JANUARY 2023

MONTHLY INVESTMENT OUTLOOK

UBP

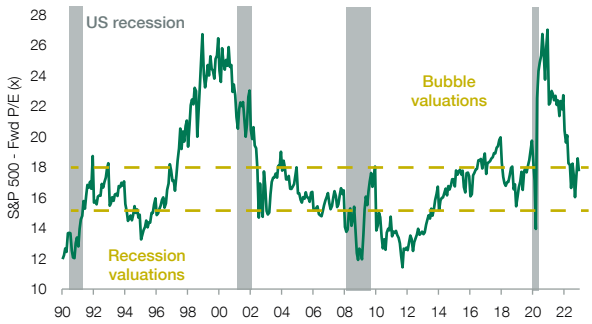
Union Bancaire Privée

MONTHLY INVESTMENT OUTLOOK

FOCUSING ON CARRY STRATEGIES

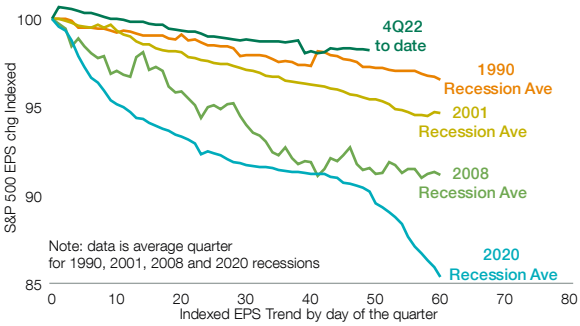
- Stock and bond markets rallied into November on the back of speculation that the Fed might step back from its rapid pace of rate hikes and, more importantly, that it may reach its 'terminal' Fed Funds policy rate by early-2023.
- While encouraging that the Fed slowed the pace of rate hikes, inflation fighting will push 'terminal' rates higher and longer than currently priced by the markets.
- With the peak of inflation in sight in the US but not in Europe, a peak in the US dollar is likely entering 2023. As a result, we closed our long-standing overweight USD positions in favour of a neutral position going into year-end.
- A 2023 economic downturn poses the greatest risk for US equities with the recent rally leaving valuations at 18x earnings, levels only seen in post-recession recoveries (1991, 2003 and 2009), policy pauses following exogenous shocks (2017 and 2019) or preludes to the equity bubbles of 1999-2000 and 2020-21.
- Outside of bubble periods, equity returns from such valuation levels have historically been disproportionately driven by earnings growth with valuations typically flat to declining in the following 6-12 month period. As the S&P 500 earnings trajectory resembles the earnings trends in the early stages of the 1990 and 2001 recessions, the current elevated level of valuations and falling earnings expectations present headwinds to equity returns in 2023.
- As a result, we are increasingly focused on strategies that deliver income/carry for portfolios in place of directional equity exposure. Strong bank balance sheets allow the attractive carry in CoCo's to more than offset our expectation of a cyclical rise in default rates in 2023.
- Short duration high yield looks poised to offer a similar cushion even though spread widening is likely moving through the new year.
- In the alternatives space, an opportunity exists to rotate some equity long-short positions into expanded credit long-short holdings. We expect credit long-short to benefit from the high absolute carry, elevated fixed income volatility and increased single credit dispersion as the US economy moves into recession, potentially offering premiums to the modest equity return outlook for 1H2023.

At nearly 18x earnings, the S&P 500 is on the cusp of bubble valuation territory



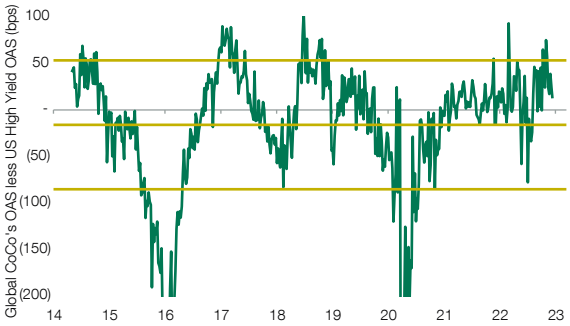
Sources: Standard & Poor's, Bloomberg Finance L.P., UBP

Since 1970, Fed pauses in the middle of Fed rate hiking cycles have been positive for investors



Sources: Standard & Poor's, Bloomberg Finance L.P., UBP

Global CoCo's offer a premium to HY backed by strong global bank balance sheets



Sources: Bloomberg Finance L.P., UBP

GLOBAL TACTICAL ASSET ALLOCATION

STAY CAUTIOUS ON EQUITIES

Global economy / Asset allocation

- Developed countries facing mild recession in the next quarters; Europe is more exposed to risks of a deep recession due to energy crisis. China has eased its "Covid-0" policy rules as it looks to drive firmer growth in 2023.
- Inflation is close to its peak in Europe; in the US, strong labour and rising wages fuel ongoing concerns on core inflation.
- Monetary policy expected to stay restrictive with ongoing rises, even after some central banks (Fed, ECB, BoE) adopted slower pace in key rate adjustments at recent meetings.
- As a result, we have become more cautious on equities after the strong rally since October (+14%). Equity markets are particularly vulnerable at historically high valuations and with over-optimistic corporate earnings estimates.
- High absolute coupons are increasingly attractive in the fixed income space, especially in selective short duration segments and CoCos.

