UBS House View

Investment Strategy Guide:
Return of the bond vigilantes?

November 2023 | Chief Investment Office GWM | Investment research

UBS

In this report

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Dear reader

Interest rate madness has been the story of the fall, with the 10-year yield at one point nearing 5%. While the worst of the rate shock may very well be over, financial markets remain choppy and questions still exist around the next thing to "break" in the face of rising borrowing costs and falling Treasury values.

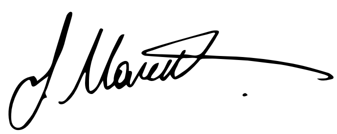
Yet at the same time, it appears the engine of the economy—the US consumer—is not as vulnerable as previously thought. Recent revisions to government data have identified an excess of USD 1 trillion in household savings, calling into question the previous belief that savings built up during the pandemic are destined to run out soon. The still resilient consumer supports our view that a soft landing remains the most likely outcome, and the risk of a recession still looks low in the coming year.

Still, we must acknowledge that we are in a world where the narrative continuously changes. And markets are still dealing with the tension between good economic data on one hand, and the prospect of higher rates and a more restrictive Fed on the other. News on US inflation has been mostly good, showing continued signs of moderation, with September's 4.1% core CPI being the lowest in two years. And the Fed recognizes that higher long-term bond yields may have already done some of its job in managing financial conditions. Yet the central bank has not claimed victory just yet—and a stronger-than-expected economy only complicates the last mile towards its 2% inflation goal.

While a variety of factors have contributed to the sharp rise in yields in recent months, we believe that, ultimately, economic fundamentals will remain in the driver's seat moving forward. And given our expectation for slowing US growth ahead, we still believe yields will trend lower toward 3.5% in 2024. Taking all this together, we maintain our preference for high-quality fixed income, which now brings the potential for price appreciation alongside compounding in the months ahead. Specifically, we prefer investment grade bonds, agency mortgage-backed securities, and 5-year TIPS. Additionally, while we believe the overall market and economic impact of the Israel-Hamas war will be limited unless we see further regional escalation, geopolitical uncertainty does typically support demand for quality bonds as well.

Zooming out, we also believe this remains a good environment for investors to put money to work in balanced portfolios, with attractive prospective returns across asset classes. In equities, we continue to hold a least preferred view on the US specifically, but the risk-reward has become more attractive after the decline since the end of July. Our positioning within the US remains the same as last month, with a preference for equal-weighted versus cap-weighted indexes, and consumer staples, energy, and industrials within our sector strategy.

Finally, in this month's Thematic Spotlight, we dive into the world of taxable munis, in line with our preference for fixed income. We believe taxable municipal bonds can provide investors with high credit quality, state tax exemption within the state of issuance, and diversification benefits within a fixed income portfolio. We also discuss opportunities within the municipal bond market as it relates to our long-term theme on education services.



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November

CIO Monthly Livestream

2 November 2023 at 1:00 PM ET

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Return of the bond vigilantes?

Bond yields rising

The rise in long-term Treasury yields in recent months has prompted some observers to ask whether the bond vigilantes are back.

Growth a key driver

We think the outlook for Treasury yields will depend more on the US economic growth trajectory than on fears around the federal deficit.

Slower momentum?

Looking ahead, we expect yields to fall as US growth slows and attention shifts to the prospect of Fed policy easing in 2024.

Asset allocation

Bonds remain our preferred asset class. We are neutral on global equities overall, but continue to favor emerging market stocks.

Mark Haefele
Global Chief Investment Officer
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Our views, live with Q&A
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James Carville, a political adviser to former US President Bill Clinton, once said that if reincarnation were real, he would like to come back as the bond market because "you can intimidate everybody."

Carville was speaking in the context of what was then a remarkable increase in the 10-year US Treasury yield, from around 5% to just over 8% between October 1993 and November 1994, driven in part by concerns over surging federal spending. The episode came to be known as the Great Bond Massacre.

Between early May and early October of this year, the 10-year yield rose from 3.3% to 4.8%, with around half of that increase taking place since the start of September. Yields have moderated in recent days. But the question remains: Are the bond vigilantes back?

While we acknowledge that we are in a period of heightened concern about the US fiscal situation, we think the outlook for Treasury yields will depend more on the growth trajectory of the US economy than on fears around the federal deficit.

Looking ahead, we expect yields to fall as US growth slows and the Federal Reserve finishes tightening and starts to ease policy later next year. We see bonds as an effective hedge to investor portfolios: In our downside scenario in which the US economy enters a recession, we expect 19% total returns for 10-year Treasuries by June next year. Quality bonds also present an attractive opportunity to earn good returns with limited risk if held to maturity. In our base case of a softish economic landing, we see 10-year yields falling to 3.5% and 10-year Treasuries returning 13%.

We also see upside potential in the equity market. Although we have a least preferred view on the US relative to other markets where we see better value, in our base case we expect the S&P 500 to reach 4,500 by June next year. Our sector preferences include global energy stocks, which we believe are attractively valued and can act as a geopolitical hedge.

Overall, we maintain our view that this remains a good environment for investors to start to put money to work in balanced portfolios, with attractive prospective returns across asset classes and diversification benefits from holding a combination of equities, bonds, and alternatives.

What's next for yields?

Bond vigilantes are attracting headlines once again.

The term "bond vigilantes" was coined in the 1980s to describe bond investors who would sell holdings in the government bonds of countries with fiscal policies deemed to be overly profligate. Amid upward surprises in the US Treasury's borrowing forecasts, a downgrade to the US sovereign AAA credit rating by Fitch, and the risk of a near-term government shutdown (see boxout), it's unsurprising that the bond vigilantes are attracting headlines once again.

Yet not even this formidable group of market influencers thinks that a country with its own currency and central bank is likely to default. Five-year credit default swaps—a measure of appetite for insurance—suggest a 0.04% probability of a US government default.

So what's going on, and what's next for yields?

We think about Treasury yields as a function of overall expectations about growth and the Fed's reaction function, market expectations about inflation, and supply and demand dynamics.

What are the risks from a potential US government shutdown?

Congress narrowly averted a US government shutdown at the beginning of October. But the enactment of a continuing resolution to fund federal spending will last only until 17 November, and we believe the subsequent ousting of Kevin McCarthy as House speaker increases the probability of further delays in reaching a bipartisan budget compromise, making a mid-autumn shutdown more likely.

The economic impact of a shutdown tends to be marginal at first, and markets have historically taken such episodes in stride. However, after around the third week, when federal workers' paychecks fail to arrive, the effects could grow larger. For example, in the last shutdown from December 2018 to January 2019, some US airports were forced to temporarily close due to absences among air traffic control staff.

In the current environment of rising yields and mixed messages from the economic data, much of the investor reaction to the shutdown could depend on the market's stability heading into it. If sentiment is already negative as the shutdown hits, it could have a bigger market impact than in the past, though we would still expect markets to recover once an agreement is eventually reached.

We expect demand to meet rising supply

Supply has been high and is likely to stay high

The supply of Treasury securities has been higher than expected.

Higher-than-expected supply of US Treasury securities to fund the country's fiscal deficit does appear to have contributed to higher bond yields in recent weeks. Ten-year yields were still less than 4% before the Treasury Department announced on 31 July that it would borrow USD 274 billion more than expected during the third quarter.

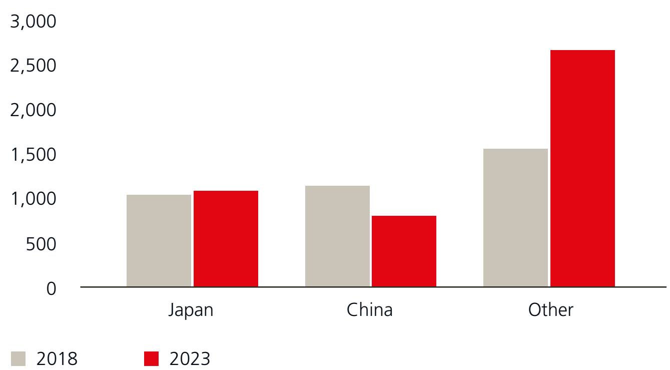
Although we do not expect further outsize adjustments in borrowing estimates, we think it's fair to say that US government bond supply will remain elevated going forward. The Congressional Budget Office projects that the federal deficit will rise from around USD 1.3 trillion last year to USD 1.4 trillion this year, USD 1.7 trillion next year, and USD 1.8 trillion in 2025.

