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Chief Investment Office GWM
Investment research

Our outlook for 2H

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**Balancing act—Our outlook for 2H**
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# Balancing act

As we approach the second half of 2023, markets are pricing a benign path forward. Implied equity volatility is the lowest since the onset of the pandemic, and the S&P 500 is up 20% from October's low. The calm before the storm? Or the end of the worst recession that never was?

From here, we think investors face a balancing act. There is a path higher for stocks, but it is a narrow one and comes with risks: Economic growth can neither be so strong as to force the Federal Reserve into further hikes, nor so weak as to drive fears of a recession.

What should investors do?

**First,** buy quality bonds. More-resilient-than-expected economic data has boosted yields in recent weeks, providing investors with a good opportunity to lock in elevated rates as the Fed engages in a balancing act between price stability, full employment, and financial stability. We see opportunities in high grade (government), investment grade, and sustainable bonds, and select senior financial debt. Actively managed fixed income strategies can help investors take advantage of the breadth of opportunities.

**Second,** seek diverse and durable income. Earning more durable income is not just about high-quality bonds. Among the riskier parts of fixed income, we like emerging market credit. We see opportunities in diverse income strategies to balance fixed income exposure. This includes quality dividend-paying equities across traditional and sustainable strategies (and by region in Switzerland and Asia), US preferred securities, and in volatility-selling strategies.

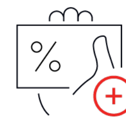
**Third,** look for equity laggards. Stock market gains have recently been concentrated in a few areas, and with valuations among some of the best performers now looking stretched, we expect the gap between the leaders and the laggards to close. Investors should protect their holdings through capital preservation strategies and rebalance into the laggards, like emerging markets, defensives, and value.

**Fourth,** position for a weaker dollar. We expect rate differentials between the US dollar and other currencies to narrow, and see the dollar's downtrend resuming in the months ahead. We therefore recommend investors with the Japanese yen, euro, British pound, or Swiss franc as their home currency strengthen their home bias. We also expect gold to reach new all-time highs.

**Fifth,** diversify with alternatives. We recommend balancing traditional portfolios with an allocation to alternatives. Hedge funds should enable investors to navigate, as well as take advantage of, dislocations in markets in a period of economic uncertainty. Meanwhile, we believe private markets offer a variety of opportunities to earn income and grow wealth over time, including in private equity, private credit, and real estate.

**Sixth,** invest in real assets. The Fed could be willing to let inflation stay modestly above target for an extended period. If the delicate balance of financial and price stability tips over into fears that the central bank is risking inflation expectations running out of control, we think allocations to infrastructure, commodities, and select core real estate could help with long-term inflation mitigation, and provide additional portfolio diversification and income.

**Finally,** go sustainable. Green investment, decarbonization commitments, consumer sentiment, and regulation will continue to drive the case for investing sustainably. We like sustainable bonds, environmental, social and governance (ESG) leaders, and innovative companies that can do more with less, including within energy and water efficiency, as well as in the transition to renewable energy—where we think investors should balance traditional with sustainable exposure. We also see opportunities to gain exposure to sustainable themes such as health and climate through hedge fund and private market vehicles.



# Buy quality bonds

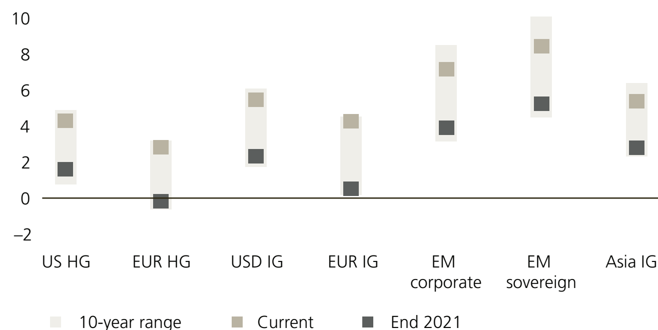
*More-resilient-than-expected economic data has boosted yields in recent weeks, providing investors with a good opportunity to lock in elevated rates as the Fed engages in a balancing act between price stability, full employment, and financial stability. We see opportunities in high grade (government), investment grade, and sustainable bonds, and select senior financial debt. Actively managed fixed income strategies can help investors take advantage of the breadth of opportunity.*

**Lock in quality bond yields (high grade, investment grade, sustainable).** Yields have risen in recent months as the economy has proved more resilient than expected. We think this provides a good opportunity for investors to put their excess cash to work by locking in attractive yields as the Fed nears the end of its rate hiking cycle and before markets start to price lower rates in the future. The more defensive, higher-quality segments of fixed income look most appealing to us, given the all-in yields on offer and the potential for capital appreciation as investors shift their focus from inflation risks to growth risks. We expect high grade (government), investment grade, and sustainable debt to deliver good returns over the balance of the year, and we prefer five to 10-year maturities.

Figure 1

Higher-quality segments of fixed income offer attractive yields

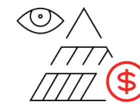
Yield-to-worst, in %




Source: Bloomberg, UBS, as of June 2023

**Select senior financial bonds.** The bonds of financial institutions came under pressure earlier this year amid fears of a full-scale banking crisis. Although they have recovered somewhat, senior bank bonds continue to offer higher yields compared to those of similarly rated non-financial companies. Highly rated covered bonds also offer significantly greater yields than government and agency notes. We believe this creates opportunities to lock in attractive yields in senior and covered bonds of larger, well-capitalized banks with strong balance sheets, stable and well-diversified deposit bases, and healthy credit metrics. While part of the appeal of paper in US dollars for non-US investors is offset by potential downside to the currency, senior financial notes are available in a range of currencies.

