UBS House View

Investment Strategy Guide: That butterfly effect

May 2024 | Chief Investment Office GWM | Investment research

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May
CIO Monthly Livestream
2 May 2024 1:00 p.m. ET

- Tune in to the event here
- Add to calendar

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Dear reader

April has brought more than showers, as investors have contended with hotter-than-expected US inflation data, the Fed's inclination to keep interest rates higher for longer, and escalating tensions in the Middle East. The result? Large swings across asset classes with the US Treasury 10-year yield rising 50bps and the S&P 500 at one point down ~5% from its peak.

Despite this renewed volatility, we believe many of the latest developments on the macro and geopolitical front represent interruptions, as opposed to inflection points for the US economy and financial markets. We still anticipate a soft landing, with slower economic growth as consumer spending comes off a boil. And we expect bumpy, yet gradual disinflation as lagging inputs like shelter inflation fall, and wage growth continues to moderate.

While the Fed is delayed, we don't believe rate cuts have been completely canceled for 2024 and still see a rate hike as unlikely. Our base case remains two rate cuts of 25bps each in 2024 – dependent on inflation falling in line with our view. In this scenario, we'd expect the 10-year US Treasury yield to trend lower in the second half of 2024, towards 3.85% by December, from 4.70% today.

Our expectation for a 2H move lower in bond yields supports our favorable view on higher quality fixed income, which should benefit from both price appreciation and attractive yields. We keep US investment grade corporate bonds, CMBS, and Agency MBS, as most preferred. We remain most preferred on Treasury Inflation Protected Securities, but have extended our 5-year TIPS allocation in favor of moving further out on the curve into the 7-10 year area, where we now see better relative value.

We are neutral on US equities, where fundamentals remain on solid footing with earnings growth set to broaden beyond the Magnificent 7, and believe stocks look more appealing after the recent pull back. Additionally, we are constructive on tech stocks, which should benefit from robust AI investment spending and a bottoming in PC and smartphone end markets. But for investors already overexposed to tech, we see opportunities in other areas like healthcare and industrials sectors, as well as small-caps.

Finally, in this month's Thematic Spotlight, we discuss the convergence of AI, space, and security into a longer-term investment theme. We believe AI will be a key driver of growth over the next decade, with AI, security, and the space economy increasingly intertwined and fueled by the vast amount of data collected via satellites. We expect the AI opportunity set to expand beyond infrastructure to software and service applications and believe several companies along the entire AI value chain could benefit.

As always, we encourage you to reach out to your UBS financial advisor with questions on how our views fit in with your goals and portfolio.

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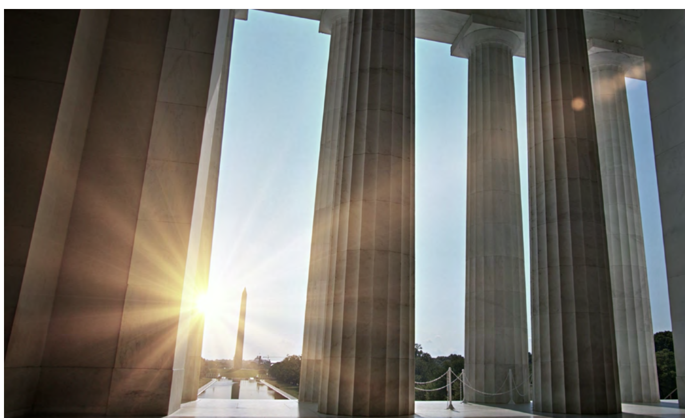

ElectionWatch 2024

UBS Road to the Election

CIO launched a new weekly video series "UBS Road to the Election." New episodes will air every Thursday at 4:30 p.m. ET. For additional election-related content, we encourage you to visit the ElectionWatch hub.

That butterfly effect

Soft landing

In our base case, US inflation and growth moderate, and the Fed starts cutting rates in September. This creates a supportive backdrop for both bonds and equities.

Overheating?

In a bear case, concerns about an overheating US economy send Treasury yields higher. An allocation to alternatives can help to stabilize portfolios.

Roaring 20s?

In a bull case, a disinflationary boom in the US and increasing optimism about the AI growth outlook drive equity markets higher.

Asset allocation

Within equities, we favor quality stocks and hold a constructive view on the US technology sector. In fixed income, we also prefer quality.

Mark Haefele
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Our views, live with Q&A
The next CIO global monthly livestream will take place on 30 April. Join here.

Increasing optimism about AI could support a bull case for equities.

Like all imperial capitals throughout history, Washington DC has a cynical streak. Last week, the buzz at the International Monetary Fund/World Bank gatherings I attended noted (with irony) that Iran's strike on Israeli soil was clearly audible even 10,000km away, in the US Congress. After months of legislative stalemate, a rare bipartisan coalition enabled Congress to enact a sweeping set of measures that include aid to Israel, Ukraine, Taiwan, and Indo-Pacific allies, as well as additional sanctions on China, Russia, and Iran.

It's too soon to say if recent events mark a turning point in world history, or indeed whether the upward surprise in US inflation marks a turn in the macroeconomic trend. But as investors, we have no choice but to navigate portfolios through a volatile and complex geopolitical and macroeconomic environment full of "butterfly effects" that don't care about earnings forecasts or valuation metrics.

Still, we find that a grounding in scenario analysis, built on understanding the most probable drivers of future market outcomes, is the best tool to help set our asset allocations. In the rest of this letter, I present our latest scenario analysis and what we think it means for investors.

In our base case, we expect US inflation to gradually resume its downward trend, falling to 3% by the end of the third quarter. Although Federal Reserve officials have indicated there is no urgency to cut interest rates, we think they will be able to make a first reduction in September. Meanwhile, we think the conflict in the Middle East will stay geographically contained. We think this scenario is consistent with the S&P 500 rising to 5,200 by year-end, and the 10-year Treasury yield falling to 3.85%.

Our bear case scenario would see a combination of "too good" US growth, worries about US fiscal policy, and/or a sustained commodity price shock driving the 10-year Treasury yield to 6%. We would expect the S&P 500 to fall to around 4,400 in such a scenario.

A bull case scenario would depend on optimism about artificial intelligence building further, at the same time as US growth stays robust and inflation resumes a downward trajectory. This could support a rise in the S&P 500 toward 5,500, in our view, despite the 10-year Treasury yield climbing to 5%.

What do these scenarios mean for investors? We see the overall risk-return outlook for equities as balanced, and therefore think investors should hold equity allocations close to strategic benchmarks. Within equities, we see better opportunities below the index level in quality stocks, including technology. We also expect small-caps to outperform.

High-quality bonds are our preferred asset class. Quality bonds have value in a portfolio context given the likelihood that they would rally sharply in case of a recession, even if we see this outcome as unlikely over our tactical investment horizon. Interest rate expectations would have to rise significantly from here for investors to earn a negative return, and in our base case we expect total returns of around 10% for quality bonds by year-end (10-year Treasuries, based on yields as of the 24 April close).

Meanwhile, an allocation to alternatives can help investors diversify and manage risks across scenarios. Our bear case would likely be negative for both bonds and equities, and hedge fund strategies like macro and equity-market neutral could help stabilize portfolios in such a scenario.

A likely undersupplied market underpins our positive view on oil, and we also see scope for gold prices to rise further by the end of the year. Both also have value in a portfolio context, particularly to help hedge geopolitical risks.

Scenarios

	Base case *Soft landing*	**Bear case** *Overheating*	**Bull case** *Roaring 20s*
Probability	60%	20%	20%
S&P 500	5,200	4,400	5,500
10-year Treasury yield	3.85%	6%	5%

Source: UBS estimates, as of April 2024

Base case: Soft landing

US CPI data have been higher than expected in recent months.

March inflation data offered little reassurance that the US is on course for a sustainable return to 2% annualized inflation. The headline and core consumer price indexes (CPI) both rose by 0.4% from the previous month. And worse, “super core” inflation—which excludes food, energy, and shelter prices, and focuses on labor-intensive core services—increased to 0.65%, driven by rising costs in medical care, motor vehicle repair, and motor vehicle insurance.

