UBS House View

Investment Strategy Guide: Inflections diverge

24 February 2023 | Chief Investment Office GWM | Investment research

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Dear reader

The widely anticipated recession has not yet arrived, leaving the markets searching for a clear direction. In recent weeks, the market narrative has flitted from "soft landing" to "hard landing" to now, what some call, the "no landing" scenario. In this narrative, the landing is delayed and the ultimate path for the economy is still, metaphorically speaking, up in the air. On one hand, the strength of the US labor market and resilient consumer spending improves the likelihood of a soft landing. But on the other, it also raises the risk that inflation would be stickier, causing the Federal Reserve to raise rates more than projected, leading to a deeper recession further down the road. We do not know what landing we will get. All we know is to expect turbulence.

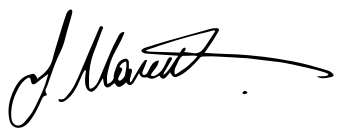
In our view, the no-landing scenario is not sustainable and the economy will eventually slow whether due to a fall in consumer spending or because of restrictive monetary policy. This makes the recent moves higher in both equities and rates untenable. We continue to believe that markets will be volatile in the next few months as investors digest every new data point and toggle between hard and soft landing scenarios. Right now, the stock market is pricing in too high a probability of a soft-landing scenario, in our estimation. The bond markets, however, are pricing in a reasonable expectation of further hikes in 2023 and cuts in 2024. At current yields and valuations, the relatively safe carry of investment grade bonds appears more attractive than the return-less risk of equities, where a lot of the good news is already priced in.

So US investment grade corporate bonds continue to be among our most preferred asset classes, while US equities and US high yield corporate bonds are both least preferred.

However, reflecting the stronger near-term data, we have raised our end-June 2023 S&P 500 target to 3,900 (from 3,700), while also downgrading our end- December 2023 target to 3,800 (from 4,000), reflecting the risk of higher rates and a recession later in the year. Sector wise, while we maintain a defensive tilt, we have moved to a more balanced tactical positioning, upgrading real estate to most preferred and lowering healthcare to neutral. Read more on the reasoning behind these and other sector changes in our Asset Allocation Implementation section.

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,



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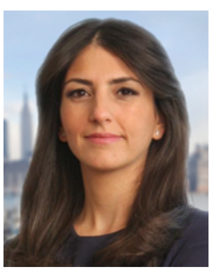

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March

CIO Monthly Livestream
2 March 2023 at 1:00 PM ET

Tune in to the event here

Inflections diverge

Earlier inflections

The latest data suggest inflections are happening at different speeds in different regions. China and Europe are inflecting sooner than expected.

US risks

The US economy has remained robust, but this may raise the risk of a later, deeper recession as the Fed tries to combat inflation.

Be selective

Diverging inflections back a more regionally selective approach to risk decisions. Tactically, we think investors should diversify beyond the US and growth stocks.

Asset allocation

We like emerging market equities and value stocks. Among defensive sectors, we see greater opportunity in consumer staples than in healthcare.

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Greetings! As we gather here again for our monthly investment letter, I can't help but wonder…what's the deal with ChatGPT? Is it a financial genius disguised as a chatbot, or just a digital Magic Eight ball that sometimes gives us accurate predictions purely by chance? The jury's still out on that one, folks. All we know for sure is that it has a knack for generating some interesting responses and occasionally dropping some humorous quips.*

Of course, ChatGPT is not the only recent development on which the jury is still out. More pressing for investors is that recent US economic data seem to have simultaneously increased the risk of a "hard landing" as well as the chance of a "soft landing" for the US economy.

Headline retail sales, job growth, and services sentiment point to an economy holding up well against interest rate headwinds. But equally, the marginal decline in US inflation in January and a still-tight labor market suggest that the Federal Reserve will need to increase rates further, perhaps substantially, in order to bring inflation back to target.

Caught between these divergent potential outcomes, equity markets have been left trading well above October's lows while also lacking the conviction to move materially higher.

What is the outlook from here? In our *Year Ahead 2023*, we said that this would be a year of inflections, in which economic growth would first slow before reaccelerating around the middle of the year. At a global level, we think this view remains intact, but the latest data suggest it is happening at different times in different regions.

* This paragraph was derived from ChatGPT's response to my instruction to "write me a witty introduction to my monthly investment letter referencing ChatGPT and uncertainty about what to make of it," with only minor edits. ChatGPT still has only limited knowledge of the world and events after 2021, so the remainder of the letter is necessarily the product of a living and breathing author.

China's and Europe's economies are inflecting sooner than expected.

After a period of weak growth over the winter, China's and Europe's economies are inflecting sooner than expected, thanks to an end to zero-COVID policies and a significant drop in energy prices, respectively. By contrast, the resilience of the US economy is perhaps raising the risk of a later, deeper recession there, resulting in a more prolonged period of uncertainty.

For investors, such divergent inflection points increase the risk of misreading market and economic signals. This makes a systematic, holistic, and professional approach to portfolio management particularly important in reducing the likelihood of making strategic portfolio errors.

Tactically, we think the current environment means investors should ensure they diversify beyond the US and growth stocks. Inflation and interest rate uncertainty means we continue to believe value stocks will outperform growth stocks. And faster inflection points in Europe and China affirm our view that emerging market equities, as well as select parts of the European market, including Germany, will perform better than US equities. Considering the downside risks to the US economy, we also continue to advocate maintaining some defensive exposure, although among defensive sectors we now see greater opportunity in consumer staples than in healthcare.

Elsewhere, given elevated yields, we continue to see a variety of opportunities across the fixed income spectrum, including in high grade, investment grade, and emerging market bonds. However, we remain cautious on high yield corporate credit. We expect broad commodity indexes to move higher given constrained supply and strong demand. We also continue to believe uncorrelated hedge fund strategies can play an important role in portfolios as we navigate correlated markets still driven by expectations for central bank policy.

US outlook: Fatter tails

US economic data has been more resilient than expected.

The US economy has remained more robust than expected so far this year. More than half a million net new jobs were created in January, and the unemployment rate fell to its lowest level in 53 years. Retail sales rose 3% compared to December, one of the biggest monthly increases of the past 20 years. The service sector also unexpectedly rebounded: The ISM services index rose to 55.2 in January after dipping below 50 the previous month.

The question investors are now grappling with is whether this represents good news or bad news.

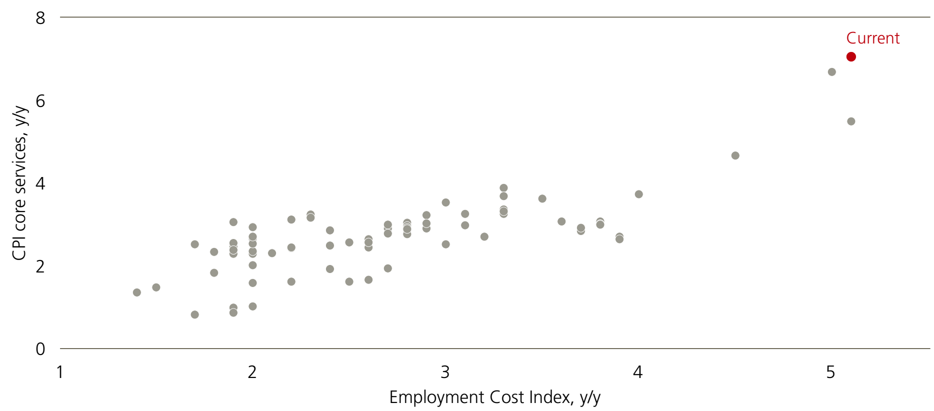
Of course, in itself, better-than-expected growth is a good thing, and resilience against higher interest rates could suggest a higher chance of the US economy achieving a soft landing, in which inflation falls back to target and growth remains positive.

But equally, a stronger economy and a resilient labor market could also suggest the Fed may have to raise rates a lot further to cool inflation. The annual rate of consumer price inflation declined only modestly to 6.4% in January from 6.5% in December, and the Cleveland Fed's trimmed mean, a gauge that strips out the biggest price moves, was up 0.6% on the month.

Figure 1

Wage costs need to come down to see a decline in services inflation

US Employment Cost Index (ECI), in %; CPI core services, in %



Source: Bloomberg, UBS, as of February 2023

In our base case, we expect the moderation in inflation to resume. Prices of certain goods that were in high demand during the pandemic, such as used cars and trucks, continue to ease amid a broader shift in consumer spending from goods back toward services. The contribution of shelter to inflation should recede as the calculation of owners' equivalent rent catches up with last year's weakness in the housing market. Growing pressure on corporate margins should also weigh on the pace of wage growth.

A robust US economy coupled with above-target inflation will likely increase the Fed's conviction to keep hiking rates.

Yet the combination of a solid economy and above-target inflation is also likely to increase the Fed's conviction to continue hiking rates to, or beyond, the point that would push the economy into recession. Markets have repriced their expectations for the terminal federal funds rate. Futures markets now point to a peak rate of 5.3% in August, up from 4.8% three weeks ago. The composition of the Fed's rate-setting committee may also become more hawkish following the recent appointment of the dovish Lael Brainard as head of the National Economic Council.

