UBS House View

Investment Strategy Guide
February 2023

Gauging the inflections

Chief Investment Office
Global Wealth Management
US edition

Dear Reader,

It is apt that we publish this edition of the Investment Strategy Guide on the eve of the Lunar New Year. China's "big bang" exit from zero-COVID not only spells good news for the hundreds of millions who will be able to travel and reunite with their families for the holiday after more than three years, but it has also injected optimism about a global soft landing into the markets. Some inflection points we had anticipated for 2023 may now arrive sooner than expected. This has opened up opportunities for investors, not only in China but also in other asset classes tied to China's recovery, such as emerging markets and commodities.

Europe, too, has benefited from a milder winter, with falling natural gas prices and fiscal support helping to cushion the downturn. On the other hand, in the US, while the labor market remains resilient, weaker economic data, mixed earnings results, and more tech layoffs continue to suggest that growth and profits are slowing. So how should investors respond to the apparent divergence in growth trajectories across different economies and markets?

As we note in our monthly House View letter, we believe this is a market in which selectivity will be rewarded, and our positioning reflects that. We incorporate a combination of defensive, value, and income opportunities that should outperform in a high-inflation, slowing-growth environment, alongside select cyclicals that should perform well as and when markets start to anticipate the inflections in inflation, rates, and growth.

Given our view that the inflection point for growth in the US will come later than in China or Europe, we maintain our least preferred view on US equities. Aside from the Fed pausing rate hikes, the end of downward earnings revisions is the other key catalyst for US equities to start a sustainable bull market rally. In our regional equity allocation, we upgraded emerging markets to most preferred. China's idiosyncratic recovery and a softer US dollar should now support emerging market equity performance versus developed markets.

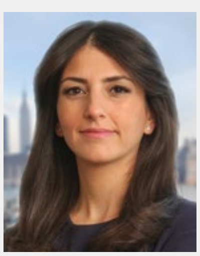
Within US equities, we moved consumer discretionary from least preferred to neutral. Although slower growth in the US could continue to weigh on the sector, China's reopening should provide a boost, particularly for the more traditional, less tech-oriented parts of the sector. As we discuss in our thematic spotlight on "Reopening China," we believe the bulk of the upside from the recovery is likely to be in segments leveraged to stronger Chinese consumer spending.

We also upgraded our view on commodities to most preferred. China's rebound should benefit energy and base metals. Commodities stand to benefit from secular demand drivers, such as the global shift to net-zero. Commodities also face supply challenges stemming from the war in Ukraine, climate developments, and broad underinvestment in upstream capacity. Read our asset allocation implementation section for more detailed guidance across asset classes.

We hope this guide will help you set your portfolio on the right track for the year ahead. As always, we encourage you to reach out to your financial advisor for any questions on our latest positioning.

Regards,

Solita Marcelli



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CIO Monthly Livestream – February:

2 February 2023
1:00 PM ET

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	Least preferred		Most preferred
Cash		=	
Fixed Income			
US Gov't FI		=	
TIPS		=	
US Municipal		=	
US IG Corp FI			+
US HY Corp FI	−		
EM Hard Currency FI		= →	+
EM Local Currency FI		=	
Equity		=	
US Large Cap Growth	−		
US Large Cap Value			+
US Mid Cap		=	
US Small Cap		=	
Int'l Developed Markets		=	
Emerging Markets		= →	+

Note: Our preferences represent the longer-term allocation of assets that is deemed suitable for a particular investor and were developed and approved by the Global Wealth Management Americas Asset Allocation Committee. Our preferences are provided for illustrative purposes only and will differ among investors according to their individual circumstances, risk tolerance, return objectives and time horizon. Therefore, our preferences in this publication may not be suitable for all investors or investment goals and should not be used as the sole basis of any investment decision. Minimum net worth requirements may apply to allocations to non-traditional assets. As always, please consult your UBS Financial Advisor to see how our preferences should be applied or modified according to your individual profile and investment goals.

Also in this report

Gauging the inflections

Challenging backdrop

Despite recent encouraging economic data, the near-term backdrop remains one of high inflation, rising rates, and slowing growth.

Inflections coming

China is reopening faster, growth has proven resilient, and some parts of the market will inflect sooner than others. Dispersion is likely to be elevated.

Be selective

We position with a combination of defensive, value, and income opportunities, alongside select cyclicals that should perform well as and when markets start to anticipate the inflections.

Asset allocation

We add preferences for emerging market equities, emerging market bonds, and commodities. In currencies, we move the euro to neutral from least preferred.

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Markets are off to a solid start in 2023 as falling inflation, relatively robust economic data, and China's COVID policy change drive investor hopes of a "soft landing" for the global economy.

The big question now is whether the latest activity readings and China's reopening mean the current rally will prove durable, or if we face more volatility and uncertainty ahead.

In our *Year Ahead* report, we said that 2023 would be a "Year of Inflections," with the timing and magnitude of turning points in inflation, interest rates, and growth shaping the outlook for markets. In this letter, we assess the progress of the key inflection points and the implications for positioning.

In short, the backdrop remains one of high inflation, rising rates, and slowing growth. But at the same time, labor market and inflation data in recent weeks has been encouraging, and we recognize that some parts of the market will reach inflection points before others, meaning dispersion between different geographical markets and sectors is likely to be elevated. We therefore think selectivity will be rewarded, and our positioning reflects that.

For example, we think China's reopening should allow for a faster turning point in global growth and prove supportive of emerging market equities and commodities. We have added a preference for both asset classes this month. Lower gas prices should reduce recession risks in Europe, and we have moved to a neutral view on the euro from least preferred. We have also added a preference for emerging market bonds relative to high grade bonds, given cooling US inflation and China's policy shift.

The risk-reward for broad US indexes remains unfavorable, and we are selective in our equity positioning.

By contrast, still-tight labor markets in the US mean that investor and central bank concerns about inflation are likely to persist despite recent declines in price readings. In addition, we do not believe that US valuations fully reflect the earnings contraction we expect this year. The risk-reward trade-off therefore remains unfavorable for broad US indexes, in our view, and we retain a least preferred stance on US equities and the technology sector.

Elsewhere, within equities, we continue to favor healthcare, consumer staples, and energy. In fixed income, we prefer higher-quality bonds, including high grade and investment grade, relative to high yield credit. In currencies, we have moved the Swiss franc down to neutral, have a most preferred view on the Australian dollar, and retain a least preferred view on the British pound.

Latest developments	**Macro impact: Positive / negative**	**Investment implications**
China ending zero-COVID policy faster than expected	Positive for Chinese and global growth	– Supportive of commodities and emerging market equities – Boost for reopening beneficiaries in China and emerging market sovereign bonds – Less downside risks to consumer discretionary stocks
Lower European gas prices	Shallower downturn in Europe and positive for recovery in 2023	– Less downside risks for the euro – Positive for German equities, which should also benefit from China reopening
Inflation moderating, but labor markets remain tight	Central banks to slow the pace of rate rises, but inflation remains a risk and rate cuts remain distant	– Supportive of commodities as an inflation hedge and beneficiaries of China reopening – Positive for value stocks, which tend to outperform in elevated inflation environments

Source: UBS, as of January 2023

Growth: Resilience so far, but divergence ahead

What's happened?

US and European growth has shown resilience, while China is reopening faster.

In the US, consumer spending has continued to increase in real terms despite the impact of higher prices and interest rates on household budgets. Even after disappointing retail sales data for December, the Atlanta Federal Reserve's GDPNow tracking estimate for consumption expenditures shows a 2.6% growth rate in the fourth quarter of last year.

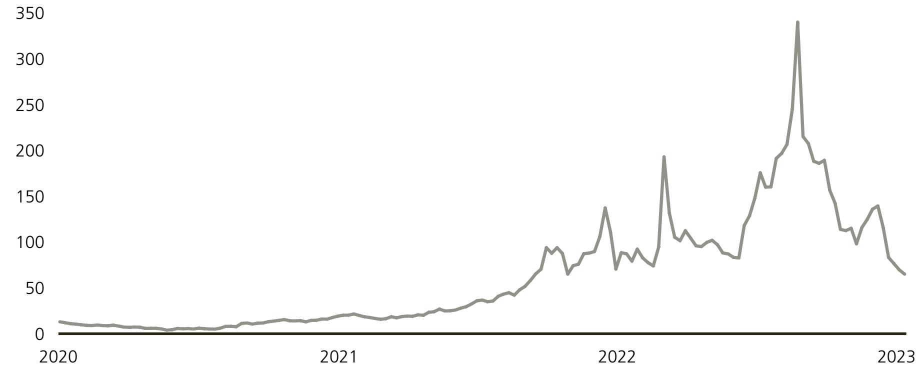
In Europe, mild weather has allowed gas storage facilities to be filled, contributing to a fall in gas prices. Hard economic data, including industrial production, and sentiment surveys have also been stronger than expected.

And in China, Beijing has opted for a "big bang" exit from its zero-COVID policy, which will likely result in a peak in infections in major cities within weeks, and thus pave the way for a faster-than-anticipated economic recovery.

Figure 1

Mild winter weather in Europe has contributed to a fall in gas prices

Dutch natural gas price, in EUR / MWh



Source: Bloomberg, UBS, as of January 2023

We expect to see a divergence in the growth trajectories for different regions.