**Actively managed fixed income strategies.** With yields now materially higher, the opportunity set in fixed income is expanding. Individual bonds can be a good way to take advantage of today's yields. A bond fund, however, offers convenience, automatic reinvestment, and diversification. In addition, the volatility and dispersion across fixed income segments, combined with the higher yields available today and the resulting higher return potential, should increase the opportunities for active managers to outperform in this environment.



# Seek diverse and durable income

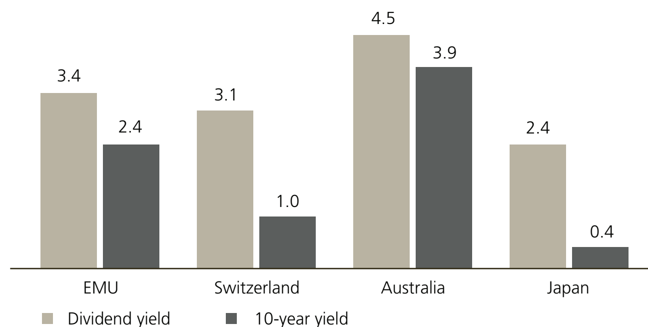
*Earning more durable income is not just about high-quality bonds. Among the riskier parts of fixed income, we like emerging market credit. We see opportunities in diverse income strategies to balance fixed income exposure. This includes quality dividend-paying equities across traditional and sustainable strategies (and by region in Switzerland and Asia), US preferred securities, and in volatility-selling strategies.*

**Emerging market bonds.** Within the riskier classes of fixed income assets, we like emerging market (EM) sovereign bonds. A Fed pause, the prospect of lower US rates ahead, and a weaker dollar should support the asset class. And, while China's recovery has been uneven, we still see good growth dynamics this year in EM. EM central banks also have scope to lower their own policy rates due to moderating inflation. In this context, we see total yields of 8.5% in the EMBIG Diversified sovereign index as representing good value. For more risk-taking investors, we also see value in some sovereign issuers that are willing and able to work with the International Monetary Fund or other international lenders in select restructuring scenarios.

Figure 2

Select markets offer attractive dividend yields

MSCI index dividend yields vs. government yields, in %




Source: Bloomberg, UBS, as of June 2023

**Quality dividend-paying equities.** Quality dividend-paying stocks can be a good source of income and can enhance potential equity returns at a time when the risk-reward outlook for broad indexes appears muted over a tactical horizon. The MSCI World High Dividend Yield index and its sustainable equivalent are currently offering a yield of around 4%, higher than some US government bonds. Quality dividend equities tend to be found in more defensive parts of the market, and history suggests dividend payments should prove relatively stable even in the event of an economic downturn. Companies in this category also often have strong pricing power, enabling them to protect margins in periods of high inflation. By region, we think this style has the most potential in Switzerland and in Asia.

In Switzerland, for example, the average dividend yield, of over 3% is well above that of Swiss franc bond yields (10-year Eidgenossen yield is just above 1%). We see Swiss corporate balance sheets and profitability as robust, suggesting that distributions are likely to be sustainable even if the economic outlook weakens.

**US preferred securities.** Preferred securities have faced performance headwinds since 2022 as interest rates have risen and, more recently, financials have underperformed. Preferreds (ICE BofA Fixed Rate Preferred Securities Index) now offer attractive yields around 7%, and in our view have potential for upside as markets start to price a lower risk of a persistent banking crisis. While investors should be prudent when it comes to selecting securities, we believe preferreds will outperform in the months ahead.

**Yield-generating structured investments.** Although implied equity volatility has fallen to the lowest level since the pandemic, we still see opportunities for investors to sell options as a way of generating yield. First, such strategies tend to outperform in rangebound equity markets, which is what we expect for the remainder of 2023. Second, while implied volatility is low in absolute terms, the volatility risk premium is relatively high at present, meaning that actual swings in equity markets have been even lower than implied volatility measures. If sustained, that increases the probability of gains for investors selling options. Separately, while equity volatility is low, cross-asset volatility remains historically high, in particular in FX, bonds, and commodities.

# Where next for the Fed?

One important factor behind the rise in equity markets in recent weeks is the increased confidence among investors that the Fed is coming to the end of its rate-hiking cycle, despite high inflation.

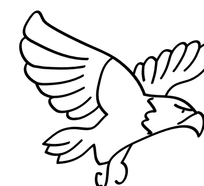
The Fed paused its hiking cycle at its June meeting, though its updated "dot plot" points to two additional 25 basis-point-hikes this year. A pause in rate hikes might seem imprudent considering current inflation data. The core consumer price index, at 5.3% year-over-year, is well above the Fed's target and was up 0.4% month-over-month in May alone. The labor market also remains tight. Despite a modest increase in the unemployment rate, recent data show job openings have actually increased and employment growth remains robust.

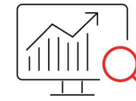
But, equally, after 500 basis points of rate hikes in just 14 months—the most rapid pace of Fed tightening in 40 years—uncertainty around the scale of the potential lagged effect on the economy is high, and we have already seen signs of financial instability and fraying balance sheets—both corporate bankruptcies and credit card delinquencies are rising. Against this backdrop, the Fed needs to consider risk management across all its areas of responsibility: price stability, full employment, and financial stability. And, while the former suggests the Fed should keep hiking, the latter two dictate a more cautious approach.