However, in our base case scenario, we expect disinflation to resume in the months ahead.

Disinflation to return

US shelter inflation is likely to trend lower.

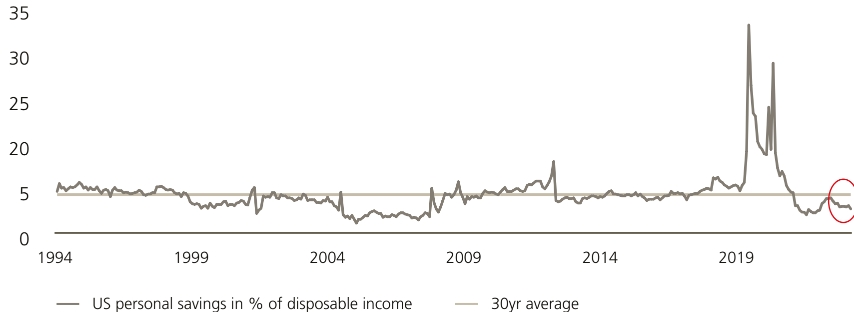
First, we are confident that shelter inflation—by far the biggest part of the CPI basket—will fall based on real-world data on new leases, which lead CPI shelter prices by around 12 months. The Apartment List National Rent Report, for example, showed rents fell 0.8% y/y in March. Second, the US savings rate is just 3.6%, a historically low level, meaning strong consumption cannot continue indefinitely. Third, wage growth has slowed to the lowest rate since June 2021—March saw average hourly earnings increase by 4.1% year-over-year. And fourth, we note greater consumer resistance to price hikes: The latest Beige Book suggests some “weakness in discretionary spending, as consumers’ price sensitivity remained elevated.”

We also note that outside the US, the disinflation trend remains intact in most other advanced economies. Recent inflation prints in the Eurozone and Switzerland came in lower than expected. Inflation has also continued to trend lower in the UK.

Figure 1

The US savings rate is at a low level

US personal savings in % of disposable personal income, 30-year average



Source: Bloomberg, UBS, as of April 2024

We still expect the Fed to cut interest rates this year, starting in September.

Rate cuts delayed, not canceled

While elevated inflation means that US rate cuts are likely to be pushed back, we do not think they will be canceled. We expect the Federal Reserve to cut rates twice this year, by 25 basis points each time, in September and December. On balance, we also think the Fed's focus on satisfying its dual mandate of price stability and full employment would override any potential concerns around shifting monetary policy settings so close to the US presidential election.

Outside of the US, we are seeing—and will most likely continue to see—rate cuts, given easing inflation pressures. Monetary easing is already under way in Switzerland. We think the European Central Bank is likely to follow in June, and the Bank of England at the start of August.

Recent events in the Middle East have raised the risk of a cycle of retaliation and escalation.

Middle East conflict remains contained

The confrontation between Iran and Israel raises the risk of a dangerous cycle of retaliation and escalation. Iran showed that it can attack Israel with hundreds of missiles and drones from multiple launch points. The 72-hour warning and US coordination of a multilateral defense did prevent significant damage, but raised the question of what would happen in a strike without warning. Meanwhile, Israel's retaliation sent a message about its ability to respond to Iranian provocation with assets operating within Iran itself.

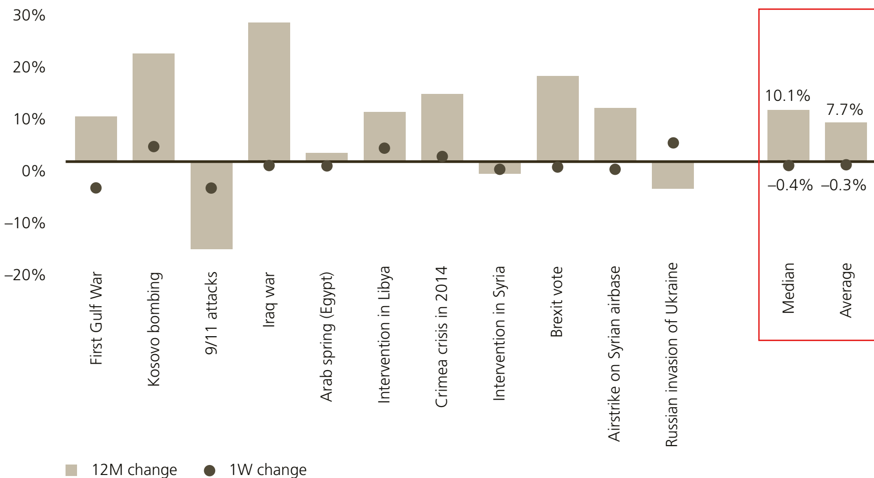
Our base case is for the Israel-Hamas war to continue alongside sporadic attacks in the broader region, but we do not expect a war between Israel and Iran. Both Iran and Israel intended to send a message with their actions in recent weeks and, fortunately, both sides think their message was heard. From this perspective, Israel as well as Iran were able to claim a victory without needing to take further action, and the US reaffirmed its commitment to Israel's defense while advocating restraint.

Overall, we think this scenario is consistent with the 10-year Treasury yield falling to 3.85% by the end of the year, as lower inflation leads markets to price a more meaningful Fed rate-cutting cycle in 2025 and 2026. Our base case target for the S&P 500 is 5,200 by year-end.

Figure 2

Historically, the impact of geopolitical risk on markets has been short-lived

One-week and 12-month percent change in the S&P 500 after select geopolitical events, median and average, in %



Source: Bloomberg, UBS, as of April 2024

In a bear case, the 10-year Treasury yield could rise to 6%.

Bear case: Overheating

In our bear case scenario, a mix of US growth being "too good," fiscal policy concerns, and a commodity price spike drives the US 10-year Treasury yield to rise to 6% (reflecting a real yield of 3%, a 10-year breakeven inflation rate of 2.5%, and a term premium of 0.5%). This scenario would imply around a negative 8% return for holders of US 10-year bonds.

While higher bond yields aren't necessarily negative for equities, sharp rises in rates can destabilize markets, and we believe increases in the 10-year Treasury yield significantly beyond 5% would fuel concerns about financial system stability, increasing the risk of weaker growth in the future. We would expect the S&P 500 to fall to around 4,400 in this scenario.

What could be some of the catalysts?

US inflation remains above target despite aggressive rate hikes by the Fed.

US growth stays "too good," shifting rate expectations

The Fed has increased interest rates by 525 basis points over the past two years to try and cool inflation. Yet, while inflation has fallen, the core personal consumption expenditure price index still rose by an annualized 3.7% in the first quarter of 2024, driven by services. First-quarter GDP growth was weaker than expected, at 1.6% annualized, but this was largely driven by higher imports and lower inventories, rather than weak final domestic sales. If US economic growth stays strong and inflation above target, the Fed may need to raise interest rates further and investors may need to reassess their estimates of US trend rates of growth. This could contribute to higher real yields on longer-term bonds.

Commodity price shock leads to fears of inflation destabilization

We believe the global oil market is likely to remain undersupplied in the second quarter of 2024 and would expect Brent crude oil prices to rise beyond USD 100/bbl if oil flows through the Strait of Hormuz are disrupted or if major oil production facilities are attacked.

The Fed and bond market investors would typically "look through" short-term changes in commodity prices. But a renewed spike in oil prices, so soon after the recent inflation shock, could lead to fears that consumer and business inflation expectations could get destabilized and require higher interest rates in response.

US fiscal policy concerns drive a higher term premium
The US runs a government deficit of 5.9% (as of March 2024), and neither presidential candidate has a record of slashing deficits. A recent projection by the Congressional Budget Office showed that interest costs on US debt are set to exceed defense spending this year. And trillions of dollars need to be refinanced each year, making the Treasury market vulnerable to a buyers' strike.