What do we expect?

From here, we expect to see a divergence in the growth trajectories for different regions.

The US economy is likely to slow further. The savings rate has fallen close to 2%, near its record low, suggesting limited capacity among consumers to continue to spend. The housing sector has turned sharply lower in response to higher mortgage rates: Existing home sales are down 35% year-over-year in November. Leading indicators also suggest weakness ahead: The ISM manufacturing PMI has been in contraction territory since November, and the ISM services PMI fell to 49.6 in December, the lowest reading since May 2020.

By contrast, growth in Europe is likely to accelerate in the coming months. Lower gas prices and fiscal support have helped cushion the downturn. We now see upside risk to our estimate that Eurozone GDP in the fourth quarter of 2022 shrank 0.4% from the previous quarter, and for the first three months of 2023, growth could be flat or even slightly positive. We expect a further improvement in the second and third quarters.

In China, the surge in infections and consumer caution are likely to dampen growth in the near term. But mobility data are pointing to increasing activity. Subway ridership, for example, rebounded rapidly in the first half of January, with the seven-day moving average reaching around 70% of 2020 levels based on our tracker. We expect a recovery in consumption and activity from February and a further acceleration from the second quarter onward. Beijing's supportive monetary and fiscal policy stance and households' pent-up savings should provide an additional boost. Overall, we expect GDP growth to recover to around 5% in 2023.

We expect market volatility to continue and are selective in our equity allocations.

What does it mean for investors?

Until a trough for the US economy and global corporate earnings is more clearly in sight, we expect equity market volatility to continue. As such, we are selective in our equity allocations. Improvements in Europe and China create opportunities for investors.

Since October's low in global equities, emerging market equities have already outperformed US equities by 10 percentage points, but China's reopening should enable this trend to continue. We move emerging market equities to most preferred and retain US equities at least preferred in our asset allocation. We also expect China to outperform other regional markets in the months ahead. We estimate 13.8% earnings per share growth for MSCI China in 2023 compared with 6% for MSCI Asia ex-Japan.

In Europe, we move our view on the euro from least preferred to neutral. European Central Bank policymakers are likely to remain hawkish for some time as they aim to bring inflation all the way down to the 2% target. We also continue to like German equities, which should benefit both from improving growth in Europe and from China's reopening, given the German market's export-oriented composition.

Inflation: Falling, but how fast?

Inflation is peaking, allowing central banks to slow the pace of rate hikes.

What's happened?
Inflation has continued to fall from its peaks late last year, largely supported by falling energy prices.

US inflation fell to 6.5% year-over-year in December after 7.1% in November and 7.7% in October. Meanwhile, Eurozone inflation slowed to 9.2% year-over-year in December, down from 10.1% in the prior month, and surveys show that both input and output prices are now rising at their slowest rate for 12 months.

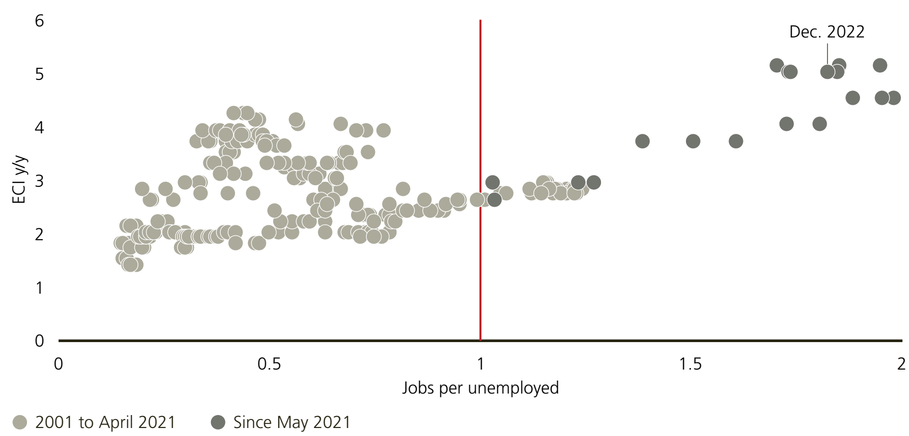
What do we expect?
The decline in inflation is already enabling central banks to slow, or discuss slowing, the pace of rate hikes. However, uncertainty remains about how smoothly and quickly inflation will fall back to target, most notably because of continued tightness in labor markets.

US nonfarm payrolls increased by 223,000 in December, around double the pace of growth in the workforce. The unemployment rate, at 3.5%, is at a 50-year low. And the JOLTS survey data showed job openings dropped by just 54,000 month-over-month in November to 10.46 million, meaning there are still 1.74 vacancies for every unemployed person. This is translating into high wage growth. The Atlanta Fed's wage tracker shows the three-month rolling average of wage growth at 6.1% in December, and, with the quits rate high by historical standards, it is important to note that job switchers are achieving 7.7% wage growth.

Figure 2

A tight US labor market means inflationary pressures from wages remain

US jobs per unemployed, Employment Cost Index (ECI), y/y, in %. Since May 2021, there has been more than one job per unemployed, a sign of a tight labor market



Source: Bloomberg, UBS, as of January 2023

In Europe, although headline inflation has fallen, core inflation has risen to a record 5.2%, and the ECB has highlighted that "wage growth over the next few quarters is expected to be very strong compared with historical patterns."

The risk is that price and wage inflation proves stickier than expected.

What does it mean for investors?
Lower inflation is positive for markets, but at over 6% in the US, there is still a long way to go before investors, or central banks, can feel comfortable that inflationary risks are behind us. The risk is that price and wage inflation proves stickier than expected and does not fall smoothly back down to central bank target levels.

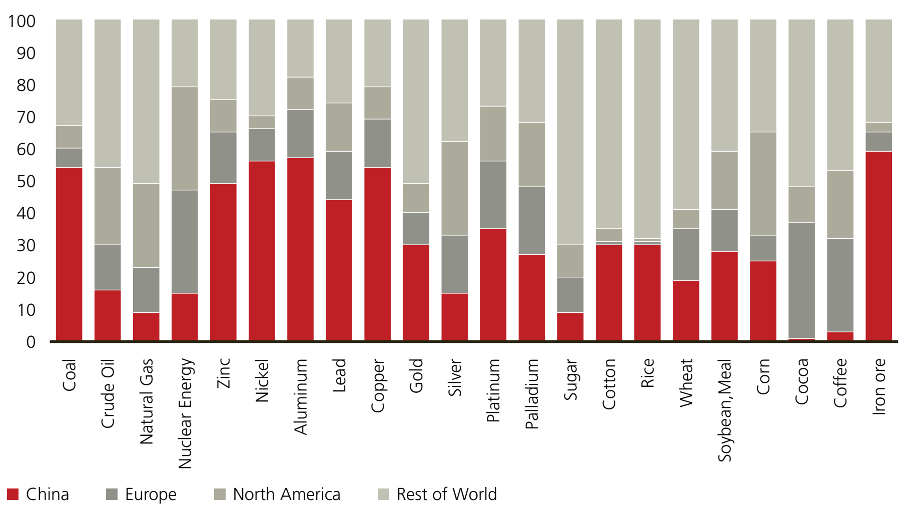
As a result, we retain a preference for value stocks relative to growth, given that value stocks tend to outperform during periods of elevated inflation, and growth stocks could be at risk if inflation proves to be stickier than we, or the market, expect in our base case.

We also think uncertainty about inflation speaks in favor of including a tactical allocation to commodities within portfolios. Commodities should benefit from increased demand following China's reopening, but can also act as a portfolio hedge against inflation proving more persistent than expected.

Figure 3

The reopening of China's economy creates upside for commodities

Chinese commodity demand, as a share of global (2021), in %



Source: BP Statistical Review of World Energy, Woodmac, WGC, Silver Institute, Johnson Matthey, USDA, ICCO, UBS, as of January 2023

Monetary policy: Peaks in sight, but cuts remain distant

Central banks have reduced the pace of hiking, but rate cuts remain a long way off.

Lower headline inflation has helped alleviate some pressure on central banks, and the Fed, ECB, and Swiss National Bank all shifted to a 50-basis-point pace of interest rate increases in December, after 75bps in their previous rate hikes. The Fed is widely expected to slow the pace of rate hikes further, to 25bps, at its next meeting on 31 January–1 February.

What's the outlook?

Markets, economists, and policymakers have a fairly clear consensus about the likely peak for interest rates in the near term. Both the Fed's "dot plot" and financial market pricing imply a further 50–75bps of interest rate increases before a peak. Federal funds futures currently imply that rates will peak around 4.95% in June, and most Fed officials expect a peak between 5% and 5.25%.

However, the timing of future rate cuts is much more uncertain. Market pricing suggests the Fed will bring rates back down to 4.5% by the end of 2023, yet the minutes of the Fed's December meeting showed no policymaker backing rate cuts until 2024. In verbal comments, central bankers have also continued to push back against the market's pricing of a more dovish future policy stance. Atlanta Fed President Raphael Bostic said interest rates should stay above 5% for "a long time," adding he was "not a pivot guy."

