's time horizon, cash flow needs, and tolerance for illiquidity. As a general rule, we think an allocation of up to 20% to less liquid asset classes should enable most investors to avoid liquidity issues. It could even rise to 40% if portfolio cash flow needs are relatively low.

### *Which assets?*

To benefit from the broadest diversification and potential for higher returns, we consider hedge funds, private equity,

private debt, and real estate as good potential additions to a portfolio.

### *How to combine them?*

We recommend considering the three alternatives "building blocks" that can complement public bonds and equities: active strategies, which improve overall diversification through uncorrelated returns; income-focused strategies, which boost portfolio income potential; and capital appreciation-focused strategies, which aim for long-term growth.

Investors can vary the weights they allocate to the different types of alternative strategies according to their specific goals, objectives, and preferences.



# The Decade Ahead

This “Decade of Transformation” has already brought significant changes in the global economic, political, societal, and environmental landscape. But we think a more positive secular backdrop remains possible.

**Central banks are determined to bring inflation under control**

Unlike in the 1970s, central banks today are highly focused on reducing inflation, even if it comes with short-term economic costs. This policy focus should mean that

inflation does not become entrenched, and a period of higher rates should ensure that investment is not directed to nonproductive areas, and that capital is allocated more efficiently in the long term.





Luis Eusebio | Unsplash

### **A secular transition to green energy will spur investment**

The global transition to clean energy and net-zero carbon emissions was already well underway as we entered this decade, but Russia's invasion of Ukraine has heightened the need for investment for national security reasons. While we think we will see continued reliance on fossil fuels in the decade ahead, driven by

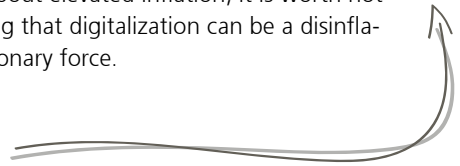
strong demand for energy and relatively low current supply of alternatives, in the longer term the race to create a greener economy should boost growth. Greater investment in industrial metal and agricultural production may also be required, given a likely increase in demand for transition metals and for food, creating investment opportunity for all investors, not just those focused on sustainability.

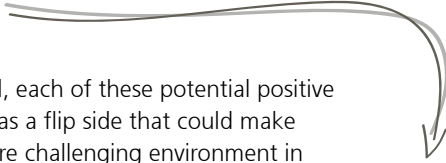
**The era of security will drive public spending on infrastructure and R&D**

We are entering an era of security where countries are increasingly focused on achieving self-sufficiency in strategically important areas such as energy and food production, technological development, and national security. Measures like the US CHIPS Act (aimed at boosting semiconductor R&D and manufacturing) and Inflation Reduction Act (in part aimed at promoting clean energy) will stimulate public and private spending over the coming years.

**The digitalization of business models is likely to gain momentum**

The past two-and-a-half years have demonstrated that companies can deploy technology to run their businesses in ways thought inconceivable before the pandemic. Looking ahead, entire business models will increasingly be built around digitalization, potentially resulting in greater efficiency gains. Amid concerns about elevated inflation, it is worth noting that digitalization can be a disinflationary force.





That said, each of these potential positive drivers has a flip side that could make for a more challenging environment in the years ahead:

**Monetary policy could become politicized**

Central banks may come under increasing political pressure to relax policy early, particularly if economic pain begins to mount. In some instances, governments may enact fiscal policy that directly or indirectly counteracts central bank objectives. This could prolong the current economic adjustment period and lead to currency and economic volatility at a local level.

**The green transition could prove inflationary**

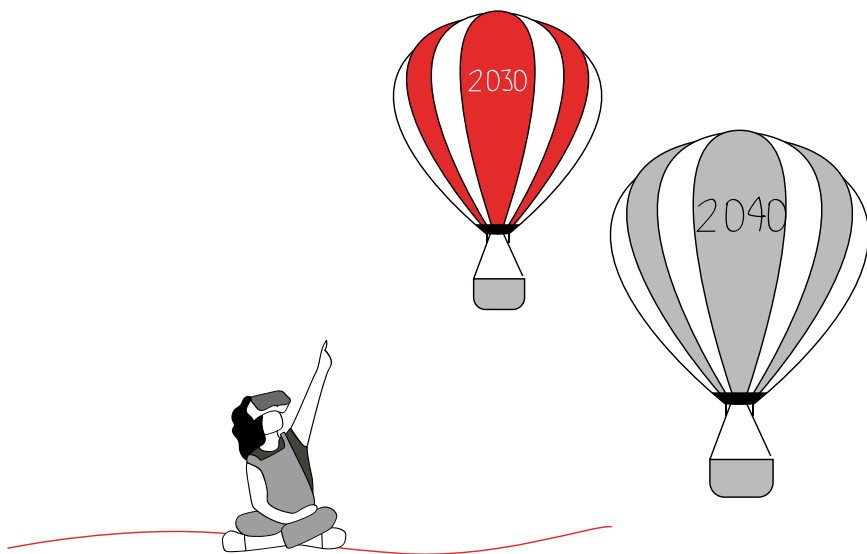
Skills and materials that help achieve the green transition will remain in high demand over the coming years, and the need for energy security only exacerbates the potential for shortages that may drive energy and commodity prices higher. Policies that try and put a price on environmental externalities could lead to higher inflation for a number of years.