Where does this leave us? First, better-than-expected economic data helped support US equities at the start of the year, but the S&P 500 now trades on a 12-month forward price-to-earnings (P/E) ratio a little below 18x, a level usually associated with environments in which corporate earnings are growing rather than contracting, and the Fed is easing rather than tightening. Yet it is hard to envisage a near-term setup in which profits are growing and the Fed is cutting rates, particularly given that lower corporate margins are one of the key paths to a soft landing.

Reflecting the stronger near-term economic data, we have raised our end-June 2023 S&P 500 target to 3,900 (from 3,700), but we also downgrade our end-December 2023 target to 3,800 (from 4,000), reflecting the risk of higher rates and of recession later in the year. We think investors should diversify beyond the US, including into the emerging markets and Germany.

Second, we continue to see risks to growth stocks. Tech, the largest growth sector, is likely to be hampered by a further slowdown in earnings growth due to a weaker enterprise outlook and slowing consumer demand, while valuations are demanding.

The US dollar may appreciate further in the near term, but we still think it will weaken over a multiyear time horizon.

Finally, we are entering a period of uncertainty in currency markets. As markets consider the data and reassess the probability of much higher rates or a hard landing for the US economy, the dollar may appreciate in the near term. But at the same time, the dollar is still overvalued, and we continue to believe that over a multiyear time horizon, the US currency will weaken against the euro, British pound, and various emerging market currencies. As such, while strength is possible in the near term, investors with a longer-term horizon should use the current USD rally to unwind some dollars.

Europe and China: Inflecting faster

Economic momentum in Europe and China is picking up sooner than expected.

As we entered the year, growth in Europe was challenged by record-high gas prices, and in China by zero-COVID policies. But a sharp fall in energy prices in response to lower demand and an end to zero-COVID policies mean that growth in both regions is picking up sooner than expected.

We expect the Eurozone economy to avoid a recession this winter, although activity is likely to remain subdued. We recently upgraded our 2023 GDP growth forecast to 0.8%, from 0.2% previously. High inflation, an overhang of last year's spikes in energy prices, and rising food costs will continue to weigh on real income growth in the coming months. However, lower energy prices, falling inflation, and China's reopening should allow for a modest recovery thereafter.

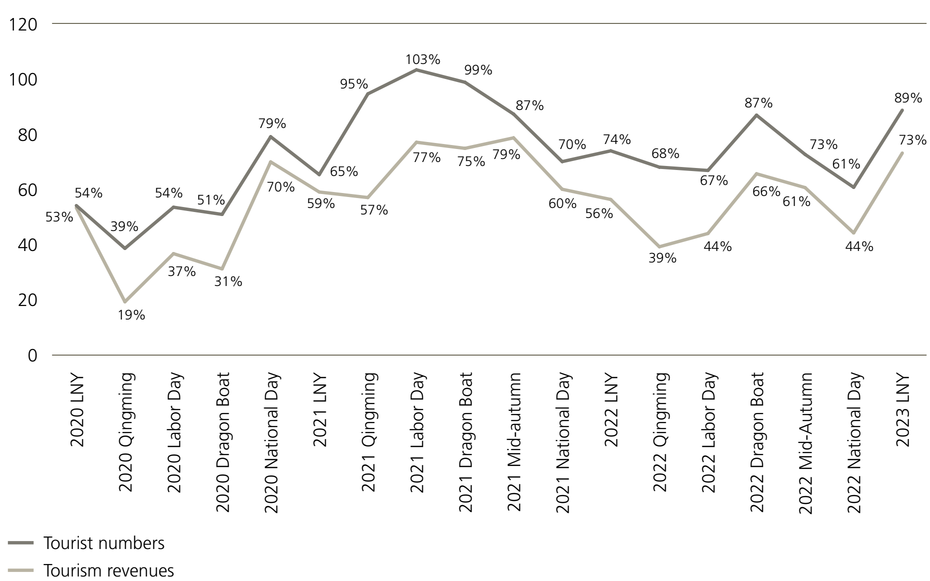
We expect China's GDP to grow by 5% this year, led by a recovery in consumption.

Meanwhile, China's smoother-than-expected reopening already lifted the manufacturing and services PMI data into expansionary territory in January, while mobility data over the Lunar New Year holiday showed an encouraging recovery in travel and consumption. We expect China's GDP to grow by 5% this year, up from 3% last year, led by a recovery in consumption.

Figure 2

Domestic tourism saw the strongest Lunar New Year holiday since COVID

Number of tourists and tourism revenues, in % of 2019 level



Source: Refinitiv Datastream, UBS, as of February 2023

Should we worry about the US debt ceiling?

On 19 January, the United States reached its statutory debt ceiling, leading the Department of the Treasury to initiate "extraordinary measures" to continue to fund government spending.

These extraordinary measures should allow the federal government to pay its operating expenses and debt obligations until at least the end of the second quarter of this calendar year. Unless the debt ceiling is raised thereafter, the US will default on its obligations, with potentially grave consequences for global markets and economies.

Yet, perhaps conditioned by the various collisions with the debt ceiling in the past decade that did not lead to either a US default or any material disruption in market functioning, markets have so far largely ignored the debate around the US debt ceiling. Are they right?

In our base case, we expect Congress to reach a compromise regarding the debt ceiling and avert a default on Treasury securities. Lawmakers still have a considerable amount of time to resolve policy differences, and most of them understand the economic and market peril of not raising the ceiling while long-term solutions to the escalating deficit are identified.

There are risks of course, which could create volatility. A quick solution does not appear likely as Republican lawmakers push for spending cuts in exchange for an agreement on the debt ceiling. At present the Republicans are not pressing for cuts to entitlement spending, which would be highly contentious, but the prospect of prolonged uncertainty remains. During the 2011 debt ceiling standoff, the Treasury was prepared to prioritize sovereign debt service over other budget items to avoid a default, although an agreement was reached before this was required. However, the uncertainty ahead of that agreement led one rating agency to downgrade its US sovereign debt rating. A default remains a possibility this year, albeit remote.

But combative political rhetoric is nothing new in Washington, and the media's attention to the issue may, counterintuitively, be a positive development, as it may force members of Congress to be more cognizant of the adverse ramifications of a failure to reach an agreement.

How do we invest?

We advocate a more regionally selective approach to risk decisions, rather than making blanket "risk-on" or "risk-off" calls.

We continue to expect 2023 to be a year of inflections for inflation, monetary policy, and economic growth. But developments over the past month have reinforced our view that inflection points are unlikely to be reached in unison. Investors will therefore need to take a more regionally selective approach to risk decisions, rather than make blanket "risk-on" or "risk-off" calls.

Our positioning reflects this, and incorporates select relative value opportunities that should enable investors to position for inflections across the global markets, while reducing downside risks.

Investors should diversify beyond the US.

First, we expect emerging markets and early cyclical equity markets, such as Germany, to perform better than US equities. We expect China's reopening to spur domestic consumption, which should benefit China's neighbors in North and Southeast Asia as well as several commodity-sensitive emerging economies such as those in the Middle East, Africa, and Latin America. Earnings momentum and estimate revisions in emerging markets have bottomed both in absolute terms and in relation to developed markets. Valuations look appealing even after the recent rally. On a price-to-book (P/B) basis, the MSCI Emerging Markets index is trading at a 43% discount to developed markets (12-month forward P/B at 1.5x versus 2.4x for MSCI World), a level historically consistent with a relative positive return over the medium term.

In Germany, the gas crisis has eased significantly compared to six months ago, economic momentum is improving, and China's better growth outlook bodes well for German exporters. Investor sentiment has started to improve but has scope to recover further, and German equities have still underperformed the Eurozone by 17% since their 2020 high. Valuations are relatively attractive: MSCI Germany is trading at 11.7x forward P/E, an 11% discount to MSCI EMU ex-Germany, which is larger than usual.

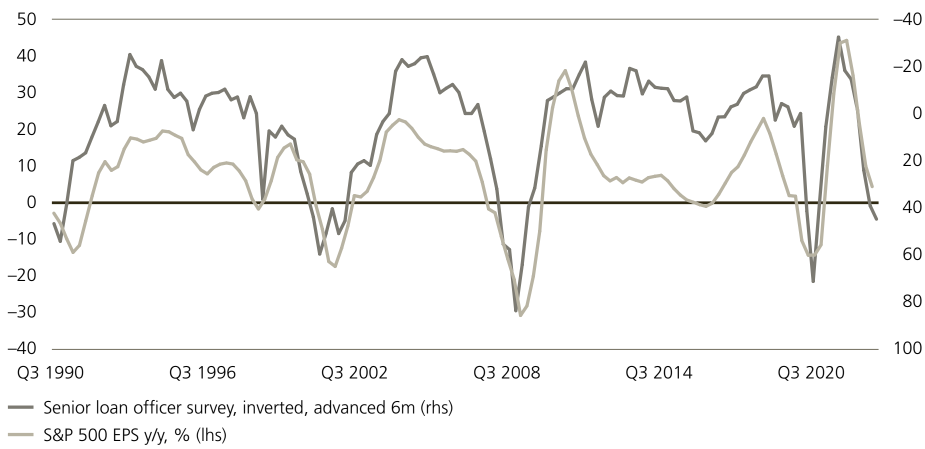
We expect US equities to underperform global markets.

