UBS House View

Monthly Letter

15 December 2022
Chief Investment Office GWM
Investment Research

Plan for 2023

Now is the time to plan for the market inflections that will come in 2023. Investors will need to pick their battles, keep focused on the bigger picture, and plan to add exposure over the course of the year.

Boost your income

Rising yields have made fixed income assets more attractive as a source of income. With bond market volatility still high and economic growth slowing, we currently prefer the higher-quality segments.

Learn something new

We see 2023 as a good year to put new money to work in private markets, because investing in vintages after public markets peak has historically generated outsize returns.

Asset allocation

We start the year with a preference for defensive sectors within equities and for higher-quality bonds, but expect the backdrop for investors to improve as 2023 evolves.

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New Year's portfolio resolutions

The end of another turbulent year is a time both to reflect and to make plans, with many of us thinking about our New Year's resolutions. In this letter, I present our 10 resolutions aimed at helping your portfolio navigate this rapidly changing environment.

1. Pick your battles – policymakers will likely drive market inflection points.
2. Think about the bigger picture – long-term returns from here should be good.
3. Stop procrastinating – plan to gain exposure and anticipate the inflections.
4. Get some insulation – add defensives and value.
5. Boost your income – seek income opportunities.
6. Cook with some new ingredients – seek uncorrelated hedge fund strategies.
7. Keep up with the news – position for the era of security.
8. Invest in what you value most – invest sustainably.
9. Learn something new – seek value and growth in private markets.
10. Spend more time with family and friends – best wishes for the year ahead.

In short, in the near term, the backdrop for risk assets is challenging: Inflation remains high, interest rates are rising, and economic growth is slowing. We therefore enter the new year with a preference for defensive sectors and strategies within equities and for higher-quality bonds.

But we expect 2023 to bring inflection points as inflation falls, central bank policy shifts from tightening to loosening, and growth bottoms. This should mean that the backdrop for investors will improve as 2023 evolves.

Investors will therefore need to stay nimble as different asset classes and regional markets try to anticipate inflection points at different times and in different ways. For more details on our views and the outlook for 2023, see our recently published *Year Ahead* report, "A Year of Inflections."

New Year's resolutions

Fed policy and China's reopening will be key market variables in 2023.

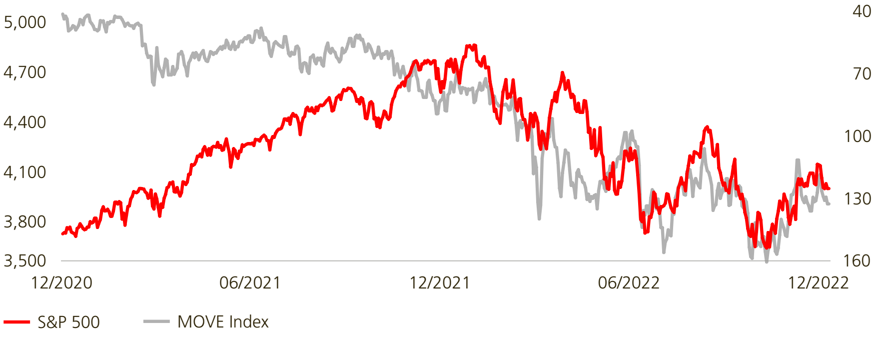
1. Pick your battles – policymakers will likely drive market inflections
Federal Reserve policy and China's reopening path are likely to be important variables for markets in 2023, and investors will need to consider how their positioning fits with the directions of these policies.

The Fed slowed the pace of rate increases to 50 basis points in December from 75bps in each of its prior four rate decisions. But we still expect a further 50bps increase in the first quarter of 2023, with the risk of more thereafter. The Fed has said it intends to keep policy restrictive for some time, and the still-tight labor market, strong nominal wage growth, and higher number of job vacancies than unemployed mean inflation could prove stickier than hoped, preventing the Fed from cutting rates until late in 2023.

Figure 1

Central bank tightening has driven bond volatility and equity performance

S&P 500 Index (lhs); MOVE Index, inverted (rhs)



Source: Bloomberg, UBS, as of December 2022

In our view, this means investors should tactically position more cautiously for now, but also prepare to shift. Cyclical and growth segments of the market and riskier credits will be more attractive as signs emerge that inflation may fall sustainably back to 2% and that the Fed is considering looser policy.