Similarly, in Europe, ECB President Christine Lagarde has said the central bank must prevent faster-than-expected wage growth from fueling inflation, and policymakers do appear concerned that high headline inflation rates could translate into higher wage settlements, risking a wage-price spiral. With this in mind, rate cuts appear to remain a distant prospect in Europe, too, and we cannot rule out the possibility that the ECB will lift the deposit rate to as high as 3.5%.

What does it mean for investors?

Sustainable rallies have historically required investors to anticipate rate cuts, not just an end to hikes.

The recent decline in inflation does support a slower pace of interest rate increases from major central banks and is consistent with a likely "peak" for interest rates in the first half of 2023.

However, as we discussed in our *Year Ahead* outlook, sustainable rallies for the broad equity indexes have historically required investors to start anticipating actual rate cuts, rather than a mere end to hikes. And here, uncertainty is higher. Tight labor markets and continued hawkish commentary mean it is likely to be hard for financial markets to fully anticipate interest rate cuts, and we should therefore expect more volatility in the near term.

Scenario targets

	Spot*	Upside	Base case	Downside
MSCI AC World	762	850	720	640
S&P 500	3,929	4,400	3,700	3,300
EuroStoxx 50	4,174	4,550	3,800	3,300
MSCI China	72	78	72	55
US 10-year Treasury yield	3.37%	2.5%	3.5%	4.5%
US 10-year breakeven yield	2.12%	2%	2.25%	3%
US high yield spread**	425bps	300bps	550bps	850bps
US IG spread**	110bps	60bps	120bps	200bps
EURUSD	1.08	1.10	1.07	1.00
Commodities (CMCI Composite)	1,915	2,200	2,100	1,600
Gold	USD 1,904/oz	USD 2,000–2,100/oz	USD 1,800/oz	USD 1,500–1,600/oz

* Spot prices as of market close of 18 January 2023
** 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 January 2023

Scenario analysis

Scenarios (June '23)	Upside	Base case	Downside	Things to watch
Probability	**25%** (up from 20%)	**50%**	**25%** (down from 30%)	
Inflation / Central banks	Inflation falls faster than expected, allowing central banks to tilt toward rate cuts sooner.	Inflation continues to slow in the US and in Europe, allowing the Fed, the ECB, the SNB, and the BoE to complete their hiking cycles in 1H23. As inflation comes closer to major central bank targets toward end-2023, interest rate cuts are considered later in the year.	Inflation proves more persistent than central banks and markets expect, resulting in a protracted period of tighter monetary policy.	*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 as falling inflation boosts real household incomes. Financial conditions ease, lifting market valuations. The outlook for corporate earnings improves.	The US economy slows further and enters a mild recession in 2H23, owing to the lagged impact of monetary policy. Economic activity in China reaccelerates from 2Q23 onwards. In the Eurozone and the UK, lower energy prices pose upside risk to growth. We still expect activity to remain below trend through the winter months, followed by a modest recovery.	Growth in Europe and the US falls more sharply than expected owing to tight monetary policy and a deepening cost-of-living crisis. Financial conditions tighten further, causing stress in the financial system. Central banks cut interest rates toward 2H23 as recession deepens and unemployment and corporate defaults rise. Economic recovery starts in 2024.	*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, e.g., via a ceasefire agreement. A quicker-than-expected reacceleration in China boosts global demand.	The war in Ukraine drags on and keeps markets volatile for the foreseeable future. A cessation of hostilities remains an unlikely outcome. Global financial conditions remain tight, increasing the market's vulnerability to negative surprises or external shocks.	China takes a U-turn in its economic reopening as COVID cases soar. The war in Ukraine escalates or US-China tensions intensify. Tail risk: The US debt ceiling is not raised by July or August, resulting in a US Treasury default and a global market sell-off.	*War in Ukraine: Territorial shifts* *War in Ukraine: Weapons supply* *War in Ukraine: Putin support polls* *Other: Financial conditions indexes*
Market path	Risk assets are lifted by easing financial conditions and a brightening outlook for global growth.	Markets remain volatile throughout 1H23 owing to uncertainty about inflation, monetary tightening, and economic growth. Risk assets start trending higher in 2H23 amid turning points in growth, inflation, and interest rates.	Markets experience a severe downturn, with global equities posting double-digit losses. Credit spreads widen, while safe-haven assets benefit.	

Source: UBS, as of January 2023

We incorporate a combination of defensive, value, and income opportunities, alongside select cyclicals.

Investment views

The near-term backdrop remains one of high inflation, rising rates, and slowing growth. At the same time, lower inflation, China's reopening, and relatively resilient growth data have been positive for markets over recent weeks. And when inflection points are reached, market rallies can be swift.

We therefore like strategies that provide exposure to equity market upside while adding downside protection. We also think selectivity will be rewarded, and our positioning reflects that. We incorporate a combination of defensive, value, and income opportunities that should outperform in a high-inflation, slowing-growth environment, alongside select cyclicals that should perform well as and when markets start to anticipate the inflections. Diversification, including into alternatives, remains a key pillar of portfolio risk management in the current environment, while we continue to see long-term opportunity in the era of security and by investing sustainably.

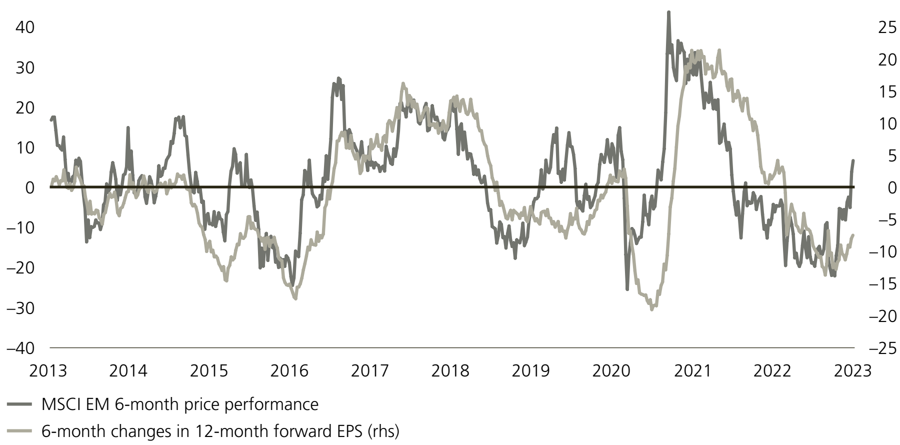
This month we make the following changes to our asset class preferences:

– We upgrade emerging market equities from neutral to most preferred. We expect China's reopening to be positive for export demand, and over the course of the year anticipate a weaker US dollar, which tends to be supportive of emerging market stocks. Earnings momentum and earnings estimate revisions are bottoming relative to developed market peers. The MSCI Emerging Markets index still trades at a 40% discount to MSCI World (at a 12-month forward price-to-book ratio of 1.5x versus 2.5x), a level historically consistent with positive performance in the next 12 months.
– We move consumer discretionary stocks from least preferred to neutral. Although slower US growth could continue to weigh on the sector, China's reopening should provide a boost, particularly for the more traditional, less tech-oriented parts of the sector. Overall valuations have improved over the last 12 months; the sector's price-to-earnings ratio was trading at 24x at the beginning of 2022 and is now at 18x, or a 5% discount versus the 10-year average.
– We upgrade commodities from neutral to most preferred. Commodities continue to benefit from secular demand drivers, such as the global shift toward net-zero carbon

Figure 4

EM performance leads earnings recovery by almost 3 months

MSCI EM 6-month price performance (lhs) and 6-month change in forward EPS (rhs), in %



Source: Refinitiv Datastream, UBS, as of January 2023 emissions. We now also anticipate a cyclical upswing in demand as economies approach growth inflection points. China's faster reopening should benefit both energy and industrial metals. The lack of adequate supply growth or even outright production cuts also favor higher prices in energy, industrial metals, and parts of agriculture. Expected returns in commodities benefit from attractive carry; downward-sloping futures curves offer roll gains, while higher yields have improved returns on cash collateral. A risk to our view is that China's property sector recovers more slowly, reducing the expected pickup in commodity demand.

– We move emerging market bonds from neutral to most preferred. Spreads have tightened recently on the back of the decline in US inflation, the shift in China's COVID policy stance, and increased support for China's property sector. Our view is that this can continue over the short term. We see the performance of this segment being driven by carry and upside on special situations in the distressed space. This includes sovereigns willing and able to work with the International Monetary Fund or other international lenders, or where we see upside to potential restructuring scenarios.