By contrast, the US equity market remains expensive in absolute and relative terms. The MSCI US index is trading at a little below 18x P/E, a 12% premium to its 20-year average (16x) and a 17% premium to the global benchmark, the MSCI All Country World Index (ACWI). The robust US economy and labor market have reduced recession probabilities in the near term, supporting this year's S&P 500 rebound. But as the Fed's tightening makes its way to the real economy, we expect earnings growth to contract in 2023. Companies are facing a challenging combination of weakening demand, rising labor costs, and unfavorable comparisons with 2021–22 earnings.

Figure 3

Leading indicators point to a contraction in US earnings

Senior Loan Officer Opinion Survey (inverted, advanced by 6 months, rhs), vs. S&P 500 EPS (y/y change in %, lhs)



Source: Refinitiv Datastream, UBS, as of February 2023

Scenario targets

	Spot*	Upside	Base case	Downside
MSCI AC World	765	880 (+15%)	770 (+1%)	670 (–12%)
S&P 500	3,997	4,400 (+10%)	3,800 (–5%)	3,300 (–17%)
EuroStoxx 50	4,250	4,900 (+15%)	4,250 (–0%)	3,650 (–14%)
MSCI China	68	83 (+22%)	80 (+18%)	59 (–13%)
US 10-year Treasury yield	3.95%	2.5%	3%	4.5%
US 10-year breakeven yield	2.43%	2%	2.25%	3%
US high yield spread**	449bps	300bps	550bps	850bps
US IG spread**	107bps	60bps	120bps	200bps
EURUSD	1.06	1.15 (+8%)	1.10 (+3%)	1.02 (–4%)
Commodities (CMCI Composite)	1,873	2,300 (+23%)	2,200 (+17%)	1,750 (–7%)
Gold	USD 1,835/oz	USD 2,200–2,300/oz (+23%)	USD 2,050/oz (+12%)	USD 1,800–1,900/oz (+1%)

* Spot prices as of market close of 21 February 2023. Values in brackets are expected percentage changes from the quoted spot level.
** 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 December 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 February 2023

Scenario analysis

Scenarios (December '23)	Upside	Base case	Downside	Things to watch
Probability	**25%**	**50%**	**25%**	
Inflation	Falls quickly back to central bank targets over the coming months.	Continues to slow in the US and in Europe, but the slowdown tempers in the coming months.	Proves more persistent than central banks and markets expect.	*US: CPI and PCE inflation* *US: ISM prices-paid subindex* *US: Average hourly earnings* *US: JOLTS openings and hires* *Eurozone: HICP inflation*
Central banks	Major central banks cut rates in 2H23.	The Fed, the ECB, the SNB, and the BoE to complete their hiking cycles in 1H23 but unlikely to cut rates in 2023.	Longer period of tighter monetary policy with rate hikes beyond 1H23, followed by recession and rate cuts in 1H24.	
Economic growth	Rebounds as the outlook for corporate earnings improves.	The US, Europe, and the UK experience subtrend growth as China reaccelerates. US consumption holds up well due to a strong labor market and solid wage growth. Lower energy prices cushion the impact of higher policy rates in Europe.	Falls sharply toward late 2023 or early 2024 owing to highly restrictive monetary policy; possible China U-turn on COVID.	*Global: Oil price* *US, China: PMI data* *US: Change in nonfarm payrolls* *China: Consumer mobility* *Europe: Gas prices*
Financial conditions	Ease, lifting market valuations.	Remain tight, increasing the market's vulnerability to negative surprises or external shocks.	Tighten further, causing stress in the financial system.	*Global financial conditions indexes*
Geopolitics / other	The war in Ukraine deescalates, e.g., via a cease-fire agreement.	The war in Ukraine drags on. A cessation of hostilities remains an unlikely outcome.	The war in Ukraine escalates or US-China tensions intensify. *Tail risk:* US debt ceiling not raised by July/August; US Treasury defaults; global markets sell off.	*Territorial gains by Russia* *Weapon shipments to Ukraine* *Putin support polls*
Market path	Risk assets are lifted by easing financial conditions and a brightening outlook for global growth.	Volatility throughout 1H23 owing to uncertainty about inflation, monetary tightening, economic activity, and geopolitics. Risk assets start trending higher in 2H23 amid turning points in growth, inflation, and rates.	Severe downturn with global equities posting double-digit losses, credit spreads widening, and safe-haven assets benefiting.	

Source: UBS, as of February 2023

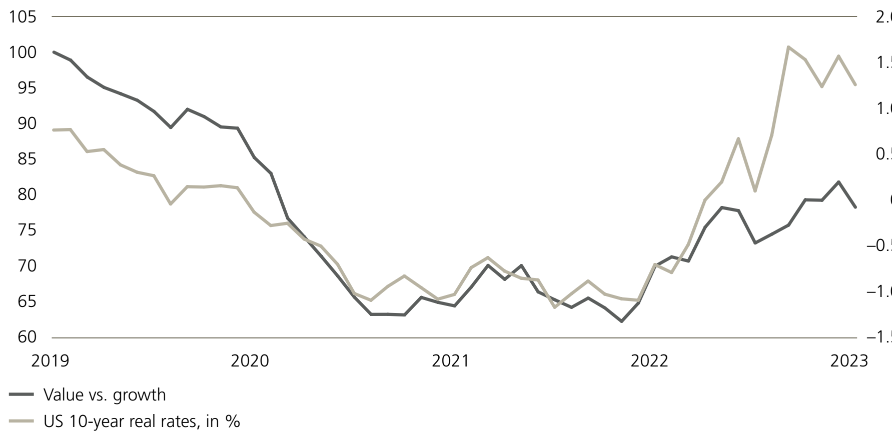
We prefer value stocks to growth stocks.

Second, we prefer value stocks to growth stocks. The MSCI ACWI Growth Index has outperformed its value equivalent so far this year. But we think an environment of stubborn inflation and higher interest rates should support value stocks' renewed outperformance in the months ahead. Meanwhile, we expect a further slowdown in tech sector earnings to be a headwind for growth stocks. Sector valuations are also demanding: The MSCI World IT index is trading on a 12-month forward P/E of 22.5x, 20% above its 10-year average. Based solely on the recent relationship with real yields, the IT subindex should trade at a multiple of between 16x and 18x, in our view.

Figure 4

Value tends to outperform with higher rates

Value vs. Growth (MSCI ACWI indexes, rebased, lhs); US 10-year real rates, in % (rhs)



Source: Bloomberg, UBS, as of February 2023

We continue to see opportunity in select defensive sectors like consumer staples.

Third, we continue to see opportunity in select defensive sectors, given the risks to the US economy, but we are revising our sector views. We continue to like global consumer staples, which tend to outperform the overall market when leading indicators, such as the ISM index, weaken. Relative earnings momentum is positive and strengthening. While valuations are not cheap, they are in line with historical averages. The sector is trading at 18.9x forward earnings, slightly below the 10-year average of 19.2x.

But this month, we shift our view on the global healthcare sector from most preferred to least preferred. Last year's stronger US dollar benefited non-US healthcare companies, which generate a high proportion of sales in the US, but that tailwind could become a headwind this year. And, after strong sector relative performance last year and recent earnings downgrades, valuations are less attractive. The sector trades at 18x forward earnings, a 15% premium to the market, above the historical average premium of 7%.

Fourth, in fixed income, we prefer investment grade bonds, high grade bonds, and emerging market bonds, relative to US high yield bonds. All-in yields look appealing across most of the higher-quality fixed income spectrum, and we think favoring higher-quality credit makes sense given the risks to the US economy. We see corporate high yield credit as more vulnerable. 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 the global money supply continues to shrink.