Looking ahead, although the Fed has indicated it intends to resume rate increases, the "skip" statement shows the deep divisions on the committee that needed to be bridged to reach a consensus. Furthermore, we think it could get harder to restart hikes as the US presidential election season approaches—we do not like election politics becoming a factor in our scenario analysis any more than the Fed does, but at least we can be open about it.

For investors, this means we may now need to consider that the Fed may be willing to let inflation stay modestly above target for an extended period. Higher inflation and a Fed on hold is not necessarily a bad combination for equities— higher nominal growth would provide an earnings tailwind. But it does increase the potential downside, particularly if markets begin to fear the Fed is risking inflation expectations running out of control.

Against this backdrop, we think investors should use a period of the Fed staying on hold to lock in yields in high-quality bonds, invest in real assets—including infrastructure and gold—to provide a partial hedge against long-term inflation, and position for a weaker dollar.





# Look for equity laggards

*Stock market gains have recently been concentrated in a few areas, and with valuations among some of the best performers now looking stretched, we expect the gap between the leaders and the laggards to close. Investors should protect their holdings through capital preservation strategies and rebalance into the laggards, like emerging markets, defensives, and value.*

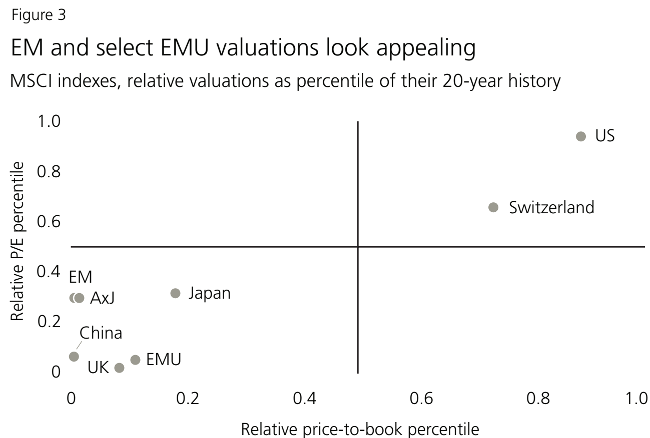
**Capital preservation strategies.** After strong year-to-date returns for US, growth, and IT stocks, investors need to think about how to balance potentially attractive longer-term gains with elevated valuations and near-term risks. In our view, the risk-reward of direct exposure of these areas is relatively unappealing versus asymmetric exposure. As a result, we recommend that investors make use of capital preservation strategies to maintain both upside exposure and some downside protection.

**Invest in EM and select European opportunities (vs. US).** We have a most preferred view on emerging market equities and expect them to deliver mid- to high-single-digit positive returns this year. Having lagged global equities by 6 percentage points year-to-date (MSCI EM vs. MSCI AC World, USD terms), we think EM stocks will likely catch up in the months ahead. Our EM earnings forecast for next year have been revised upward (13% vs. 7% for developed

Figure 3

EM and select EMU valuations look appealing

MSCI indexes, relative valuations as percentile of their 20-year history




Source: Refinitiv, UBS, as of June 2023

markets), and we see current valuations as attractive with EM as a whole trading at a 46% discount to developed markets on a 12-month forward price-to-book (P/B) basis, with China also trading at an appealing discount.

The market outlook for parts of the Eurozone also looks promising, and we particularly like consumer discretionary, Germany, and small- and mid-cap companies in the region. European consumer stocks, including the consumer discretionary sector, look poised to benefit from an improving consumer outlook as wages rise, inflation pressures ease, and central banks stop hiking. MSCI Germany is trading at 11.1x forward price-to-earnings (P/E) multiple, a 10% discount to MSCI EMU. The current forward P/E of EMU small- and mid-caps is now below 12x and trading at a 5% discount to large-caps.

**US equal-weight vs. cap-weight (i.e., “the rest” vs. tech).** Within US equities, we recommend investors consider switching into equal-weighted indexes where the majority of stocks have catch-up potential. The 86% rally for the seven US mega-cap tech names (trading on 31x forward earnings) compares to just a 4% year-to-date advance for the rest of the S&P 500 (which trades on just 15.8x forward earnings, below the pre-pandemic average). Investors can also consider shifting to our most preferred US sectors that combine defensive and quality cyclical exposure in case of a soft landing (including consumer staples, energy, and industrials).

**Value vs. growth.** From a style perspective, we favor an allocation to value over growth. Value stocks have underperformed their growth counterparts by 21 percentage points so far this year (MSCI All Country World data), largely due to the AI-driven tech rally. But we think they can catch up in the coming months as we expect the wide gulf between growth sector performance and fundamentals (leading indicators of earnings and real yields) to narrow if central banks keep rates elevated or accept a period of higher-than-target inflation—an environment that has historically supported the outperformance of value stocks.

From a global sector perspective, we favor consumer staples (defensive and resilient earnings at reasonable valuations) and industrials (to benefit from ongoing business investment). We are least preferred on global information technology (with US valuations particularly looking too rich compared to real yields, earnings yields versus US Treasuries, and on equity risk premiums to the broader US market).