– Within fixed income more broadly, rate volatility has moderated as the inflation outlook has cooled and expectations grow that central banks are close to the end of

Investment idea	
Protect with defensives and value	Slowing US growth, rising interest rates, and fears about inflation proving more persistent are likely to impact markets over the coming months. Defensive sectors such as consumer staples and healthcare should prove relatively insulated from a weakening economy, while value stocks tend to perform well when inflation is high. Elsewhere, high grade bonds and currencies like the Swiss franc and Japanese yen should also offer defensive characteristics.
Seek income opportunities	Interest rates and bond yields moved significantly higher in 2022, boosting the range of options for investors seeking income, and we see particular opportunity in investment grade bonds, resilient credits, emerging market credit, and quality-income stocks. Market volatility itself can also offer investors a means of generating income. A slowing US economy means we are cautious on high yield credit.
Anticipate the inflections	In our base case, broad equity markets face a challenging backdrop in the months ahead. But we also believe that 2023 will bring inflection points in inflation, monetary policy, and economic growth, which will eventually lead to a turning point for broader markets. Lower inflation data and China's reopening also mean that turning points may come earlier for individual parts of the market. Investors should therefore plan how to phase cash into markets, and seek opportunities in commodities, emerging markets, early-cycle markets like Germany, select stocks exposed to China's reopening process, the Australian dollar, and currency structures to take advantage of the turn in the US dollar.
Seek uncorrelated hedge fund strategies	Equities and bonds failed to act as a counterweight to each other's performance in 2022, as concerns around monetary policy and inflation drove their correlation to a 23-year high. Despite data showing falling inflation, fears about future inflation and monetary policy are likely to remain in focus in 2023, and so uncorrelated hedge fund strategies such as macro, equity market neutral, and multi-strategy funds should once again play an important role in diversifying portfolios.
Position for the era of security	The government, business, and consumer response to US-China tensions and Russia's invasion of Ukraine demonstrate that we are entering an era of security, in which energy security, food security, and technological security will be increasingly prioritized, even if they come at the cost of efficiency. The era of security will drive winners and losers across the investment landscape. We see opportunities in greentech, agricultural yield, and cybersecurity solutions.
Invest sustainably	The long-term performance of sustainable investments remains strong on an absolute and relative basis, despite the underperformance in certain areas over the past year. Sustainability can be a key driver of corporate performance, and companies that manage their business, stakeholder, and environmental impacts better should also be well positioned to deliver on financial results. As the past year has shown, investors should pay particular attention to portfolio diversification by sector, style, and asset class.
Seek value and growth in private markets	Some private market funds are likely to revise down net asset value estimates, as a result of the public market correction in the past year. But putting fresh capital to work in private markets following declines in public market valuations has historically been a rewarding strategy. In the current environment, value-oriented strategies are becoming increasingly attractive, in our view.

their rate-hiking cycles. All-in yields remain appealing, particularly relative to opportunities in other asset classes, and investor demand for fixed income exposure has increased. We maintain a preference for high grade (HG) and investment grade corporate bonds (IG).

- In corporate high yield (HY), tighter lending standards feed through with a lag, and the current slower growth and earnings in developed economies suggest higher default risk in the future. Additionally, liquidity risk premiums are likely to rise over time as global money supply continues to shrink. As a result, we see corporate HY spreads as being vulnerable relative to corporate IG and HG and have a least preferred stance on HY.

- We move our view on the euro from least preferred to neutral. China's reopening should be positive for Eurozone exporters, and the ECB is likely to keep monetary policy hawkish for some time to bring down inflation. We have a preference for the Australian dollar, which is supported by China's reopening, Australia's relatively strong economic growth, and a central bank that is likely to keep the reins tight when the Fed starts to ease monetary conditions. We change our most preferred view on the Swiss franc to neutral after its strong gains against the US dollar. Nevertheless, we believe the Swiss National Bank is committed to preserving the franc's strength to limit imported inflation, and that the currency will be supported by safe-haven flows. In the UK, the weak growth outlook and still-high inflation are likely to weigh on sterling, and we maintain our least preferred view.

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Global Wealth Management

Asset allocation implementation

The UBS House View is our current assessment of the global economy and financial markets, with corresponding investment recommendations. The asset allocation implementation of this view can vary based on the portfolio types and objectives.

Our tactical asset class preferences

Most preferred

- **NEW** EM equities
- **NEW** EM hard-currency bonds
- **NEW** Commodities
- US large-cap value
- UK equities
- Australia equities
- US investment grade corporate bonds
- US agency MBS
- Oil

Least preferred

- US equities
- US large-cap growth equities
- US government intermediate bonds
- US high yield corporate
- bonds
- Senior loans

Implementation guidance

Financial markets have ebbed and flowed with incoming data on growth and inflation, and with implications for central bank policy. We expect this to continue in the near term. News over the past month has increased the probability of a global soft landing and reduced the downside tail risks, resulting in a more symmetric distribution of potential macro outcomes, and markets have rallied accordingly. This change in outlook is due to China dropping its zero-COVID policies and reopening much sooner than anticipated; Europe benefiting from better-than-expected weather and steeply falling energy costs; and "Goldilocks" inflation and jobs data in the US. While headline US inflation is falling rapidly, recent data indicate that the economy is slowing in response to higher interest rates, with a resilient labor market being the primary offset. The US economy's ability to achieve a soft landing hinges on inflation moderating back to 2% while significant job losses are avoided.

While the next 3–6 months are likely to remain volatile with large market swings as investors assess whether inflation or growth is falling faster, a better market outlook could emerge later in year. The Fed stopping its rate hikes will be the clearest sign that the risk-reward is starting to shift, and that is likely to happen with the March FOMC meeting. The better news for China and Europe means their growth should start to recover by late 1Q and 2Q, respectively, while we expect the US to be the laggard on growth inflecting higher. A consequence of these regional macro dispersions is a preference for ex-US equities over the US. Aside from the Fed pausing rate hikes, the end of downward earnings revisions is the other key catalyst for US equities to start a sustainable bull market rally. For now, we maintain an overall risk bias that favors higher-quality and defensive assets, while beginning to add risk selectively.

Equities

In our regional equity allocation, we upgraded emerging markets to most preferred. China's idiosyncratic recovery and a softer US dollar should now support emerging market equity performance versus developed markets. Earnings momentum and revisions have also bottomed in emerging markets versus developed markets, and valuations look appealing even after the recent rally. US equities remain least preferred across regions. The S&P 500 forward P/E is about 17.5x, above the pre-pandemic average of 16.6x and higher than at the start of the last two earnings seasons. We see limited upside based on elevated valuations and earnings that we expect to contract 4% in 2023. Among other regions, the UK and Australia stay most preferred. Australia should benefit from higher commodity prices and spillover benefits from China's reopening. UK equities are attractively valued with a forward P/E at a 34% discount to global equities, while the market has high exposure to energy and defensive sectors.

In our intra-US equity allocation, we maintain our value preference and keep large-cap growth stocks as least preferred. Value stocks tend to outperform in periods of above-average inflation, which should persist for most of the year. Growth stock valuations also still look elevated relative to real interest rates and from a historical perspective. Growth stocks' outperformance has extended their lofty valuation premium versus value stocks, which trade at a large discount relative to growth. Value stocks have also been out-earning growth stocks, and we expect that to continue in 2023.

In our US equity sector preferences, we maintain a defensive positioning. Our most preferred sectors are consumer staples (earnings growth for the sector should be more resilient relative to the market, and relative valuations are reasonable given the sector's defensiveness), energy (free cash flow yield is attractive, capital discipline has improved, and the sector should benefit from tight oil markets), and healthcare (drug pricing reform lifts a long-standing overhang, providing earnings clarity; medical procedures are rebounding; and profit growth should be more resilient versus the market). We upgraded consumer discretionary to neutral from least preferred, as it has significantly derated over the past 12 months and should benefit from lower inflation and China's reopening. To offset this, we further downgraded information technology, which should continue to underperform as growth slows and rates stay elevated, and the relative valuations of tech remain lofty and above pre-pandemic levels. The other least preferred sector is financials, a cyclical sector that faces the headwinds of slowing growth and net interest margin compression.

Fixed income

Treasury yields have declined by about 20–40bps to start the year on good inflation data and the market pricing in less Fed tightening and an earlier start to rate cuts. The market is now pricing in a terminal federal funds rate of about 4.85% and close to 50bps of rate cuts before the end of 2023. We expect the 10-year Treasury yield to trade within a range of 3.4–3.9%. With the yield currently below 3.5%, we would trim some interest rate exposure through longer-duration fixed income, looking for a better entry point near the top of the expected range.

We maintain an "up in quality" allocation in fixed income as US growth slows, while spreads for lower-quality bonds have tightened significantly to start the year and do not adequately price in the risk of a recession. Therefore, we continue to prefer investment grade corporate bonds and US agency MBS for their high quality relative to high yield corporate bonds and senior loans, both of which remain least preferred. We prefer more resilient credits, which also have the benefit of longer duration in the event that Treasury yields fall in a recession.

Real assets

Commodity prices may drop in the short term due to slowing global growth, but supply and demand dynamics should favor the asset class from 2Q onwards. Consequently, we upgraded the asset class to most preferred. We expect China's growth to rebound starting later in 1Q, supporting energy and base metals. Commodities stand to benefit from secular demand drivers, such as the global shift to net-zero. Commodities also face supply challenges stemming from the war in Ukraine, climate developments, and broad underinvestment in upstream capacity. Aside from supply and demand dynamics, commodities also offer attractive carry, which we forecast in the high-single digits attributable to roll gains and cash collateral returns.