Finally, we favor exposure to broad commodities, which are a good hedge against the risk of more persistent inflation, as well as beneficiaries of China's reopening. Expected returns in commodities benefit from attractive carry; downward-sloping futures curves offer roll gains, while higher yields have improved returns on cash collateral

Messages in Focus

Diversify beyond the US and growth	We think investors should diversify beyond the US and growth stocks. We like value, including energy, which should be more resilient if inflation proves sticky or rates go up by more than expected. Earlier inflection points in China and Europe favor outperformance in select European names, emerging market equities, and some early-cycle markets relative to the US. And with uncertainty around the US economic outlook still elevated, we also like more defensive areas like consumer staples, while utilizing capital preservation strategies where applicable.
Seek income opportunities	Bond yields have increased in recent weeks, reflecting the prospect of higher interest rates and boosting the range of options for investors seeking income. We see particular opportunity in investment grade bonds, resilient credits, emerging market credit, select AT1 bonds, and quality-income stocks. Investors should also ensure they take steps to actively manage their liquidity. We are cautious on high yield credit given a slowing US economy.
Anticipate the inflections	China's reopening and an end to the winter gas crisis in Europe have brightened the growth prospects for emerging markets and Europe. We therefore see opportunity in emerging market equities, including China and stocks exposed to China's reopening, and commodities. We also think early-cycle markets like Germany, select semiconductor stocks, and select Asia-Pacific currencies look well positioned to benefit from an upturn in growth in the region.
Seek uncorrelated hedge fund strategies	Monetary policy expectations are likely to remain a key market driver in the months ahead. This can lead to both equities and bonds moving in tandem, and means that uncorrelated hedge fund strategies such as macro, equity market neutral, and multi-strategy funds could play a particularly important role in diversifying portfolios.
Position for the era of security	One year after Russia's invasion of Ukraine, the war continues and the world's energy landscape has been fundamentally changed. Meanwhile, heightened tensions between the US and China have led to a renewed focus on national and technological security. We believe we are at the early stages of a new 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. This will have effects across the investment landscape, including in themes like renewable energy, greentech, and cybersecurity.
Invest sustainably	Despite relative underperformance in certain parts of the sustainability investment universe over the past year, the long-term performance of sustainable investments remains strong on an absolute and relative basis. Sustainability can be a key driver of corporate performance, and we believe that companies that manage their business, stakeholder, and environmental impact better should also be well positioned to deliver on financial results. Investors need to diversify by sector, style, and asset class to ensure more consistent performance through the cycle.
Seek value and growth in private markets	Putting fresh capital to work in private markets following a period of 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.

Mark Haefele
Chief Investment Officer
Global Wealth Management

Messages in Focus

The Messages in Focus (MIFs) are a set of high-conviction investment narratives from CIO. These narratives combine our top views across asset class preferences, short-, medium-. and longer-term themes, and alternatives.

MIFs	Elevator pitch	Investment ideas
Downside **Seek uncorrelated hedge fund strategies**	• Stocks and bonds failed to act as counterweight to each other's performance in 2022. But alternative sources of diversification, including hedge funds, have performed well, and will remain an important source of diversification in 2023. • Macro funds have been particularly strong performers, historically producing annualized returns of 6.1% when volatility is high. • We also think equity market neutral strategies stand to benefit in 2023 as macro uncertainty persists and equity dispersion increases. • Multi-strategy funds can offer a simple way for investors to build a diversified hedge fund allocation.	• Macro • Equity market neutral • Multi-strategy • "Opportunities in dislocated credit markets"theme
Base case **Diversify beyond the US and growth**	• Value sectors have historically outperformed growth in the 12 months following the Fed's last rate hike, and tend to outperform when US inflation is above 3%. Within value, we like energy, where we think stocks underprice the likelihood that oil prices stay higher for longer. • Capital protection strategies can help investors protect against downside risks while retaining upside exposure. • Defensive sectors should prove relatively insulated from slower growth. We like consumer staples which should offer positive earnings growth in 2023.	• Global and US value • Global and US consumer staples • Global and US energy • Capital protection structured investments • "Enhancing liquidity strategy return" theme • "Time for quality" US tactical equities theme • US real estate • ESG matters in EM
Base case **Seek income opportunities**	• The opportunity to earn more predictable returns is appealing against an uncertain backdrop. • We like US investment grade bonds, which yield approximately 5%, select short-duration bonds, resilient credits, and sustainable bonds. • We also favor quality-income stocks. Such strategies have historically proven resilient during periods of economic contraction. • Market volatility can itself also offer a means of generating income. Yield-generating structured investments in equities, commodities, and currencies look attractive in our view.	• Investment grade corporate bonds • Agency MBS • Select short-duration bonds (including Pan-American bonds theme) • Quality income stocks • Yield-generating structured investments (including enhancing liquidity strategy return theme) • "Yield opportunities in Latin • America" theme • "Opportunities in dislocated credit markets" theme

MIFs	Elevator pitch	Investment ideas
Base case **Invest sustainably**	• Despite underperformance in the past year, the long-term performance of sustainable investments remains strong on an absolute and relative basis. • The past year has shown why investors need to diversify across sustainable investment themes, including value-oriented themes as well as growth themes. • It has also shown why a focus on ESG improvers as well as leaders can improve outcomes, with improvers offering outperformance in the past five years of 2ppts per annum versus the broader market. • Diversification across sustainable asset classes, for example by including sustainable bonds and multilateral development bank bonds, could also help drive better risk-adjusted portfolio returns.	• Sustainability-linked LTIs • ESG equity strategies including engagement, leaders, improvers • Thematic sustainable fixed income • Sustainable asset allocations • "ESG matters in emerging markets" theme
Base case **Position for the era of security**	• We believe we are at the beginning of an era of security, in which energy security, food security, and cybersecurity will be prioritized by governments and businesses. • Energy security favors investments in active commodity strategies, greentech, clean air and carbon reduction, and energy efficiency. • Food security should favor stocks linked to improving agricultural yields, saving water, and adapting to climate change. • We expect the cybersecurity market to grow 10% a year through.	• Energy security (active commodity exposure, clean air and carbon reduction, energy efficiency, Greentech • Food security • Cybersecurity • "Resilient spending" US tactical equity theme
Base case **Seek value and growth in private markets**	• Putting fresh capital to work in private markets in the years following declines in public markets has historically proven a rewarding strategy over the long term. • We currently favor strategies that can take advantage of price dislocations, like secondaries, where buyers are now able to negotiate better prices for assets. • We also like distressed/restructuring debt strategies. Managers in this space have earned higher returns during periods of higher corporate default rates, which we expect in 2023. • Value-oriented buyout strategies, in particular with investments in carveouts and divestitures, are also set to be a growing trend in 2023, in our view.	• Secondaries • Distressed/restructuring debt (including Opportunities in dislocated credit markets theme) • Value-oriented buyouts • Direct lending
Upside **Anticipate the inflections**	• We expect turning points in the economy and policy this year. • For more risk-tolerant investors looking to anticipate the inflection already, we see select opportunities in early-cycle markets, "deep value" stocks, and sectors exposed to China's reopening. • These include the German and Korean equity markets, parts of the semiconductor sector, and select companies exposed to China's reopening.	• Emerging market equities • Germany • Commodities • China and stocks exposed to China's reopening • "23 for '23" tactical theme • "ESG matters in emerging markets" theme • "EM internet and e-commerce" theme

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.

Jason Draho, PhD, Head of Asset Allocation Americas; **Michael Gourd,** Asset Allocation Strategist; **Danny Kessler,** Asset Allocation Strategist

Our tactical asset class preferences

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

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

*See note on page 16

Implementation guidance

After strong performance across financial markets in January, returns in February are a reminder that 2023 is likely to remain a challenging environment for investors to navigate until there are clear and favorable inflection points in growth, inflation, and central bank policy rates. Soft-landing hopes drove the start-of-year rally, fueled by signs of rapid disinflation, global growth expectations being revised higher, and central banks close to pausing rate hikes.

But data out in February shows that US growth is not only proving to be resilient, but appears to be accelerating. That fact, coupled with evidence of inflation being stickier than presumed, has already led the market to price in two additional Federal Reserve rate hikes in 2023, with the risk skewed to even more, and price out almost all rate cuts before year-end.

As a result of the surprisingly strong US economic momentum, the timing of the start of a potential recession has been pushed back later in the year. This improves the near-term investment outlook relative to our year-ahead expectations, and it also increases the probability of a soft-landing. But the current strength could also force the Fed to implement even more restrictive rate hikes that increase the risk of a hard-landing recession later on.

Our overall asset allocation guidance reflects these dual upside and downside risks to the US economy, and the more clearly improving economic outlook in China and the Eurozone. The guidance also reflects the relative risk-reward trade-offs currently priced into different asset classes based on the latest economic and policy news. Specifically, US equities at the broad market level are pricing in too high a probability of a soft-landing scenario, in our estimation, while the bond market is pricing in a reasonable expectation of further hikes in 2023 and cuts in 2024.

These considerations are captured by our asset class preferences, which are mostly unchanged this month. US equities and high yield corporate bonds remain least preferred. Meanwhile, at current yields and valuations, the relatively safe carry of US investment grade bonds keeps them among our most preferred asset classes.

The rise in the 10-year Treasury yield to nearly 4%, the top end of the range we expect it to trade in for the next few months, makes the current pricing an attractive entry point to lengthen duration in portfolios. We recommend doing this by increasing allocations to investment grade corporate bonds at the expense of US large-cap growth stocks. This is consistent with the preferences among US risk assets, and the recommendation to **seek income** in high-quality fixed income.

The greater clarity on the macro improvement in China and the Eurozone, combined with the relatively rich valuations of US assets, including large-cap growth stocks, which remain least preferred, is why we recommend **diversifying outside the US and growth**. This is consistent with our preference for value and energy stocks in the US and emerging market equities and hard-currency sovereign bonds outside of the US. The reopening of China has only just begun, and while geopolitical risks remain elevated, financial markets have not fully priced in the likely growth acceleration in the next few quarters.

