

Brighter outlook after downbeat October

UBS House View - **Daily US**

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Thought of the day

Global stocks and bonds both retreated in October amid the outbreak of war in the Middle East, a mixed third-quarter earnings season, and continued concerns that US interest rates look likely to stay higher for longer. The MSCI All Country World Index lost 3% in October, trimming its 2023 total return to 6.7%. The S&P 500 lost 2.1% and at certain points in the month was down more than 10% from its peak in late July—satisfying a common definition of a correction. Rising yields were a major drag on equity markets, generally reducing the relative appeal of stocks. The yield on the 10-year US Treasury continued to climb, hitting 5% for the first time since 2007.

The Hamas attack on Israel was the defining event of October. The outbreak of war added to demand for several traditional safe-haven assets, including gold, which rose 7.3% over the month. The risk that the war could spill over into a broader regional conflict, disrupting oil supplies, initially pushed up Brent crude prices. However, Brent ended the month down 3.1%—reflecting optimism that the war would not draw in more combatants in the region and that OPEC+ oil exporters had the potential to plug any shortfall in oil supplies.

The US third-quarter reporting season, which is still going on at the time of writing, has been robust overall, with just over 70% of companies beating earnings per share estimates. However, with several disappointments from prominent tech-related companies, the season has not been sufficiently positive to shift attention from worries over the Federal Reserve and geopolitical strains.

But, despite a downbeat October, we believe the medium-term outlook for major asset classes remains positive, as earnings growth returns, the US economy heads for a softish landing, and inflationary pressures continue to subside. Against this backdrop, we recommend the following strategies:

Add to diversified portfolios: We see a solid foundation for diversified portfolios over the next six to 12 months—and our base case is for good returns on cash, bonds, stocks, and alternatives. This is a rare conjunction and makes it a good time for investors to bolster their core balanced

What to watch: 2 November 2023

- US September factory orders
- Bank of England rate decision

portfolios. While we do see growth slowing, our base case is that the US economy will avoid the kind of deep contraction that has often followed aggressive monetary tightening by the Fed. The outlook for corporate earnings is also looking up, and we expect 9% earnings growth from S&P 500 companies in 2024. That should contribute to solid returns for equity investors, even if—as we expect—multiples don't expand much from current high levels. The outlook for bonds is even more promising. Market expectations that Fed rates will stay high for longer have gone too far, in our view. As the mood changes, we expect yields—which are at their most attractive level since the global financial crisis—to move lower.

Manage liquidity: Cash rates are currently attractive, but we believe the central bank tightening cycle is close to completion and high rates are likely to prove short-lived. We therefore recommend investors hold no more than two to five years of expected net portfolio withdrawals in a liquidity strategy. The remainder should be put to work in a balanced portfolio. Within liquid holdings, we believe investors can optimize and future-proof yields by using a combination of deposit vehicles, bond ladders, and select structured solutions.

Consider adding exposure to alternatives: Alternative asset classes are a key part of long-term portfolio diversification for risk-tolerant investors, particularly during market environments when stocks and bonds move together. We currently see particular opportunities in specialist credit hedge fund strategies and secondaries in private equity. Higher interest rates can also support return potential for alternative asset managers, given higher yields and returns on offer in underlying assets, including private debt. Investing in alternative assets does come with notable drawbacks, however, including illiquidity risks.

So, we advise investors to avoid overreacting to the recent negative turn in market sentiment. With economic growth likely to slow and inflation moderating, we see the greatest near-term upside in fixed income—especially quality bonds. However, the good return outlook across asset classes over the coming 6–12 months makes it an opportune moment for investors to strengthen their core balanced portfolios, in our view.

Caught our attention

US employment costs up more than expected in 3Q. The headline Employment Cost Index (ECI) report, the Fed's most watched data series for employment costs, showed hourly labor cost growth cooled in the third quarter but at a slower pace than economists expected. The index rose 4.3% y/y, down from 4.5% y/y last quarter and a peak of 5.1% y/y in 2Q22. On a q/q basis, ECI grew 1.1% in the third quarter. Economists expected hourly labor costs to grow 1.0% q/q and 4.1% y/y by the end of 3Q23.

Our view: We believe the Fed will see slowing employment cost growth as one step closer to achieving its 2% target for inflation over time, and make allowances for the continued challenges of volatile data. While the index showed growth in labor costs cooled at a slower-than-expected pace, we expect the Federal Open Market Committee to announce that it is keeping policy rates steady after its meeting concludes later today. We expect the US economy to slow and inflation to continue to normalize in 2024, leading to a lower Fed policy rate. In this environment, we maintain a preference for high-quality bonds of 1–10-year duration, particularly the 5-year maturity.

China recovery not on solid footing yet. China's Caixin private sector manufacturing purchasing managers' index unexpectedly declined to 49.5 in October (vs. 50.6 prior), slipping back below the 50 line that indicates a contraction. That mirrors the surprise contraction in the official PMI reading earlier this week, confirming softening sentiment at Chinese factories. Some of this may reflect seasonality amid the annual Golden Week holiday, but the moderation was broad-based with pressure on production, new orders, and prices. Chinese policymakers, meanwhile, closed their twice-a-decade Central Financial Work Conference (CFWC) with a new pledge to "optimize the debt structure of central and local governments."

Our view: October PMIs suggest that while the economy may be past the July bottom, the recovery itself is not yet on a firm footing and more policy support is needed. The tone of the CFWC was supportive and in line with market expectations that the debt structure will be centralized. The market reaction was muted though, with long-term directives not as compelling a catalyst as immediate policy action. We anticipate more policy support to come this year, and with Chinese equity valuations trading at a discount to historical levels, we stay positioned in a barbell mix of both high-growth and defensive names.

Market update

Percent change. For volatility indices, net change in points.
For yields, net change in bps

01.11.2023

	Current	1D	5D	1M	YTD
VIX Index	18.1	-0	-2	+1	-4
MOVE Index	127	-5	-4	+13	5
S&P 500	4194	+0.6%	-1.3%	-2.2%	+9.2%
Euro Stoxx 600	435	+0.3%	-0.0%	-3.4%	+2.4%
Shanghai Composite	3023	+0.1%	+1.6%	-2.8%	-2.1%
US 10-year Treasury	4.91	-2	-4	+34	+104
US 2-year Treasury	5.08	-1	-4	+3	+65
Germany's 10-year Bund	2.85	+4	-4	+1	+28
Germany's 2-year Bund	3.02	+1	-9	-17	+29
EURUSD	1.056	-0.1%	-0.0%	+0.8%	-1.3%
EURCHF	0.960	+0.3%	+1.3%	-0.3%	-7.4%
Brent crude, USD/bbl	86	+0.6%	-5.1%	-10.3%	-0.4%
Gold, USD/oz	1987	-0.4%	+0.1%	+7.5%	+8.8%

Source: FactSet, UBS, as of 1 November 2023

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Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

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