We maintain oil as most preferred since prices are supported by very low inventories and spare capacity, the desire of OPEC+ to keep prices higher, and the risk of additional geopolitical tensions. The outlook for industrial metals is more closely tied to China's recovery, which is likely to improve as the year progresses. We remain neutral on gold. Gold prices have reached their highest level in six months, triggered by a rally in US bonds and weakness in the USD on poor economic data. Gold has a strong correlation with broad USD moves and a moderate link to nominal rates. Given recessions risks, we reiterate gold's insurance qualities in a portfolio context.

Note: See explanations about asset classes in the Appendix. Changes are based on the US asset class preferences table found in UBS House View Monthly Extended: January 2023, published on 15 December 2022. *We hold a most preferred stance on EM Hard Currency sovereign bonds and remain Neutral on EM Hard Currency corporate bonds.

Our preferences

	Least preferred		Most preferred
Cash		=	
Fixed Income			
US Gov't FI		=	
US Gov't Short		=	
US Gov't Intermediate	−		
US Gov't Long		=	
TIPS		=	
US Agency MBS			+
US Municipal		=	
US IG Corp FI			+
US HY Corp FI	−		
Senior Loans	−		
Preferreds		=	
CMBS		=	
EM Hard Currency FI*		= →	+
EM Local Currency FI		=	
Equity		=	
US Equity	−		
US Large Cap Growth	−		
US Large Cap Value			+
US Mid Cap		=	
US Small Cap		=	
Int'l Developed Markets		=	
UK			+
Eurozone		=	
Japan		=	
Australia			+
Emerging Markets		= →	+
Other			
Commodities		= →	+
Gold		=	
Oil			+
MLPs		=	
US REITs		=	

Bull Market Monitor

Equity markets have been helped by more favorable inflation data

Current status

We judge that the economy is in late-cycle, with growth slowing and the Fed continuing to hike rates. We also judge that the economy is not in recession, but downside risks are high as tighter policy weighs on activity.

What's new?

COVID-19 hospitalizations and deaths have risen off of their recent lows. However, with few government restrictions in place and many people returning to more normal lifestyles, the economic impact has been limited. Economic data for December was mostly weaker. The ISM Manufacturing PMI fell to 48.4 from 49 in November, while the Services PMI dropped sharply to 49.6 from 56.5. Manufacturing output fell by 1.3%, and retail sales were down 1.1%. Nonfarm payrolls increased by 223,000, the smallest rise since December 2020, while the unemployment rate fell to 3.5%, matching the pre-pandemic level at a 50-year low. CPI inflation slowed to 6.5%, down from a peak of 9.1% in June.

The Fed raised rates by 50 basis points on 14 December, setting the federal funds target range at 4.25–4.5%. Public comments from FOMC participants suggest that there will be another rate hike on 1 February, but it is likely to be only 25bps. Markets are pricing in rate cuts to start before the end of the year.

The yield curve is inverted, with 2-year Treasury yields around 70bps higher than 10-year. Spreads on corporate bonds narrowed over the past month. Mobility indicators suggest that there is little residual impact from the pandemic.

What are we watching?

We are looking at a wide range of indicators to gauge the strength of consumer demand, inflation, and labor market conditions. We are watching for any hints that the Fed is approaching the end of the rate-hiking cycle.

What are the investment implications?

We like strategies that provide exposure to equity market upside while adding downside protection. We upgrade emerging market equities to most preferred.

Key cycle indicators

The cycle indicators gauge whether the economy is overheating and if financial conditions are restricting growth. These determine our assessment of where we are in the cycle.

▼ Current ▽ Previous

Economic indicators

Growth (relative to potential)

Below | Above

Labor market

Shrinking | Growing

Mobility (relative to normal)

Restricted | Unrestricted

Inflation (relative to 2%)

Below | Above

Financial indicators

Monetary policy

Accommodative | Restrictive

Yield curve

Steep | Inverted

Credit conditions

Loose | Tight

Each indicator is evaluated relative to a neutral level that is sustainable over time in order to determine whether the economy is at risk of overheating or if financial conditions will start to restrict growth.

Reopening China

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CIO's recently added preferences for both commodities and emerging markets stem from our view that China's reopening should fuel a turning point for global growth. Chinese equities were also recently upgraded to most preferred within Asia-ex Japan. The upgrade was driven by a faster-than-anticipated reopening; increased domestic policy support; signs of stabilization in the property market; easing regulatory pressures on Chinese internet companies with the US now having full access to audited financials of US-listed Chinese companies; and stronger expected earnings growth compared to other emerging markets.

As such, we recently launched a theme, "Reopening China," that includes a stock list of US companies we expect to benefit from China's abandonment of the zero-COVID policy. While some stocks leveraged to the reopening have performed well in recent weeks, we continue to see opportunity for further earnings upside, and see the "Reopening China" theme as a way to anticipate the inflection point in markets.

After years of enforcing a strict COVID-19 containment strategy, China is reopening at a rapid pace and is expected to fully reopen during the first quarter of this year. Ebbs and flows are expected as episodic COVID-19 waves work their way through the population, and we are already seeing a proliferation of the disease in the early days of reopening. Still, China's top policymakers have shifted the focus to economic growth and are likely to continue to adopt pro-growth initiatives to smooth the path.

We believe the bulk of the upside is likely to be in segments leveraged to stronger Chinese consumer spending. A boost in private consumption will be key to China's economic recovery. Years of pent-up demand could lead to "revenge" spending in consumer services. As mobility indicators improve, this should be beneficial to consumer-facing companies, like casinos in Macau that US companies have exposure to. The return of international tourism should provide a source of upside to earnings as well.

When crafting our stock list, not only did we screen for companies with revenue exposure to China, but we also did for those that might benefit indirectly from the knock-on effects that surging China demand might have, especially on the commodity complex. China represents a large share of global commodity demand. Oil prices are likely to increase as mobility trends improve. Industrial metals could also get a lift from end-market demand in the electrical network and transportation sectors, and from policy support to stabilize the property sector.

Profits for many of the companies on the stock list are well below prior peaks, suggesting significant recovery potential as China reopens. On average, forward earnings estimates for the companies on our list are nearly 40% lower than peak earnings over the last five years. This discount rises to nearly 50% if we exclude the energy companies, which benefited from the surge in oil prices in 2022 due to Russia's invasion of Ukraine.

Key risks

First, China's reopening could be in doubt if policymakers reverse recent measures to loosen the country's zero-COVID policies. Snap lockdowns would impair economic and earnings growth. Second, continued monetary policy tightening by key central banks raises the risk of a global recession, and this may outweigh the positive impact from China's reopening on our theme. Third, increased tensions between the US and China may have a negative impact. Finally, each company on our stock list has its own idiosyncratic risks that may impact future performance.

Tactical themes

Tactical equity themes capture opportunities that cannot be expressed through size, sector, and style allocations. Instead, our thematic lists reflect groupings of securities that we view as well positioned to benefit from a common set of drivers. Drivers for tactical themes include macroeconomic forces, policy changes, geopolitical events, temporary mispricing of opportunities (valuations), or timely factors. Our tactical themes span across asset classes, including equity, fixed income, and commodities.

US equity

Resilient spending: We've put together a list of companies we expect to benefit from an increase in spending.

Pricing power standouts: Companies with pricing power should be better able to offset any potential increase in input prices.

Time for quality: With uncertainty over the outlook for economic growth likely to persist, in conjunction with a flat yield curve, we believe high-quality stocks are particularly well positioned.

Reopening China: We highlight US stocks that we expect to benefit from China's reopening.

Note: For each US equity theme, a stock list is available and updated monthly in our report "Tactical US Equity Themes."

International equity

ESG matters in emerging markets: Incorporating ESG considerations into EM equity investment decisions may provide a competitive edge.

EM internet and e-commerce: We see an opportunity in high-quality and structurally attractive emerging market internet and e-commerce stocks.

Fixed income

Yield opportunities in Latin America: This theme is constructed around a basket of Latin American bonds that have the potential to outperform the ICE BofA Corporate IG index.

Taxable munis: Taxable munis can be attractive to taxable fixed income buyers for three principal reasons.

Enhancing liquidity strategy return potential with MLCDs: Market-linked certificates of deposit can offer some limited upside exposure to stocks while providing a "floor" to prevent capital losses if they are held to maturity.

Short-duration Pan-American bonds: This theme provides a list of issuers domiciled in the US and Latin America with relatively short maturities in the corporate bond market.

Alternatives

Opportunities in dislocated credit markets: Stress in the credit market has expanded the opportunity for hedge fund and private managers to deploy capital toward dislocations.

Highlighted global themes

Greentech goes global: We bring together our best investment ideas from several CIO regional greentech themes.

22 for '22: Identifying the "new normal" in 2022 should bring multiple opportunities for investors, including reopening, restocking, and a return to expansion.

30 for 30: This stock list seeks exposure to secular growth companies in the greentech, 5G+, fintech, and healthtech spaces.

ABCs of technology: We believe three major foundational technologies—artificial intelligence, big data, and cybersecurity—are at inflection points.

Security takes center stage: The Russian invasion of Ukraine will likely have a meaningful and long-term impact on security considerations that will affect conventional defense spending, cyberspace, as well as energy, food, and semiconductor supplies. This theme identifies companies that are leveraged to these trends.