Our preference for emerging market (EM) assets is one way to selectively position portfolios to **anticipate the inflections** toward a better macro environment this year. Commodities and oil are also most preferred asset classes that provided attractive ways to prepare for the improvement in global growth. Demand for oil is rising steadily, and we expect it to start outstripping supply growth later in the first half, leading to upward pressure on oil prices.

Changes to our US sector preferences this month make the allocation less defensive and closer to a balance with cyclicals. This is consistent with a better near-term outlook and probability of a soft landing. We did this by downgrading healthcare, a defensive sector, to neutral from most preferred, while upgrading real estate to most preferred from neutral. The latter sector has some defensive attributes given its income-generating properties, but should also benefit from the falling interest rates that we expect. We also downgraded communication services to least preferred from neutral, as a competitive environment could weigh on the performance of the mega-caps in the sector. We offset this by making tech less of a least preferred sector. The other most preferred sectors are consumer staples, a defensive sector that should benefit from the resilient consumer spending, and energy, which remains inexpensive and not priced for the expected rise in oil prices. Financials remains least preferred as it is sensitive to falling rates and vulnerable to slowing economic activity.

Finally, diversification, including into alternatives, remains a key pillar of portfolio risk management in the current environment. We continue to recommend that investors **seek uncorrelated hedge fund strategies** as a way to protect against a hard-landing scenario in which bonds may initially struggle to offer diversification due to sticky inflation.

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		=	

Source: UBS, as of 23 February 2023

*Note: We hold a most preferred stance on EM Hard Currency sovereign bonds and remain Neutral on EM Hard Currency corporate bonds.

Note: See explanations about asset classes in the Appendix. Changes are based on the US asset class preferences table found in the UBS House View Investment Strategy Guide published 21 January 2023.

Least preferred: We expect this asset class to deliver the least attractive risk-adjusted returns over the next 12 months within our asset class universe.

Most preferred: We expect this asset class to deliver the most attractive risk-adjusted returns over the next 12 months within our asset class universe.

Asset allocation: Themes implementation

With alignment to our Messages in Focus (MIFs)

Asset class	Theme and description	MIF alignment: Diversify beyond the US and growth	Income opportunities	Anticipate the inflection	Uncorrelated hedge fund strategies	Position for the era of security	Invest sustainably
Cash/liquidity	**Enhancing liquidity strategy return** Market-linked CDs can offer upside exposure to stocks while providing downside protection.	✓	✓				
EM fixed income	**Yield opportunities in Latin America** We provide a basket of Latin American bonds with attractive yields and low probabilities of default.		✓				
	Short-duration Pan-American bonds CIO has a preferred view toward short-end investment grade corporate bonds. We believe this list offers relative value.		✓				
Global equities	**23 for '23** This list of 23 stocks has cross-sector exposure and can provide equity ideas for investors anticipating the inflection.			✓			
	Greentech goes global Companies with greentech exposure should be positively levered to an improvement in risk sentiment.			✓		✓	
US equities	**Pricing power standouts** Companies with pricing power should be better able to pass on higher input costs, but the list should also participate in an inflection to the upside if inflation eases.			✓			
	Time for quality These high quality stocks offer exposure to US value sectors.	✓					
	Resilient spending Businesses that are leveraged to government and relatively resilient corporate spending should remain well supported.					✓	
	Reopening China We continue to see upside in US companies exposed to China's reopening following years of strict lockdown policies.			✓			
EM equities	**ESG matters in emerging markets** This theme provides leverage to CIO's preferred view on emerging markets.	✓		✓			✓
	EM internet and e-commerce EM internet and e-commerce stocks should outperform their EM peers in 2023, driven by China's economic reopening and reduced regulatory risk.			✓			
Hedge funds/ alternatives	**Opportunities in dislocated credit markets** Credit market stress has expanded the opportunity for hedge fund and private managers to deploy capital toward dislocations.		✓		✓		

Simplifying themes: Expressing themes in a portfolio context

Michelle Laliberte, CFA, Thematic Investment Strategist; **Nadia Lovell,** Senior US Equity Strategist

In this month's *Investment Strategy Guide*, we introduce a new presentation format for our themes universe. We've selectively highlighted our best ideas that align with the current house view. The selected themes can also help investors tap into our messages in focus. The themes are also presented as part of an asset allocation, to provide better information about how each theme fits within a total portfolio.

In this month's iteration, our selections focus on themes with emerging market exposure, income opportunities, and global equities that provide upside leverage to anticipate the inflection. Many of the selected themes are positively exposed to China's economic reopening, and many provide a way to express CIO's preference for emerging markets. These selections reflect CIO's view that emerging market equities and select global regions will likely outperform US equities.

We've also shifted to be more selective in regards to our "Position for the era of security" message in focus, as we recently closed the "Security takes center stage" theme. The theme had significant exposure to defense companies, and with the outlook less clear on defense spending moving forward, we saw this as a prudent time to take gains. As such, we shift our focus to themes that still align with the era of security concepts, but also have leverage to the Inflation Reduction Act in the United States, namely the "Resilient spending" theme, and "Greentech goes global."

Our new approach aims to simplify our thematic offering by providing actionable ideas that we believe offer upside opportunities. Moving forward, we will provide the thematic asset allocation grid on a monthly basis. For more information on the selections, please see the full report for each theme.

Tactical equity and longer-term 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. The table below shows alignment to our messages in focus. For theme details, see Tactical US Equity Themes: monthly update, 17 February 2023.

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. Learn more about the longer-term themes and our thematic investment framework based on three megatrends 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, especially on goods. In the US, stronger growth data and stubborn service price inflation may push the Fed to extend its rate hiking cycle. In Europe, adequate natural gas supplies have allowed prices to fall, improving the growth outlook. In China, the removal of pandemic restrictions and strong policy support set the stage for faster growth this year.

Brian Rose, PhD, Senior US Economist

Economic outlook summary: CIO view

Probability: 50%*
Slower demand, slowing inflation
Negative real wage growth in developed economies is slowing consumer demand, and with that overall growth. However, employment remains relatively strong, limiting the need for precautionary savings. Changing consumption patterns also mean that some parts of the economy have more resilience. Seasonal adjustment may add to data volatility in the early part of the year.

Inflation starting to moderate. Consumer durable goods are in disinflation or deflation as demand has switched toward services. While profit margin expansion has pushed inflation higher in certain sectors, weakening consumer demand and less consumer acceptance of price increases are likely to squeeze margins in some sectors. Base effects from energy will push the year-over-year inflation lower from the second quarter.

Positive scenario

Probability: 25%*
A faster decline in inflation will restore real wage growth stability more quickly, stabilizing consumer demand earlier than anticipated. Inflation rates for middle-income consumers are already less than the headline rate in many economies, which helps spending power in an important demographic.

Negative scenario

Probability: 25%*
Real wages remain negative for a longer period of time. Nominal wage growth slows faster than expected, while inflation remains higher. Interest rates rise further than expected, and increasing unemployment causes households to start to increase their precautionary savings rates.

*Scenario probabilities are based on qualitative assessment.

Global growth in 2023 expected to be **2.4%**

	Real GDP growth in %			**Inflation in %**		
	2022F	2023F	2024F	2022F	2023F	2024F
US	2.1	0.8	0.4	8.0	3.7	1.8
Canada	3.5	-0.3	0.3	6.8	3.1	1.6
Brazil	2.8	0.0	1.0	9.3	4.4	3.8
Japan	1.1	1.3	1.2	2.5	2.4	1.4
Australia	3.6	1.4	1.7	6.6	5.2	2.8
China	3.0	4.9	4.8	2.0	3.0	2.1
India	7.0	5.5	5.9	6.6	5.2	5.0
Eurozone	3.5	0.8	1.0	8.4	5.0	2.3
Germany	1.9	0.2	0.9	8.6	4.8	2.1
France	2.6	0.6	1.0	5.9	4.2	1.6
Italy	3.9	0.7	1.0	8.7	6.8	1.9
Spain	5.5	1.7	2.1	8.3	3.0	2.3
UK	4.0	-0.4	0.6	9.0	6.5	2.4
Switzerland	2.0	0.4	1.0	2.8	2.1	1.3
Russia	-2.1	-0.8	0.7	13.7	5.0	4.4
World	3.3	2.4	2.7	8.5	6.1	3.7

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.
Source: Reuters EcoWin, IMF, UBS, as of 23 February 2023