In China, health authorities this month announced further easing on a range of COVID restrictions—another signal the country is edging toward reopening. This has come alongside additional assistance to property developers and more pro-growth statements from the Politburo. Recent economic measures have progressed faster than expected, but we still see a bumpy transition to a full reopening. Public concern over the virus remains high and could be stoked further as infections strain hospital capacity over the winter. Therefore, we keep a selective approach on China at this stage, focusing on individual winners from the reopening while staying neutral on the market overall.

After declines in both stocks and bonds this year, we expect better returns from here.

2. Think about the bigger picture – long-term returns from here should be good
It can be easy to get wrapped up in the day-to-day. But a new year is a time when many of us get some time and space to think about the bigger picture, and for investors, that should mean a more encouraging perspective.

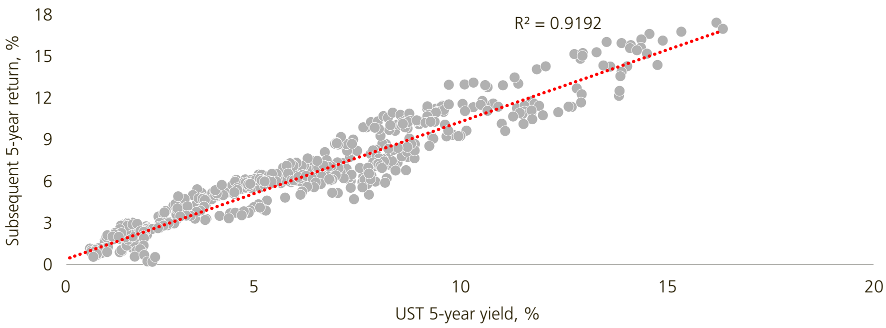
This year, equity valuations, based on the S&P 500 index, have fallen from a 21.3 times 12-month forward price-to-earnings ratio to 17.1 times, while 5-year US Treasury yields have risen from 1.26% to 3.65%. Both suggest decent long-term returns for diversified portfolios.

Historically, current equity market valuations have been consistent with subsequent 10-year returns of 6–9% per year. For bond markets, initial yields are generally a good indicator of subsequent long-term returns, suggesting that current yields—close to the highest since 2009—should mean among the best long-term return outlooks in 13 years.

Figure 2

Higher starting yields may signal improved forward bond returns

5-year US Treasury yields and subsequent 5-year returns, in %, since 1973



Source: Bloomberg, UBS, as of December 2022

This more appealing outlook means 2023 should provide a good opportunity to build up a diversified portfolio for the long term.

As the year unfolds, investors will need to consider when and where to gain more cyclical exposure.

3. Stop procrastinating – plan to gain exposure and anticipate the inflections
Procrastination is a problem that many people try to solve in their new year's resolutions. The same is true for investors. Waiting for precisely the "right time" to invest often results in missed opportunities to earn longer-term returns.

The macroeconomic conditions necessary for a sustainable rally may not yet be in place. But trying to time the precise day, week, or month when markets bottom is always challenging and could backfire if proven wrong. So for investors with excess cash balances today, we see "phasing in" as an effective strategy for building exposure to financial markets next year.

To do this, investors can use dollar-cost averaging and establish a set schedule to invest. Market dips such as an S&P 500 loss of 5% or 10% can be used to accelerate the buying. Meanwhile, a strategy of investing capital immediately in bonds and then phasing into stocks is another approach that can reduce the opportunity cost of holding uninvested cash and potentially enhance investors' ability to buy stocks if there is a market correction.

Inflection points in inflation, rates, and growth should lead to a turning point for markets.

As well as considering when to put cash to work, investors also need to consider where to put it to work. In our base case, we expect broad equity markets to trade lower in the months ahead. But by this time next year, we think the backdrop will have improved in line with our expected inflection points in inflation, monetary policy, and economic growth.

For more risk-tolerant investors looking to identify parts of the market that could rally most strongly when the inflection arrives, we see select opportunities in early-cycle markets, "deep value" stocks, and the likely beneficiaries of China's reopening. These include the broad German and Korean equity markets, parts of the semiconductor sector, select companies exposed to China's reopening, and currency structures that allow investors to navigate the turn in the dollar.

Recent market moves have shown that the US dollar is anticipating the changing macro environment relatively quickly, and we have moved our stance to neutral from most preferred. The Fed's tightening cycle is moving closer to completion, which reduces potential USD upside, while lower US inflation has reduced the risk of a terminal federal funds rate that is significantly higher than the current market pricing of around 5%. In addition, progress toward reopening in China creates room for growth to improve outside the US, particularly in Asia, lending support to more procyclical currencies.