But although higher Treasury supply could put some near-term upward pressure on yields, we ultimately think the demand for Treasuries is likely to remain sufficiently strong to meet the additional supply.

Figure 1

Foreign demand has increased

Foreign holders of US Treasuries, holdings amount in USD bn, 2018 vs. 2023



Source: Bloomberg, UBS, as of October 2023

Foreign demand is likely to remain robust

Foreign investors are likely to remain an important source of Treasury demand.

In total, around one-third of outstanding US Treasuries are held by foreigners, and as a result we often get questions like, "What happens if Japan and China start dumping Treasuries?"

We have a pragmatic view of this scenario. On one hand, demand shifts from China and Japan are more usually influenced by changes in their trade balances than active decisions by reserve managers. On the other, their significance in the Treasury market has declined markedly in recent years. Japan and China now each hold less than 4% of US government debt, down from highs of 7% and 9%, respectively, in 2011–12.

Meanwhile, other countries including the UK, Belgium, Luxembourg, Switzerland, and Ireland have become more active buyers (Figure 1). The data could reflect changes in where overseas buyers hold their Treasuries—for example, China holding Treasuries with overseas banks. But the overall point is that foreign demand has increased and is likely to prove robust given US Treasuries' established role as a marketable collateral within the global financial system. We believe this role is unlikely to change anytime soon.

The Fed will remain a flexible buyer

The Fed's shift from quantitative easing to quantitative tightening has contributed to lower demand for Treasuries.

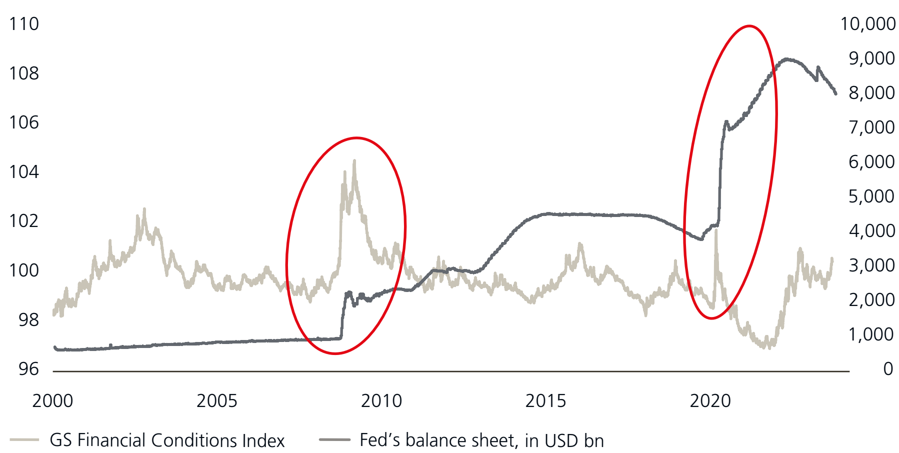
A quarter of US Treasuries are held by the Fed, and the shift in the central bank's use of asset purchases as a monetary policy tool has clearly contributed to lower demand for Treasuries. Under quantitative easing, at the height of the COVID-19 pandemic, the Fed was buying USD 80 billion of Treasuries and USD 40 billion of mortgage-backed securities each month. Today, under quantitative tightening, it is allowing up to USD 60 billion of Treasuries and USD 35 billion of mortgage-backed debt to mature without replacement each month, as it moves to shrink its balance sheet.

However, as we have seen in recent years, the Fed can quickly change its stance, and we would expect it to step in should the Treasury market's functioning become impaired. And if higher Treasury yields were to lead to overly tight monetary policy and an economic contraction, we think the Fed would restart quantitative easing.

Figure 2

In the past, the Fed provided liquidity when financial conditions tightened sharply

Goldman Sachs Financial Conditions Index (lhs) and Fed's balance sheet in USD bn (rhs)



Source: Bloomberg, UBS, as of October 2023

Treasuries are attractive from a portfolio perspective

Institutional demand for Treasuries should remain robust.

A third of US Treasuries are held by financial institutions including mutual funds, pension funds, banks, insurance companies, and other private holders, and here we expect demand to also remain robust.

Within the US, regulatory changes should mean continued bank buying of Treasuries. An increase in risk-weighted capital requirements and greater liquidity capital needs for large banks should result in increased purchases in the coming years. Nearer term, we think that downward adjustments by banks to their Treasury holdings in the wake of Silicon Valley Bank's collapse are largely complete.

A significant proportion of institutional demand is insensitive to price, driven by such regulatory requirements or collateral needs. But even among investors such as mutual funds and private buyers, we think demand will stay strong. In a portfolio context, US Treasuries remain nearly unmatched as a safe-haven asset, as seen from their recent rally following the Hamas attack on Israel (see boxout).

And despite lingering questions about whether we are entering an environment of permanently higher real interest rates or permanently higher economic uncertainty, we do not see evidence that the long-term "neutral" level of interest rates (also known as "r star" or r*) has changed, nor that the economic future is fundamentally more volatile.

The Israel-Hamas war and the hedging value of quality bonds

Demand for quality bonds is likely to be supported by elevated levels of geopolitical uncertainty following Hamas's attack on Israel. We think concerns about, or an actual regional escalation of, the conflict would lead to lower yields as investors seek shelter in safe-haven assets.

Broadly, we see the following potential scenarios:

- **Contained confrontation.** At the time of writing, Israeli troops are gathering on the border with Gaza, suggesting the exchange of hostilities could be protracted. In this scenario, the conflict continues for an extended period but remains largely confined between Hamas and Israel in their respective areas of control. The impact on global financial markets fades, but with the potential for a longer-lasting impact on local markets and assets.

- **Regional escalation.** In a downside scenario, the conflict could expand to draw in other regional actors, with a heightened risk of Iranian involvement. In this scenario, we would expect a larger impact on financial markets, with oil prices spiking given the risks to Iranian oil supply and heightened risks to energy flows out of the region. Safe-haven assets including US Treasuries and gold would rally as investors attempt to hedge against further escalation or a global economic slowdown driven in part by higher oil prices.

- **De-escalation.** The best outcome from a humanitarian perspective would be a swift cessation of hostilities. In this scenario, we would expect geopolitical risk premiums to fade quickly as investors refocus their attention on previous market drivers, namely developments in the US and Chinese economies.

Inflation has not contributed to higher yields

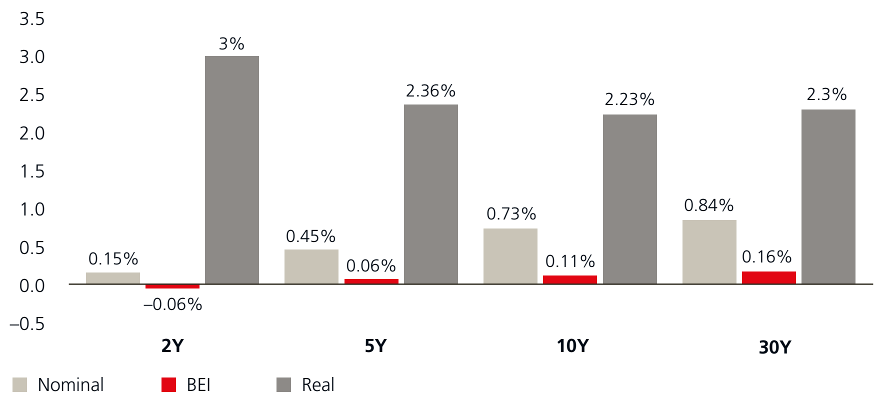
Inflation has not been a significant factor in the recent rise in yields.

While persistent and surprisingly high inflation was clearly an initial cause for higher central bank rates and bond yields, we do not think that inflation has been a factor in the recent rise in yields.

Figure 3

Yield changes in 3Q can be attributed primarily to real rates, not breakeven inflation rates

Changes in the nominal, real, and breakeven inflation rates in 3Q, in %



Source: Bloomberg, UBS, as of October 2023

Ten-year US breakeven inflation rates have remained stable in recent weeks and are currently trading at 2.31%. Recent data has also supported the notion that inflation continues to make progress toward the Fed's 2% target.

The Fed's preferred inflation measure—the core personal consumption expenditures (PCE) deflator—was up 3.9% year-over-year in August, the lowest since May 2021. Month-over-month, it rose by just 0.1%. Following monthly increases of 0.2% in June and July, this brings the three-month run rate close to the Fed's 2% inflation target.