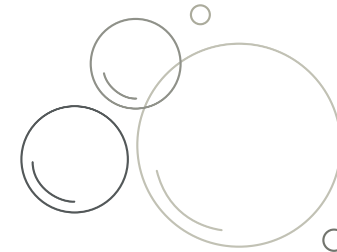
# Is AI a bubble? If not, how should I participate?

Tech stocks have been among the standout performers in the first half of 2023. Nvidia, whose chips underpin many artificial intelligence applications, has surged 194% and seen its market value top USD 1 trillion. And other tech companies have also benefited from hopes for an AI-driven rise in revenue, with the NYSE FANG+ index—tracking the top 10 US tech stocks—rising 75% year-to-date.

We see high long-term growth potential stemming from artificial intelligence. ChatGPT has more than 200 million users less than seven months after its launch, a far faster uptake than prior technological innovations. It has also sparked a rush to incorporate AI tools across a wide range of businesses and services, including in knowledge services, financial services, and pharmaceuticals. Furthermore, the associated demand for semiconductors and cloud computing is likely to power growth in the AI hardware and services market.

However, we also note tech stocks have moved very quickly to price in the potential upside. While artificial intelligence is likely to prove a transformative technology in the long term, predicting the short-term impact on share prices is, by its nature, speculative and subject to swings in sentiment. We also do not believe current developments in AI justify the elevated valuations of the MSCI All Country World IT index, which is trading at a 25% premium to its average price-to-earnings ratio over the past decade.

So, while we think artificial intelligence is likely to become a key long-term driver of performance for technology companies, current valuations look stretched to us. And even if only half of the "AI-rally" among the "surging seven" stocks were to reverse, that would trigger more than 5% downside for the overall index, all else being equal. So, we believe investors looking to add equity exposure should focus more on parts of the market that have lagged the recent rally.



# Position for dollar weakness

*We expect rate differentials between the US dollar and other currencies to narrow and see the dollar's downtrend resuming in the months ahead. We therefore recommend investors with the Japanese yen, euro, British pound, or Swiss franc as their home currency strengthen their home bias. We also expect gold to reach new all-time highs.*

**Diversify USD holdings.** The US dollar held firm for much of the first half as the Fed tightened policy and US economic data proved more resilient than expected. But we expect the US dollar to weaken in the months ahead. US inflation has almost halved from its 2022 peak and continues to fall. And as the Fed's hiking cycle gets closer to an end, we expect the US interest rate premium to shrink further, especially given the US central bank's pause in rate hikes. We recommend diversifying USD holdings, and advise investors with portfolios based in the Japanese yen, British pound, euro, or the Swiss franc to tactically strengthen their home bias.

We particularly like the Japanese yen for its safe-haven qualities, which makes it a good hedge in an uncertain environment. Additionally, the improving economic backdrop suggests the Bank of Japan is likely to tighten its very loose monetary policy in the second half of 2023. In Switzerland, we expect the Swiss National Bank to remain hawkish to keep price pressures contained and the franc stable in real terms, meaning we still see value in the CHF as a safe-haven currency vs. the USD.

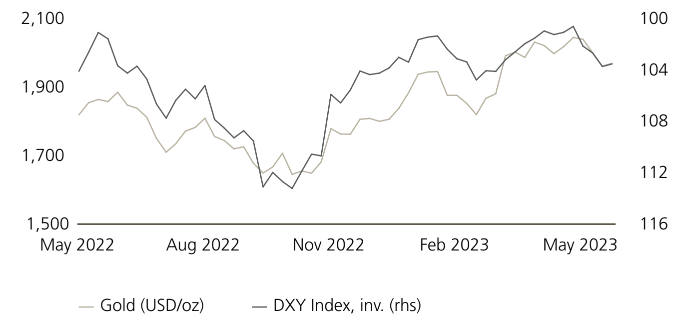
**Gold.** A weaker US dollar should benefit gold, and we expect the yellow metal to reach a new all-time high of USD 2,250/oz by June 2024. Robust central bank demand, the Fed nearing the end in its rate hiking cycle, and concerns about financial and geopolitical stability should also favor higher gold prices over our forecast horizon. Our analysis shows that a mid-single-digit percentage allocation to gold in a balanced USD-based portfolio would have improved risk-adjusted returns and lessened portfolio drawdowns over recent decades.

**Structured strategies on select currencies.** Investors can consider various strategies to enhance yield by utilizing volatility in the options market. Volatility-selling strategies based on the pound, the Australian dollar, and the yen all look attractive to us in the current environment.

Figure 4

Gold tends to perform well with a weaker US dollar

Gold (USD/oz, lhs), DXY Index, inverted (rhs)




Source: Bloomberg, UBS, as of June 2023

# Does a weaker US dollar undermine its status as a global reserve and trading currency?

From a cyclical perspective, we expect the US dollar to depreciate as the US growth and interest premium to the rest of the world erodes. But it is important to note that our call for a weaker greenback does not mean we expect its global currency status to decline.