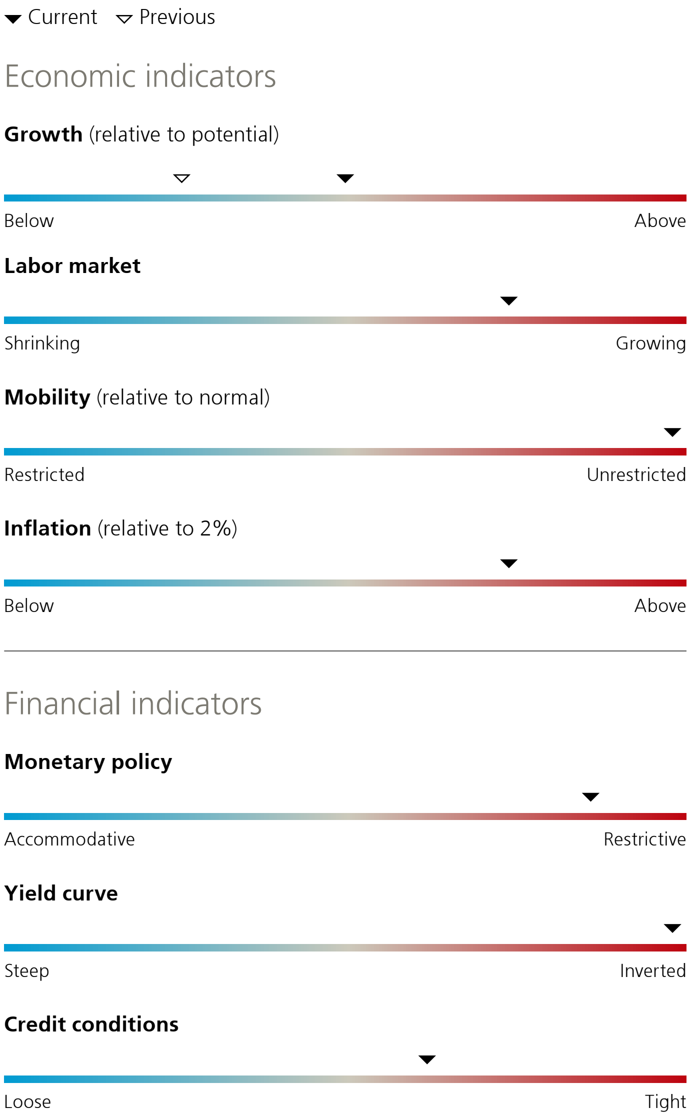
Bull Market Monitor

Prospects for higher rates have weighed on equity markets

Brian Rose, PhD, Senior US Economist

Key cycle indicators

The indicators gauge whether the economy is expanding, the pandemic is affecting activity, and if financial conditions are restricting growth.



Note: Each indicator is evaluated relative to a neutral level in order to determine whether the economy is improving or if financial conditions will start to restrict growth.
Source: UBS, as of February 2023

Current status
We judge that the economy is in late-cycle, with the Fed continuing to hike rates and growth likely to slow. Tighter policy creates downside risks for markets.

What's new?
With few government restrictions in place and many people returning to more normal lifestyles, the economic impact of the pandemic has been limited. US economic data for January was mostly stronger. The ISM Manufacturing PMI fell to 47.4 from 48.4 in December, but hard data on manufacturing output showed an increase of 1%. The Services PMI rebounded to 55.2, making the weak December reading of 49.2 appear to be a one-off. Nonfarm payrolls jumped 517,000 and the unemployment rate fell to 3.4%. Unemployment has not been lower than this since 1953. Headline CPI inflation slowed to 6.4%, down from a peak of 9.1% in June, but service prices continue to rise rapidly. Retail sales rose by 3% over December.

The Federal Reserve raised rates by 25 basis points on 1 February, setting the federal funds target range at 4.5–4.75%. Public comments from FOMC participants suggest that the Fed is likely to continue hiking rates in the months ahead. Markets are pricing in 25bps hikes at the next three FOMC meetings.

The yield curve is inverted, with the 2-year Treasury yield around 75bps higher than the 10-year. Spreads on corporate bonds are close to month-ago levels, while banks are tightening their lending standards. 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 and developments on the debt ceiling debate.

What are the investment implications?
We see the S&P 500 finishing the year close to current levels, with better upside potential in more cyclical markets outside the US, including emerging markets and Germany. We prefer value over growth.

Equities

In our global tactical asset allocation, we keep equity at neutral. Within equities as a whole, we prefer the UK, Australia, and emerging markets over US stocks. Across sectors, we upgrade industrials to most preferred and downgrade healthcare and communication services to least preferred. We still like global energy and consumer staples, and stay least preferred on information technology. Across styles, we prefer value and quality income to growth.

Eurozone

NEUTRAL

EURO STOXX 50 (index points, current: 4,243)	December 2023 target
House view	**4,250**
Positive scenario	4,900
Negative scenario	3,650

Note: All current values as of 23 February 2023

We are neutral on Eurozone equities in our global asset class universe. While fears of energy crunches in the Eurozone have faded on the back of a milder-than-expected winter, geopolitical tensions are still looming over the region, which is also likely to enter a period of slower growth. All in all, downside risks to earnings seem partially priced in at current levels, with valuations looking fair to us. We believe that much of the recent strength is justified by an improving fundamental outlook, but we see limited further upside from here.

Emerging markets

MOST PREFERRED

MSCI EM (index points, current: 982)	December 2023 target
House view	**1,100**
Positive scenario	1,150
Negative scenario	850

Note: All current values as of 23 February 2023

We hold a most preferred stance on emerging market equities. Over the past month, MSCI EM saw a mid-single-digit pullback as markets reassessed expectations of the Federal Reserve's terminal rate and geopolitical tensions rose. We still expect China's economic reopening to be a catalyst for EM stocks' outperformance relative to their developed market peers. The pickup in Chinese consumer demand is set to benefit emerging Asia and increase the demand for raw materials, supporting several commodity producers in the emerging world.

Japan

NEUTRAL

TOPIX (index points, current: 1,975)	December 2023 target
House view	**2,100**
Positive scenario	2,200
Negative scenario	1,700

Note: All current values as of 23 February 2023

We are neutral on Japanese equities in our global asset class universe. We see limited downside risks to share prices, given their cheap valuations and resilient earnings trends relative to other developed markets. We think China's faster-than-expected reopening should also be positive for select Japanese companies in 2023, particularly in the machinery-related and consumer sectors. Other factors that may spur earnings growth include the ongoing domestic reopening and the increase in inbound tourism, supported by a weaker yen versus pre-pandemic levels.

UK

MOST PREFERRED

FTSE 100 (index points, current: 7,931)	December 2023 target
House view	**8,300**
Positive scenario	9,000
Negative scenario	6,700

Note: All current values as of 23 February 2023

UK equities are most preferred in our global equity preferences. Our view is that the FTSE 100 will continue to make new highs over the course of this year. While we anticipate an overall earnings decline of around 5% this year, this is mostly driven by year-over-year declines in commodity prices along with some negative impacts on the consumer from negative real wages. The majority of other sectors are still expected to post positive earnings growth for 2023. Meanwhile, we expect a moderate rerating of the UK equity market, as yields and inflation stabilize through the year.

US equities

US stocks are off to a good start this year, propelled by better near-term US and global economic growth prospects. However, further upside from here seems limited due to continued downward pressure on profits, lagged effects of Fed rate hikes, and full valuations. We recently revised our June 2023 and December 2023 S&P 500 price targets to 3,900 and 3,800, respectively. We lowered our 2023 S&P 500 EPS estimate to USD 210 (–4.5%) and introduced a 2024 estimate of USD 230 (+9.5%).

David Lefkowitz, CFA, Head of US Equities; **Nadia Lovell,** Senior US Equity Strategist; **Matt Tormey,** US Equity Strategist

US equities overview

LEAST PREFERRED

Ultimately, we think the lagged effects of Fed rate increases will have a more meaningful negative impact on economic growth. But it may take more time for these risks to materialize than we had previously anticipated. Until then, an economic soft landing may look more plausible, which could support equity markets in the near term. Still, the ongoing and lagged effects of Fed rate hikes will continue to exert downward pressure on economic activity and corporate profit growth. And we still think it will be hard for the Fed to reach its inflation target without some softening in the labor market.

US equities: Sectors

This month, we slightly reduced our defensive positioning by downgrading healthcare to neutral and upgrading real estate to most preferred. Real estate offers a mix of cyclical and defensive exposure and should get a boost from a decline in long term interest rates, which seems likely in the coming months. We see more upside than downside risk for oil prices, which should be supportive of the energy sector. Tech valuations appear stretched, and a more competitive environment for mega-cap communication services companies could weigh on the sector's performance.

US equities: Size

We remain neutral across size segments. Smaller size segments have outperformed on increased hopes of a soft landing. Valuations are near their lowest levels relative to large-caps in at least 40 years, suggesting downside risks should be limited and that both small-caps and mid-caps are likely to produce better returns over the next decade. However, we would prefer to become more aggressive on smaller size segments when the yield curve starts to steepen, signaling a potential reacceleration in profit growth.

US equities: Style

We maintain our preference for value over growth. Growth stocks have gotten off to a good start this year. Better economic data and a rebound in last year's laggards have contributed to performance. However, we continue to favor value stocks on more favorable earnings drivers as spending shifts back to pre-pandemic activities, and bloated earnings for many growth companies continue to normalize. Also, value stocks tend to outperform when inflation is higher than 3% and their relative valuations remain attractive.

