UBS

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Investment Research

Volatile conditions highlight the appeal of alternatives

UBS House View - Daily US

Solita Marcelli, GWM Chief Investment Officer Americas, UBS Financial Services Inc. (UBS FS)
Mark Haefele, Global Wealth Management Chief Investment Officer, UBS AG
Karim Cherif, Head Alternative Investments, UBS Switzerland AG
Antoinette Zuidweg, Alternative Investments Strategist, UBS Switzerland AG
Jon Gordon, Strategist, UBS AG Hong Kong Branch
Jennifer Stahmer, Strategist, UBS Financial Services Inc. (UBS FS)

From our New York studio: Preparing for a new world of increasing geopolitical conflict

Thought of the day

Global investors have faced volatile conditions in recent weeks, with markets pulled in several directions by geopolitical risks, uncertainty over monetary policy, and robust tech earnings. We believe the overall risk-return outlook for equities remains fairly balanced, supporting an in-line equity allocation, and we continue to prefer quality income in our global portfolios.

But with near-term public asset volatility likely to continue, investors seeking smoother returns and who can tolerate lower liquidity should consider adding more alternative assets to their portfolios:

Adding private market exposure may help steady portfolio returns. Locking up capital for longer also has its advantages, giving fund managers more scope to take advantage of market dislocations, and protecting investors from behavioral biases like panic-selling. Public markets offer many examples of fast repricing of risk assets, both up and down; private markets only moderately participated in the move higher, and so far have remained broadly stable. A CIO analysis shows that adding private equity could help reduce the expected swings in an investor's portfolio—the reported volatility —by about 30 basis points per annum over a longer time horizon.

Private equity and debt could deliver strong returns, in our view. We expect private equity and private debt to return around 11% and 9% per year, respectively, over a full business cycle, in excess of many public stock and bond markets. Based on CIO analysis, a balanced investor who replaces up to 10% of their global public equity exposure with private equity exposure could benefit from around 20–30 basis points of additional expected returns each year over the long term.

Private markets offer access to underrepresented industries and sectors. More firms are choosing to stay private, delay listings, or avoid them altogether. Between 2000 and 2023, the number of private-equity-backed

What to watch: 9 May 2024

- US initial jobless claims
- China trade data for March
- Bank of England rate decision

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companies has risen sixfold to nearly 11,000. This is a trend we think is unlikely to reverse. Overlooking these opportunities risks leaving investors with long-term underexposure to those fast-growing sectors of the economy whose companies choose not to list.

So, we suggest investors with a long-term time horizon and the ability to lock away capital for longer consider adding more private market exposure to their portfolio. Within private markets, entry multiples have moved lower, with particular opportunities to create value in the middle market, and in carveouts and divestures. We like secondaries with solid fundamentals that can capitalize on market needs for liquidity events, and we like thematic growth exposure to healthcare and software. We are more selective in private credit given rates risks, with a preference for senior upper-middle-market and sponsor-backed loans, and a sector tilt to less cyclical exposure. We also like infrastructure assets, with a low correlation to other investments and resiliency both to the economic cycle and to inflationary environments.

Of course, investors considering private market investments must consider important risks around leverage, illiquidity, the potential for defaults, and concentration. We believe strict manager selection, due diligence, and investment monitoring can help address some of these risks.

Caught our attention

Amazon's cloud push... Amazon plans to spend USD 9bn over the next four years to expand its cloud-computing infrastructure in Singapore. According to a statement, the Amazon Web Services' (AWS) investment will help it meet growing customer demand for cloud services and accelerate the adoption of artificial intelligence. Last week, the company reported a first-quarter operating margin of 38% for AWS, adding that the cloud platform was on track to bring in more than USD 100bn in sales over the course of a year for the first time due to corporate technology modernization projects and demand for AI services.