We start the year with a focus on more defensive areas of the equity market.

4. Get some insulation – add defensives and value

Adding home insulation has become a more popular talking point in Europe this winter amid elevated energy prices.

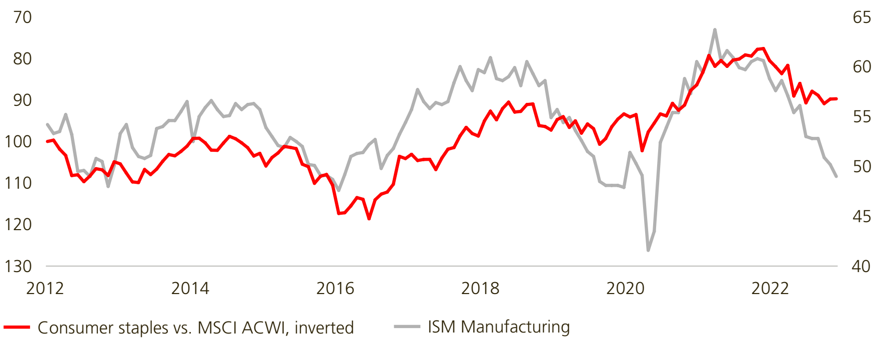
With a backdrop of high inflation, rising rates, and slowing growth, we also think some portfolio insulation for investors makes sense. We currently prefer more defensive areas of the equity market—including consumer staples, healthcare, and quality-income stocks.

The consumer staples and healthcare sectors outperformed the MSCI All Country World Index (MSCI ACWI) by 9 and 11 percentage points, respectively, in the first 11 months of 2022. We expect both sectors to continue to outperform in the months ahead, given that they should be relatively resilient as economic growth deteriorates.

Figure 3

Consumer staples offer a defensive tilt

Consumer staples relative performance vs. MSCI ACWI, rebased to 100 (lhs); ISM Manufacturing (rhs)



Source: Bloomberg, UBS, as of December 2022

With inflation still high, we expect value outperformance to continue.

We also favor value stocks, which have outperformed growth stocks by 19 percentage points in the first 11 months of 2022 (based on MSCI indexes). Inflation above 3% has historically favored value stocks relative to growth, and value has also historically outperformed growth by an average of 4 percentage points in the 12 months following the Fed's last rate hike of a cycle.

Rising yields have made fixed income assets more attractive.

5. Boost your income – seek income opportunities

Many people try to find ways to increase their income in a new year.

Rising yields in 2022 have made fixed income assets more attractive as a source of income. But with bond market volatility still high and economic growth slowing, we currently prefer the higher-quality segments of fixed income, including high grade and investment grade bonds. We expect returns in the first half of the year to be largely driven by the yield on offer, which is currently 4.1% for USD high grade and 5% for USD investment grade bonds.

Quality-income stocks tend to outperform in economic slowdowns.

We also like "quality-income" stocks, which combine higher-than-average dividend yields, a high return on equity, low earnings variability, and low debt-to-equity. Quality-income stocks have a defensive sector bias: Based on data going back to 1988, quality-income stocks (MSCI World High Dividend Yield index) have delivered an average 5.1% annualized return while the ISM is below 50, compared with 1.4% for the MSCI ACWI.

Also, elevated volatility can be used to earn additional portfolio income—for example, through premiums generated in structured investments or put-writing strategies.

Some hedge fund strategies offered portfolios protection from market events in 2022.

6. Cook with some new ingredients – seek uncorrelated hedge fund strategies

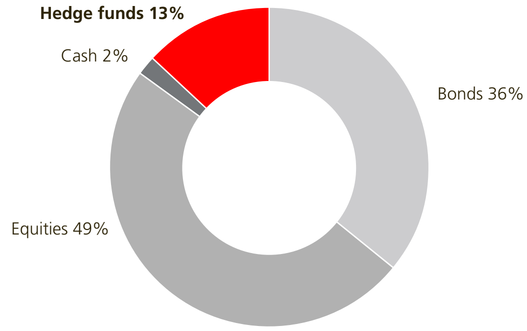
Cooking more often and trying new recipes are popular new year's resolutions, and investors should not neglect the opportunity to consider adding new asset classes into their portfolios, either.