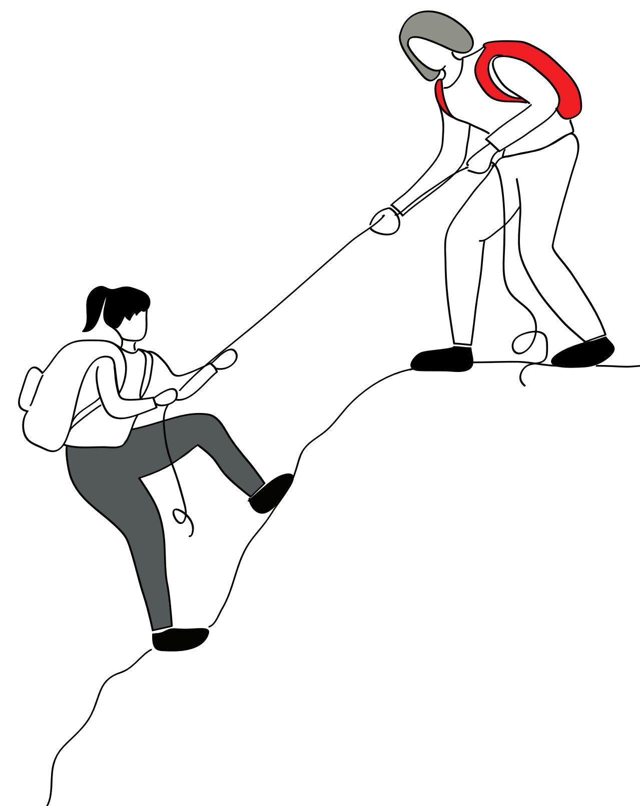
First, global currency regimes are sticky, and the US dollar dominates financial markets and international trade. The latest International Monetary Fund survey on the currency composition of global foreign exchange reserves reveals that the share of US dollars held by central banks still stands at almost 60%. The greenback is also used in over 40% of every global payment and 85% of trade finance contracts, according to SWIFT.

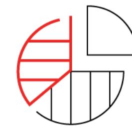
Second, the US dollar is still the world's dominant currency in terms of liquidity—the key property that global reserve managers and those involved in international trade look for in a currency. The greenback was on one side of 88% of all trades in 2022, according to the Bank for International Settlements.

Third, stability and safety matter. For all the challenges the US financial and political system has faced of late, the US still ranks highly on various gauges including rule of law, regulatory quality and efficiency, and market openness (the prevalence of capital controls, for example). As a result, the US continues to attract large flows of foreign investment.

Over time, the greenback will likely make some room for competitors. China, for instance, is working to accelerate the yuan's internationalization. But while the landscape is evolving, we believe a US dollar-centric world will continue for years to come.

For more information, please see "Toward a more diversified, yet still US dollar-centric, global currency order."





# Diversify with alternatives

*We recommend balancing traditional portfolios with an allocation to alternatives. Hedge funds should enable investors to navigate, as well as take advantage of, dislocations in markets in a period of economic uncertainty. Meanwhile, we believe private markets offer a variety of opportunities to earn income and grow wealth over time, including in private equity, private credit, and real estate.*

## Hedge funds

**Discretionary macro funds.** Discretionary macro funds have so far delivered a flat performance this year (based on HFRI data), with many managers having to reposition portfolios frequently to account for changing expectations about the growth, inflation, and US monetary policy outlook.

However, we believe the strategy will ultimately capitalize on persistent macroeconomic uncertainty and the normalization in US equity market volatility, and offer a counterbalance to rising equity-bond correlations. Macro hedge funds have in the past generally helped to reduce portfolio swings during times of economic slowdowns or recessions. Between 1997 and 2022, macro hedge funds outperformed other hedge

fund strategies (HFRI Fund Weighted Index) by 1 percentage point (1997 to June 2022) during manufacturing slowdowns and by 12 percentage points (over the same period) during manufacturing recessions (all based on BarclayHedge and HFR data, using global industrial production as a business cycle indicator).

They have also shown shallower peak-to-trough losses during market sell-offs. Discretionary macro recorded a maximum drawdown of 8.1% over the 1997–2022 period previously cited, compared to a 50.9% peak drawdown for US equities (S&P 500 Total Return Index). And while discretionary macro funds showed modest positive return correlations to global bonds (0.28) and global equities (0.54), macro hedge funds have delivered negative return correlations to equities during periods of acute market stress.

**Other hedge fund approaches (equity low-net, credit, multi-strategy).** Equity dispersion remains high, so we continue to favor uncorrelated strategies such as low-net equity long-short strategies—across traditional and sustainable equity exposure. These funds have historically shown they can benefit from market dispersion, mitigate market directionality, and complement traditional equity positions.

While equity low-net strategies can enhance equity exposure, we think the opportunity set for alternative credit strategies has increased favorably. Specialized credit hedge fund managers are likely to take advantage of this environment to generate attractive carry, convexity with potentially lower directionality, and sensitivity to interest rates and credit risk.

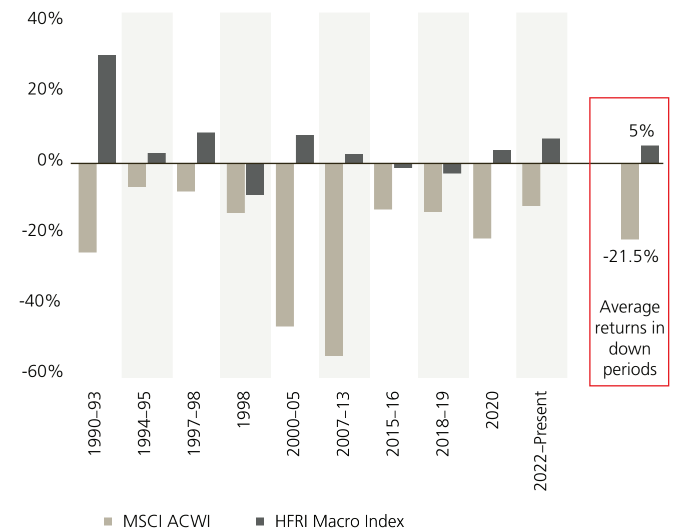
Finally, we think multi-strategy funds, which combine different hedge fund strategies, also remain a key component of portfolios. They can provide investors with attractive risk-return characteristics and diversification in periods of market turmoil.