Concerns about the US debt burden and loose fiscal policy could lead investors to demand a higher term premium, or compensation for locking up their money with the US government for the long term (a dynamic that was evident for a short time in September/October 2023 after the US Treasury announced a larger than expected funding requirement). Prior to the global financial crisis, investors typically demanded a "term premium" of between 0.5% and 1.5%. We think a return to this range (from around zero today) is plausible if concerns about the US fiscal trajectory mount, though Fed intervention (akin to the Bank of England's actions in 2022), should limit the size of the term premium.

Bull case: Roaring 20s

At the time of writing, options markets are pricing around a 20% probability that the S&P 500 could rise by roughly another 10% in the remainder of 2024. What could such a bull case look like?

US inflation resumes a clear downward trend
We already see a variety of evidence to suggest that inflation will turn down again in the coming months, including lower rental inflation, slowing wage growth, and consumer resistance to price increases. In our bull case, these trends play out more quickly, leading to a sustainable fall toward central banks' targets.

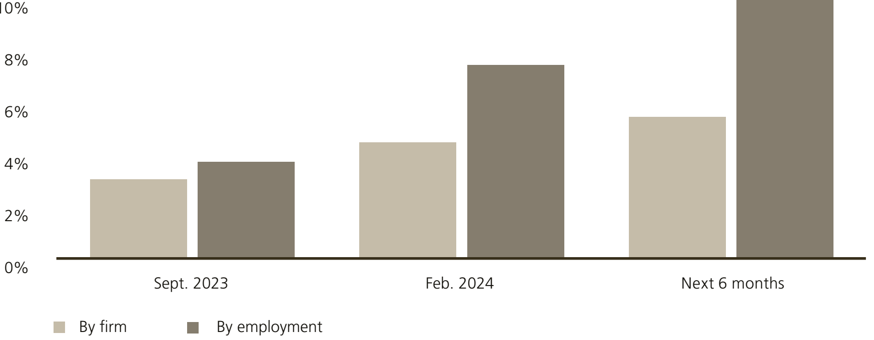
In our bull case, the US economy continues to grow at an above-trend rate.

Growth stays strong in the US, and improves in Europe and China
In our base case, we expect US economic growth to moderate to around trend this year, from a 4% annualized rate in the latter half of 2023. In our bull case, US growth stays above trend in 2024, supported by strong job creation, resilient consumer spending, and increased capital expenditure. The picture of robust growth could be further supported if the European economy expands faster than expected or if China enacts large-scale fiscal stimulus to bolster growth.

Investors front-load AI growth
Given the significant weight of technology stocks in the US index, a bull case scenario would likely require investor optimism about the potential for AI to boost corporate earnings and for investors to price that growth into stocks.

Figure 3

Rising AI adoption could increase optimism about the outlook
Percentage of firms using/planning to use AI in the US



Source: Business Trends and Outlook Survey (BTOS), US Census Bureau, UBS, as of April 2024

AI adoption is increasing rapidly.

Increasing optimism about AI could be driven by faster-than-expected adoption of copilots, especially in office productivity software. The US Census Bureau's recent Business Trends and Outlook Survey—which tracks AI use across 1.2 million firms in the US—found that adoption is rising. In the first quarter of 2024, 5.4% (firm-weighted) to 9% (employment-weighted) of companies said they were now using AI, up from 3.7–4.5% in the third quarter of 2023. Participants' responses suggest this share could rise to 6.6–12% over the next six months—an encouraging increase, and one that still leaves plenty of scope for penetration to rise further. We believe increasing AI adoption—and further evidence of its monetization—should strengthen investor confidence in the sustainability of the AI growth outlook.

Overall, in this bull case scenario—a disinflationary boom—we would see the S&P 500 rising to around 5,500 by the end of the year, despite a 10-year Treasury yield of 5%, supported by better-than-expected economic and earnings growth.

Investment ideas

By diversifying and balancing across regions and asset classes, investors can manage volatility and keep their portfolio on track.

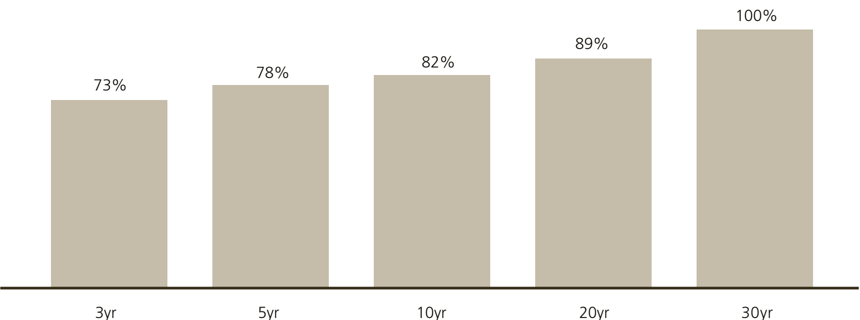
As the market oscillates between pricing different scenarios, asset class volatility could remain elevated. By diversifying and balancing across global equity markets and asset classes, investors can mitigate that volatility and keep their portfolio on track. Including alternative assets in portfolios may also help manage the risk of our bear case scenario, in which both bonds and equities fall.

Bonds. We keep a preference for quality bonds, including investment grade. Investors should use currently attractive yields to gain exposure if they are underallocated strategically.

Figure 4

Bonds tend to outperform cash—increasingly so with longer holding periods

Probability of bonds outperforming cash, by holding period, in %. Monthly data since 1960.



Source: Ibbotson, UBS, as of April 2024

High-quality bonds offer significant value in a portfolio context.

In our base case, we expect returns of around 10% for 10-year Treasuries by year-end as a renewed fall in inflation and slower economic growth lead investors to price a more meaningful rate-cutting cycle in 2025 and 2026. Unlike cash, high-quality bonds offer significant value in a portfolio context, given their potential for outsized returns if there is a growth misstep, or heightened fears about geopolitical uncertainty.

We note that diverging government policies, as well as different inflation and growth trends across regions, increase the complexity of global fixed income investing. However, that divergence potentially boosts the value of a more active and diversified approach to investing. This can include judicious exposure to riskier credits alongside quality bonds, as part of a well-diversified bond allocation.

Equities. We see the equity outlook as broadly balanced. At an index level, US equity valuations are elevated, but we expect AI-related companies to drive strong earnings growth in the years ahead. Indexes outside of the US are cheaper, though have more limited exposure to companies with the most appealing structural growth prospects. We therefore advocate diversified strategic exposure across key regions.

We think the recent volatility in tech stocks offers an opportunity for investors to build exposure.

Within equities, the level of technology exposure investors hold in portfolios is likely to be a key driver of outcomes in the remainder of 2024 and in the years ahead. In this light, we think it is key for investors to hold a healthy strategic allocation to technology stocks, while also being mindful of concentration risks. For investors who are underinvested in the tech sector and the AI revolution, we think the recent market volatility may offer an opportunity to gain exposure.

Investors looking to build technology exposure can also consider strategies that combine a bond with the sale of a put option—the right but not the obligation to sell an asset at a predefined price—as a way of getting "paid to wait" to potentially buy at lower prices. Capital preservation strategies may also help manage investors' "fear of regret." Meanwhile, investors looking to diversify existing technology exposure can consider alternative growth themes like the low-carbon transition, healthtech, and ocean economy; as well as small- and mid-cap stocks, where relative valuations are close to multi-decade lows.

At a country level, we move the UK equity market from least preferred to most preferred this month. With the improving global manufacturing outlook, we have positive views on oil and industrial metals. We expect earnings growth to accelerate from 4% this year to 7% in 2025, driven by improving profits for commodity-linked companies and banks, alongside a strengthening UK economy. The outlook for domestic consumption is likely to improve amid a resilient labor market and normalizing inflation. Likely Bank of England rate cuts should help equity valuations rebound from currently low levels (the FTSE 100 trades on 11x forward price-to-earnings, versus a long-run average of 12.8x).

We expect the US dollar to remain well-supported in the near term as the Fed delays rate cuts.