Long-term themes

Longer-term themes are expected to unfold over a longer time horizon, perhaps over the course of a decade or longer. These themes are based on secular trends that, CIO anticipates, will endure over multiple business cycles. Longer-term themes extend beyond the time frame of our strategic asset allocation. CIO developed a thematic investment framework based on three megatrends:

The global population is expected to reach almost 10 billion by 2050 from the current 7.3 billion. The vast majority of this population growth will occur in low- and middle-income countries.

The number of people aged 60 and older will exceed the number of those under 25 in developed countries by 2030. Urban populations in emerging economies are forecast to climb by 78% in the years to 2050.

Read more in our Thematic guide.

Global economic outlook

Central bank tightening has helped the supply side of the global economy to catch up with demand, easing inflationary pressure. In the US, the Fed should end the rate-hiking cycle once the labor market softens a bit further. This would take some pressure off of other central banks. China is being hit by a wave of COVID infections, but less restrictive policies should set the stage for faster growth this year. In Europe, lower energy prices and strong fiscal support are providing relief.

Economic outlook summary

Brian Rose, PhD
Senior Economist Americas

CIO view

Probability: 50%*
Declining inflation does less damage to consumers

- Inflation should continue to moderate across most major economies, although local peculiarities in the calculation of consumer prices will mean the decline is not necessarily smooth. Profit-led inflation could surprise with the speed of the decline—as this pricing power can correct more quickly than an inflation that has been spurred by higher labor costs. The decline in inflation is likely to focus market attention on the sustainability of consumer demand, and thus the resilience of economic activity.
- Lower-income consumers are more negatively affected by recent price increases. As turnover in the labor market slows, this group is also likely to experience more pressure on wages. This may result in a further increase in the number of people taking multiple jobs (increase labor supply, without increasing the labor force participation rate). Middle- and higher-income consumers are generally better positioned, and this may result in more resilience in spending from these groups.
- Central banks do not wish to encourage a market-led easing of financial conditions, and so are likely to maintain a fairly hawkish rhetoric. However, the trashing of forward guidance by the Fed and the ECB in 2022 means that market attention to central bank speak has perhaps declined.

Global growth in 2023 expected to be 2.2%

	Real GDP growth in %			Inflation in %		
	2022F	2023F	2024F	2022F	2023F	2024F
US	2.0	0.4	0.3	8.0	3.2	1.8
Canada	3.5	–0.3	0.3	6.8	3.1	1.6
Brazil	3.1	0.7	1.8	9.3	4.3	3.8
Japan	1.2	1.1	1.2	2.5	2.3	1.4
Australia	3.6	1.4	1.7	6.6	5.3	2.9
China	3.0	4.9	4.8	2.0	3.0	2.1
India	6.9	5.5	6.0	6.5	5.2	5.0
Eurozone	3.2	0.2	0.8	8.4	6.0	2.2
Germany	1.7	–0.5	0.7	8.7	7.7	2.0
France	2.5	0.4	0.9	5.9	4.2	1.6
Italy	3.7	0.4	1.0	8.7	7.4	1.9
Spain	4.7	1.4	2.1	8.3	2.7	1.8
UK	4.3	–0.5	0.6	9.1	6.5	2.4
Switzerland	2.0	0.4	1.0	2.8	2.1	1.3
Russia	–3.2	–3.0	0.8	13.7	4.5	4.3
World	3.2	2.2	2.7	8.5	5.9	3.6

Source: Reuters EcoWin, IMF, UBS, as of 19 January 2023
Note: In developing the CIO economic forecasts, CIO economists work in collaboration with economists employed by UBS Investment Research. Forecasts and estimates are current only as of the date of this publication and may change without notice.

Positive scenario

Probability: 20%*
More resilience from consumer demand

Consumer spending continues to rise as higher-income households' savings are put to work. Inflation is less damaging than headline numbers suggest, implying more spending firepower for middle-income households. New forms of employment, unreported in the traditional data, mean better household income than is officially recognized.

Negative scenario

Probability: 30%*
Negative real wages drive negative consumption

Inflation is slower to fall, leading to a prolonged period of negative real wages and falling wage share of GDP. Fears over job security increase, leading to a desire to hold precautionary savings. Consumer spending starts to decline in line with real wages. Poor-quality data or policy error leads to a delayed central bank response to weaker demand.

*Scenario probabilities are based on qualitative assessment.

Equities

Within equities as a whole, we keep the UK and Australia at most preferred and the US at least preferred. Across sectors, we upgrade consumer discretionary to neutral as it has significantly derated over the last 12 months and should benefit from China's reopening and lower inflation. We still like global energy, healthcare, and consumer staples, and stay least preferred on information technology and industrials. Across styles, we prefer value and quality income to growth.

Eurozone

NEUTRAL

We are neutral on Eurozone equities in our global asset class universe. We see more risks to Eurozone profits compared to other developed market regions as a result of EU-Russia tensions and the risk of energy crunches during winter, although we believe this is partly already reflected in valuations. While inflation pressures are showing signs of subsiding, economic growth is continuing to slow and is likely to weigh on equities in the near term until we have greater clarity on how long or deep the downturn could be.

EURO STOXX 50 (index points, current: 4,174)	June 2023 target
House view	**3,800**
↗ Positive scenario	4,550
↘ Negative scenario	3,300

Emerging markets

MOST PREFERRED

We hold a most preferred stance on emerging market equities. The faster-than-expected economic reopening should be a catalyst for the asset class to outperform its developed market peers. A recovery in domestic consumption demand (on goods and services including tourism) is set to benefit the country's neighbors in emerging Asia. China's likely increase in demand for raw materials should also support several commodity producers in the emerging world.

MSCI EM (index points, current: 1,030)	June 2023 target
House view	**1,050**
↗ Positive scenario	1,150
↘ Negative scenario	820

Japan

NEUTRAL

We are neutral on Japanese equities in our global asset class universe. We see limited downside risks to share prices given cheap valuations and resilient earnings trends relative to other developed markets. China's rapid reopening should be positive for select Japanese companies in 2023, particularly in capital-expenditure-related and consumer sectors. The ongoing domestic reopening, including the increase in inbound tourism, should also spur earnings growth. Japanese financials have emerged as an immediate beneficiary of the Bank of Japan's recent surprise policy action.

TOPIX (index points, current: 1,935)	June 2023 target
House view	**1,950**
↗ Positive scenario	2,200
↘ Negative scenario	1,600

UK

MOST PREFERRED

UK equities are most preferred in our global equity preferences. The FTSE 100 has proven to be relatively resilient to domestic challenges, thanks in part to its large international exposure and heavy weighting to commodity and defensive sectors. We expect this to continue to support UK equities relative to other major regional markets in the coming months, and recommend a broad-based exposure to the UK stock market, given market given that our most preferred global sectors (energy, healthcare, and consumer staples) are well represented in the FTSE 100.

FTSE 100 (index points, current: 7,831)	June 2023 target
House view	**8,100**
↗ Positive scenario	8,600
↘ Negative scenario	6,500

Note: All current values as of 19 January 2023

US Equities

Stocks are off to a good start in 2023 on better global growth prospects and improvements in US wage and inflation data. However, further upside from here seems limited due to continued downward pressure on profits, lagged effects of Fed rate hikes, and valuations that are full. We think US equities are at the higher end of our expected near-term range.

David Lefkowitz, CFA; Nadia Lovell; Matt Tormey

US equities overview

NEUTRAL

We have a hard time seeing much near-term equity market upside. Based on tightening lending standards, a likely move higher in the unemployment rate, and continued weak business sentiment, S&P 500 profits will likely be under pressure in the coming months. Additionally, we don't think there is much upside to the current forward P/E of 17x. While not our base case, there is still a material risk the US economy slips into a full-blown recession that could drive stocks around 15% lower. Our June and December S&P 500 price targets are 3,700 and 4,000, respectively.

US equities – sectors

We maintain a defensive bias within sectors. We prefer both consumer staples and healthcare due to their more resilient earnings growth amid macro headwinds. Elsewhere, we think the energy sector should benefit from continued demand and limited supply growth. Relative valuations in the tech sector remain lofty, and there are risks to enterprise IT spending. Finally, financials may come under pressure as bank deposit rates rise, and there is a risk of a significant increase in loan-loss provision expense.

US equities – size

We remain benchmark-weight across size segments. Smaller size segments have historically underperformed in the late stages of the business cycle, which is consistent with the current environment. Additionally, forward EPS estimates for smaller segments are not keeping pace with large-caps. But at some point later this year, the yield curve may start to steepen as 2-year Treasury yields fall in anticipation of Fed interest rate cuts, which typically corresponds to outperformance of small- and mid-caps. Also, relative valuations for smaller size segments are already quite depressed and suggests there is less scope for near-term underperformance.

US equities – style

We maintain our most preferred view on value and least preferred view on growth. Value stocks have outperformed growth stocks over the last year. Initially, higher interest rates weighed more on growth stock valuations. But more recently, relative earnings trends have moved in favor of value stocks. Finally, growth valuations are still higher than normal versus value.