Looking ahead, we anticipate inflation expectations to remain well contained and the economic data to validate the message that inflation is under control.

Slower growth and lower rate expectations should lead to lower yields

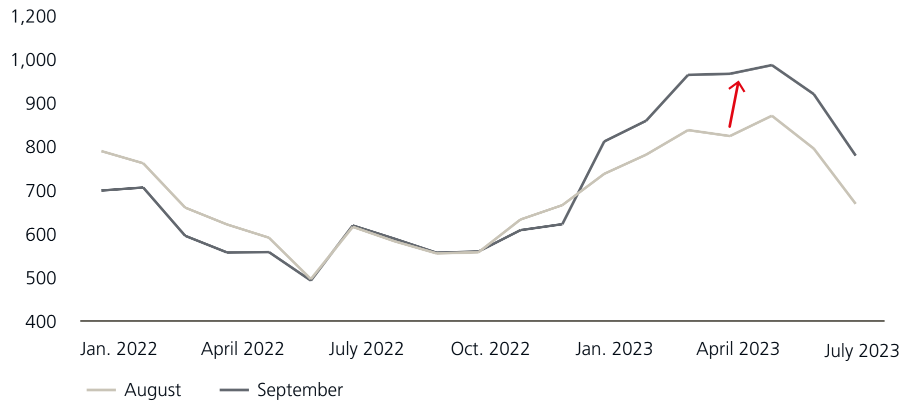
Economic resilience has been a key driver of the rise in yields.

With structural demand likely to keep pace with supply, and inflation not being a major contributor to the recent moves in yields, by process of elimination we are left with economic growth and the Fed's reaction function as the primary yield driver.

Figure 4

The US consumer has more excess savings left than previously thought

Bureau of Economic Analysis estimates of households' savings, in USD bn, August vs. September release



Source: BEA, Bloomberg, UBS, as of October 2023

The resilience of the US economy has led investors to assume that interest rates will remain higher for longer. Recent official revisions to the national accounts suggest that US consumers are using up their excess savings built up during the pandemic far less rapidly than previously reported—by around USD 50 billion a month rather than USD 100 billion. And labor demand remains strong: Nonfarm payrolls grew by 336,000 in September, more than twice the expected number, with the unemployment rate still at just 3.8%.

As a result, markets are now anticipating the first rate cut from the Fed only in May or June next year, and a total of three 25-basis-point cuts by December 2024.

However, we do expect the US economy to slow in 2024, leading to lower Fed policy rate expectations, even if the sturdiness it has shown so far reduces the risk of a recession in the next 12 months.

Consumer spending and business investment are likely to slow.

While US consumers may have spare capacity to spend, they are likely to tighten their purse strings as interest rates rise and the labor market cools. They also face additional headwinds from the end of childcare subsidies, the trimming of Medicaid rolls, new work requirements for food assistance programs, and the resumption of student loan payments. Business investment is also unlikely to be sustained at the current pace given higher borrowing costs.

With this in mind, we think it is unlikely that bond markets will continue to price the Fed keeping rates above 4% throughout 2025. We expect that data demonstrating slower growth will lead to lower interest rate expectations and bond yields.

What does all this mean for investors?

We continue to like quality bonds.

Bonds

We retain our preference for the higher-quality segments of fixed income, given the all-in yields on offer and likely capital appreciation as inflation cools, growth slows, and Fed rate expectations reduce. We favor high grade (government) and investment grade bonds, and are neutral on high yield and emerging market credit.

In our base case, we expect the 10-year US Treasury yield to fall to 3.5% by June 2024, which would translate into total returns of 13% over this period. In our downside scenario, we expect a drop to 2.75%, for a return of 19%. In our upside economic scenario, we could see the 10-year yield at 5%, for a total return of 1%.

Within equities, we favor areas of the market that have lagged this year's rally.

Equities

We hold a neutral view on global equities. While we see upside potential over our forecast horizon—8% for the MSCI All Country World Index by June 2024 in our base case—uncertainty about the monetary policy outlook may keep markets range-bound and choppy for now. We recommend focusing on areas that have lagged this year's rally, such as emerging market equities. In the US, we expect the S&P 500 to reach 4,500 by June 2024 and 4,700 by December 2024.

In our downside scenario of a recession, global stocks could fall 16% by June 2024. But for diversified investors, we would expect this decline to be offset by performance in bonds as markets move to price swifter Fed rate cuts. Meanwhile, in our upside scenario of a positive surprise in economic growth, global stocks could rally by 16%.

Energy remains one of our preferred global equity sectors. The global energy sector (MSCI ACWI Energy) trades on a 12-month forward price-earnings ratio of 10x, a 35% discount to the broader benchmark and a 32% discount to history, with a supportive return on equity and free cash flow yield. Consensus earnings growth expectations for 2024 also appear somewhat pessimistic, in our view. In a portfolio context, we believe energy stocks can serve as a good hedge against both geopolitical and inflation risks. Higher oil prices are one factor that could lead inflation and interest rates to stay higher for longer

The US dollar should be well supported in the months ahead but may weaken in 2024 as growth slows.

Currencies and commodities

The US dollar is finding support from multiple angles, particularly from resilient US macro data and a Fed that has signaled its intention to keep policy rates higher for longer. We think the greenback is likely to stay well-bid until the end of 2023, though we still expect it to weaken next year as US growth slows. We maintain a neutral view on the US dollar. Short term, we like to use option markets for yield pickup when it comes to the USD, and we think investors should consider beneficiaries of higher energy prices (e.g., the Norwegian krone, the Australian dollar, or the Canadian dollar) in the crosses.

Within commodities, we hold a preference for oil. Oil prices have had a volatile October so far, falling amid global growth concerns before rising after Hamas's attack on Israel. We still look for higher prices over our forecast horizon driven by an undersupplied oil market, and expect Brent crude to move back into the USD 90–100/bbl range. We are neutral on gold, but we see it as a good portfolio hedge in the current environment. We also maintain a neutral view on commodities overall, and recommend that investors in the asset class actively manage their exposure.

Mark Haefele
Chief Investment Officer
Global Wealth Management

Global forecasts

Economy

Real GDP y/y, in %

	2022	2023E	2024E
US	1.9	2.4	1.0
Canada	3.4	1.4	0.5
Japan	1.0	2.0	0.8
Eurozone	3.5	0.5	0.7
UK	4.1	0.2	0.6
Switzerland	2.7	0.7	0.9
Australia	3.7	1.9	1.6
China	3.0	4.8	4.2
India	7.2	6.2	6.0
World*	3.4	2.9	2.6

Inflation (average CPI), y/y, in %

	2022	2023E	2024E
US	8.0	4.2	2.5
Canada	6.8	3.5	2.3
Japan	2.5	3.1	2.0
Eurozone	8.4	5.5	2.4
UK	9.0	7.3	2.4
Switzerland	2.8	2.2	2.0
Australia	6.6	5.7	3.2
China	2.0	0.5	1.2
India	6.7	5.6	5.0
World*	8.4	6.3	5.1

* Excludes Venezuela

Source: Bloomberg, UBS, as of 12 October 2023. Latest forecasts available in the *Global forecasts* publication, published weekly.

Asset classes

	Spot	Jun-24
Equities		
S&P 500	4,377	4,500
Eurostoxx 50	4,201	4,600
FTSE 100	7,620	8,200
SMI	11,038	12,000
MSCI Asia ex-Japan	610	670
MSCI China	59	65
Topix	2,308	2,500
MSCI AC World	808	870
Currencies		
EURUSD	1.06	1.10
GBPUSD	1.23	1.28
USDCAD	1.36	1.30
AUDUSD	0.64	0.69
EURCHF	0.96	0.97
USDCHF	0.90	0.88
USDJPY	149	140
USDCNY	7.30	7.20

	Spot	Jun-24
2-year yields, in %		
USD 2y Treas.	4.98	4.00
EUR 2y Bund	3.09	2.50
GBP 2y Gilts	4.77	4.00
CHF 2y Eidg.	1.21	0.75
JPY 2y JGB	0.05	0.05
10-year yields, in %		
USD 10y Treas.	4.56	3.50
EUR 10y Bund	2.72	2.25
GBP 10y Gilts	4.32	3.50
CHF 10y Eidg.	1.06	0.90
JPY 10y JGB	0.76	0.80
Commodities		
Brent crude, USD/bbl	95.3	95
WTI, USD/bbl	83	91
Gold, USD/oz	1,873	1,950

Source: Bloomberg, UBS, as of 12 October 2023. Latest forecasts available in the *Global forecasts* publication, published weekly.