**The era of security could intensify deglobalization**

While the era of security could boost investment and R&D, it might also sacrifice efficiencies, lowering potential economic growth. The reestablishment of trade barriers in pursuit of national security would do the same and could also contribute to higher inflation.

**Digitalization could spur labor and popular discontent**

Technological transformation can bring about economic and societal challenges. Capital-intensive and “labor-lite” innovations could concentrate wealth in fewer hands, potentially stimulating populist narratives. It is also worth monitoring how the recent changes in working arrangements will affect labor force participation and productivity in the long term.



# Investing in the decade ahead

Despite heightened risks to the near-term outlook, lower equity valuations and higher bond yields should also be supportive of stronger returns for diversified portfolios over the decade ahead.

## **Government bonds**

Government bond yields increased sharply in 2022 as investors repriced the outlook for interest rates. But while painful for investors in 2022, this bodes well for longer-term returns on government bonds, in our view. Historically, current yields have been good indicators of expected returns in local-currency terms.

And, given large financing needs for infrastructure spending, we think real rates are likely to be higher in the coming decade than in the past one. As we expect inflation to move lower over the medium term, the correlation between stocks and high-quality bonds should turn negative again, stabilizing traditional portfolio diversification.

## Credit

Yields on corporate credit have increased even more than government bond yields so far in 2022, amid worries about slowing economic growth. Although near-term risks are elevated, current credit spreads are wide relative to long-term averages, suggesting a potentially attractive return outlook for investors over a multi-year horizon. And as pressures from tighter US monetary policy fade, we also see good potential for long-term returns in high yield credit and emerging market bonds.

## Equities

Most equity markets declined considerably in 2022, driving valuations much lower. The forward price-to-earnings ratio of the MSCI All Country World Index fell from 18.6 times at the beginning of the year to 14.1 times at the end of October, 3% below the 20-year aver-

age of 14.6 times. Based on historical data, current valuations would be consistent with 10-year returns in the 8–10% range, versus 10-year average annualized returns of 7.4% over the last decade. We note that profit margins are high by historical standards, and higher interest rates, taxes, and commodity prices, along with investments in supply chain security, could dampen margins in the future. Nonetheless, we think the expected long-term return for equities has improved over the past year.

## Alternatives

Hedge funds fared better than equities and bonds in the first 10 months of 2022. Looking ahead, we think hedge fund returns will benefit from higher interest rates and higher expected returns in traditional asset classes, and hedge funds will continue to play a key role in reducing risk and adding diversification to a multi-asset portfolio. Meanwhile, the fall in public markets may lead to delayed markdowns in net asset values in private equity. But we continue to see

the potential for private market investments to deliver a longer-term return premium over public market investments. Our analysis of Cambridge Associates data going back to 1995 found that private market vintages launched the year after a peak drawdown in public markets delivered an internal rate of return of 18.6%, versus 14.8% for funds launched the year of a peak and 11.4% for funds launched the year prior.