S&P 500 (index points, current: 3,899)	June 2023 target
House view	**3,700**
↗ Positive scenario	4,400
↘ Negative scenario	3,300

Note: All current values as of 19 January 2023

Figure 1

Maintain a defensive bias in our sector positioning

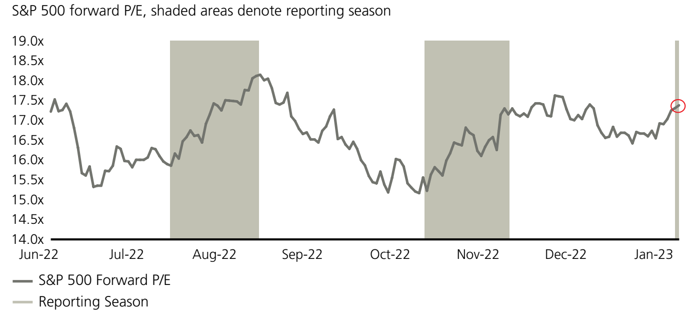
	Least preferred	Neutral	Most preferred
US Equities			
Communication services		=	
Consumer discretionary	→	=	
Consumer staples			+
Energy			+
Financials	–		
Healthcare			+
Industrials		=	
Information technology	–		
Materials		=	
Real estate		=	
Utilities		=	

Note: Changes are based on the Tactical preferences table found in CIO View: US equity sectors, published on 15 December 2022.
Source:UBS, as of 19 January 2023

Figure 2

Valuation is higher than prior to the last two reporting seasons

S&P 500 forward P/E, shaded areas denote reporting season



Source: FactSet, UBS, as of 12 January 2023

Bonds

We believe that the Fed will hike again in February and March and that the magnitude of hikes will continue to downshift as inflation appears on track for a sustained period of decline. However, we still see a risk that the COVID pandemic might have fundamentally altered the US economy's productive capacity by causing a shortage of workers. If this were indeed the case, then the soft-landing projected by the Fed might not be sufficient to bring the labor market back into balance. This risk is not being priced into the long end of the curve, in our view.

Alejo Czerwonko; Leslie Falconio; Kathleen McNamara, CFA, CFP; Barry McAlinden, CFA; Frank Sileo, CFA

Government bonds

NEUTRAL

The 10-year US Treasury yield has rallied nearly 50bps since the start of the year, as weaker economic data results in the market perception of a dovish Fed by 2H23. CIO looks for the 10-year yield to trade in the 3.4–3.9% range in the short term, and to 3% by year-end.

US 10-YEAR YIELD (current: 3.4%)	June 2023 target
House view	**3.5%**
Positive scenario	2.5%
Negative scenario	4.5%

US investment grade corporate bonds

MOST PREFERRED

We hold a most preferred stance on IG. Spreads are sitting around their long-term average; however, we gain comfort from the higher outright yields of about 5% and the fact that Treasury yields are a large component of the yield. This should provide an offset based on our expectation that credit spreads move wider. IG issuer fundamentals are strong with improved levels of coverage and leverage, but some degradation is expected as earnings growth slows.

US IG SPREAD (current: 129bps)	June 2023 target
House view	**155bps**
Positive scenario	90bps
Negative scenario	225bps

Benchmark: ICE BofA

Emerging market bonds

MOST PREFERRED

Emerging market bonds have recently benefited from a decline in US inflation, a shift in China's COVID policy stance, and increased support to China's property sector. Emerging market sovereign and corporate bond spreads should remain well-supported the back of these drivers. We hold a most preferred stance on hard currency sovereign bonds and remain neutral on hard currency corporate bonds. Key risks include faster-than-expected Fed tightening, worsening geopolitical tensions, and sharp corrections in commodity prices.

EMBIG DIV. / CEMBI DIV. SPREAD (current: 445bps / 335bps)	June 2023 target
House view	**425bps/300bps**
Positive scenario	300bps/280bps
Negative scenario	600bps/550bps

EMBIG = hard currency sovereign bonds
CEMBI = hard currency corporate bonds
Note: Current values as of 19 January 2023

US high yield corporate bonds

LEAST PREFERRED

We maintain HY at least preferred. Given our expectation of slowing growth in 2023, we do not believe that investors are compensated with ample risk premium to protect against weakening credit fundamentals and rising defaults. With the ample yields earned in higher-quality sectors, we believe that moving up in credit is a prudent risk/reward strategy.

USD HY SPREAD (current: 427bps)	June 2023 target
House view	**550bps**
Positive scenario	300bps
Negative scenario	850bps

Municipal bonds

NEUTRAL

Munis are off to a strong start in 2023. Month-to-date, tax-exempt debt has gained almost 3%. At the same time, high yield muni credits are up by close to 5%. We attribute these price gains in large part to lower US Treasury yields and anemic muni new issue supply. We favor high-quality muni sectors such as state general obligation, electric utilities, and water and sewer that can prove resilient through an economic downturn. Current AAA 10-year muni-to-Treasury yield ratio: 65.4% (last month: 69%).

Non-US developed fixed income

NEUTRAL

Over the past month, bond yields in non-US developed markets moved mostly lower on the perception that central banks are approaching the end of the rate-hiking cycle. On foreign exchange markets, the dollar was weaker against other major currencies. These factors combined to produce strong returns for the asset class. With yields still mostly lower than in the US, non-US developed fixed income remains unattractive. We do not recommend a strategic asset allocation position on the asset class.

Additional US taxable fixed income (TFI) segments

Agency bonds

While the fourth-quarter effect has widened agency debt spreads, we retain a preference for higher-quality agency securities such as agency MBS. Although we look for agency debt to outperform in the second half of 2023, the wider opportunity set within higher-quality assets points to an allocation to agency MBS versus debt. Current spread is +8bps to the 5-year (versus +12bps last publication)

Mortgage-backed securities (MBS)

MOST PREFERRED

Agency MBS is a favored asset class for 2023. Although 2022 saw historically lower total returns, agency MBS still outperformed most asset classes. The sector's higher quality and greater liquidity lend to a strong performance for the year ahead. With interest rate volatility expected to remain elevated but not spike in 2023, combined with the potential for slower growth, this AAA sector should bode well as investors continue to seek higher-quality assets. While spreads compressed to 127bps to Treasury, we look for 100bps as a potential target over the longer term. Current spread is +135bps to the 5-year and 10-year Treasury blend (versus +175bps last publication)

Preferred securities

NEUTRAL

Preferreds are off to a great start this year, helped by the 5- and 10-year Treasury rate dropping below 3.5%. A more favorable inflation outlook and less hawkish Fed should sustain the more benign rate backdrop in 2023, and this would support the preferred sector, especially given current valuations. With average yields of more than 6%, absolute and relative valuations appear fair-to-attractive, with the yield advantage over 10-year Treasuries a bit higher than the 20-year average spread. Gaining sector exposure with a combination of fixed- and variable-rate coupons may provide better resilience.

Treasury Inflation-Protected Securities (TIPS)

Despite the inflationary environment, TIPS in 2022 suffered from interest rate volatility. TIPS still outperformed most asset classes in 2022, but are poised to take advantage of declining real yields in 2023. With lower inflation expectations now priced in to the forward curve, we like TIPS but we do not add at these levels as we wait for real yields to reach near 1.6% during 1H23. Current 10-year break-even inflation rate of 1.16% (2.48% last publication)

Figure 1

UBS CIO interest rate forecast

In %

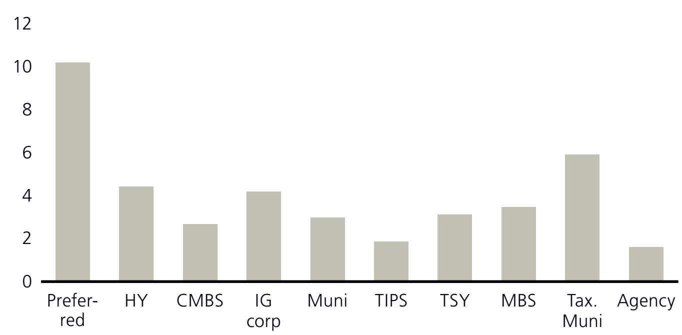
US Treasury	Current	Mar-23	Jun-23	Sep-23	Dec-23
2-year	4.1	4.0	4.0	3.5	3.3
5-year	3.4	3.8	3.5	3.3	3.0
10-year	3.4	3.5	3.5	3.3	3.0
30-year	3.6	3.5	3.5	3.5	3.3

Source: Bloomberg, UBS, as of 19 January 2023

Figure 2

Fixed income has been off to a strong start

Year-to-date total return, in %



Source: ICE BofA, UBS, as of 18 January 2023

Commodities and listed real estate

We see another strong year for commodities in 2023, and forecast high-teens percentage total returns on an asset class level. Much of this performance should come from higher spot prices, while roll yields and cash collateral returns are each expected to deliver 4–5 percentage points of returns. In terms of spot appreciation and roll yields, we expect energy to take the top spot again, with total returns of more than 30%. Industrial and precious metals are forecast to return 10% and close to 5%, respectively. Agriculture and livestock should deliver flat to positive returns.