Currencies. With the Fed likely to delay the start of its rate-cutting cycle until September, we expect the US dollar to remain well-supported in the months ahead. But we still expect the Fed to follow the European Central Bank and the Bank of England—which are likely to start lowering rates in June and August, respectively—in easing policy. In the near term, we could see EURUSD dipping temporarily below 1.05, though over the medium term we expect modest USD depreciation as growth improves outside the US. We see the currency pairing at 1.09 by the end of the year.

We keep a most preferred view on the Australian dollar, as the Reserve Bank of Australia is likely to be among the last developed market central banks to start reducing rates. We expect the AUDUSD pairing to reach the high 0.60s by year-end.

The Swiss franc has weakened since the Swiss National Bank's March interest rate cut. While we think the franc is reaching the end of its depreciation trend, its negative carry and stabilizing risk sentiment in markets mean we keep our least preferred view.

Commodities. We expect total returns of around 10% for broad commodity indexes over the next six to 12 months, with all subsectors contributing to performance. For oil, a likely undersupplied market—given solid demand and OPEC+ supply discipline—underpins our positive view, and we see Brent crude prices trading in a range of USD 85–95/bbl over our forecast horizon. We also see scope for gold prices to rise further by the end of the year, with a December price target of USD 2,500/oz. We believe both oil and gold have value in a portfolio context, particularly to help hedge geopolitical risks. Elsewhere, a recovery in global industrial activity, the prospect of lower interest rates, and various commodity-specific supply-side constraints should combine to push prices higher.

Alternative investments have a key role to play in portfolios.

Alternatives. Hedge fund strategies like macro funds can navigate and diversify in an environment where US stock-bond correlations are elevated (a 1-year rolling measure has only been higher on 5% of occasions since 2000). Equity-market neutral and specialist credit strategies look for differentiated returns by exploiting the wide current dispersion between the strongest and weakest companies.

Meanwhile, the long-term case for private equity in a well-diversified portfolio remains strong, as we expect a continuation of its outperformance since 1993 (based on vintage year internal rates of return comparison for global private equity and global public equity equivalent using Cambridge Associates and MSCI AC World data, respectively). Today's uncertainty favors building and maintaining positions across geographies, strategies, and vintages (starting year of the fund).

We also think inflation-linked cash flows provided by private infrastructure assets—including sustainable and impact assets tied to renewables—may appeal in stronger growth and inflation scenarios. Infrastructure assets can also help diversify, with correlations of between –0.2 and 0.6 to other asset classes between 2005 and 2022, according to Cambridge Infrastructure Index data.

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
Take advantage of tech volatility	The recent sell-off in technology stocks provides a potential opportunity for investors who are underinvested in the technology sector and the AI revolution. We advocate diverse strategic exposure to the sector and hold a most preferred view on tech, balancing the beneficiaries of tech disruption (incl. AI) with sector leaders including "Asia's Super 8." Structured strategies can help investors position for further upside while protecting against downside, or earn income while awaiting a potentially better entry point.	• Global technology stocks • Technology disruption (incl. AI) • "Asia's Super 8" • Structured solutions on technology stocks
Opportunities beyond technology	Tech is one of our most preferred sectors, but investors should be wary of concentration risks and overexposure. We recommend investors diversify beyond technology by investing in quality companies, including the low-carbon transition and healthtech. We also like small-caps in the US and small- and mid-caps in Europe due to deep valuation discounts. Structured investments are an additional option for exposure.	• Quality stocks (incl. "Europe's Magnificent 7") • Alternative growth themes (low-carbon transition, healthtech) • Small- and mid-caps (incl. US small-caps, European small- and mid-caps, ESG Engagement) • Structured investments (yield-generating and capital preservation)
Manage liquidity	Investors are holding more cash than usual as global central banks have taken interest rates sharply higher. With rates likely having peaked and rate cuts on the horizon, 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 structure investments
Buy quality bonds	Robust economic growth and elevated inflation have driven bond yields higher in recent months, improving potential returns for investors in quality fixed income. Within fixed income, quality bonds offer attractive yields and should experience price appreciation if yields fall as we expect.	• Quality bonds (incl. US TIPS, IG, munis, agency MBS, CMBS) • Sustainable bonds incl. MDBs
Generate income from currencies and commodities	In currencies, with uncertainty around rate cut timings, we see value in income-generating strategies in the USD, British pound, and the euro. We also like strategies that take advantage of the trading ranges within commodities, with gold and crude oil particularly interesting.	• Generate income from USD, EUR, GBP, and CNY • Structured solutions on oil and gold

MIFs	Elevator pitch	Investment ideas
Get in balance	With stocks at record highs, interest rate paths uncertain, and portfolios at risk of overconcentration, investors face a complex financial environment. Against this backdrop, balance is a key portfolio principle. We recommend diversification across asset classes, regions, and sectors to ease the tensions of short-term market dynamics while positioning for long-term growth.	• Balanced portfolios
Diversify with alternatives	Alternative assets are a key building block of portfolios, enhancing return and diversifying risk. We see particular opportunity in strategies with unique return sources, or that provide access to fast-growing companies. We also like strategies that align with disruptive long-term trends such as digitalization and decarbonization.	• Infrastructure • Hedge funds • Private equity

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 CMBS
- US investment grade corporate bonds
- US small-cap equities
- UK equities *(upgrade from least preferred)*
- Oil

Least preferred
- US large-cap equities

Neutral

Downgraded from most preferred
- EM equities

Implementation guidance

As inflation and growth have continued to exceed expectations, the Fed has dramatically changed its tone regarding the path of future interest rates. As a result, 10-year yields have moved up more than 40bps in a matter of weeks, with the sharp move higher pressuring equities. Looking ahead, we maintain our view of two cuts in 2024, but the market needs to see real evidence-not speculation-that growth and inflation are indeed on a downward path for this to be realized.

We continue to hold our view of a macro soft landing scenario, even in the face of hotter than anticipated data. Our view is largely driven by expectations that growth and inflation will eventually moderate, because 1) consumer spending is unlikely to stay at this pace; 2) real-time rent data points to a decline in the lagging indicator of shelter inflation, which is roughly a third of the CPI basket; and 3) the labor market is getting back into balance with almost all indicators of wage growth continuing to decline, which makes the threat of an inflation re-acceleration a low risk.

Given our outlook, we keep bonds as most preferred and a neutral view on equities. We adjust our year-end target for the 10-year Treasury yield to 3.85% from 3.5% previously, reflecting the recent sharp rise in yields, but reinforcing our view for lower yields through the coming quarters. On the equity front, we maintain our year-end price target on the S&P 500 of 5,200, suggesting low to mid single-digit returns for the remainder of 2024. After a modest earnings recession last year, we forecast earnings growth for the full year of around 9%.

Given heightened interest rate volatility, stocks just below all-time highs, and many portfolios likely overconcentrated in certain asset classes due to drift, we urge investors to **get in balance**. By diversifying across asset classes, regions, and sectors, investors can hedge against market risks while positioning for portfolio appreciation.

Within fixed income, our message remains to **buy quality bonds**. We expect high quality bonds to deliver good total returns in 2024, as economic growth gradually decelerates and inflation falls closer to target with yields falling in tandem. Now is an attractive time to lock in yields, benefit from potential capital gains if yields fall, and diversify against portfolio risks. Specifically, we see good value in US TIPS, investment grade corporate bonds, Agency MBS, CMBS, municipals, and sustainable bonds.

With the Fed likely to begin rate cuts in coming quarters, we reiterate our message to **manage liquidity**. As inflation continues to moderate, the Fed has room to cut rates quickly if growth begins to falter. This would be particularly painful for depositors who haven't locked in higher rates for the next few years.

Within US equities, we are neutral on value versus growth, and have a relative preference for small caps versus large caps. This month we make no changes to our US equity sector preferences. Healthcare is our preferred defensive sector due to faster earnings growth relative to other defensives. Industrials should benefit from resilient economic growth, improving manufacturing sentiment, a bottoming in cyclical activity, and more structural tailwinds around reindustrialization of US economic activity. We remain least preferred on real estate, which looks slightly expensive relative to real interest rates, and utilities, which may underperform due to increased regulatory risks and resilient economic data.