### **Currencies**

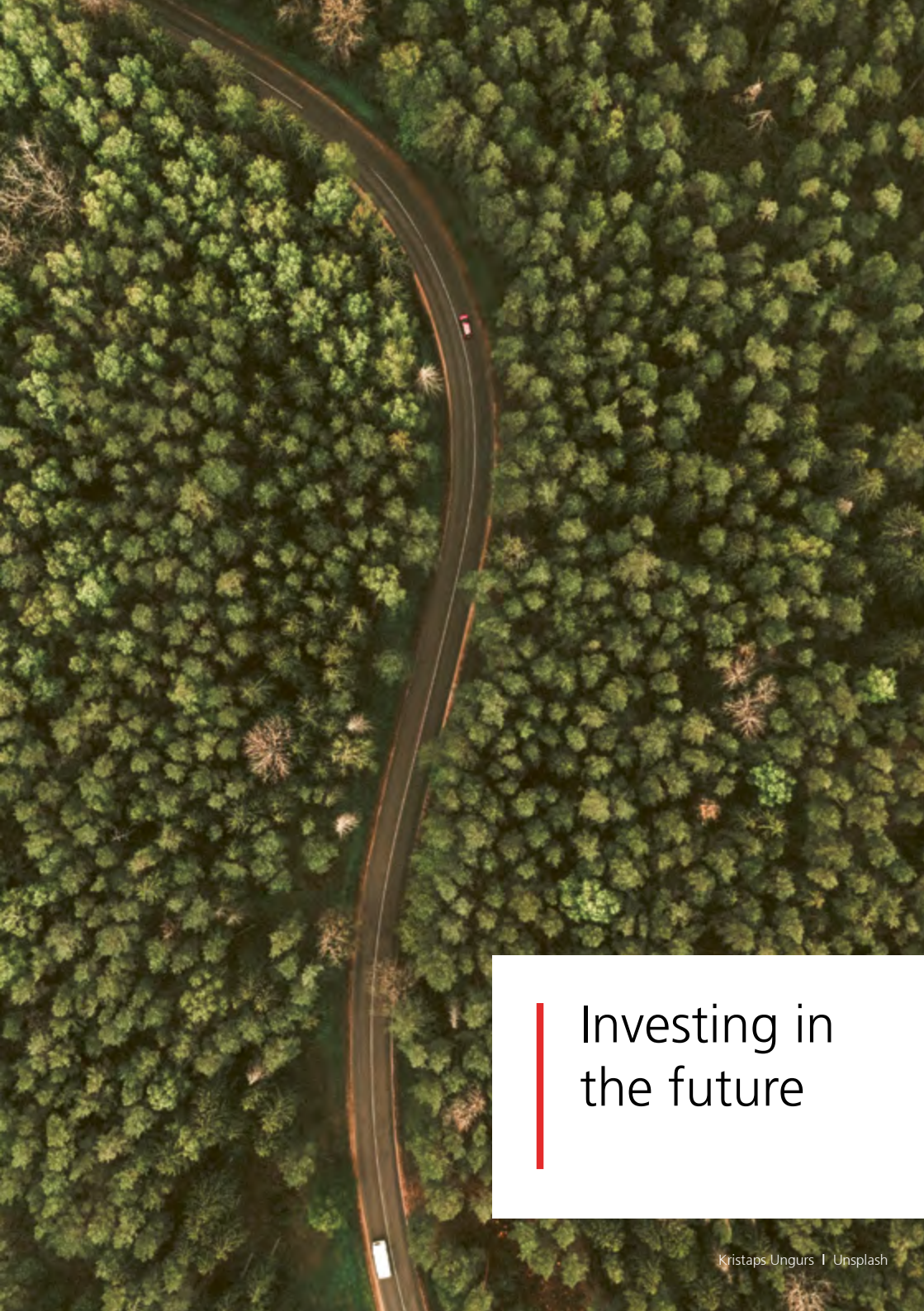
The US dollar strengthened considerably in 2022, driven by the large increase in US interest rates and the currency's status as a safe-haven asset. While we expect the dollar to remain strong as we enter 2023, over the medium term we expect it to depreciate; it is overvalued by around 30% in purchasing power parity terms versus major currencies like the Swiss franc, the euro, the yen, and

sterling. Given the yen's and pound's significant undervaluation and the export-oriented nature of the Japanese and UK equity markets, we choose not to hedge our currency exposure to either of those markets.

### **Commodities**

Over the past two years, broad commodity investments have delivered strong performance and provided significant diversification benefits for multi-asset portfolios. In the longer term, we think the sustained growth in demand for energy, food, and transition metals, and the focus on energy sustainability and security, should continue to support prices. We favor an active approach when investing in commodities to manage the high level of cyclicity of the asset class, as well as to exploit opportunities coming from the diversity of individual commodity performance. Portfolio exposure to rising commodity prices can also be achieved indirectly, through investments in equity sectors, or through countries and currencies with high commodity exposure.





# Investing in the future

# Position for the era of security



We believe we are at the beginning of an era of security, in which energy security, food security, and technological security will be increasingly prioritized by governments and businesses, even if they come at the cost of efficiency. The era of security will drive winners and losers across the investment landscape in the decade ahead.