S&P 500 (index points, current: 4,012)	December 2023 target
House view	**3,800**
↗ Positive scenario	4,400
↘ Negative scenario	3,300

Note: All current values as of 23 February 2023

Figure 1

Shifting to a somewhat more balanced sector positioning

	Least preferred		Most preferred
US equities			
Communication services	−	← (=)	
Consumer discretionary		=	
Consumer staples			+
Energy			+
Financials	−		
Healthcare		= ←	(+)
Industrials		=	
Information technology	−		
Materials		=	
Real estate		(=) →	+
Utilities		=	

Note: Tactical preferences from benchmark (S&P 500)
Source: UBS, as of 23 February 2023

Figure 2

Tightening lending standards suggest EPS slowdown

S&P 500 EPS (YoY growth %) vs. Senior Loan Officer Opinion Survey (%)

Source: Bloomberg, FactSet, UBS, as of 22 February 2023

Bonds

Much of January's gains have been given back as the market has begun to price the Fed's "higher for longer" rhetoric and its associated risks. We believe there will be three more 25bps rate hikes in March, May, and potentially June to settle at a 5.25–5.5% terminal rate. China's reopening, stickier inflation, oil, and robust jobs are all risks that may still force a hard landing in 2H23.

Alejo Czerwonko, Chief Investment Officer Emerging Markets Americas; **Leslie Falconio,** Head of Taxable Fixed Income Strategy; **Kathleen McNamara,** CFA, CFP, Municipal Strategist; **Barry McAlinden,** CFA, Fixed Income Strategist; **Frank Sileo,** CFA, Fixed Income Strategist

Government bonds

NEUTRAL

US 10-YEAR YIELD (current: 3.9%)	December 2023 target
House view	**3.0%**
Positive scenario	2.5%
Negative scenario	4.5%

Note: All current values as of 23 February 2023

The US 10-year yield has touched above 3.9% amid strong jobs, resilient inflation, and weaker economic data. The potential exists for moves higher, but not sustainably so. We maintain our range of 3.4–3.9% in the short term, trending to 3% by year end.

US investment grade corporate bonds

MOST PREFERRED

US IG SPREAD (current: 128bps)	December 2023 target
House view	**155bps**
Positive scenario	90bps
Negative scenario	225bps

Benchmark: ICE BofA
Note: Current values as of 21 February 2023.

We have a preferred allocation to IG. Favoring a higher quality fixed income allocation remains a focus, and IG corporates are part of our preferred allocation versus higher credit embedded high yield. We have maintained a barbell approach of short end 1–3-year IG alongside incrementally adding to our interest rate risk via 7-10-year IG corporates. For those who haven't yet increased duration exposure, we see an opportunity to incrementally add interest rate risk following the recent bearish rates sentiment.

Emerging market bonds

MOST PREFERRED*

EMBIG DIV. / CEMBI DIV. SPREAD (current: 457bps / 327bps)	December 2023 target
House view	**425bps / 300bps**
Positive scenario	300bps / 280bps
Negative scenario	600bps / 550bps

Note: Current values as of 23 February 2023

Tailwinds for emerging market (EM) bonds have weakened a bit recently. However, we believe the current environment remains supportive, and we keep EM bonds as most preferred in our global asset allocation. Key risks include a deteriorating inflation outlook that forces central banks to tighten policy further; much weaker economic growth amid softer commodity prices and renewed USD strength; and various idiosyncratic risks such as rising US-China tensions and a further escalation in Ukraine.

EMBIG = hard currency sovereign bonds
CEMBI = hard currency corporate bonds
*See Note on page 16.

US high yield corporate bonds

LEAST PREFERRED

USD HY SPREAD (current: 450bps)	December 2023 target
House view	**550bps**
Positive scenario	300bps
Negative scenario	850bps

Note: Benchmark: ICE BofA. All current values as of 21 February 2023

We maintain HY at least preferred. Given our expectation of slowing growth, 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. But for investors who are willing to endure mark-to market volatility, we see justification for riding out the likely near-term downside risks given HY's outright yield level.

Municipal bonds
NEUTRAL

After a strong January (+3.1%), muni performance has reversed course. We attribute this shift to concerns over inflation, while the labor market remains tight. At the same time, the pace of new muni issuance is finally picking up and providing a better entry point for investors seeking tax-exempt income. We continue to favor investment grade munis in higher-quality sectors rather than lower-rated high yield munis. Current AAA 10-year muni-to-Treasury yield ratio: 65% (last publication: 65.4%).

Non-US developed fixed income
NEUTRAL

Over the past month, bond yields in non-US developed markets moved mostly higher as many central banks continue to hike their policy rates. On foreign exchange markets, the dollar was stronger against other major currencies. These factors combined to produce negative 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
We maintain a neutral allocation for agency debt, with a preference for higher quality agency MBS. While spreads have modestly tightened since a January peak of 30bps, investors should seek quality and liquidity in a slowing growth environment, such as is expected for 2023. Current spread is +24bps to Treasury (vs. +8bps last publication).

Mortgage-backed securities (MBS)
MOST PREFERRED

Agency MBS remains our preferred sector, and the recent widening in agency MBS spreads has not changed our view. The give-back from the January performance is due to rising interest rates, and particularly volatility which we have expected to be an occasional headwind to performance. With current coupon spreads now 153bps to Treasury, a large U-turn from the spread compression witnessed in January which trended as low as 118bps to Treasury. Economic data will dictate the near-term trend in agency MBS; however, we continue to hold the higher-quality, stronger-liquidity sector as a preferred weighting as the economy slows in the second half of the year. Current spread is +153bps to the 5-year and 10-year Treasury blend (versus +135bps last publication)

Preferred securities
NEUTRAL

After an impressive start to the year, preferreds are once again facing the familiar headwinds of higher interest rates, with 5-year Treasuries breaching 4% and the 10-year rate close behind. A reacceleration of economic growth may prolong the Federal Reserve's tightening cycle and continue to skew rate risks to the upside. Nonetheless, we expect these trends to eventually dissipate and give rise to a more benign interest rate backdrop. A more favorable inflation outlook and less hawkish Fed should produce a more benign rate backdrop later in 2023 and this would support the preferred sector. Absolute and relative valuations appear fair-to-attractive.

Treasury Inflation-Protected Securities (TIPS)
We expect TIPS to have a strong 2023, after interest rate volatility dampened performance in 2022. We believe 10-year real yields will trend toward the 1.5% level. Inflation expectations and our view that nominal yields will decline by year end leave room to wait for a better entry point. Current 10-year breakeven inflation rate of 2.4% (1.16% last publication).

Figure 1

UBS CIO interest rate forecast

In %

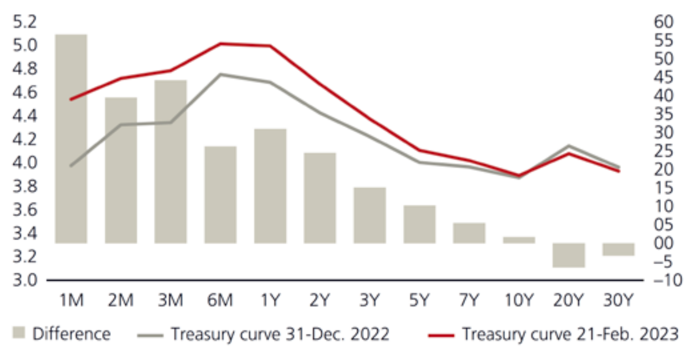
US Treasury	Current	Jun-23	Sep-23	Dec-23	Mar-24
2-year	4.69	4.00	3.50	3.25	3.25
5-year	4.15	3.50	3.25	3.00	3.00
10-year	3.92	3.50	3.25	3.00	3.00
30-year	3.91	3.50	3.50	3.25	3.25

Source: Bloomberg, UBS, as of 23 February 2023

Figure 2

10-year Treasury yields have moved back to YE 2022 levels

Yield, in %



Source: Bloomberg, UBS, as of 21 February 2023

Commodities and listed real estate

We see another strong year for commodities in 2023, and forecast high-teen percentage total returns on an asset class level. Our positive view is based on a robust economic recovery in China from 2Q23 onwards, the start of a Fed rate cutting cycle later in the year, and several unresolved supply-side issues that should keep market balances tight.

Dominic Schnider, CFA, CAIA, Strategist, UBS Switzerland AG; **Giovanni Staunovo,** Strategist, UBS Switzerland AG; **Thomas Veraguth,** Strategist, UBS Switzerland AG; **Wayne Gordon,** Strategist, UBS AG Singapore Branch

Commodities

MOST PREFERRED

GOLD (current: 1,825.00/oz) — December 2023 target

NEUTRAL

House view	USD 2,050/oz
Positive scenario	USD 2,200–2,300/oz
Negative scenario	USD 1,800–1,900/oz

Note: All current values as of 23 February 2023

Precious metals

US data have beaten expectations with labor data, sticky inflation readings, and surprisingly resilient retail sales all supporting dollar strength. And this has weighed on precious metals in February. At the same time, money markets have cut the probability of Fed rate cuts this year while lifting the possibility of a higher terminal federal funds rate (now estimated to end up above 5%). Importantly, we maintain the view that the US economy will slow this year and inflation will ease, while the Fed is likely to pause or even pivot, meaning the US dollar should decline. Ongoing solid central bank demand, together with a return of ETF buyers, should be supportive for gold this year.