We remain most preferred on US technology, even as the sector has grown significantly over the past year. With the AI revolution upon us, investors' exposure to the technology sector will be key to performance. Thus, we recommend that investors **take advantage of tech volatility** to ensure a diverse exposure to the sector as a whole while also avoiding the pitfalls of overconcentration.

While technology is one of our most preferred sectors, we also believe investors need to be wary of concentration risks and overexposure. In diversifying beyond technology, we like **opportunities beyond technology,** specifically in quality companies (such as regional champions in Europe and Asia) with exposure to the

energy transition, healthcare disruption, and water scarcity, as well as US small-caps and European small- and mid-caps. Structured investments can be an attractive way to gain exposure here.

Looking beyond public markets, we continue to advise investors to **diversify with alternatives**. Our future will see significant investments made in realms like healthcare, digitalization and energy efficiency. But already high government debt levels suggests public spending for innovative solutions will be constrained. Private market managers with the ability to provide debt or equity capital at different company lifecycle stages are expected to have a key role to play. Additionally, with the majority of firms in the US now privately held, accessing private markets offers a good way to achieve enhanced portfolio diversification and improve longer-term risk-adjusted returns.

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	−		
US Growth Equity		=	
US Value Equity		=	
US Mid Cap		=	
US Small Cap			+
Int'l Developed Markets		=	
UK	(−) →	→	+
Eurozone		=	
Japan		=	
Australia		=	
Emerging Markets		= ←	(+)
Other			
Commodities		=	
Gold		=	
Oil			+
MLPs		=	
US REITs		=	

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: Buy quality bonds	MIF alignment: Opportunities beyond technology	MIF alignment: Diversify with alternatives	MIF alignment: Take advantage of tech volatility
US fixed income	**Taxable munis**	✓			
	Taxable municipal bonds offer incremental yield pickup vis-à-vis corporate debt along the curve.				
	Quality IG credits present an income opportunity	✓			
	We believe investment grade issuers offer attractive yields and exhibit balance sheet strength and earnings resilience.				
EM fixed income	**Short-duration Pan-American bonds**	✓			
	We believe this list offers relative value in short-end investment grade corporate bonds.				
	EM bond top picks	✓			
	We believe that our selected basket of emerging market bonds offers US investors the opportunity to enhance total returns in exchange for a modest increase in risk.				
Global equities	**Greentech goes global**		✓		✓
	This equity list has significant ex-US exposure and should benefit from infrastructure spending plans.				
US equities	**Tactical US equity themes**		✓		✓
	Our tactical themes cover a variety of topics, many of which span beyond the tech sector, including a "Housing recovery" theme.				
Hedge funds/ alternatives	**Opportunities in dislocated credit markets**			✓	
	Credit market stress has expanded the opportunity for hedge fund and private managers to deploy capital.				

AI, space, and security

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

We recently launched the *Longer-term Investments Quarterly* report series, which aims to keep investors apprised on what's driving thematic market performance. In the inaugural edition, we touched on AI in the realm of security, the US election, and we provided more color on how the longer term themes we've identified fit together. Given CIO's message in focus on taking advantage of tech volatility, below we expand further on AI and security, and on the near term case for AI exposure. Investors interested in the full quarterly report can read more here.

Despite a pause in the year to date tech rally, we continue to believe artificial intelligence will be a key driver of growth over the next decade. Tactically, recent volatility offers a chance to reassess and optimize exposure. AI-related infrastructure spending has surged, but it's still in the early stages. As AI demand broadens and monetization rises, we expect the opportunity set to expand beyond infrastructure to software and service applications, and several companies along the entire AI value chain should benefit. Investors looking for ways to gain exposure can refer to our *Tactical US Equity Themes* publication for more information.

Over the longer term, we also see AI as uniquely tied to the space economy. AI, security, and the space economy are increasingly intertwined, fueled by the vast amount of data collected via satellites. This data could become more valuable when paired with AI's ability to synthesize and process vast amounts of it rapidly.

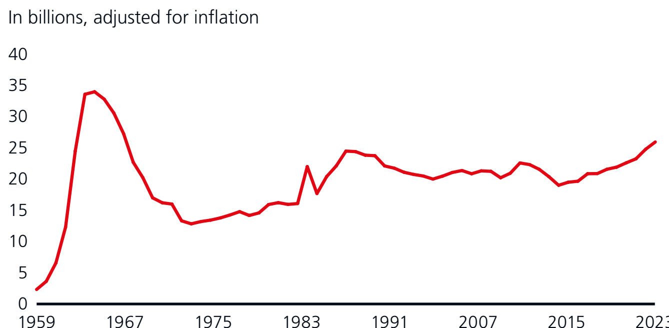
Current geopolitical tensions have underlined the relationship between security and space, with much of modern defense relying on space based infrastructure for things like early missile detection. The space economy has become so intertwined with the idea of security that the US government is considering labeling it as "critical infrastructure," and the EU launched a strategic initiative aimed at investing in space based assets for security and defense. It's not all bad news though. We'd argue there are a plethora of more positive use cases, as space based infrastructure paired with AI can actually help improve security, for example through earth observation and natural disaster response.

AI and satellite data can be used for a variety of applications, from flood prediction to landslide detection. Wildfire detection and response has been one area where AI has proven to be a useful tool. In addition to providing 24/7 monitoring and early detection, AI can improve predicative capabilities once a fire has ignited. By analyzing real time and historical data – satellites can be one of many sources – AI can predict the fire's path and aid in forming an evacuation strategy. The California Forestry and Fire prevention department has adopted AI at 21 dispatch centers since 2023. In a similar vein, satellite imagery paired with additional data has been tapped to predict flood risk, including in basins without gauges. It's still early days but initial research appears promising – some studies suggest this method could predict floods five days in advance of traditional methods.

For investors, space infrastructure becoming mission critical should support the government sector. NASA's inflation adjusted budget is getting closer to levels seen in the 1960s. This should be a positive backdrop for the *Space economy* theme, but many risks exist. Beyond sustainability considerations, another risk stems from the occurrence of an accident severe enough to deter future exploration, like the rising threat of space junk or a test flight failure. Investors can read more in the full report, *Longer-term Investments: Space economy*.

NASA's budget is approaching levels seen in the early 1960s

In billions, adjusted for inflation



Source: CSIS Aerospace Security Project (2022), Our World in Data, UBS

Longer-term themes

Top 5 favorite LTI themes

1. Water scarcity
2. Education services
3. Food revolution
4. Emerging market infrastructure
5. Consumer experience

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

Our base case remains a soft landing, with the Fed starting to trim rates as growth and inflation cool off. Rising income should help to sustain growth in consumer spending.

Brian Rose, PhD, Senior US Economist

Overview

There have been some interesting developments in the economy over the past month. Payrolls and retail sales data both came in far above consensus forecasts, suggesting that economic growth was maintaining the strong momentum built during the second half of 2023. As shown in the chart, this data helped to convince people that recession risks were becoming more remote. Against this backdrop, 1Q GDP growth turned out to be much weaker than expected, slowing to a two-year low of 1.6%. Meanwhile, recent inflation data has continued to surprise to the upside, limiting prospects for Fed rate cuts in the near term even considering the softer GDP print. Our base case remains a soft landing, with economic growth and inflation cooling off as consumers take a breather after a long period of strong spending, and the Fed starting to cut rates before the end of the year.

Growth

GDP growth surprised to the downside in 1Q24, slowing to an annualized pace of 1.6%. As shown in the chart, this is the first quarter of below-trend growth since 2Q22. Consumer spending (2.5%), nonresidential investment (2.9%), and residential investment (13.9%) all increased at a solid pace, but inventories and net exports dragged 1.2 percentage points off of GDP growth. Disposable income increased 1.1%, and with spending continuing to rise faster than income, the savings rate fell to 3.6%, around half its pre-pandemic level. Interest rates remain elevated, giving consumers an incentive to save rather than spend, and we do not see much room for savings rates to fall further. We expect consumption growth to slow over the remainder of the year as part of our base case scenario of a soft landing, but rising labor income should help to limit downside risks on spending. In our view, nothing in the data suggests that a hard landing is likely over the next 12 months.