Investors should note that alternatives can carry unique risks, including reduced liquidity, high costs, and various complexities. Following the US banking sector stress, hedge funds' access to funding is a factor to watch.

Figure 5

Hedge funds: Macro funds tend to offset some of the declines in equities

Global macro vs. global equities, during equities' worst down periods




Source: Bloomberg, UBS, as of June 2023

## Private markets

**Private equity.** We think investors should balance public equity with private equity exposure, given the potential for higher returns.

First, widening valuation dispersion should offer opportunities for managers to acquire assets at compelling valuations. This is especially true for investors in new private equity vintages whose capital will be gradually invested across various companies and at different multiples over 4–6 years. Second, private equity managers can use active ownership tools to reduce financial stresses, create value, and boost valuations in their portfolio companies during a period of economic uncertainty.

Third, historical analysis using data since 1993 shows private equity pooled returns (Cambridge Associates global private equity pooled internal rate of return) have consistently outperformed global equities (MSCI AC World public market equivalent). And global buyout outperformance over global stocks is the highest (by 8.9 percentage points) one year after the public market peak, according to data from Cambridge Associates.

We see opportunities in seeking exposure to value-oriented buyout strategies and secondaries. Typically, when investors sell private equity commitments in the secondary market, the transactions clear at around 95% of the Net Asset Value (NAV) of the portfolio companies—or a 5% discount. At present, there is a 15–20% discount generally available in secondaries, creating additional value potential for investors to increase the internal rate of return.

Finally, private equity represents an opportunity for investors who want to create additional measurable environmental and social impact in the long term. We like investments in health, education, and climate-related solutions.

**Stay invested in private credit and real estate.** Higher default rates amid higher interest rates have weighed on the outlook for private credit. At the same time, the loss of access to easy money has highlighted dwindling office and retail occupancy since the pandemic, raising concerns over the commercial real estate market.

But, we continue to see value in private debt and expect it to deliver attractive income in 2023, with stronger covenants protecting capital as economic growth slows. Our estimate is for potential in the mid-single-digit percentage range, as the high-income cushion of private loans offsets some capital losses from an expected rise in defaults.

First, further bank retrenchment could provide more private credit opportunities for direct lenders. Second, we see private lenders have used their negotiating power to secure higher yields. At current levels, private loans are yielding a coupon of close to 12.5% per year, a 400-basis-point spread over high yield. Third, private debt managers have focused on prudence. Net-debt-to-enterprise-value ratios on new loans stood at 5.1x in April this year, compared to highs of 6x in February 2022, according to JPMorgan analysis.

We also see continued value in private real estate, albeit selectively. Over a strategic (7–15 year) horizon, we expect global direct real estate could deliver potential annual returns of 7–9%. For more on this, see p. 20.

Investors should note that investing in private markets comes with certain drawbacks that should be accounted for in financial plans and overall asset allocation. Investors need to be willing and able to lock up capital for longer, given potential illiquidity.

# Invest in real assets

*The Fed could be willing to let inflation stay modestly above target for an extended period. If the delicate balance of financial and price stability tips over into fears that the central bank is risking inflation expectations running out of control, we think allocations to infrastructure, commodities, and select core real estate could help with long-term inflation mitigation, and provide additional portfolio diversification and income.*

**Infrastructure including greentech.** Infrastructure-linked assets often operate on long-term contracts tied to inflation, helping investors balance their long-term spending plans with the inflation-adjusted value of their assets. In addition, they can help stabilize income generation in a multi-asset class portfolio. Investors can gain infrastructure exposure directly or indirectly. For individual investors, direct exposure to the cashflows from utility, communication, or transportation assets can be attained via private market vehicles.

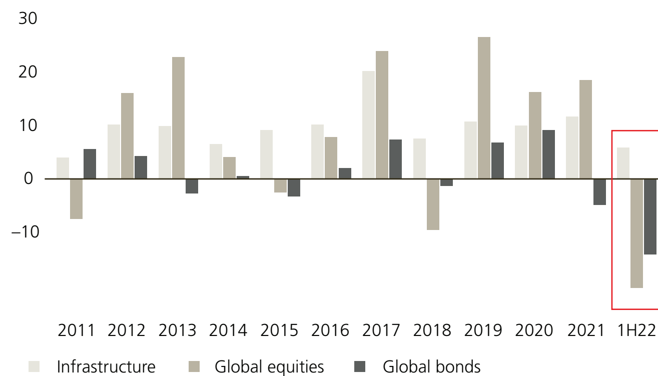
We see value in assets linked to digital connectivity (5G, fiber networks, and data storage) and the energy transition (renewables, storage, and transmission).