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
Get in balance	While currently high rates on cash are likely to fall in the years ahead, we expect attractive returns across stocks, bonds, and alternatives both over the next six to 12 months, and over the longer term. Investors should review their portfolios to ensure an effective balance across asset classes to manage potential risks and ensure returns are durable. As well as convenience, professionally managed balanced portfolio solutions provide systematic rebalancing, broader diversification, and access to attractive underlying investments.	• Balanced asset allocation (including alternatives) • Balanced sustainable asset allocation (including alternatives)
Manage liquidity	Investors have held more cash than usual as global central banks have taken rates sharply higher recently. With rates likely nearing a peak, we think now is an appropriate time for investors to review their liquid assets, consider diversifying exposures, and lock in attractive yields.	• Bond ladder • Certificates of deposit • Capital preservation structured investments • Money market funds • Bond funds
Buy quality bonds	We expect high-quality bonds to deliver total returns of 10–15% over six to 12 months, as economic growth gradually decelerates and inflation falls closer to target. At current yield levels, we see it highly unlikely that quality bonds will deliver negative returns over investment horizons of 12 months or more. Our preferred duration stance is in the 5–10-year range (12–20-year for munis), where we see the income durability and greater scope for capital appreciation as attractive.	• Government bonds (including TIPS) • Investment grade corporate bonds • Municipal bonds • Sustainable bonds • Actively managed fixed income strategies
Look for equity laggards	Year-to-date global equity gains look inconsistent with a slower second-half growth, a likely earnings contraction, and appealing risk-reward in bonds. This year's leaders linked to artificial intelligence (AI) look vulnerable to correction, at valuations of more than 30x price-to-earnings multiples. Capital preservation strategies on US secular winners can limit corrections, while better earnings and valuations can support emerging markets, select parts of Europe, lagging sectors across defensives and cyclicals, and value.	• US equal-weight vs. cap-weight • Value vs. growth • Capital preservation strategies • Emerging markets • Quality income
Pick leaders from disruption	Technological disruption across industries is creating opportunities for investors looking for longer-term portfolio growth potential. In the technology sector, among disruptors, we like platform companies with network effects in industries like internet and software as the impact of AI broadens. In energy, we see opportunity in the transition to renewables. We also see opportunities in the healthcare sector, as advances in drug development in areas like diabetes and weight loss are driving significant industry growth.	• Technology disruption • Energy transition • Healthcare innovation

MIFs	Elevator pitch	Investment ideas
Diversify with alternatives	Uncertainty about whether the US economy experiences a soft, hard, or no landing may mean higher volatility and mispricing across assets. Hedge funds, especially discretionary macro, can seize mispricings to generate returns while reducing portfolio drawdowns. Valuation differences and active ownership can help private equity deliver returns above public markets, while private assets in debt and real estate can offer an alternative income source for the long run.	• Hedge funds (discretionary macro, equity low-net, credit, multi-strategy) • Private markets (private equity, private credit, real estate)
Invest in infrastructure	Inflation and a slower growth outlook have not derailed business spending plans in key areas linked to upgrading infrastructure and supporting the net-zero carbon transition. Longer-term inflation uncertainty is likely to remain elevated, favoring exposure to assets that have a degree of inflation protection built in. Infrastructure assets can be less correlated to stocks and bonds in periods of volatility. Private infrastructure delivered mid-single-digit returns in 2022 when public markets and private equity turned negative.	• Infrastructure (including green-tech) • Industrials (including automation and robotics)
Go sustainable	Green investment, decarbonization commitments, consumer sentiment, and regulations will continue to drive the case for investing sustainably. We like sustainable bonds, ESG leaders, and innovative companies that can do more with less, including within energy and water efficiency, as well as in the transition to renewable energy, where we think investors should balance traditional with sustainable exposure. We also see opportunities to gain exposure to sustainable themes such as health and education through private market vehicles.	• Sustainable bonds • Sustainable equities • Private market impact investing

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

- Fixed income
- TIPS
- US agency MBS
- US investment grade corporate bonds
- Preferreds
- US large-cap value equities
- Emerging market equities
- Oil

Least preferred

- US equities

Implementation guidance

The worst of the rate shock, which saw 10- and 30-year Treasury yields rise over 60 basis points in September, appears to be over, but financial markets remain choppy. With most data continuing to surprise to the upside, there isn't yet clear evidence that the US economy is slowing, as it is widely expected to do in the fourth quarter. Consequently, the markets are dealing with the tension between good economic data on one hand, and the prospect of higher rates and a more restrictive Fed on the other.

The economic resiliency supports our view for a soft-ish landing and no recession in the next 12 months. Recent data revisions indicate that consumers have more excess savings than previously assumed, and with inflation running below income growth, real incomes are recovering, providing more support for the consumer. In addition, manufacturing and housing—two of the most interest-rate-sensitive sectors in the economy—have likely already experienced their worst in this cycle. That said, after the recent strong pace, the economy should experience a period of subtrend growth, weighed down by the lagged effects of restrictive monetary policy and tighter lending standards, higher energy prices, and the resumption of student loan repayments. Inflation trends point to the core measures continuing to move back to 2%. Despite job growth being very strong, wage growth has continued to moderate. With the economy growing below trend and monetary policy still restrictive, inflation is unlikely to reaccelerate.

The Fed is likely to stay on hold at the 1 November FOMC meeting but be clear that another rate hike is still possible. Despite the economic resiliency, there is enough evidence of moderating inflation and a cooling labor market, coupled with tighter financial conditions, for the Fed to stop hiking. Yet the risk that growth and inflation don't decline sufficiently in the next couple of months means another hike can't be ruled out. A clear indication that the Fed is done will reduce upside risk for Treasury yields across the curve, which should decline as the economy slows. Even more important than another rate hike is the potential for rate cuts in 2024. Based on our macro outlook, we don't expect the Fed to start cutting rates before June, with a total of 50–75bps of rate cuts in 2024.

With our macro outlook largely unchanged this month, we keep bonds as most preferred and maintain a neutral view on equities. The likelihood of rates staying higher for longer has led to an upward revision in our targets for 10-year Treasury yields, which we now forecast to be 3.5% in June 2024. With the yield currently near 4.6%, the implied total return is over 10%. The higher rate outlook also results in a modest reduction in our S&P 500 price target for June, down to 4,500 from 4,700, which we now expect to be reached by December 2024. These price targets are consistent with our expectation that high-quality, longer-duration bonds will produce higher returns with lower risk than US equities.

Our regional preference for equities did not change: Emerging markets remain most preferred and the US least preferred. Within US equities, we maintain our relative preference for value stocks over growth, and thus continue to recommend **looking for equity laggards**. One way we have been recommending investors express the preference for value and equity laggards is through the equal-weighted S&P 500 index. Growth equity's larger share of the market-cap-weighted index is neutralized when allocating to equal-weight, and the equal-weight S&P 500 has meaningfully lagged its cap-weighted counterpart this year—a trend we expect to reverse. Other equity laggards that are appealing include quality-income stocks and emerging markets.

Within fixed income, our message remains to **buy quality bonds**. We expect high-quality bonds to deliver total returns of 10–15% over six to 12 months, as economic growth gradually decelerates and inflation falls closer to target. At current yield levels, we see it as highly unlikely that quality bonds will deliver negative returns over investment horizons of 12 months or more. Specifically, we see good value in US Treasuries (including TIPS), investment grade corporate bonds, agency MBS, municipals, and sustainable bonds.

Given the volatile rate environment, we recommend investors consider actively managed fixed income strategies to take advantage of tactical opportunities as they present themselves. We also see value in inflation-protected securities. With the Fed near the end of the hiking cycle, but likely on hold for a long time, we reiterate our message to **manage liquidity**. With inflation continuing to decline, if we get a growth scare, the Fed has room to cut rates very quickly. This would be particularly painful for depositors who haven’t locked in these higher rates for the next few years.

From a long-term perspective, we recommend sectors and industries experiencing innovative changes. Specifically, our message to **pick leaders from disruption** highlights opportunities in technology, energy, and healthcare. In the tech space, we expect AI beneficiaries to broaden beyond the enablers and platforms to software and internet firms. In energy, the ongoing shift to a renewable economy will be further supported by fiscal investment in the US and Europe, allowing investors to participate in this transition. And in healthcare, recent advances in drug development in the fields of diabetes and weight loss are driving significant industry growth—a trend we expect to continue as demand remains high.