Figure 1

Recession fears have diminished

Bloomberg consensus recession probability, in %

Source: Bloomberg, UBS as of 24 April 2024

Figure 2

GDP growth slowed sharply in 1Q24

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

Source: Bloomberg, UBS as of 25 April 2024

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

Read the report ›

Inflation

As shown in the chart, after slower inflation in 2H23, the monthly inflation prints have been higher so far in 2024, and it is no longer clear that inflation is on a slowing trend. Goods inflation has turned negative, but strong demand and rising wages are keeping upward pressure on prices in the services sector. We expect more favorable data over the rest of the year that will result in a lower inflation rate at year-end. Business surveys indicate that consumers are pushing back harder against further price increases, and political pressure ahead of the election may also make companies think twice about price hikes or "shrinkflation" through smaller package sizes. We remain confident that shelter inflation, which is by far the biggest component of the CPI, will continue to slow given the modest increases in rents for new tenant leases, which leads CPI shelter prices by around 12 months. Overall softer economic conditions in 2024 should also help to ease inflationary pressure.

Policy

Recent public comments from FOMC members, including Fed Chair Jay Powell, have made it clear that the higher inflation data so far this year is likely to delay the start of rate cuts. Reflecting this, we have shifted the timing of the first cut from June to September in our base case, as or while risks appear skewed toward further delays. While markets are hyper-focused on the monthly inflation prints, the Fed is more concerned about the medium-term outlook. As shown in the chart, wage growth continues to trend downward despite strong job growth in recent months. From the Fed's perspective, this suggests that supply and demand for workers is moving into better balance, and that wage growth is slowing toward a level that is more compatible with their 2% inflation target. We believe that a cooling labor market will make it easier for the Fed to cut rates even while inflation remains above-target, and we view additional rate hikes as unlikely even if inflation remains sticky in the near term.

Figure 3

Monthly inflation has been higher in 2024

CPI and core CPI, month-over-month change in %

Source: Bloomberg, UBS as of 24 April 2024

Figure 4

Slowing wage growth can help Fed cut rates

Average hourly earnings and Atlanta Fed Wage Tracker, year-over-year change in %

Source: Bloomberg, UBS as of 24 April 2024

Equities

We maintain a neutral view on global equities. Solid macroeconomic data and improving earnings lifted global equities to fresh all-time highs in late March. The flip side is that inflation pressures did not abate as quickly as anticipated and even started to tick marginally higher again in the US, which weighed on the asset class in April. Inflation is a near-term risk but should keep falling in the medium-term in our view.

Eurozone

EURO STOXX 50 (index points, current: 4,990)	December 2024 target
House view	**4,900**
↗ Positive scenario	5,400
↘ Negative scenario	4,200

Note: All current values as of 24 April 2024

We maintain our neutral stance on Eurozone equities. An improving economic outlook coupled with expectations of easing interest rates provides a supportive backdrop for Eurozone equities. However, after strong performance, we expect further gains from here to be more modest. We anticipate a slow profit recovery given softening selling prices and expectations of relatively slow economic growth in our base case. We forecast 3% earnings growth in 2024. We favor beneficiaries of disinflation, interest rate cuts, and bottoming manufacturing activity, where valuations are attractive.

Emerging markets

MSCI EM (index points, current: 1,035)	December 2024 target
House view	**1,060**
↗ Positive scenario	1,150
↘ Negative scenario	880

Note: All current values as of 24 April 2024

We rate emerging market equities as neutral in our global strategy. Although economic activity in emerging markets continues to surprise to the upside while inflation moderates, the delay in the Federal Reserve's interest rate cutting cycle has clouded the near-term outlook. Higher US rates along with elevated geopolitical concerns are also weighing on emerging stocks' risk premium. We forecast low-single-digit returns from companies in the region in 2024, on the back of solid mid-teens earnings growth.

Japan

TOPIX (index points, current: 2,711)	December 2024 target
House view	**2,800**
↗ Positive scenario	2,900
↘ Negative scenario	2,300

Note: All current values as of 24 April 2024

We are neutral on Japanese equities in our global strategy. TOPIX has fallen 7% since its recent peak on 22 March, underperforming the MSCI ACWI after a strong rally of 18%. This is likely due to international investors pausing after two significant macro events in March: the labor union wage hike and the BoJ's historic shift to policy normalization. Additionally, a riskoff sentiment has emerged due to hotter-than-expected US inflation data and escalating geopolitical concerns.

UK

MOST PREFERRED

FTSE 100 (index points, current: 8,040)	December 2024 target
House view	**8,500**
↗ Positive scenario	9,000
↘ Negative scenario	7,000

Note: All current values as of 24 April 2024

The outlook for UK equities is improving, and we have upgraded UK equities from least preferred to most preferred. With the improving global manufacturing outlook, we have positive views on oil and industrial metals, which should boost profits for the UK's commodity-linked sectors. In addition, the outlook for domestic consumption is likely to improve amid a resilient labor market and normalizing inflation. The latter should allow the Bank of England to start cutting rates from August on, which should help equity valuations rebound from currently low levels.

US equities

After rising more than 10% in the first quarter, so far in April the S&P 500 has pulled back due to a rapid rise in interest rates in the context of extended positioning and sentiment. Still, we continue to believe the four key equity market drivers remain largely in place: 1) solid earnings growth, 2) disinflation, 3) Fed pivot, and 4) surging AI investment.

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

US equities overview

NEUTRAL
US equities
The rapid rise in interest rates in April comes on the heels of somewhat hotter inflation readings. Although this has weighed on stocks, we would highlight that the risk-reward for US stocks is starting to get more appealing. Healthy labor market dynamics should continue to support consumer spending and we expect earnings growth to start to broaden out beyond the Magnificent 7. The first quarter earnings season has gotten off to a good start and we look for S&P 500 EPS growth of +9% (USD 245) in 2024 and +6% (USD 260) in 2025.

US equities – sectors
Healthcare is our preferred defensive sector driven by solid earnings growth. Industrials should benefit from resilient economic growth, an improvement in manufacturing business sentiment, and a bottoming in cyclical areas such as transport. Tech should benefit from its higher quality bias, AI-driven growth, and a pickup in key end-markets. For real estate, growth in adjusted funds from operations this year will likely lag S&P 500 profit growth. Resilient economic data may lead to underperformance for utilities.

US equities – size
Our expectations for earnings growth to broaden out beyond the largest US companies is a key driver for our preference for small-caps. Leading indicators of profit growth such as improving access to capital, a better tone in manufacturing business surveys, and the potential for Fed rate cuts are all supportive. With small-cap valuations quite low, any improvement in profit growth—which admittedly has not happened yet—would likely drive substantial outperformance. On a relative basis, a larger concentration of Russell 2000 debt is floating rate, offering these companies a clear benefit from potential Fed rate cuts.

US equities – style
The valuation premium for growth relative to value has narrowed in recent months, but remains elevated versus the historical average. AI excitement and a stronger earnings growth outlook for growth stocks are likely reasons for this premium to hold. While the prospect for Fed rate cuts could be positive for value stocks, we prefer to take advantage of this opportunity via small-caps as their balance sheets should get a bigger benefit from Fed rate cuts compared to large-caps.