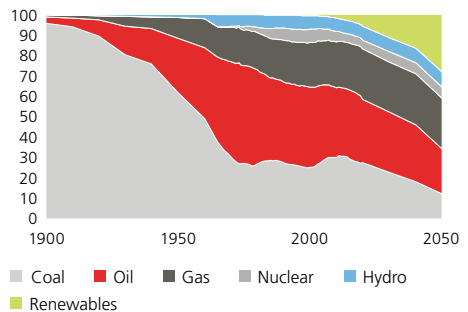
**Energy security.** Plans to transition energy production away from fossil fuels have been underway for years. But Russia's invasion of Ukraine, and subsequent disruptions to European energy supplies, are likely to accelerate those plans—as much on security grounds as on environmental ones.

We expect the era of security to drive commodity prices higher over the long term. A focus on sourcing supplies from allied nations, structural underinvestment, efforts to achieve net-zero emissions, and a need to meet growing emerging market demand should all help support prices. We see near-term upside in oil prices, given gas-to-oil switching this winter, a likely

Figure 1

Greentech is a way to participate in the broad trend toward net-zero

Primary energy consumption by fuel, share of total, in %



Source: Historical data from 1900–2020: Smil (2010), BP Statistical Review of World Energy 2021. Projection to 2050: IEA World Energy Outlook 2021 under its Stated Policies Scenario; UBS estimates

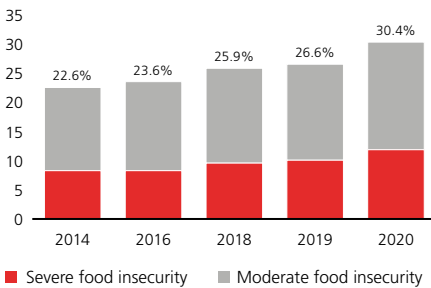
end to OECD releases of strategic oil reserves, and Europe's upcoming ban on waterborne Russian crude imports.

We also continue to expect companies linked to renewable energy solutions to see increased demand in the years ahead—supporting our “Clean air and carbon reduction” and “Energy efficiency” long-term investment themes.

Figure 2

## Moderate or severe food insecurity has been climbing

Prevalence of severe food insecurity in total population, in %



Source: FAO, UBS, as of November 2022

**Food security.** The food price shocks stemming from supply disruptions related to COVID-19, climate change, and the Russia-Ukraine war are driving governments and international organizations to rethink all aspects of food security, in our view.

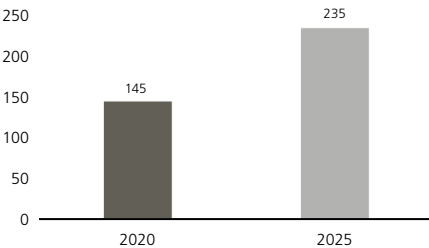
We think this will favor stocks linked to improving agricultural yields alongside reducing environmental damage, saving water, and adapting to climate change, as businesses are increasingly rewarded for boosting production efficiency and reducing overall emissions. If current consumption of land-intensive foods such as animal proteins persists, food production would need to increase by around 50–60% according to forecasts by the UN Food and Agriculture Organization.

Efforts to improve efficiencies across the supply chain will drive opportunities in areas including smart agriculture, alternative protein, and logistics. We forecast the smart agriculture market to expand by 11% a year until 2030 from an estimated USD 13 billion today.

Figure 3

We expect the cybersecurity market to grow 10% a year until 2025

CIO estimates of global cybersecurity market, in USD bn

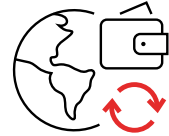


Source: UBS, as of October 2022

**Cybersecurity.** An increase in remote working, alongside a growing perceived threat from both state and non-state actors, is driving an increased focus on cybersecurity solutions. This supported the sector’s 10-percentage-point outperformance versus the broader tech sector in the first 10 months of 2022.

Cybersecurity companies are relatively defensive within the technology sector because security is seen as essential, and companies and governments tend to maintain spending even in the face of economic downturns. Gartner, a technology research firm, forecasts that cybersecurity spending will rise by 11.3%, to USD 188 billion, in 2023, and again by a double-digit rate in 2024.

# Invest sustainably



The long-term performance of sustainable investments remains strong on an absolute and relative basis, despite underperformance in the past year. Companies that manage their business, stakeholders, and environmental impact sustainably should also be in a position to deliver sustainable financial results. Investors, however, need to pay attention to diversification by sector, style, and asset class.

**Diversify across sustainable investing themes.** Some sustainability-linked themes with exposure to high-growth technologies did poorly in 2022 as investors exited growth-oriented sectors in favor of value. We maintain a positive view on the long-term prospects of companies whose products and services address environmental and social challenges. Governments have made strong capital commitments toward sustainable goals, including the EUR 300 billion REPowerEU and the USD 370 billion US Inflation Reduction Act. This has strengthened our conviction that sustainability will be a key long-term driver of investment returns.