Indirect exposure can be attained via bond or equity markets. For example, in the US REIT sector, we like the exposure to communication towers and data centers. Greentech companies are exposed to infrastructure spending on the

Figure 6

Infrastructure assets tend to provide stable income and diversification benefits

CA infrastructure index, MSCI ACWI and Bloomberg global aggregate bond index, % returns




Source: Cambridge Associates, Bloomberg, UBS, as of June 2023

energy transition, decarbonization, and energy efficiency. We also have a most preferred stance on the global utilities and industrials sectors—both are indirect ways of investing in infrastructure and benefiting from increased infrastructure investment.

**Commodities.** In the first half of the year, better-than-expected North American production, higher Russian exports, and destocking unexpectedly kept the global oil market in surplus, and disappointing Chinese activity data and cuts to global growth weighed on industrial metals. Near-term pressure on commodities could persist.

But the recent weakness provides an opportunity to add to select positions. We have a most preferred stance on oil and gold. We expect the implemented and announced production cuts by Saudi Arabia to feed through into lower oil inventories, supporting prices. Also, with Iranian oil exports at the highest level since September 2018, we think the risk of additional supply that has weighed on sentiment recently is overstated. For gold, we have a June 2024 price target of USD 2,250/oz, which would represent a new all-time high. Continued central bank demand and a resumption of the US dollar downtrend should help reverse recent price weakness, in our view.

Longer term, we also believe the structural drivers for higher commodity prices remain intact. A steady rise in emerging market demand, global efforts to achieve net-zero $CO_2$ emissions, climate change, and structural underinvestment across almost all sectors should support commodity prices over the coming years, in our view. Given the unique characteristics and drivers of individual commodities and structural commodity trends, actively managed strategies enable investors to potentially boost their returns relative to risk. An alternative way of accessing these structural opportunities is by investing in select metals and mining stocks, where valuations are low at present.

**Global direct real estate.** We also see continued value in global direct real estate, albeit selectively. Over a strategic (7–15 year) horizon, we expect global direct real estate to deliver potential annual returns of 7–9%.

First, fundamentals remain robust in defensive parts of the market, including logistics, US and European multifamily apartment assets, and smaller market segments (data centers, healthcare, and student housing). Second, higher real estate yields should raise its attractiveness from next year, as higher potential incomes eventually offset capital depreciation from a higher cost of funding. Investors may also be underestimating real estate's income resilience through the indexation of rental income. And third, historical annual returns, volatility, and correlation data from the last 25 years demonstrate that allocations to private real estate can complement bonds as a source of income while diversifying portfolios.

# Go sustainable

*Green investment, decarbonization commitments, consumer sentiment, and regulations will continue to drive the case for investing sustainably. We like sustainable bonds, ESG leaders, and innovative companies that can do more with less, including within energy and water efficiency, as well as in the transition to renewable energy—where we think investors should balance traditional with sustainable exposure. We also see opportunities to gain exposure to sustainable themes such as health and climate through hedge fund and private market vehicles.*

**Sustainable bonds.** Our preferred areas in fixed income—high grade (government), investment grade, and emerging market bonds—all have sustainable counterparts that have provided comparable returns year-to-date, while allowing investors to align their portfolios with their values. We expect attractive risk-adjusted returns, given currently elevated yields. In addition, we still see positive fund flows into sustainable fixed income areas year-to-date, highlighting investor interest, particularly in Europe, remains strong.

**Sustainable equities: ESG leaders, renewables, and water scarcity.** So far this year, stocks of companies leading on sustainability criteria have outperformed their global counterparts, most notably in the US and Europe. We expect this outperformance to continue as these stocks can offer high dividend yields (i.e., more predictable income as

the index has a near 4% dividend yield), while offering quality characteristics.

The disruption in traditional energy production due to Russia's war in Ukraine has caused investors to balance traditional energy exposure with renewables. But despite the underperformance versus traditional energy last year, over the past five years the MSCI Global Alternative Energy index has outperformed the traditional energy index by 35ppts. The share of renewables is continuing to rise in the US and Europe (from 17% and 30% in 2017 to 21% and 39% in 2022, respectively), and the US IRA has placed a powerful spotlight on the green energy transition, so we expect the near-term outlook to be strong.

We also see thematic opportunities in solutions to address water scarcity—and the S&P Global Water Index has outpaced the global equity market by over 24 percentage points over the past five years. The theme's balance between defensive water utilities—which benefit from predictable revenues—and cyclical characteristics through industrials makes it a promising investment across cycles, in our view.

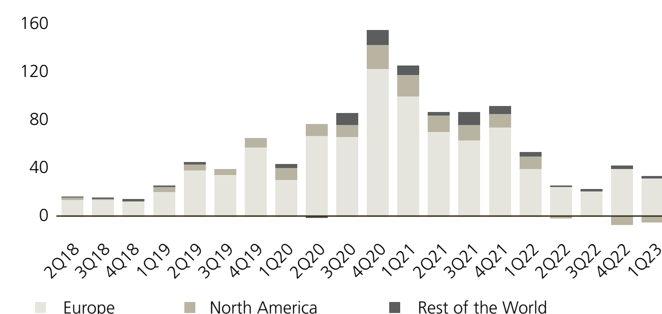
**Sustainable hedge funds.** We see a growing number of opportunities to implement sustainable hedge fund exposures within portfolios, allowing investors to diversify more effectively as well as access additional sources of returns. Sustainability-focused hedge funds typically focus on green technologies, carbon certificates, and broader sustainable opportunities across themes and sectors. We anticipate sustainable hedge fund portfolios could deliver a comparable performance to that of traditional hedge funds, though likely in a more volatile fashion.