Beyond these disruptors, we continue to recommend to **invest in infrastructure**. Still-high inflation and potentially slower growth ahead haven’t stopped business plans to spend on infrastructure investments, and these plans are supported by substantial fiscal backing, which we explore further in our recent report “Made in America.” We think infrastructure can provide strong returns amid elevated inflation, while also diversifying sources of portfolio return due to their low correlation with stocks and bonds. Within the commodities space, oil remains most preferred. On top of the geopolitical risks that have driven crude oil prices higher recently, the market’s underpricing of ongoing supply constraints, declining global oil inventories, and growing demand all support oil prices.

We made no changes to our US equity sector views this month. We remain most preferred on consumer staples, industrials, and energy, and least preferred on real estate and utilities. Tighter oil supplies in the second half of the year should support prices and allow US energy stocks to rally, while industrials offer exposure to secular growth and some cyclical upside. The consumer staples sector could lag the market if we do indeed get a soft-landing economic scenario, but provides an attractive hedge given its low valuation.

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 16 September 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.

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		=	

Asset allocation: Themes implementation

With alignment to our Messages in Focus (MIFs)

Asset class	Theme and description	Manage liquidity	Buy quality bonds	Look for equity laggards	Diversify with alternatives	Invest in infrastructure	Go sustainable	Pick leaders from disruption
		MIF alignment						
Cash	**Enhancing liquidity strategy return: MLCDs** Market-linked CDs can offer upside exposure to stocks while providing downside protection.	✓						
US fixed income	**Taxable Munis** Taxable municipal bonds offer incremental yield pickup vis-à-vis corporate debt along the curve.		✓					
US fixed income	**Quality IG credits present an income opportunity** We believe investment grade issuers offer attractive yields and exhibit balance sheet strength and earnings resilience.		✓					
US fixed income	**Short-dated high yield bonds** 1–3-year maturity BB rated high yield bonds can provide over 100bps of spread pickup relative to similar-duration IG bonds, offering yields of around 6.5–7%.		✓					
EM fixed income	**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	**Greentech goes global** This equity list has significant ex-US exposure and should benefit from infrastructure spending plans.					✓		✓
US equities	**Investing in self-help** We believe companies with self-help measures to enhance profitability and increase margins should be rewarded.			✓				
US equities	**Diabetes and obesity** Innovative new obesity treatments are spurring opportunities in the healthcare sector.							✓
US equities	**Made in America** This stock list invests in opportunities stemming from US infrastructure and government spending plans.					✓		
EM equities	**ESG matters in emerging markets** This theme provides leverage to CIO’s preferred view on emerging markets.			✓			✓	
Hedge funds/ alternatives	**Opportunities in dislocated credit markets** Credit market stress has expanded the opportunity for hedge fund and private managers to deploy capital.		✓		✓			

Themes in focus: Taxable munis and education services

Kathleen McNamara, CFA, CFP, Municipal Strategist; **Sudip Mukherjee,** Fixed Income Strategist; **Michelle Laliberte, CFA,** Thematic Investment Strategist

Taxable munis

In this month's themes allocation, we've added an additional theme within the US fixed income sleeve: taxable munis. Taxable municipal bonds can provide investors with high credit quality, state tax exemption within the state of issuance, and diversification benefits within a fixed income portfolio. The yield on long-dated AA taxable munis now sits near the highest levels seen in over a decade (around 6%). At the same time, the spread on AA 30-year taxable munis to corporate debt with comparable ratings and structure rests at about 20bps, suggesting that an opportunity to pick up incremental yield while positioning in high-quality municipal bonds persists. In credit, our recent update on our "States" municipal risk framework concludes that the sector's credit quality remains sound. Strong fund balances and fiscal discipline provide states with a strong foundation for continued resilience in the year ahead.

Munis for education services

We've also recently updated our longer-term investment theme "Education services," which includes our views on the municipal bond market for education. In addition to municipal bonds, the update discusses regional differences in the education services market, the lasting impact of COVID-19, and two driving forces transforming education: technology and policy.

Economies worldwide are increasingly based on the services sector, and in our view they will require immense investment in human capital, advanced education, and specialized training to produce knowledgeable professionals. We expect continued change in both the way we learn and where we learn. Beyond increasing expansion of online education, lifelong learning and upskilling are likely to grow in relevance.

Four-year public and private not-for-profit institutions are financed primarily through the US municipal bond market. Most municipal higher education bonds are federally tax-exempt, a key attraction for US investors. In addition, investors often enjoy state tax exemption on bonds issued by institutions based in their home state. The sector also issues taxable municipal bonds.

The dispersion of student demand and financial strength between higher education institutions is increasing, resulting in increased credit quality bifurcation in the sector. That presents both opportunities and challenges for investors in this space. Higher-rated, large flagship public institutions and selective private institutions with large endowments are strongly positioned in a competitive market and provide better risk-return trade-offs compared to smaller colleges with limited resources. In our view, long-dated tax-exempt bonds of the former provide good long-term opportunities for investors to earn an attractive yield with limited credit risks.

For more, read our full "Education services" report under our Longer-Term Investments series, published 5 October 2023.

Longer-term themes

Top 5 favorite LTI themes

1. Emerging market infrastructure
2. Diversity and equality
3. Clean air and carbon reduction
4. Frontier markets
5. Education services

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."

US economic outlook

Recent data offers hope that the economy is headed for a soft landing. Core inflation continues to slow even as the unemployment rate remains low. Downside risks remain, as the lagged impact of higher interest rates feeds through and student loan payments restart. We also see a considerable risk of a government shutdown.

Brian Rose, PhD, Senior US Economist

Overview

Since the start of the pandemic, economic data has been unusually noisy, creating uncertainty over current trends in the economy. Recent revisions to the historic national accounts data, especially regarding household income and spending, has in our view changed the narrative. Prior to the revisions, it appeared that by the end of 2023, households were going to use up all of the excess savings built during the pandemic. A lot of recession fears revolved around a consumer slowdown once the excess savings were gone. As shown in the chart, after revision, it appears that excess savings still exceed USD 1 trillion, and the burn rate is USD 50 billion per month or less. With the strong labor market providing rising wage income and inflation slowing, it suddenly appears that consumer spending is not as vulnerable as we thought. Overall, the economy appears to be heading for a soft landing.

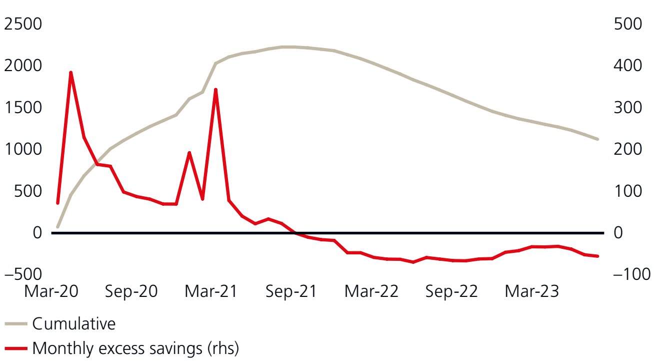
Growth

As shown in the chart, economic growth has remained above our 1.8% estimate of the potential GDP growth rate since 3Q22. It appears that growth was particularly strong in 3Q23. Job growth was also stronger than we expected in 3Q, averaging 266,000 per month after a big gain in September payrolls combined with upward revisions to July and August. While the economy has defied gravity so far, we still expect growth to slow from 4Q. The high level of interest rates is negative for both businesses and consumers who need to borrow. The resumption of student loan payments from October should also weigh on consumer spending. The household savings rate is unsustainably low in our view, so we should be entering a period where spending grows in line with income, or less. The impact of the ongoing UAW strike will become more significant in 4Q if a settlement isn't reached, and a possible government shutdown after 17 November is another downside risk. Our base case calls for a soft landing rather than a recession.