Base metals

Our constructive demand view for industrial metals banks on a trough in global activity in 1Q and an acceleration from 2Q onwards. China's reopening should drive this growth narrative with the country accounting for the most demand by region. Beyond cyclical demand considerations, sector specific factors—like the demand associated with the green transition—remain at play as well. Both demand drivers together should ensure a robust uptake for industrial metals, despite subdued activity in the US and Europe.

Agriculture

Agricultural markets have outperformed broader commodities this year, the major surprise being soft commodities, namely sugar and coffee. The grains subindex has held up as well. Hard red winter wheat and soybean meal gained ground, though the USDA February inventory forecast was above projections. While La Niña ebbs, weather-related risks in Argentina, southern Brazil, central US, and western Europe keep parts of the market on alert. CMCI Livestock, against our view, declined 3.5% year-to-date. Elevated index-related roll costs, lower wholesale pork prices, and upside surprises to US production estimates weighed on performance. We expect some recovery as live cattle prices could rise further amid worsening cattle availability in 2023–24.

BRENT (current: USD 80.6/bbl) — December 2023 target

MOST PREFERRED

House view	USD 105/bbl
Positive scenario	USD 130–160/bbl
Negative scenario	USD 40–70/bbl

Note: Current values as of 23 February 2023

Crude oil

Russia announced plans to reduce production in March. The move—likely in response to the European embargo on Russian crude and refined product imports—aims to improve oil revenues by narrowing the discount of Russian oil to Brent. Meanwhile, China's reopening is lifting the country's oil demand. We expect greater domestic demand to result in higher crude imports over the coming months, tightening market balances further.

Listed real estate

RUGL Index (current: USD 5,409) — December 2023 target

House view	USD 6,800
Positive scenario	USD 7,000
Negative scenario	USD 6,000

Note: All current values as of 22 February 2023

We like companies with superior implied yield gaps to finance costs, relatively low leverage, and comparatively strong pricing power. Earnings visibility remains good despite uncertainties around values, dividend payments, and potential rights issues (which are mostly priced in). We like Hong Kong developers amid mainland China's reopening and after the recent profit-taking. Despite the strong rebound over the last few weeks, we continue to favor a pan-European exposure. By contrast, we expect Japanese companies to underperform on weak fundamentals. Uncertainties around the Fed's monetary policy may weigh on the US performance in the short-term, especially after the recent market rally. We think UK real estate companies are comparatively attractively valued and well capitalized.

Foreign exchange

Among the G-10 currencies, we prefer the Australian dollar.

Thomas Flury, Strategist, UBS Switzerland AG

This month we establish a neutral view across all G10 currencies, the one exception being a long position in the Australian dollar which could be financed from any of the major currencies in our neutral basket. We see a high likelihood that a Fed pivot toward easing will strengthen high-beta currencies like the euro, the British pound, and many emerging market currencies versus the USD. However, the timing remains uncertain. Over the past 24 months, assumptions on the terminal federal funds rate underwent frequent upward corrections, and the timing was pushed further into the future. In this adjustment process, we learned that one needs to stay sensitive to incoming data and keep a flexible stance in currency exposure.

We still believe that an investor looking for strategic performance over the longer term would benefit from selling USD versus EUR, GBP, or emerging market currencies right now, and should use the current USD rally to unwind their dollar position. However, if the major concern is near-term performance, a long USD position might make more sense. In the middle of these two views lies our stance, which reflects our tactical recommendation to have a neutral allocation.

Over the past two years and indeed over the past couple of weeks, the USD has been supported by the prospect of additional Fed rate hikes. A global recession, where all central banks look to cut interest rates, is another possible path to USD strength. A bullish scenario for the other G10 currencies would be a recovery in global growth coupled with a moderation in inflation. This is our forecast, and hence we maintain our long-term bearish view on the USD.

In Asia, we expect the Chinese yuan to appreciate steadily in 2023 thanks to growth tailwinds from reopening as well as measures to support its property sector. We also expect the Singapore dollar to trend stronger thanks to its central bank's policy of gradual, trade-weighted currency appreciation. While US data surprises are likely to recur, we believe fading Fed hawkishness and stronger growth outside the US present an opportunity to collect high nominal yields in select emerging market currencies. We think the Mexican peso and Czech koruna are attractive in this regard, and while the South African rand's carry appeal is lower, it should benefit from China's reopening. The Indonesian rupiah and Indian rupee have relatively attractive yields, and come with manageable volatility profiles, in our view. The risk to these high-yielding currencies, apart from global risks, would stem from some central banks turning dovish too soon.

FX strategy

	Least preferred	Neutral	Most preferred
USD		=	
EUR		=	
JPY		=	
GBP	− →	=	
CHF		=	
AUD			+

FX forecasts

	Current	Jun 2023	Sep 2023	Dec 2023	Mar 2024
EURUSD	1.06	1.08	1.10	1.12	1.14
USDJPY	135	125	122	120	120
GBPUSD	1.21	1.24	1.28	1.30	1.33
USDCHF	0.93	0.91	0.88	0.86	0.84
USDCAD	1.35	1.35	1.35	1.35	1.35
AUDUSD	0.68	0.72	0.74	0.76	0.78
NZDUSD	0.62	0.65	0.66	0.67	0.67
USDSEK	10.40	10.37	10.00	9.73	9.56
USDNOK	10.32	9.72	9.27	8.93	8.60

Sources: SIX Financial Information, UBS, as of 23 February 2023

Investment committee

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.

The GIC comprises top market and investment expertise from across all divisions of UBS:
- Mark Haefele (Chair)
- Solita Marcelli
- Paul Donovan
- Min Lan Tan
- 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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This report contains statements that constitute “forward-looking statements,” including but not limited to statements relating to the current and expected state of the securities market and capital market assumptions. While these forward-looking statements represent our judgments and future expectations concerning the matters discussed in this document, a number of risks, uncertainties, changes in the market, and other important factors could cause actual developments and results to differ materially from our expectations. These factors include, but are not limited to (1) the extent and nature of future developments in the US market and in other market segments; (2) other market and macroeconomic developments, including movements in local and international securities markets, credit spreads, currency exchange rates and interest rates, whether or not arising directly or indirectly from the current market crisis; (3) the impact of these developments on other markets and asset classes. UBS is not under any obligation to (and expressly disclaims any such obligation to) update or alter its forward-looking statements whether as a result of new information, future events, or otherwise.

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Our preferences do not assure profits or prevent against losses from an investment portfolio or accounts in a declining market.

Statement of risk

Equities – Stock market returns are difficult to forecast because of fluctuations in the economy, investor psychology, geopolitical conditions and other important variables.

Fixed income - Bond market returns are difficult to forecast because of fluctuations in the economy, investor psychology, geopolitical conditions and other important variables. Corporate bonds are subject to a number of risks, including credit risk, interest rate risk, liquidity risk, and event risk. Though historical default rates are low on investment grade corporate bonds, perceived adverse changes in the credit quality of an issuer may negatively affect the market value of securities. As interest rates rise, the value of a fixed coupon security will likely decline. Bonds are subject to market value fluctuations, given changes in the level of risk-free interest rates. Not all bonds can be sold quickly or easily on the open market. Prospective investors should consult their tax advisors concerning the federal, state, local, and non-U.S. tax consequences of owning any securities referenced in this report.

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Municipal bonds – Although historical default rates are very low, all municipal bonds carry credit risk, with the degree of risk largely following the particular bond’s sector. Additionally, all municipal bonds feature valuation, return, and liquidity risk. Valuation tends to follow internal and external factors, including the level of interest rates, bond ratings, supply factors, and media reporting. These can be difficult or impossible to project accurately. Also, most municipal bonds are callable and/or subject to earlier than expected redemption, which can reduce an investor’s total return. Because of the large number of municipal issuers and credit structures, not all bonds can be easily or quickly sold on the open market.

Appendix

Emerging Market Investments
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 socio-political risk, interest rate risk, and higher credit risk. Assets can sometimes be very illiquid, and liquidity conditions can abruptly worsen. CIO GWM 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 GWM 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.

Investors interested in holding bonds for a longer period are advised to select the bonds of those sovereigns with the highest credit ratings (in the investment grade band). Such an approach should decrease the risk that an investor could end up holding bonds on which the sovereign has defaulted. Sub-investment grade bonds are recommended only for clients with a higher risk tolerance and who seek to hold higher yielding bonds for shorter periods only.

Nontraditional Assets
Nontraditional 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-US 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 US dollars, changes in the exchange rate between the US 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 US investor.

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