...and the double-digit growth for global semis sales this year. The Semiconductor Industry Association's (SIA) World Semiconductor Trade Statistics (WTSC) database reported the three-month rolling average of global semiconductor industry sales rose 15.2% year-over-year in March. According to the SIA, the results keep the global semiconductor market on track to grow in the double digits in 2024. The industry group also indicated March global semiconductor chip sales rose 16.4% from February as memory chip pricing improved while analog pricing declined. Both analog and microcontroller chips posted strong unit growth in March (up 50% from February), as customers replenished inventory. DRAM sales grew 18.3% in a month helped by stronger pricing.
Our view: Without taking a view on individual names, Amazon's cloud push on the back of faster revenue growth provides further evidence of AI-related monetization. During the current earnings season, the cloud platforms of Microsoft and Alphabet also reported acceleration in revenue growth, taking the growth of the three cloud businesses combined to 24% year over year, from below 20% during the September 2023 quarter and earlier. We see this as a clear tailwind for software companies. Overall, we maintain our positive stance on the AI theme, and favor the software, semiconductors, and big tech segments. Opportunities also exist in Asian beneficiaries for diversified exposure, while structured strategies can be utilized for a more defensive way to gain exposure.

Credit card spending holds the line. The Federal Reserve Board's March Consumer Credit report showed a slower rise in the seasonally adjusted annualized rate for consumer credit, as the growth of credit card balances slowed sharply. On an annualized basis, total consumer credit outstanding grew 1.5%, compared to growth of 3.6% last month. Revolving credit increased 0.1% (annualized) and nonrevolving credit increased 2.0%.

Our view: We think banks and credit card companies provide the best read on aggregate consumer spending. The message from these companies during first-quarter conference calls was that credit card credit quality continues to normalize from historically low levels. Additionally, recent trends suggest that consumer household balance sheets remain relatively healthy, albeit with some pressure on lower-end segments. Looking forward, we expect consumer spending growth to slow over the remainder of the year as higher interest rates provide consumers with more incentive to save than spend and slowing wage growth. This falls in line with our base case for a soft landing where economic growth and inflation cool, and the Fed begins to cut rates in September. As a result, we recommend quality bonds and quality stocks.

Market update

08.05.2024	Current (*)	1D	5D	1M	YTD
		Percent change. For volatility indices, net change in points. For yields, net change in bps			
VIX Index	13.2	-0	-2	-2	+1
MOVE Index	98	+4	-3	-1	-17
S&P 500	5188	+0.1%	+3.0%	-0.3%	+8.8%
Russell 2000	2065	+0.2%	+4.6%	-0.4%	+1.9%
Euro Stoxx 600	514	+0.3%	+2.2%	+1.3%	+7.6%
Shanghai Composite	3148	-0.6%	+1.3%	+2.7%	+5.2%
US 10-year Treasury	4.46	+1	-17	+4	+58
US 2-year Treasury	4.83	+0	-13	+4	+58
Germany's 10-year Bund	2.44	+2	-15	+0	+42
Germany's 2-year Bund	2.91	+1	-12	-1	+52
EURUSD	1.076	-0.1%	+0.3%	-1.1%	-2.7%
EURCHF	0.98	+0.1%	-0.5%	-0.4%	+5.1%
USDCHF	0.91	-0.0%	+0.8%	-0.3%	-7.4%
USDJPY	155	-0.3%	-0.4%	-2.2%	-9.1%
Brent crude, USD/bbl	83	-1.1%	-1.5%	-9.0%	+6.7%
Gold, USD/oz	2324	-0.2%	+0.4%	-0.5%	+12.0%

(*) or last close if not available

Source: Bloomberg, UBS, as of 8 May 2024

Non-Traditional Assets

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.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, "junk bonds," derivatives, distressed securities, non-U.S. securities and illiquid investments.
- Managed Futures: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- Real Estate: There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- Private Equity: There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- Foreign Exchange/Currency Risk: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. 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 U.S. investor.

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