That said, volatility among growth companies in 2022 highlights why investors should ensure portfolio diversification and not neglect more value-oriented long-term ideas in the sustainability space. For example, there are numerous value-oriented opportunities in food supply chains, waste management, and recycling.

**Focus on improvers as well as leaders.** Having previously outperformed conventional indexes over a number of years, environmental, social, and governance (ESG) leaders underperformed in 2022, mostly due to their relative underallocation to traditional energy companies. We believe this

demonstrates the importance of considering not only ESG leaders, but also ESG improvers—companies that demonstrate consistent improvement on ESG issues that affect their financial performance. At the index level, ESG improver equities have outperformed broad equity markets by nearly 2 percentage points a year over the past five years. We also continue to focus on ESG engagement strategies, which see shareholders engaging with companies to actively address material sustainability issues.

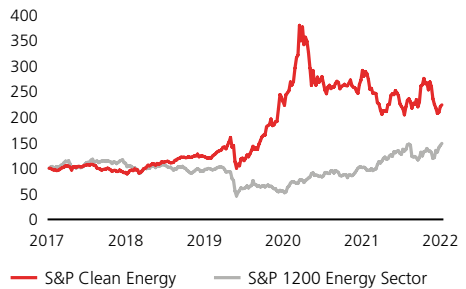
ESG improvers and engagement approaches recognize that key sustainable secular trends like the transition to a low-carbon economy will not happen overnight and will require participation from companies across all sectors and industries. Investors looking for more consistent performance should therefore be selective, but not actively exclude pollutive or ESG laggard sectors. Within sustainable portfolios, we prefer companies with credible decarbonization targets, those making active progress toward diversification into lower-carbon energy sources, and those seeing meaningful improvements on social issues.

**Diversify across sustainable investing strategies.** Diversification was not only a challenge for sustainability-focused investors in 2022; the high correlations between bonds and equities affected traditionally managed portfolios, too. Nonetheless, we believe diversification across sustainable investing asset classes should help improve risk-adjusted returns in the future.

Figure 4

### A longer-term view puts clean energy's recent underperformance in context

Global energy sector vs. clean energy sector total returns



Source: Bloomberg, UBS, as of 10 November 2022



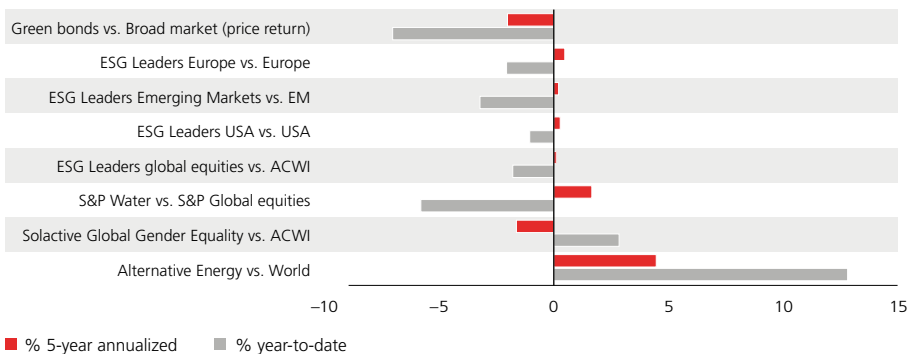
In addition to the opportunities to diversify across equities, we therefore highlight the need to proactively address sustainable fixed income allocations. We see particular opportunity in sustainable bonds—including green, social, sustainability, and sustainability-linked bonds—with shorter tenors and somewhat higher credit risk than benchmark indexes. We think such positioning should result in lower volatility

and higher total returns during periods of slower economic growth. We also continue to see multilateral development bank debt as a sustainable alternative to US Treasuries. As of end-October, these bonds offer a yield of 4.1%, and their proceeds are used to finance projects in emerging markets with a positive economic and social impact.

Figure 5

## A diversified sustainable investment approach has supported long-term returns

Annualized returns of select SI vs. “conventional” indexes



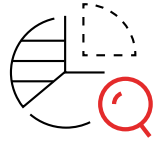
Note: Green bonds refer to GREN index. All other references are to MSCI indexes unless otherwise specified.