Figure 1

Revised estimates show more excess savings

UBS estimates of excess savings in USD bn

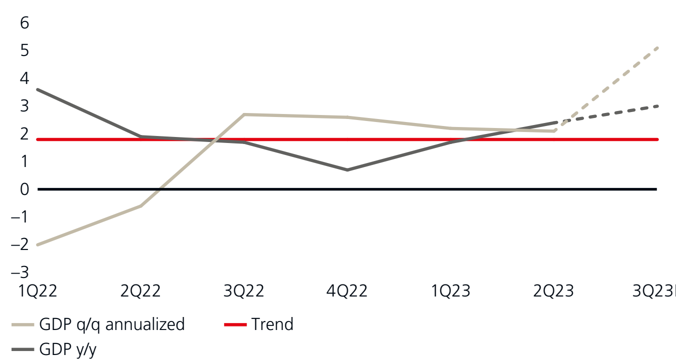


Source: Bloomberg, UBS, as of 11 October 2023

Figure 2

Growth has been above trend since 3Q22

GDP, q/q annualized rate and y/y change, in %



Note: 3Q23F based on Atlanta Fed GDPNow tracking estimate
Source: Atlanta Fed, UBS, as of 11 October 2023

For our global economic forecasts,
please see our report *Global forecasts*.

Read the report ›

Inflation

Core inflation, which excludes food and energy prices, has been trending lower in recent months despite robust economic growth. As shown in the chart, the 4.1% core inflation rate in September was the lowest in two years. Core goods inflation dropped all the way to zero, so all of the inflation was driven by services, and within services, shelter is by far the biggest factor pushing up inflation. Excluding shelter, both core and headline inflation were subdued at 2%. Data on new rental agreements suggests that shelter inflation, which lags new rental agreements by around 12 months, will slow in the months ahead, helping to bring down the overall inflation rate. Wage growth is still too high to be compatible with the Fed's 2% inflation target, but this is a long-term relationship, and does not preclude lower inflation in the near term. If economic growth slows in line with our expectations, this should also help to bring inflation down.

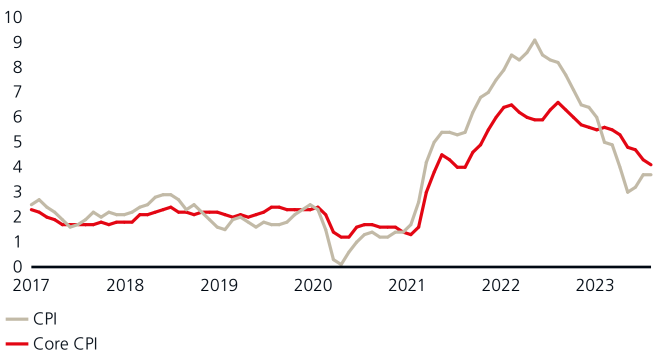
Policy

The "dot plot" from the September FOMC meeting showed a majority of participants expecting one more rate hike by the end of 2023. Economic growth and the labor market have exceeded the Fed's expectations, and as noted above, inflation is still far above their target, so why not hike? One factor that makes a rate hike less likely is the recent run up in longer-term bond yields. As shown in the chart, there has been a significant tightening of financial conditions independent of any change in Fed policy, and FOMC members are already talking about this as a possible reason to refrain from raising their policy rate. There is a strong consensus that interest rates are well above neutral, which means that inflation will eventually come down to the target if the Fed just leaves rates where they are. The main reason to consider raising rates again is to speed up the process. Given the uncertain outlook, we believe that the Fed may be satisfied to stay on hold and wait to see how the economy develops.

Figure 3

Core inflation remains on downward trend

CPI and core CPI, y/y change in %



Source: Bloomberg, UBS, as of 12 October 2023

Figure 4

Tighter financial conditions may keep Fed on hold

Goldman Sachs US Financial Conditions Index

Source: Bloomberg, UBS, as of 11 October 2023

Equities

Over the last month, lofty equity valuations have been pressured by surging real rates. Apart from higher US rates, other near-term headwinds to global equities have been the risk of a US government shutdown and economic weakness in China and Europe. Nevertheless, while it may be challenging to see where the economy is headed, the recent moderation in job growth has yet to dent the labor market. The latest new-orders and inventories readings in the US support the view that corporate earnings are back on the rise. In our global tactical strategy, we have a neutral rating on equities.

Eurozone

NEUTRAL

EURO STOXX 50 (index points, current: 4,201)	June 2024 target
House view	**4,600**
↗ Positive scenario	5,100
↘ Negative scenario	3,700

Note: All current values as of 12 October 2023

We maintain our neutral stance on Eurozone equities. Valuations are now relatively attractive and already reflect higher bond yields and our below-consensus earnings estimates. Concerns over higher-for-longer interest rates and weak economic growth have led to a sell-off, after which we see double-digit upside to Eurozone equities over the next 12 months. We favor laggards and segments that can benefit from improving trends or potential inflections in the coming months.

Emerging markets

MOST PREFERRED

MSCI EM (index points, current: 957)	June 2024 target
House view	**1,050**
↗ Positive scenario	1,150
↘ Negative scenario	820

Note: All current values as of 12 October 2023

We keep emerging market equities as most preferred. Aggregate manufacturing PMIs in emerging economies have improved, mostly due to China's sequential recovery, and the growth gap with developed economies persists. Emerging market central banks' easing bias should continue to be a positive for local stocks. Valuations for the MSCI EM index, at 11.6x 12-month forward P/E, are largely in line with the 10-year average and stand at a 36% discount to the S&P 500. In our view, the gap does not factor in better earnings growth prospects for emerging markets relative to developed markets next year.

Japan

NEUTRAL

TOPIX (index points, current: 2,308)	June 2024 target
House view	**2,500**
↗ Positive scenario	2,700
↘ Negative scenario	2,000

Note: All current values as of 12 October 2023

We are neutral on Japanese equities in our global portfolio. The TOPIX underperformed in late September against MSCI ACWI, falling to mid-August levels after the recent FOMC meeting turned global sentiment risk-off. In addition, after the TOPIX hit a 33-year high in mid-September, profit-taking occurred before the end of the month's ex-dividend date. However, these drivers were all either non-domestic or one-time events. Looking into 2024, we continue to think the Japanese equity market will offer relative safety, supported by a more favorable macro environment.

UK

NEUTRAL

FTSE 100 (index points, current: 7,620)	June 2024 target
House view	**8,200**
↗ Positive scenario	8,500
↘ Negative scenario	6,700

Note: All current values as of 12 October 2023

We are neutral on UK equities within our global equity preferences. We expect UK earnings to fall around 6% in 2023 as global growth weakens and tailwinds from higher commodity prices fade. Meanwhile, into 2024, earnings should recover and grow by around 5% on an improving economic outlook. Current valuations appear to already reflect expectations of soft earnings growth this year. The FTSE 100 trades on a 12-month forward P/E of 10.2x—around 20% below its long-run average—with a 4% dividend yield, which is a reflection of its value-heavy sector makeup.

US equities

US equities have benefited from solid growth and falling inflation this year. While we believe the economy is on track for a soft-ish landing, economic growth will likely slow in the months ahead. Still, we believe the profits recession is over and S&P 500 earnings growth should ramp up to a high-single digit pace in the coming quarters, paving the way for some additional upside from current levels into 2024.

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

US equities overview

LEAST PREFERRED

After the recent pullback, we believe the risk-reward is more attractive on a 12-month time horizon. Higher rates have been a key driver, but if the move is due to more resilient economic growth, stocks should rebound once rates begin to stabilize. However, forward returns are a bit lower than normal, on average, after large upward moves in rates. This is a key reason why we pushed out the timing of reaching our 4,700 S&P 500 price target from June to December 2024. Our new June target is 4,500. With the start of the 3Q earnings season, we expect earnings beats of around 3–4%. If results play out as we expect, this would be the first quarter of positive profit growth since the third quarter of last year (Fig. 2).

US equities: Sectors

We are most preferred on the consumer staples, energy, and industrials sectors. The energy sector looks more appealing after the recent fall in oil prices, which should reverse as inventories continue to decline. Consumer staples have been pressured by the potential negative impact of obesity drugs, but this looks overdone to us. Industrials offer exposure to secular growth and some cyclical upside. We are least preferred on the real estate and utilities sectors. In our view, both are likely to remain under pressure until there are clear signs that interest rates are heading lower.

US equities: Size

We remain neutral across size segments. Small- and mid-cap stocks remain cheap and could benefit from a soft landing if the downside risks continue to diminish. However, it may still be too early to anticipate an inflection in the cyclical outlook; earnings revisions for small- and mid-caps are lagging large-caps; and smaller companies' balance sheets are more exposed to higher rates.

US equities: Style

We maintain a small preference for value over growth. Growth stocks have benefited this year from AI excitement and improving earnings growth. But the gains have far outweighed the earnings improvements, lifting relative valuations to double their historical average. Any hiccup in the outlook for select mega-cap growth companies could prompt a rotation into value stocks and other segments that have lagged, in our view.