In 2022, traditional bond-equity diversification failed to offer portfolios much protection from market events. But some hedge fund strategies fared much better: Macro strategies, for example, returned 8% on average in the first 11 months of the year [HFRI Macro (Total) Index], as managers successfully positioned long the US dollar and short rates and equities.

Figure 4

Hedge funds have a role to play in a moderate portfolio

CIO's recommended portfolio weightings for a balanced portfolio, in %



Source: UBS, as of December 2022

For investors, this underlines the importance of seeking alternative sources of return that are less correlated with broad market moves.

Looking forward, macro strategies have historically performed well in periods of high implied volatility (i.e., VIX above 25), capitalizing on market stress to generate annualized returns of 6.1%, compared with an average loss of 11.3% for global equities during those periods. We also think equity market-neutral strategies stand to benefit from divergent stock performance in 2023, while multi-strategy funds can offer a simple way for investors to build a diversified hedge fund allocation.

The drive for self-sufficiency in strategic areas will be one of the enduring trends of the decade.

7. Keep up with the news – position for the era of security
The most important geopolitical event of 2022 was Russia's invasion of Ukraine in February, an event that has intensified a drive for self-sufficiency in strategically important areas such as energy, food production, and technological development.

While we don't yet know what news 2023 will bring, we believe this era of security will be one of the enduring trends of the decade, stimulated by measures like the US Inflation Reduction Act, which includes investments in green energy, and the CHIPS Act, which aims to boost domestic semiconductor production.

The global drive for energy security should favor investments in active commodity strategies, greentech, and energy efficiency, while efforts to improve food security should favor stocks linked to improving agricultural yields and water conservation.

Cybersecurity is another potential beneficiary of this trend. The sector is a relatively defensive part of the broader technology space, as companies and governments tend to maintain spending even in the face of economic downturns. We expect the cybersecurity market to grow by 10% per year through 2025.

Many sustainable strategies underperformed in 2022, but their long-term performance remains strong on an absolute and relative basis.

8. Invest in what you value most – invest sustainably
The new year is a good time to review whether you are investing your time, energy, and resources in the things you value most.

Sustainable investments aim for compelling financial performance by tapping into key environmental and social trends that present long term opportunities and are in line with investor interests.

Many sustainable strategies underperformed in 2022 due to higher exposure to growth sectors, though their long-term performance remains strong on an absolute and relative basis. And fund flows to sustainable investments remain more resilient than the broader market. According to Morningstar, while net inflows into sustainable funds slowed to USD 22.5bn in 3Q22 from the revised USD 33.9bn in 2Q22, the overall fund market suffered USD 198bn net outflows over the period.

We see diversification within sustainable investments as key to improving the risk-reward of portfolios—and helping mitigate potential volatility over shorter time horizons. Investors can can diversify across sustainable themes, including more value-oriented topics, alongside growth strategies; focus on environmental, social, and governance (ESG) improvers, as well as companies that are already ESG leaders; and include sustainable bonds as counterweights to equity exposure.

One of the most notable trends in financial markets over the past decade has been the growth of the private market asset class.

9. Learn something new – seek value and growth in private markets
One of the most notable trends in financial markets over the past decade has been the growth of the private market asset class. The industry is likely to continue growing as companies opt to stay private for longer, and investors seek diversification, higher returns, and access to growth.

Private equity (PE) managers are likely to mark down their portfolios further in the months ahead. But it is unlikely that private investments will be marked down to the same extent as public markets. Looking at the past three recessions, US PE markdowns on average only reflected 55% of the S&P 500 drawdown, as measured by Cambridge Associates US Buyout.

We also see 2023 as a good year to put new money to work in private markets because investing in vintages after public markets peak has historically generated outsize returns. Based on our analysis of Cambridge Associates data stretching back to 1995, investing in private equity vintages one year after a peak in public markets delivered a subsequent internal rate of return (IRR) of 18.6% per annum. This compares with an IRR of 11.4% for vintages one year prior to a public market peak.