Source: Bloomberg, ICE, UBS, as of November 2022

**51%**  
of investors expect better returns from sustainable investing than from traditional investing.

Source: UBS Investor Sentiment survey, November 2022

# Seek value and growth in private markets



Putting fresh capital to work in private markets in the years following declines in public markets has historically proven a rewarding strategy over the long term. We currently favor strategies that can take advantage of price dislocations. But we also see opportunity to grow exposure to digitalization and the transition to a low-carbon economy.

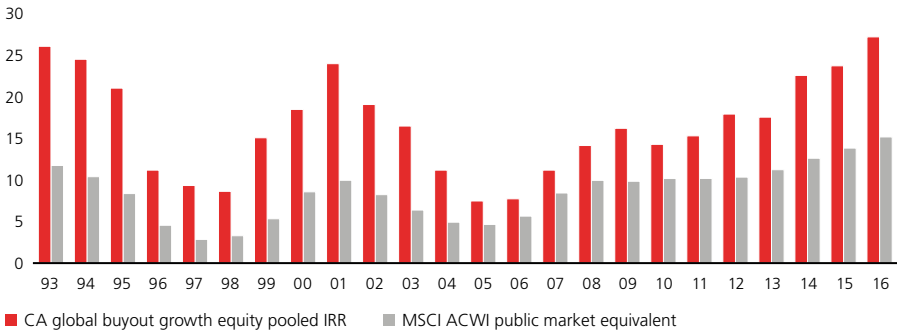
**Secondaries.** Secondary market managers specialize in buying assets from other private market managers and investors who are seeking to liquidate their holdings. With some investors needing liquidity due to portfolio rebalancing or forced selling, buyers are able to negotiate better prices for assets. According to Jefferies, in the first half of 2022, the price to net asset value for buyout funds stood at

91% compared to 97% at the end of 2021. And volumes appear to be growing. Over the same period, total secondaries deal volume stood at USD 57 billion, surpassing the record USD 48 billion set in the first half of 2021.

Figure 6

## Global private equity has outperformed public equity markets across multiple cycles

Vintage year internal rate of return (IRR), global PE vs. public equities, in %



Source: Cambridge Associates, UBS, as of October 2022

**Distressed/restructuring debt.** As interest rates rise and global economic growth slows, the ability of over-levered companies with weak fundamentals to service their debt is likely to deteriorate. While this is challenging for the companies in question, it may also provide investment opportunities for credit and distressed managers that have the expertise to navigate such situations. Historically, dis-

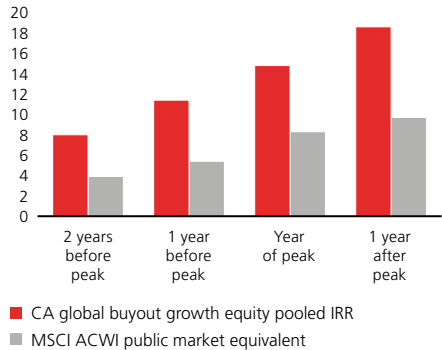
tressed debt managers have earned higher returns during periods of higher corporate default rates. Default rates in US high yield remain low, close to 1%, but we expect them to pick up to the mid-single-digit rates over the next 12 months.

**Value-oriented buyout.** As businesses streamline costs, focus on core assets, and spin off nonperforming assets, we expect to see increased opportunity for buyout funds to invest in take-private deals, carveouts, and divestitures. Carve-outs and divestitures in the first half of 2022 increased to 13% of total US private equity middle-market deals, compared to 11.2% in 2021, and we expect this to be a growing trend in 2023. We are also seeing an increase in buyout strategies with explicit objectives around environmental and social impact, which, when done credibly, can also drive real-world sustainable change.

Figure 7

### Investing in private equity following public market declines can provide strong returns

Vintage year IRR, in %



Source: Cambridge Associates, UBS, as of November 2022

Note: Public market equivalent (PME) calculation is a private-to-public comparison that seeks to replicate private investment performance under public market conditions.

Above graph references pre- and post- 2000 and 2007 equity peaks.



## What to do with direct lending and real estate?

Direct lending and real estate have been among the most popular investment trends in recent years as investors have sought to earn higher yields in a low-yield world. With interest rates and yields now higher, we provide our view on the outlook.

### *Direct lending*

In the first half of 2022, the Cliffwater Direct Lending Index posted returns of 2.3% compared with US high yield losses of 15%. Looking ahead, we expect loan income generation consistent with positive total returns despite a gradual increase in default rates and wider spreads. We note that private loans are senior and underwritten to be held to maturity. They also contain provisions for stress situations and historically have been resilient to macro shocks. For investors prepared to look past ongoing volatility, we think the asset class remains an attractive source of differentiated income in an endowment style portfolio.