Fixed income

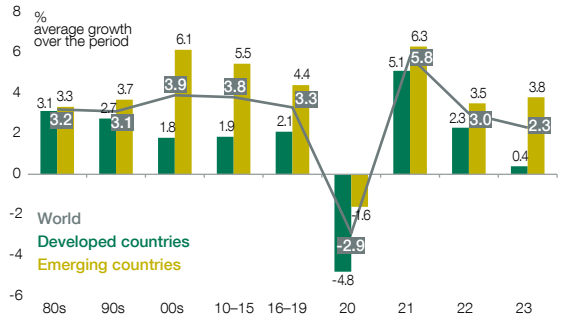
- Pressures on government bond yields remain, after temporary easing, as central banks confirmed ongoing rises in key rates and restrictive policy lasting into next quarter.
- US 10y treasuries should remain within our estimated 3.50%-4% range with German 10y yields above 2% y/y in the next few months.
- Investment-grade corporate bonds and hedge funds are preferred strategies within fixed income. Rising yields create opportunities to rebuild carry strategies in favour of global credit and US high yield in particular.

Equities/ Alternatives

- Further cuts to earnings estimates will be inevitable in the coming months on the back of the significant slowdown in the business cycle and strong downward pressures on margins. We believe that equity multiples are too high given the deterioration in fundamentals, which has prompted us to move part of our equity exposure to bonds.
- Hedge funds are particularly valuable in generating alpha especially should volatility stay high. We prefer alternative strategies to directional exposure in equities, providing some cushion to further equity market declines.

Global slowdown in progress

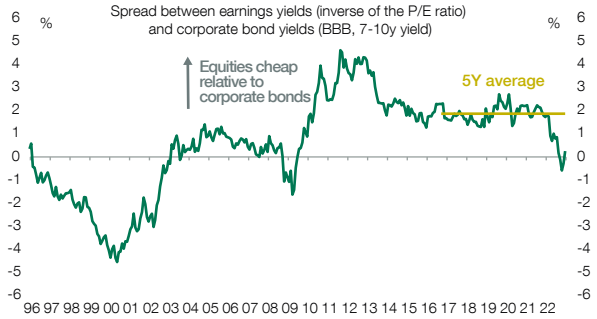
GDP growth by main region



Sources: IMF, UBP

Bonds now offer a highly attractive alternative to equities

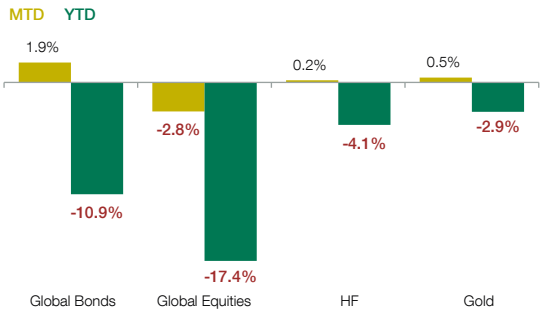
US: equity yield vs cost of debt



Sources: Refinitiv, BofAML, UBP

Stock markets fell again after the December Fed meeting

Major Asset Classes Performance



Performance is as end of December 2022
Sources: Refinitiv, UBP

UBP ECONOMIC OUTLOOK

DEVELOPED COUNTRIES ON THE GLIDE PATH TO RECESSION

Key points:

- Global growth looking likely to be weak in 2023 and tail risks stay high due to geopolitical tensions, energy crisis and ongoing restrictive monetary policy.
- Developed countries facing a recession in 2023, and Europe looks more fragile due to continuing uncertainties around the energy supply.
- Emerging countries, mainly Asia, offer a relatively constructive outlook as a recovery is expected in China next year after changes in health and economic policy.
- Inflation should decline from its peak, but on a progressive path, leaving inflation still above 2% at 2023 year-end.
- Restrictive monetary policy to remain in place, with key rates rising further but at a moderate pace.

Developed countries on the way to recession

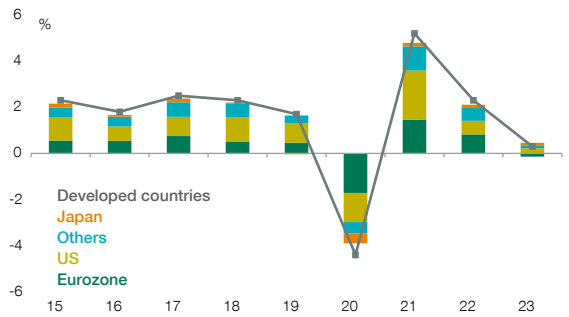
- Growth in developed countries to weaken further over the next quarters in both industry and consumer sectors.
- In the US, domestic demand set to deteriorate, with labour market expected to weaken while maintaining positive momentum. Core inflation remains resilient, obliging the Fed to maintain a restrictive stance, with no easing in key rates expected in 2023 under our scenario.
- Europe faces a deeper contraction in activity at year-end, due to the combination of shocks from energy prices, high inflation and ongoing restrictive monetary policy. After confidence hit lows during the year, real data should deteriorate further in Q4-22, and a recession is expected in 2023.