**Private market impact investing.** The global focus on advancing social and environmental objectives creates opportunities for early-stage companies operating in private markets. We see promise in the future of healthcare, as techniques like cell and gene therapy can now be used as the basis for innovation across viral and infectious diseases. The post-COVID world creates an opportunity for education-focused technology to enhance student outcomes, with private equity serving as a source of capital for innovation. Resource scarcity underpins the need for investment in the circular economy, and environmental infrastructure and technologies in the long run.

Figure 7

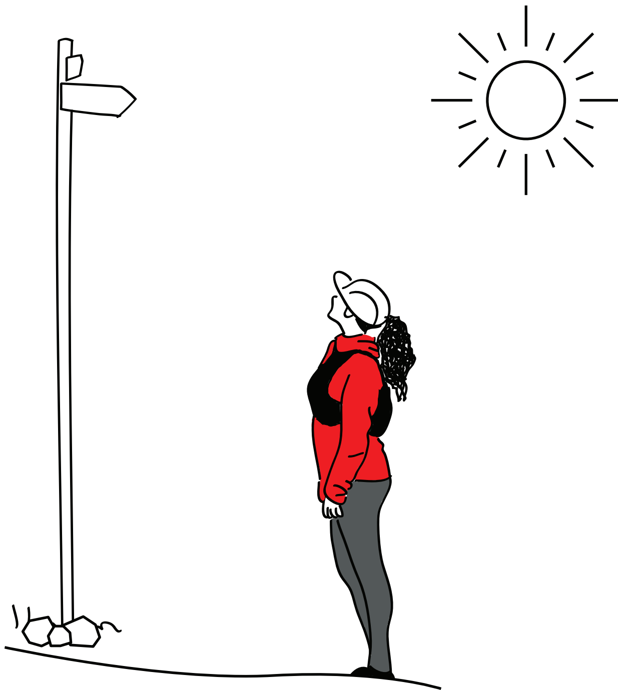
Sustainable bonds: Fund flows remain positive, Europe leading in assets

Flows in sustainable funds, by region, in USD bn




Source: Morningstar, UBS, as of June 2023

# 1H in review



**Bonds** had a volatile first half amid banking sector turbulence, the US debt ceiling standoff, and rapid shifts in market pricing of the growth and central bank policy outlooks. The 2-year US Treasury yield fell from its early-March high of 5.07% as financial stability fears intensified, but has rebounded to around 4.69% as of mid-June (+26bps year-to-date). The 10-year US Treasury yield fell 9bps year-to-date to 3.79%, deepening the inversion of the 2-year/10-year yield curve. In Europe, the 10-year Bund yield fell 12bps to 2.45%, while the 2-year yield rose 26bps to 3.0%. Corporate bond indexes delivered modestly positive returns (Bloomberg Barclays US Intermediate Corporate: +2% year-to-date).

**Equities.** After a tough 2022, global stocks have bounced this year, helped by falling inflation, resilient US economic data, and better-than-expected corporate earnings. The MSCI All Country World Index has surged 12% year-to-date. The S&P 500 has risen 14%, though its rally was narrow, driven largely by a handful of mega-cap growth equities that benefited from investor enthusiasm for AI-related stocks. Elsewhere, Japanese equities performed well, helped by improving economic momentum, while Eurozone stocks were boosted as fears about an energy crisis eased. In contrast, MSCI China's upbeat start to the year was tempered by signs that the country's economic recovery is proving uneven, and the index has lost 3% year-to-date.

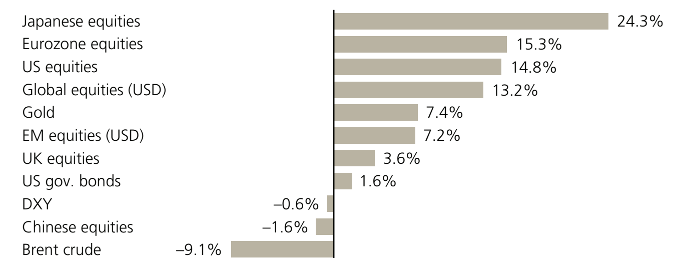
**Currencies.** More-resilient-than-expected US economic data and further Fed rate hikes supported the US dollar in the first half, leaving the Dollar Index broadly flat year-to-date, though still 10% below its September 2022 peak. The British pound was the best-performing G10 currency against the US dollar, helped by its cheap valuation unwinding. The Swiss franc also strengthened amid safe-haven demand and tighter monetary policy. However, the Japanese yen lost ground against the US dollar, with USDJPY climbing above 140.

**Commodities** have been under pressure in the first half. The UBS CMCI index has delivered a total return of –4%, as concerns about the durability of China's economic recovery weighed on oil and base metals prices. Spot Brent crude prices fell 15% to below USD 75/bbl. Gold, by contrast, had a strong first half, including rallies above USD 2,000/oz as growth and financial stability concerns spurred investor demand for safe-haven assets. Agricultural commodities delivered a modestly positive total return.

Figure 8

Stocks outpaced bonds and commodities so far this year

Performance of select asset classes year-to-date, in %




Source: Bloomberg, UBS, as of 14 June 2023

# Appendix

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

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**Managed Futures:** There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.

**Real Estate:** There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.

**Private Equity:** There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.

**Foreign Exchange/Currency** Risk: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in US dollars, changes in the exchange rate between the US dollar and the issuer's "home" currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a US investor.

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