Dominic Schnider, CFA, CAIA; Giovanni Staunovo; Thomas Veraguth; Wayne Gordon

Commodities

MOST PREFERRED

Precious metals: Gold has rallied to its highest level since June thanks to a rally in US Treasuries and broad USD weakness. US average December hourly earnings undershot expectations, while the US services ISM posted its biggest monthly drop outside of a recession since the mid-1990s. We expect a terminal federal funds rate around 5%, with a relatively low likelihood of rate cuts this year unless the unemployment rate rises sharply. Given our view and gold's correlation with the USD and nominal interest rates, we expect prices to fall over the short run. As 1Q unfolds, we anticipate some residual USD strength, a revaluation of expectations for Fed rate cuts, and subsequently higher US real rates, which limit gold's upside for now. But as a hard-landing in the US cannot be ruled out, we reiterate gold's insurance qualities in a portfolio context alongside an income strategy, which can enhance returns on gold holdings.

GOLD (current: USD 1,904/oz) — June 2023 target

NEUTRAL

House view	USD 1,800/oz
↗ Positive scenario	USD 2,000–2,100/oz
↘ Negative scenario	USD 1,500–1,600/oz

Crude oil: We expect crude prices to rise in 2023 for several reasons. With China's reopening, oil demand looks set to exceed 2019 levels and hit a record high in 2H23. Emerging Asia, including India, should also drive demand growth. Meanwhile, Russian oil production should fall due to the EU embargo on Russian crude and refined products (coming into force on 5 February). While non-OPEC+ production, driven primarily by the US, will likely expand again this year, the increase should only be modest following years of underinvestment in new capacity. So, to keep the market in balance, we expect OPEC+ to ease production cuts once again and provide more barrels to meet rising demand as Russian supply drops off. Given our positive price outlook, we reiterate our investment recommendations. With the oil futures curve sloping downward and higher prices likely ahead, we continue to advise risk-taking investors to add long positions in longer-dated Brent oil contracts.

BRENT (current: USD 85/bbl) — June 2023 target

MOST PREFERRED

House view	USD 110/bbl
↗ Positive scenario	USD 140–170/bbl
↘ Negative scenario	USD 50–80/bbl

Note: Current values as of 19 January 2023

Base metals: Industrial metal prices, and copper in particular, are seeing signs of life. On balance, we expect industrial metal prices to be well bid with room to appreciate another 10% on a sector level. Higher industrial metal prices strongly hinge on a firm recovery in China to keep market balances tight. This is needed as mining supply has room to expand more firmly in 2023 compared to 2022. Our metals of choice are copper, aluminum, and zinc. As for nickel and lead, we expect prices to move modestly lower. Well-bid prices on average also make the sector attractive for yield pickup strategies.

Listed real estate

We seek exposure to companies with superior implied yield gaps to financing costs, with relatively low leverage and comparative strong pricing power. We think earnings visibility remains good despite some uncertainties around values, dividend payments, and potential rights issues that have so far been mostly priced in. We like Hong Kong based on valuations and the swift reopening, and we also favor Singapore real estate investment trusts (REITs) with attractive yields. After a severe price correction from the summer, we favor a pan-European exposure. By contrast, we expect Japanese companies and Australian REITs to underperform as inflation is still on the rise. Economic uncertainty is weighing on the US. We think UK real estate companies are cheaply valued and relatively well capitalized, but there are lingering questions over the growth outlook.

RUGL Index (current: USD 5,664) — June 2023 target

House view	USD 6,200
↗ Positive scenario	USD 7,000
↘ Negative scenario	USD 6,000

Note: Current value as of 17 January 2023

Foreign exchange

We upgrade EUR and downgrade CHF, both to neutral, and add AUD as most preferred.

Brian Rose, PhD

Support for the US dollar has evaporated as the Fed's rate hike campaign winds down. The strong equity performance in Europe, China, and Japan in recent months has not helped the currency, either. As a result, many investors highly exposed to the US after several years of USD strength and solid US equity gains had to reposition their exposure. We are still in the neutral camp on the USD, though we expect it to weaken by year-end. A lot depends on the Fed's policy cycle. Market expectations for rate cuts are more aggressive than the Fed's own assumptions, and we see a possibility that the current risk-on sentiment supporting the rest of the G10 currencies versus the USD may flip again to a more cautious stance that supports the greenback.

We raise the euro to neutral. The ECB has turned increasingly hawkish in response to inflation, which has proven sticky. The general risk-on mood is also supporting Italian bonds, which are the Achilles' heel for European rate hikes. The opportunity to hike has therefore increased. Finally, China's reopening supports European equities, and with this, demand for euros. That said, we are not lifting the euro to most preferred. The war in Ukraine is ongoing, and the geopolitical risk raises the risk premium for the euro and limits the trade opportunities with Central and Eastern Europe.

We change our most preferred view on the Swiss franc to neutral after strong gains versus the USD recently. Nevertheless, we believe the Swiss National Bank is committed to preserving CHF strength to limit imported inflation, and that the currency will be supported by safe-haven flows. In sum, we expect USDCHF to consolidate over the next couple of months. In 2H23, we expect USDCHF and EURCHF to follow the drop seen in their respective equilibrium values during 2022. With the CHF well bid during unexpected bouts of market uncertainty, the currency continues to offer an attractive risk-reward to investors, in our view. The Bank of England faces a big dilemma. Growth concerns challenge rate-hike prospects, while higher yields are needed to rein in rising inflation expectations. Meanwhile, our stance on the Japanese yen remains neutral. We see potential for the Bank of Japan to tighten policy, but it remains willing to keep policy settings unchanged for now. The Australian dollar enters our list as most preferred. It is supported by China's reopening, Australia's relatively strong economic growth, and a central bank likely to keep the reins tight while the Fed starts to ease.

In Asia, we expect the Chinese yuan to appreciate steadily thanks to tailwinds from China's reopening and measures to support the property sector. We also expect the Singapore dollar to trend stronger thanks to its central bank's policy of gradual, trade-weighted currency appreciation. Sentiment toward emerging market currencies in Latin America and EMEA is thawing as the outlook for China improves and the end of Fed rate hikes draws closer. Near-term setbacks are possible until we have greater clarity on Fed policy and the global growth outlook. With more certainty on these factors, select currencies in Latin America and EMEA can continue to do well thanks to their interest rate carry. Risks persist that some central banks, particularly in Central and Eastern Europe, are turning dovish too soon.

FX strategy

	Least preferred		Neutral		Most preferred
USD			⊖	←	⊕
EUR	⊖	→	⊖		
JPY			⊖		
GBP	⊖				
CHF			⊖	←	⊕
AUD					⊕

FX forecasts

	Current	Mar 2022	Jun 2023	Sep 2023	Dec 2023
EURUSD	1.08	1.05	1.07	1.07	1.10
USDJPY	128	125	122	120	120
GBPUSD	1.24	1.19	1.23	1.24	1.30
USDCHF	0.91	0.91	0.89	0.89	0.86
USDCAD	1.34	1.35	1.36	1.38	1.38
AUDUSD	0.70	0.70	0.72	0.74	0.76
NZDUSD	0.65	0.65	0.66	0.67	0.67
USDSEK	10.25	11.27	10.67	10.19	9.64
USDNOK	9.84	10.29	9.52	9.16	8.64

Sources: SIX Financial Information, UBS, as of 20 January 2023

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The UBS investment process is designed to achieve replicable, high-quality results through applying intellectual rigor, strong process governance, clear responsibility, and a culture of challenge.

Based on the analyses and assessments conducted and vetted throughout the investment process, the Chief Investment Officer (CIO) formulates the UBS Wealth Management Investment House View at the Global Investment Committee (GIC). Senior investment professionals from across UBS, complemented by selected external experts, debate and rigorously challenge the investment strategy to ensure consistency and risk control.

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- Mark Haefele (Chair)
- Solita Marcelli
- Paul Donovan
- Tan Min Lan
- Themis Themistocleous
- Bruno Marxer (*)
- Adrian Zuercher
- Mark Andersen

We recognize that a globally derived house view is most effective when complemented by local perspective and application. As such, UBS has formed a Wealth Management Americas **US Investment Strategy Committee**:

- Solita Marcelli
- Alejo Czerwonko
- Jason Draho (chair)
- Leslie Falconio
- David Lefkowitz
- Brian Rose
- Daniel Scansaroli

(*) Business area distinct from Chief Investment Office Global Wealth Management

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Explanations about asset classes

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Appendix

Investors should be aware that Emerging Market assets are subject to, among others, potential risks linked to currency volatility, abrupt changes in the cost of capital and the economic growth outlook, as well as regulatory and sociopolitical risk, interest rate risk and higher credit risk. Assets can sometimes be very illiquid and liquidity conditions can abruptly worsen. CIO Americas, WM generally recommends only those securities it believes have been registered under Federal US registration rules (Section 12 of the Securities Exchange Act of 1934) and individual State registration rules (commonly known as "Blue Sky" laws). Prospective investors should be aware that to the extent permitted under US law, CIO Americas, WM may from time to time recommend bonds that are not registered under US or State securities laws. These bonds may be issued in jurisdictions where the level of required disclosures to be made by issuers is not as frequent or complete as that required by US laws.

For more background on emerging markets generally, see the CIO Americas, WM Education Notes "Investing in Emerging Markets (Part 1): Equities," 27 August 2007, "Emerging Market Bonds: Understanding Emerging Market Bonds," 12 August 2009 and "Emerging Markets Bonds: Understanding Sovereign Risk," 17 December 2009.

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