S&P 500 (index points, current: 4,377)	June 2024 target
House view	**4,500**
Positive scenario	5,000
Negative scenario	3,500

Note: All current values as of 12 October 2023

Figure 1

Balanced in our sector positioning

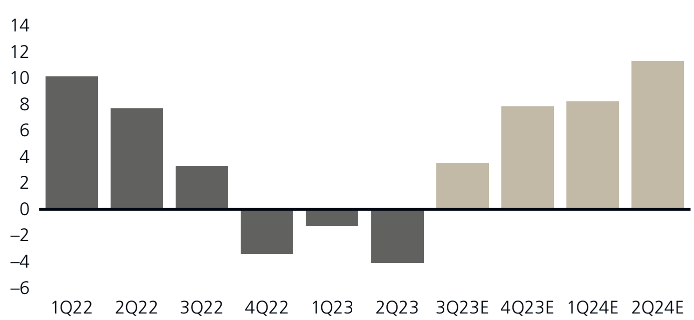
	Least preferred	Neutral	Most preferred
US equities			
Communication services		=	
Consumer discretionary		=	
Consumer staples			+
Energy			+
Financials		=	
Healthcare		=	
Industrials			+
Information technology		=	
Materials		=	
Real estate	−		
Utilities	−		

Note: Tactical preferences from benchmark (S&P 500)
Source: UBS, as of 12 October 2023

Figure 2

3Q should mark the return to profit growth

S&P 500 EPS y/y growth in %, actuals and consensus estimates except for 3Q23, which reflects CIO estimate



Source: UBS, as of 10 October 2023

Bonds

The recent spike in US government bond yields was spurred by a higher-for-longer fed funds rate expectation being priced into the market, plus other factors such as a higher term premium for owning longer-maturity bonds. We continue to think this provides a good opportunity for investors to put their excess cash to work by locking in attractive yields as the Fed nears the end of its rate-hiking cycle, and before markets start to price lower rates in the future and turn their attention to rate cuts. The more defensive, higher-quality segments of fixed income look most appealing to us, given the all-in yields on offer and the potential for capital appreciation as rates decline.

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: 4.6%)	June 2024 target
House view	**3.5%**
↗ Positive scenario	2.8%
↘ Negative scenario	5.0%

Note: All current values as of 12 October 2023

Geopolitical factors spurred a flight to quality in Treasuries that was carried on by a lower month-over-month PPI print on 11 October. Bond yields have rallied 20bps since reaching 4.8% on 6 October, and we expect that trend to continue into year-end. While moves higher toward and beyond 5% are possible, we believe those will be temporary and yields will trend lower on the back of slowing economic growth into 2024.

US investment grade corporate bonds

MOST PREFERRED

US IG SPREAD (current: 127bps)	June 2024 target
House view	**145bps**
↗ Positive scenario	80bps
↘ Negative scenario	200bps

Benchmark: Bloomberg Barclays US Int. Corp.
Note: Current values as of 12 October 2023

We hold a most preferred view on investment grade bonds. Average US IG yields are at historically elevated levels of over 6% while spreads are sitting slightly above their long-term average. We expect prospects of falling government bond yields as economic growth slows in the coming quarters to contribute nicely to total returns for the asset class. US IG fundamentals started to modestly weaken in 2Q, though from a position of strength. Overall earnings have been sound from a fixed income perspective and are likely to limit material near-term deterioration, in our view. We view the risk of rising downgrades and upward pressure on spreads as limited outside a deep recession.

Emerging market bonds

NEUTRAL

EMBIG DIV. / CEMBI DIV. SPREAD (current: 449bps / 346bps)	June 2024 target
House view	**425bps / 300bps**
↗ Positive scenario	340bps / 280bps
↘ Negative scenario	600bps / 550bps

Note: Current values as of 12 October 2023

We keep emerging market credit as neutral as valuations look fair on average. Following spread widening in September, our base case calls for gradual risk premium compression over our forecast horizon. Key risks include a global recession, a reacceleration of inflation requiring tighter policy in the US and other key markets, softer commodity prices, and various idiosyncratic risks, such as US-China tensions and further escalation of the war in Ukraine and violence in the Middle East.

EMBIG = hard-currency sovereign bonds
CEMBI = hard-currency corporate bonds

US high yield corporate bonds

NEUTRAL

USD HY SPREAD (current: 427bps)	June 2024 target
House view	**500bps**
↗ Positive scenario	370bps
↘ Negative scenario	850bps

Benchmark: ICE BofA.
Note: All current values as of 12 October 2023

We are neutral on high yield, reflecting mainly our view of relative value rather than an expectation of soaring defaults. HY has performed well year-to-date, and spreads are below historical average levels. We believe that weakening credit fundamentals are somewhat offset by the outright level of yields, which provide carry and a buffer to total returns. We think HY default rates could rise to mid-single-digits, which would be lower than in past default cycles. However, as the last downturn was relatively recent, we have not seen the classic buildup of financial excess or leverage as in previous cycles.

Municipal bonds

NEUTRAL

Despite the initial rally in safe-haven assets (including munis) following the Hamas attack on Israel, yields on tax-exempt paper are still hovering around their highest levels in over a decade. As the Fed nears the end of its rate-hiking cycle, we believe investor demand for munis can pick up in the months ahead. We see an opportunity to lock in attract after-tax yields on longer-dated high-quality munis (12-year to 20-year range). AAA 10-year muni-to-Treasury yield ratio: 73% (last publication: 70%)

Non-US developed fixed income

NEUTRAL

Over the past month, bond yields in non-US developed markets were mostly flat or higher as central banks maintained a tightening bias. On foreign exchange markets, the dollar mostly gained against other major currencies, reducing the value of non-dollar bonds when measured in dollars. These factors combined to produce negative returns. We do not recommend a strategic asset allocation position on the asset class, but if the dollar weakens as we expect, it could potentially boost returns over the next 6–12 months.

Additional US taxable fixed income (TFI) segments

Agency bonds

We continue to have a least preferred view in agency debt, with a preference for agency MBS.

Mortgage-backed securities (MBS)

MOST PREFERRED

The recent bond sell-off and concurrent volatility pushed MBS spreads to 187bps, an 18-week wide. While volatility and higher rates remain a headwind, we maintain our preferred weighting given the sector's relative value, higher quality, and liquidity. While some buyers remain on the sidelines, we believe that the completion of selling in the FDIC pool and slowing growth in the fourth quarter will be a tailwind to outperformance over other high-quality sectors in the months ahead.

AGENCY MBS SPREAD (current: 182bps)	June 2024 target
House view	**125bps**
Positive scenario	100bps
Negative scenario	185bps

Note: Current values as of 12 October 2023

Preferred securities

MOST PREFERRED

After two consecutive months of gains in June and July, the recent surge in interest rates has stopped the preferred securities sector in its tracks with back-to-back losses in August and September. As a result, preferreds posted lackluster results for the third quarter of 2023. Valuations remain generally favorable and—against a backdrop of lower-trending interest rates—could lead to impressive performance. Resilient fundamentals and favorable technicals have the potential to lend support as well. We remain constructive on the preferred securities sector and believe that current conditions could contribute to solid 12-month returns.

Treasury Inflation-Protected Securities (TIPS)

Real yields have risen for many the same reasons as nominal yields, including supply, volatility, and the repricing of the Fed path as well as sentiment that a soft landing will be achieved while keeping rates higher for longer. Our preferred weighting in TIPS reflects our conviction that the Fed is reaching the end of its hiking cycle and the fact that TIPS tend to rally following a Fed pause. We favor 5- and 10-year real yields at current levels on the expectation they will rally as growth slows.