S&P 500 (index points, current: 5,048)	December 2024 target
House view	**5,200**
↗ Positive scenario	5,500
↘ Negative scenario	4,400

Note: All current values as of 25 April 2024

Figure 1

Remain balanced in our sector positioning

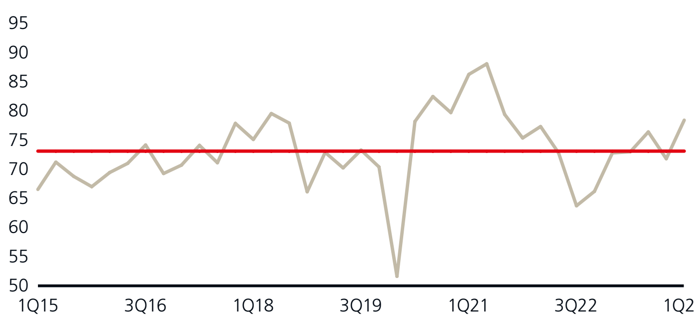
	Least preferred	Neutral	Most preferred
US equities			
Communication services		⊜	
Consumer discretionary		⊜	
Consumer staples		⊜	
Energy		⊜	
Financials		⊜	
Healthcare			⊕
Industrials			⊕
Information technology			⊕
Materials		⊜	
Real estate	⊖		
Utilities	⊖		

Note: Tactical preferences from benchmark (S&P 500).
UBS, as of 25 April 2024

Figure 2

Earnings beats are better than average

Percent of S&P 500 companies that beat analyst estimates



Source: FactSet, UBS, as of 24 April 2024

Bonds

We think the current risk-reward proposition for quality bonds is attractive, and we see the potential for capital appreciation as inflation recedes and growth moderates. Our base case is that the Fed will cut rates by 50bps by the end of this year with the first cut occurring in September and we look for the 10-year US Treasury yield to fall to 3.85% by year-end, from 4.7% today. Within fixed income, we keep US investment grade (IG) corporate bonds, TIPS, CMBS, and agency MBS most preferred, advising an "up-in-quality" allocation.

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: 4.70%)	December 2024 target
House view	**3.85%**
↗ Positive scenario	5.00%
↘ Negative scenario	6.00%

Note: All current values as of 24 April 2024

Nearly 80% of the rise in 10-year Treasury yields this year has occurred within the three days preceding and following CPI releases. Rising inflation expectations and market pricing of fewer than two rate cuts for 2024 has bear steepened the yield curve, with 10-year yields reaching as high as 4.7%. We continue to recommend buying at these levels—a move toward 4.75% is possible, but a rise to 5% would be caused by an additional rate hike, unlikely in our view. We revised our December 2024 target to 3.85% from 3.5%. We see growth slowing from weakening labor and consumer demand and 50bps of cuts starting in September.

US investment grade corporate bonds

MOST PREFERRED

US IG SPREAD (current: 92bps)	December 2024 target
House view	**110bps**
↗ Positive scenario	85bps
↘ Negative scenario	200bps

Benchmark: Bloomberg Barclays US Int. Corp.
Note: Current values as of 24 April 2024

We hold a most preferred view on investment grade bonds. On spread valuation, IG bonds are not cheap at a current index spreads levels of 92bps, but are supported by the economic data, a solid corporate profit picture, and strong investor demand, at an overall corporate yield of 5.7%. We continue to favor a barbell approach consisting of short-end (1–3-year) and intermediate (7–10-year) exposure. Despite the recent strong relative performance of financials, they remain wider than non-financial bonds with comparable duration and credit ratings. We find good relative value in bonds within the financial sector.

Emerging market bonds

NEUTRAL

EMBIG DIV. / CEMBI DIV. SPREAD (current: 342bps / 263bps)	December 2024 target
House view	**400bps / 325bps**
↗ Positive scenario	340bps / 260bps
↘ Negative scenario	550bps / 500bps

Note: Current values as of 24 April 2024

We keep emerging market credit as neutral. Valuations look moderately expensive, and we expect wider spreads by year-end. However, our base case scenario of an unlikely US recession should allow the asset class to deliver positive total returns this year. Key risks include negative growth and inflation shocks in the US and other key countries, softer commodity prices, escalating geopolitical tensions, or rising defaults, whether in developing or developed markets, triggering a flight to safety.

US high yield corporate bonds

NEUTRAL

USD HY SPREAD (current: 319bps)	December 2024 target
House view	**400bps**
↗ Positive scenario	300bps
↘ Negative scenario	500bps

Benchmark: ICE BofA
Note: All current values as of 24 April 2024

We are neutral on high yield, reflecting our view that spreads are tight but yields provide ample carry. With the economy surprising to the upside, fundamentals in HY remain at healthy levels, while the outright levels of yield provide a buffer to total returns. We think HY default rates could rise slightly but would be lower than in past default cycles and barring a major economic slowdown, HY issuers should be able to refinance their maturities in 2024.

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

Municipal bonds

NEUTRAL

Over the past month, muni yields moved higher based on two reasons. First, a jump in the 10-year US Treasury benchmark note, reflecting higher inflation prints pulled munis along. Second, an uptick in net muni supply placed some downward pressure on prices. That said, muni yields now on offer are providing investors with another opportunity to lock-in attractive taxable-equivalent-yields, particularly at the long end of the curve. AAA 10-year muni-to-Treasury yield ratio: 59% (last publication: 57%).

Non-US developed fixed income

NEUTRAL

Over the past month, bond yields in non-US developed markets moved mostly higher as the prospect of delayed Fed rate cuts may limit the speed of cuts by other central banks. On foreign exchange markets, the dollar gained against other major currencies, hurting the value of non-US bonds in dollar terms. These factors combined to produce negative returns for the month. With US bonds still offering higher yields than in most other developed markets, we do not recommend a strategic asset allocation position on the asset class.

Additional US taxable fixed income (TFI) segments

Agency bonds

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

Mortgage-backed securities (MBS)

MOST PREFERRED

Our preferred view on MBS is derived from its attractive relative value to other high quality fixed income. Volatility and high rates have been a headwind, but with IG spreads compressed we believe MBS has more room for outperformance. Falling rates and declining volatility will be a tailwind for MBS in 2H24. We continue to hold our preference for higher quality CMBS. While spreads have tightened amidst outperformance to start 2024, CMBS is still wide to corporates and agency MBS and will benefit from the same market dynamics as agency MBS in 2H24.

AGENCY MBS SPREAD (current: 150bps)	December 2024 target
House view	**110bps**
↗ Positive scenario	100bps
↘ Negative scenario	185bps

Note: Current values as of 24 April 2024

Preferred securities

NEUTRAL

Preferreds had been surprisingly resilient during the first quarter of 2024 in the face of higher-trending interest rates. Valuations had tightened at the end of the first quarter. This left the sector somewhat vulnerable, and returns are facing headwinds as the 5- and 10-year Treasury rates are up by 30bps so far in April. The latest pullback has now reduced some valuation pressure. As we look further out into 2024, our outlook is positive. We expect generally lower-trending interest rates to support the sector and produce solid 12-month returns.

Treasury Inflation-Protected Securities (TIPS)

MOST PREFERRED

Real yields have gone up as breakeven inflation expectations have risen to meet forward inflation expectations, with 5-year real yields rising nearly 50bps, but still remaining below our entry level of 2.25%. Despite market headwinds, real yields have outperformed nominals so far this year. We believe real yields will trend lower into year end on the back of falling nominal yields and elevated breakevens, as reaching the 2% inflation target is unlikely to be a 2024 event. Given that inflation is likely to stay above target in the coming months, we see holding TIPS in a diversified portfolio as prudent.