### *Real estate*

After a period of supernormal returns for direct real estate, we think the next two years will be more challenging, with capital values set to decrease by 5–10% per annum over that period. Increases in rental income will be the main driver of returns.

That said, we think private real estate remains a critical component in a long-term focused portfolio. It can provide a stable and sizable yield component to returns. Compared with listed real estate, it can offer lower volatility, a more diversified exposure to property markets, and the ability to invest in niche strategies. With leases and rental income often adjusting in line with inflation, real estate investments can also add an important element of inflation protection.

For more guidance on how to construct an alternatives portfolio, see p. 39.





# 2022 in review

## Four things we got right

- ✓ Look beyond mega-cap tech
- ✓ The US dollar would strengthen and gold would fall
- ✓ Energy equities and hedge funds would help shield portfolios
- ✓ Crypto is an “entertainment” trade, not an investment

## Four things we got wrong

- ✗ We did not expect the Russia-Ukraine war
- ✗ Inflation would fall
- ✗ Monetary policy would tighten modestly
- ✗ Bond yields would rise slightly





Josh Withers | Unsplash

Here is what happened as a result:

### **Growth**

In *Year Ahead 2022*, we said that we expected economic growth to slow as reopening was completed and stimulus measures were withdrawn. Economic growth did slow, but more quickly than expected due in large part to the war in Ukraine, higher commodity prices, and continued lockdowns in China. Developed economies are on track to grow by 2.4% in 2022 versus our estimate of 4.2%, and emerging economies by 3.8% versus our estimate of 5.1%.

### **Inflation**

We expected inflation to decline as supply chain issues were resolved, energy prices stabilized, and labor market frictions eased. However, the war in Ukraine drove commodity prices higher, labor markets remained tight, and consumers' spending transition away from goods and toward services triggered higher-than-expected services inflation. US consumer price inflation looks likely to end 2022 at 7.2%, versus our original expectations of 1.8%.

## **Rates**

Persistent inflation led central banks to take far more hawkish policy actions than we expected. While we had thought central banks would tighten policy gradually, high inflation led to a historically rapid pace of interest rate hikes. US interest rates look set to end 2022 at 4.25% versus zero at the start of the year, and Eurozone interest rates look set to end at 2% versus –0.5%.

## **Bonds**

We expected yields to rise in line with modestly tighter monetary policy, but much higher-than-expected inflation and interest rate movements led to a much larger increase in bond yields. We expected 10-year US Treasury yields to rise from 1.5% to 2%; they are at 4% as of this writing.

## **Stocks**

Slower-than-expected economic growth and higher discount rates led to a significant decline in equity markets, with cyclical and growth-oriented sectors worst affected. Defensives and value sectors performed better, and healthcare and energy—two of our preferred sectors as

we entered 2022—outperformed. Meanwhile, our call to look beyond the tech mega-caps bore out. The NYSE FANG+ index was down by 41% at the end of October versus 29% for the broader Nasdaq index.

## **Currencies**

We expected the US dollar to strengthen, and it did, even beyond our expectations. Slower economic growth and relatively aggressive interest rate hikes by the Fed attracted flows into the US currency. The euro-dollar exchange rate moved from 1.16 to below parity.

## **Commodities**

We expected oil prices to remain elevated, and Russia's invasion of Ukraine drove a significant increase in prices. Our broad view on oil—that longer-dated oil contracts and energy equities were underpricing longer-term upside risks to commodity prices and could act as a hedge against inflation risks—bore out. Gold prices fell in line with our expectations as higher US real interest rates weighed on metals prices.





# | Forecasts

# Asset class forecasts

## Currencies

Developed markets						
	Spot	Mar 23	Jun 23	Sep 23	Dec 23	PPP
<b>EURUSD</b>	1.03	0.96	0.98	1.00	1.04	1.30
<b>USDJPY</b>	140	155	150	140	135	62
<b>GBPUSD</b>	1.17	1.10	1.13	1.16	1.21	1.59
<b>USDCHE</b>	0.95	0.97	0.94	0.92	0.88	0.76
<b>EURCHF</b>	0.98	0.93	0.92	0.92	0.91	0.99
<b>EURGBP</b>	0.88	0.87	0.87	0.86	0.86	0.82
<b>AUDUSD</b>	0.67	0.67	0.70	0.72	0.74	0.68
<b>USDCAD</b>	1.33	1.35	1.32	1.28	1.26	1.19
<b>EURSEK</b>	10.82	11.50	11.20	10.94	10.60	10.09
<b>EURNOK</b>	10.34	10.50	10.00	9.80	9.50	11.23