Scenario analysis

Scenarios (June '23)	**Upside**	**Base case**	**Downside**	**Things to watch**
Probability	**20%**	**50%**	**30%**	
Inflation / Central banks	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% y/y targets toward end-2023 for rate cuts to be considered.	One of at least two paths could lead financial conditions to tighten much further from current levels: 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 later.	*US: CPI and PCE inflation* *US: ISM prices-paid subindex* *US: Average hourly earnings* *US: JOLTS openings and hires* *Eurozone: HICP inflation* *Global: Oil price*
Economic growth	Economic activity reaccelerates due to: A faster-than-expected 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; or A détente between Europe and Russia or a warmer winter, alleviating the energy crisis.	The US economy is still in expansion but slowing. Following a period of sub-trend or negative growth, a trough in economic activity is likely to come later in the year given the lagged impact of monetary policy. In China, provided zero-COVID policies are at least partially relaxed by midyear, economic growth should also improve. The Eurozone and the UK are likely already in recession. Growth in Europe should improve as the energy crisis begins to ease after the winter.	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 downturn prompts lower corporate earnings, rising default rates, and falling commodity prices.	*US, China: Manufacturing PMI* *US, China: Services PMI* *US, China: Industrial production* *US: Change in nonfarm payrolls* *China: Consumer mobility* *Europe: Gas prices*
Geopolitics and others	The war in Ukraine deescalates 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.	*War in Ukraine: Territorial shifts* *War in Ukraine: Weapons supply* *War in Ukraine: Putin support polls* *Global: Financial conditions indexes*
Market path	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 for risk assets, with stocks ending June 2023 slightly below current levels.	Markets experience a severe downturn, with riskier asset classes such as equities posting double-digit losses. Credit spreads widen, while safe havens benefit.	

Source: UBS, as of December 2022

Scenario targets

	Spot*	Upside	Base case	Downside
MSCI AC World	756	850	720	640
S&P 500	3,995	4,400	3,700	3,300
EuroStoxx 50	3,975	4,550	3,800	3,300
MSCI China	65	73	69	52
US 10-year Treasury yield	3.48%	2.5%	3.5%	4.5%
US 10-year breakeven yield	2.19%	2%	2.25%	3%
US high yield spread**	437bps	300bps	600bps	850bps
US IG spread**	117bps	60bps	150bps	200bps
EURUSD	1.07	1.10	1.05	0.98
Commodities (CMCI Composite)	1,884	2,200	2,000	1,600
Gold	USD 1,807/oz	USD 2,000–2,100/oz	USD 1,800/oz	USD 1,500–1,600/oz

* Spot prices as of market close of 14 December 2022
** During periods of market stress, credit bid-offer spreads tend to widen and result in larger ranges.

Note: The asset class targets above are for June 2023 and refer to the respective macro scenarios. Individual asset prices can be influenced by factors not reflected in the macro scenarios.

Source: UBS, as of December 2022

We see attractive returns for value-oriented buyout strategies with a focus on healthcare and technology.

For investors looking to augment their core private equity exposure, we see attractive returns for value-oriented buyout strategies with a focus on healthcare and technology. The trend toward a green economy is generating new investment strategies in a growing sector. Finally, secondaries could present both new and existing investors with a timely opportunity to enter the market at a discount.

Investors should of course remember that investing in alternatives like private equity comes with certain drawbacks, including the risk of illiquidity, and investors need to be willing and able to lock up capital for longer.

Being more sociable benefits your well-being and your professional life.

10. Spend more time with family and friends – best wishes for the year ahead
Given the unprecedented disruption to everyone's personal lives caused by the COVID-19 pandemic in recent years, our last resolution is to spend more time with family and friends over the holiday season and in the coming year.

Being more sociable can also have benefits in your professional life. Numerous studies point to a link between social skills and success in the classroom, being valued by employers, and entrepreneurial success. One of the most well-known proponents of this view is the Dale Carnegie Foundation, which claims that "85% of your social and financial success in life is determined by your social and communication skills."

Whatever your aspirations for the coming year, I hope these resolutions can help you build a robust portfolio for 2023 and beyond. We wish you a happy holiday season and a prosperous year ahead.

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UBS Investor Forum Insights

At this month's Investor Forum, participants discussed the outlook for growth and inflation, and how to position as we head into 2023:

- Headline inflation was seen as coming down throughout 2023, but most participants also believed that core inflation would settle higher and cause central banks to keep monetary policy tight.
- Most participants had a more negative outlook on equities as they saw a growth and earnings slowdown into 2023. China was seen as accelerating through 2023, as reopening gathers pace. On corporate credit, most expected a pickup in default rates and a widening of credit spreads in the lower-rated segment for developed market credit. Some participants found value in emerging market bonds, which were seen as a very "unloved" investment.
- Diversification was an important topic for many participants, with some believing equity-bond correlations may not go back to the negative levels we have seen over the past decade or so.

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.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

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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