US 5-YEAR YIELD (current: 2.27%)	December 2024 target
House view	**1.75%**
↗ Positive scenario	1.50%
↘ Negative scenario	2.40%

Note: All current values as of 24 April 2024

Figure 1

UBS CIO interest rate forecast

In %

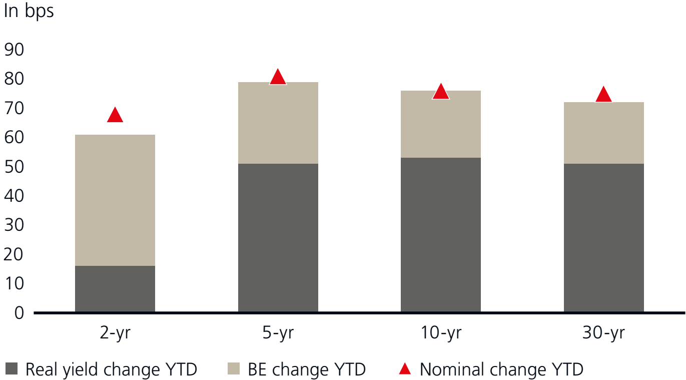
UST	Current	Jun-24	Sep-24	Dec-24	Mar-25
2-year	4.9	4.5	4.3	3.8	3.3
5-year	4.7	4.0	3.8	3.8	3.3
10-year	4.7	4.0	4.0	3.9	3.5
30-year	4.8	4.3	4.3	4.0	3.8

Source: Bloomberg, UBS, as of 24 April 2024

Figure 2

The rise in real yields on the back of higher inflation expectations has pressured nominal yields higher

In bps



Source: Bloomberg, UBS, as of 24 April 2024

Commodities and listed real estate

Benefit from optimized rolling of commodity futures. Our strategy aims to systematically generate returns by being long a second-generation commodity index while being short a first-generation commodity index. This allows investors to generate yield through the outperformance of the second-generation index. With little sensitivity to individual commodity spot moves, the strategy also provides investors with diversification benefits. We expect total returns of around 10% for broad commodity indexes over the next six to 12 months, with all subsectors contributing to performance. This outlook is supported by a recovery in global industrial activity, the prospect of lower interest rates, and commodity-specific supply-side constraints, which should combine to push prices higher.

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 2,316/oz) — December 2024 target

NEUTRAL

House view	USD 2,500/oz
Positive scenario	USD 2,250/oz
Negative scenario	USD 2,750/oz

Note: All current values as of 24 April 2024. Gold is a safe-haven asset whose price tends to rise when risk assets, such as equities, fall, and vice versa.

Precious metals

We remain positive on the long-term outlook for gold. This year's rally in gold has evolved without the traditional support from ETF buying—something we expect to see once US rate cuts are more certain. We target a price of USD 2,500/oz at the end of this year and continue to see gold as a longer-term diversification asset. Investors should keep existing positions or add new ones on pullbacks. We continue to recommend investors use gold as a diversifier, despite being neutral in our global asset allocation. Within a balanced USD portfolio, our analysis shows around a mid-single-digit percentage as most optimal.

Base metals

Macro tailwinds and tightening fundamentals should support industrial metals. With recent PMI data beating expectations and a modest rebuild cycle in inventories underway, we think the case for stronger 2H global manufacturing activity is taking shape. As such, we see scope for high-single-digit upside to industrial metal prices over coming months, supported by firmer demand and supply-side constraints. Copper remains our metal of choice, while we see a recovery in nickel much further out. The main risks to our positive industrial metal view continue to stem from China's struggling property sector.

Agriculture

La Nina risks return. Another year of elevated wheat production in Russia continues to weigh on the overall grains sector. However, elevated short positioning and rising prospects of a return of La Nina see us revise up our expectations for corn and soybean prices in 2024–25. Conversely, supply shortfalls in cocoa and coffee, while acute now, could ease in 2025. Livestock remains underpinned by further tightness in live cattle supply.

BRENT (current: USD 88.02/bbl) — December 2024 target

MOST PREFERRED

House view	USD 87/bbl
Positive scenario	USD 120–140/bbl
Negative scenario	USD 40–60/bbl

Note: Current values as of 24 April 2024

Crude oil

Crude oil has shown muted reaction to geopolitical tensions. Oil prices have been volatile in recent weeks due to geopolitical tensions in the Middle East, but the price reaction has been relatively muted compared to previous episodes, mostly due to high available spare capacity. As per history, geopolitical risk premiums have tended to be fleeting if there are no actual production losses or supply chain disruptions. With oil demand rising seasonally, we continue to see the oil market as being undersupplied, and we target a rise in Brent crude oil to USD 91/bbl by mid-year.

Listed real estate

RUGL Index (current: USD 5,241) — December 2024 target

House view	USD 7,100
Positive scenario	USD 7,300
Negative scenario	USD 6,900

Note: All current values as of 24 April 2024

We like companies with strong pricing power, large pipelines, attractive yield gaps, and robust cash flows, as well as acquisitive ones. Stocks trading at large discounts may selectively offer above-average returns. Historically, the sector has started to rally 18 to 24 weeks before the first actual Fed rate cut, but this hasn't materialized amid strong US economic data. We like Japanese developers' attractive valuations and robust fundamentals. Singapore REITs are only beginning to enjoy a decrease in interest rates. Hong Kong developers and mainland China are only nearing a bottom in valuations. Continental Europe has become cheaper after a few months of underperformance. The predominant office exposure in the UK is still an overall drag but reflected in valuations, and while US REITs look well capitalized.

Foreign exchange

We prefer the Australian dollar and the Swiss Franc is least preferred.

Thomas Flury, Strategist, UBS Switzerland AG

Solid economic growth in the US, higher Federal Reserve rates for longer, and geopolitical risks in Europe, the Middle East, and Asia all speak for US-linked assets and therefore robust USD demand. We stick to our guidance to keep USD longs unhedged and look for incremental strength from here.

The biggest risk to our short-term USD view is a rapid fall in US GDP growth, which would put investor focus on structural USD negatives and the currency's elevated valuation. The speed at which the US economy slows, matters. If it doesn't slow because consumer demand or fiscal spending comes in strong ahead of the US presidential election, current market expectations for lower US rates could still be revised higher.

Conversely, a hard landing for the US economy with risk assets under downward pressure could support the USD beyond the ranges that we currently forecast. The USD tends to perform positively in a risk-off environment, while risk-on currencies (the EUR, GBP, commodity-related currencies, and emerging market currencies) tend to depreciate. Still, a hard landing would likely lead to a strong reaction from the Fed. Therefore, we think any major USD rally could be sharp initially, but would be watered down eventually by expansive central bank action.

In our base case, we still see relative growth dynamics converging—i.e., US growth moderates, while growth in the Eurozone picks up in 2H. The growth convergence should be modest, but sufficient to bring EURUSD back toward 1.09.

This topping out of dollar strength into 3Q allows USD investors to engage in volatility-selling strategies to pick up additional yield. The rise in option volatility across the asset class is clearly helpful in deploying such strategies. Still, the shifts higher have been rather modest so far. This leaves currency markets with a still-depressed volatility backdrop. So, where should investors sell volatility, then? We see scope for this strategy in AUDUSD, USDNOK, and USDJPY.

As for other G10 currencies, we think that low yielders, like the CHF or the JPY, will continue to struggle to deliver performance in the short run. While CHF and JPY weakness looks extended from a longer-term perspective, the negative carry remains a total return drag. Once clarity emerges on the first rate cut by the Fed, we look for a trough in the CHF and the JPY. In that context, we expect better returns in the AUD and to some degree in the GBP, where rate cuts are likely to materialize toward year-end or should be more shallow.

Because we expect the Fed rate-cutting cycle to be delayed, but not canceled, once it is approaching and then underway, it should relieve some pressure on emerging market currencies and benefit high-carry currencies again. We currently like the Brazilian real for its high nominal and real carry and supportive trade balance. And for investors willing to venture even further into the emerging and frontier market space, we think the Turkish lira and the Egyptian pound are good additions to diversified portfolios. The narrative for the CNY is different. With upside risks to USDCNY to 7.35 and the CNY offering a negative carry, we advise investors to hedge their long CNY exposure.

FX strategy

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

FX forecasts

	Current	Jun-24	Sep-24	Dec-24	Mar-25
EURUSD	1.07	1.05	1.07	1.09	1.11
USDJPY	155	155	152	148	145
GBPUSD	1.24	1.24	1.26	1.30	1.32
USDCHF	0.91	0.92	0.91	0.89	0.87
USDCAD	1.37	1.39	1.39	1.36	1.34
AUDUSD	0.65	0.65	0.67	0.68	0.69
NZDUSD	0.59	0.59	0.60	0.60	0.61
USDSEK	10.89	11.05	10.75	10.46	10.18
USDNOK	11.00	10.95	10.65	10.37	10.09

Sources: SIX Financial Information, UBS, as of 24 April 2024

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 House View Investment Meeting (HVIM). 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 participants in the HVIM include 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 Group:
- 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.

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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.

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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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