Source: UBS, as of 14 November 2022

Emerging markets					
	Spot	Mar 23	Jun 23	Sep 23	Dec 23
<b>USDCNY</b>	7.04	7.30	7.10	7.00	6.90
<b>USDIDR</b>	15,517	15,700	15,500	15,300	15,300
<b>USDINR</b>	81.3	83.0	82.0	81.0	81.0
<b>USDKRW</b>	1,326	1,400	1,360	1,320	1,280
<b>USDBRL</b>	5.32	5.00	5.00	5.00	5.00
<b>USDMXN</b>	19.40	20.50	21.00	21.50	21.50

Source: UBS, as of 14 November 2022

## Commodities

	Spot	Mar 23	Jun 23	Sep 23	Dec 23
<b>Brent crude oil (USD/bbl)</b>	93.1	110.0	110.0	110.0	110.0
<b>WTI crude oil (USD/bbl)</b>	85.8	107.0	107.0	107.0	107.0
<b>Gold (USD/oz)</b>	1,777	1,600	1,600	1,600	1,650
<b>Silver (USD/oz)</b>	22.1	18.0	18.0	18.0	19.0
<b>Copper (USD/mt)</b>	8,375	9,000	9,500	9,500	9,500

Source: UBS, as of 14 November 2022

## Rates and bonds

	Base rates			10-year yields (%)		
	Current	2023E	2024E	Spot	Jun 23	Dec 23
<b>USD</b>	4.00	4.30	3.32	3.85	3.50	3.00
<b>EUR</b>	1.50	2.81	2.43	2.15	1.95	1.95
<b>CHF</b>	0.50	1.35	1.50	1.07	1.25	1.25
<b>GBP</b>	3.00	4.41	3.85	3.37	3.20	2.90
<b>JPY</b>	-0.10	0.11	0.24	0.24	0.25	0.35

Note: Base rates refer to market pricing.

Source: UBS, Bloomberg, as of 14 November 2022

# Economic forecasts

	GDP growth (%)					Inflation (%)				
	2021	2022E	2023E	2024E	2025E	2021	2022E	2023E	2024E	2025E
<b>Americas</b>										
US	5.9	1.9	0.1	0.3	2.7	4.7	8.1	3.6	1.9	1.8
Brazil	4.6	2.8	1.3	2.5	2.2	8.3	9.3	4.1	3.3	3.0
Canada	4.6	3.0	-0.6	0.3	0.3	3.4	6.8	3.1	1.6	1.5
<b>Europe</b>										
Eurozone	5.3	3.2	0.2	0.8	1.1	2.6	8.5	5.3	2.2	2.0
Germany	2.6	1.7	-0.5	0.7	1.0	3.2	8.8	5.4	2.0	1.8
France	6.8	2.5	0.4	0.9	1.4	2.1	6.0	4.2	1.6	1.5
Italy	6.7	3.7	0.4	1.0	0.9	1.9	8.7	6.1	1.9	2.0
Spain	5.5	4.7	1.4	2.1	1.8	3.0	8.5	3.0	1.9	1.8
UK	7.5	4.3	-0.5	0.6	1.5	2.6	8.9	5.3	2.3	2.1
Russia	4.7	-3.2	-3.0	0.8	1.3	6.7	13.8	4.6	4.2	4.4
Switzerland	4.2	2.1	0.4	1.0	1.8	0.6	2.9	2.1	1.3	1.3
<b>Asia</b>										
China	8.1	3.1	4.5	4.8	4.6	0.9	2.1	2.0	1.8	2.2
Japan	1.7	1.5	1.0	1.2	1.5	-0.2	2.4	1.1	1.7	1.0
India	8.7	6.9	5.5	6.0	6.0	5.5	6.7	5.2	5.1	5.2
South Korea	4.1	2.5	1.1	1.7	2.5	2.5	5.1	3.4	2.1	2.3
<b>Developed markets</b>	5.2	2.4	0.4	0.8	2.1	3.2	7.1	3.7	1.9	1.8
<b>Emerging markets</b>	7.3	3.8	3.5	4.2	4.3	4.7	9.7	7.0	4.8	4.3
<b>World</b>	6.3	3.2	2.1	2.7	3.3	4.0	8.6	5.6	3.6	3.2

E= Estimate

Source: UBS, as of 8 November 2022

# Impressum

## **Year Ahead 2023 – UBS House View**

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This report reflects the insights and perspective from the entire CIO team across the globe and demonstrates the intellectual leadership of UBS.

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