US 5-YEAR YIELD (current: 2.43%)	June 2024 target
House view	**1.75%**
Positive scenario	1.50%
Negative scenario	2.40%

Note: All current values as of 12 October 2023

Figure 1

UBS CIO interest rate forecast

In %

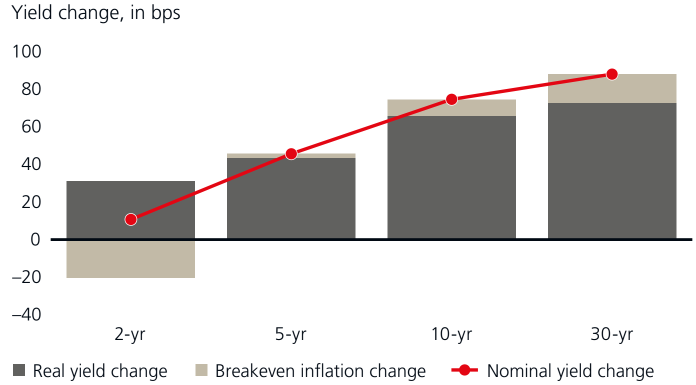
UST	Current	Dec-23	Mar-24	Jun-24	Sep-24
2-year	5.0	4.8	4.3	4.0	3.8
5-year	4.6	4.0	3.5	3.5	3.5
10-year	4.6	4.0	3.8	3.5	3.5
30-year	4.7	4.3	4.0	4.0	4.0

Source: Bloomberg, UBS, as of 10 October 2023

Figure 2

Nominal Treasury move by real and inflation components: 30 June to 10 October

Yield change, in bps



Source: Bloomberg, UBS, as of 10 October 2023

Commodities and listed real estate

Our UBS CMCI broad commodity index trended sideways in September, delivering a total return of 0.3% and is up 2.7% year-to-date. Energy has been a key driver behind the performance of the asset class. The UBS CMCI energy index gained 2.5% during the month. Therefore within the asset class, we retain our preference for oil. We see further gains for commodities as a whole into year-end and target low-teens total returns on a 12-month basis. We also continue to recommend actively managing commodity exposure.

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

NEUTRAL

GOLD (current: USD 1,874/oz) — June 2024 target

NEUTRAL

House view	**USD 1,950/oz**
Positive scenario	USD 2,150–2,250/oz
Negative scenario	USD 1,650–1,750/oz

Note: All current values as of 12 October 2023. Gold is a safe-haven asset whose price tends to rise when risk assets, such as equities, fall, and vice versa.

BRENT (current: USD 83.5/bbl) — June 2024 target

MOST PREFERRED

House view	**USD 95/bbl**
Positive scenario	USD 120–150/bbl
Negative scenario	USD 40–70/bbl

Note: Current values as of 12 October 2023

Precious metals

Gold has reacted to headline geopolitical events as expected. With investors looking for safe-haven assets, the yellow metal has benefited from the spike in tensions. That said, high US interest rates will remain a headwind for gold. We expect only higher gold prices once the Fed starts to sound more dovish in 2024. We continue to recommend investors use gold as a hedge despite being neutral in our global strategy.

Base metals

Industrial metal prices are likely to be volatile in the near term on global growth concerns. However, supply disappointments and structural demand drivers have been offsetting forces to weaker global manufacturing and disappointing China data. Our supply and demand estimates still point to an undersupplied market for most metals, which favors higher prices in the coming quarters.

Agriculture

Agriculture ended 3Q23 lower overall, although differences between each sector over the quarter were stark, e.g., grains declined by 6.5%, while softs including cocoa, coffee, cotton, and sugar rose by above 10%. Livestock eked out a small gain of 2%. Most significant to grains prices were the USDA's surprise upgrades to the US planted area for corn, as well as higher-than-expected quarter-end domestic grain inventory data. Wheat led the decline (–12.5%) as speculators added to their short positioning following the USDA report alongside improved export flows from Ukrainian Black Sea ports (despite no UN-sponsored grain initiative) and as Russian shipments set new seasonal record highs. However, El Nino and other weather risks loom large.

Crude oil

Oil prices have been very volatile so far in October. Recession fears saw oil prices falling sharply at the start of the month, then later rose following the Hamas attack on Israel. That said, geopolitical risk premiums tend to fade quickly if oil supplies are not impacted. We still look for higher prices driven by an undersupplied oil market and expect Brent to move back into the USD 90–100/bbl range.

Listed real estate

RUGL Index (current: USD 4,947) — June 2024 target

House view	**USD 7,000**
Positive scenario	USD 6,600
Negative scenario	USD 5,400

Note: All current values as of 12 October 2023

We like companies with strong pricing power, attractive implied yield gaps, robust cash flows, and selectively those trading at large discounts. Earnings visibility continues to improve as uncertainty around potential rights issues fades. We like Japanese developers and REITs. Singapore REITs and developers may slightly lag, as fundamentals are fully priced in, while Hong Kong and China still suffer from market uncertainty. We favor pan-European exposure, as we expect investors to gradually return amid appealing valuations. UK real estate firms are comparatively attractively valued, and well-capitalized US companies take advantage of comparatively robust fundamentals.

Foreign exchange

We are neutral on the US dollar and other major currencies.

Thomas Flury, Strategist, UBS Switzerland AG

Elevated interest rates and robust economic growth in the US relative to the rest of the world have provided broad USD support over the past two months. Considering the latest data, the US appears to be the only major economy that can still handle higher interest rates for now. We think this will keep the USD well bid across all currencies into year-end. The biggest risk to our short-term USD view is a step down in US growth, which would put investor focus on structural USD negatives and the greenback's elevated valuation.

Our big question for the EUR is whether the European Central Bank or the Federal Reserve will cut rates first. Some weeks ago, our answer would have been the Fed. But the ECB may now be one that acts first, with European activity data coming in on the soft side and recession risks increasing. Hence, we think EURUSD faces near-term downside risks, potentially trading deeper into the 1.0–1.05 range.

As for the GBP, the dovish turn from the Bank of England has left its mark. Housing market data is starting to become a greater concern as monetary policy works its way through the economy, and labor market leading indicators are pointing at a downturn. Falling relative real rates between the UK and the US could push GBPUSD to 1.19 and EURGBP to 0.88 temporarily, in our view.

While the Swiss franc is a safe-haven currency, a disappointing Swiss National Bank and lower-than-expected inflation in Switzerland are taking the steam out of the CHF in the absence of a material recession in Europe. For now, we like to sell the CHF upside risks for yield pickup versus the euro or British pound. As for USDCHF, we are looking for a top at 0.94.

The rise in US yields continues to drive USDJPY upwards, even though markets have gotten more wary of the 150 level given the prospect of FX intervention. We think FX intervention should cap USDJPY but is not yet a sufficiently strong reason to believe in Japanese yen strength or chase a lower USDJPY. This should come once US economic data steps down and US yields finally retreat.

For the Norwegian krone or the Canadian, Australian, or New Zeland dollar, we see room for relative outperformance in the crosses. Chinese data should stabilize further with room to grind higher. The pullback in oil prices should also be transitory, which should ultimately support the CAD and NOK. We expect EURCAD to move lower and the NOK to outperform the Swedish krona again.

Pressure on emerging market currencies has intensified as global rates continue to march up. Carry currencies—including some of the market's most preferred picks like the Mexican peso and Brazilian real—have suffered the most, with investors clearing out high-yielding positions. We have little conviction on the near-term direction for carry currencies. The current environment is more suitable for yield-enhancement strategies than outright carry positions in emerging market currencies, in our view, especially against the US dollar.

FX strategy

	Least preferred	Neutral	Most preferred
USD		=	
EUR		=	
JPY		=	
GBP		=	
CHF		=	
AUD		=	

FX forecasts

	Current	Dec-23	Mar-24	Jun-24	Sep-24
EURUSD	1.06	1.06	1.08	1.10	1.12
USDJPY	149	145	143	140	136
GBPUSD	1.23	1.20	1.24	1.28	1.30
USDCHF	0.90	0.92	0.90	0.88	0.87
USDCAD	1.36	1.32	1.31	1.30	1.29
AUDUSD	0.64	0.65	0.67	0.69	0.71
NZDUSD	0.60	0.61	0.62	0.63	0.63
USDSEK	10.88	11.32	11.02	10.73	10.45
USDNOK	10.84	10.66	10.28	10.00	9.64

Sources: SIX Financial Information, UBS, as of 12 October 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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Our preferences do not assure profits or prevent against losses from an investment portfolio or accounts in a declining market.

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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.

Preferred securities – Prospective investors should consult their tax advisors concerning the federal, state, local, and non-U.S. tax consequences of owning preferred stocks. Preferred stocks are subject to market value fluctuations, given changes in the level of interest rates. For example, if interest rates rise, the value of these securities could decline. If preferred stocks are sold prior to maturity, price and yield may vary. Adverse changes in the credit quality of the issuer may negatively affect the market value of the securities. Most preferred securities may be redeemed at par after five years. If this occurs, holders of the securities may be faced with a reinvestment decision at lower future rates. Preferred stocks are also subject to other risks, including illiquidity and certain special redemption provisions.

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:

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– **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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