Asia: slower growth but strong fundamentals

- Asian countries anticipated to remain on a 4.2% aggregated growth in 2023 after 3.6% in 2022; positive trend in demographics, solid regional exports and comfortable external position are buffers to past strong dollar and rising rates.
- In India, growth is expected to slow from 7.2% to 6.5% in 2023, but consumption should remain a large support. Infrastructure spending and developments in new technologies should underpin regular growth trend.
- In China, after a strong rebound in Q3, headwinds were back due to renewed local lockdowns with weak growth expected in Q4-22. However, rules of Covid-0 policy now eased and more support is in the pipeline.

Developed countries facing rising recession risks

GDP growth Developed countries



Sources: IMF, UBP

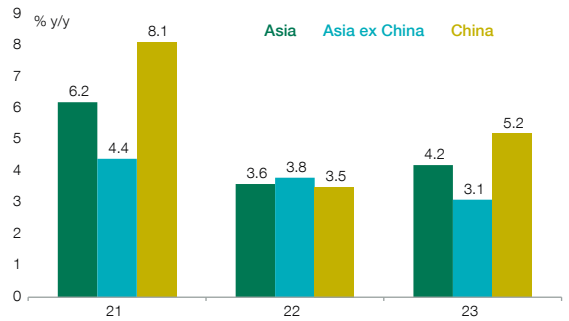
Weak global growth expected in 2023

GDP y/y %	2021	2022	2023
WORLD - *MER*	5.6	2.7	1.7
*- on PPP basis**	*5.8*	*3.0*	*2.3*
USA	5.7	1.6	0.6
Japan	1.8	1.6	1.2
Eurozone	5.4	2.9	(0.5)
United Kingdom	7.2	3.4	(0.5)
Switzerland	4.3	2.1	0.8
Brazil	4.8	2.0	1.0
Russia	4.7	(6.0)	(3.0)
India	8.5	7.2	6.5
China	8.1	3.5	5.2
Developed countries	5.1	2.3	0.3
Emerging countries	6.3	3.5	3.8

Sources: UBP - Economic & Thematic Research, Bloomberg consensus
MER: market exchange rates; PPP: purchasing power parity

Asia offers still constructive growth outlook for 2023

Asia: GDP Forcast



Sources: Bloomberg Finance L.P., UBP

UBP ECONOMIC OUTLOOK

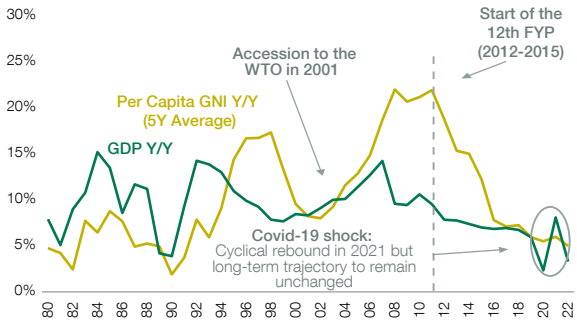
CHINA: A GRADUAL REOPENING PROCESS IN THE MONTHS AHEAD

A bumpy reopening expected

- After Covid infections rebounded, we expect signs of a gradual reopening to take shape later. The newly found urgency can be partially explained by the emergence of social tensions. Protests erupted in cities that had been heavily impacted by lockdowns with policy now relaxed around Covid-0.
- The Center for Disease Control and Prevention (CDC) previously played down the severity of Covid, arguing that the pathogenicity and virulence of Omicron are weaker than other strains. The National Health Commission issued 20 measures aimed at reducing the economic impact of Covid-0 and boosting vaccination rates amongst the elderly. Fewer than 60% have had a booster shot, including 40% of those age 80 and above. Increasing vaccination rates to safer levels will still require several months. Resources will also be redeployed away from testing and towards ensuring healthcare services can cope with cases.
- In terms of housing, the People's Bank of China (PBOC) and the China Banking and Insurance Regulatory Commission (CBIRC) issued a 16-point plan of measures to support the housing sector. The package was comprehensive and covered six areas, ranging from temporary extensions to bank and shadow bank loans, to additional macroprudential support for first time home buyers. PBOC Governor Yi Gang stated that the measures are meant to achieve a "soft landing" for the sector. While these are encouraging, investors should remember that it will still take many quarters for the real estate sector to return to expansion, given the low starting point and longer lifecycle of construction activity. Caution is still warranted.
- Economic activity continued to decelerate, refuelling downside risks on Q4-22 growth. PMIs and retail sales declined more than expected, while investment has stabilised since November. In parallel, foreign demand from developed countries has slowed down and exports contracted by 9% y/y in Nov.
- Going forward, the macro backdrop should improve as the central government is delivering a blueprint for reopening the economy. Moreover, authorities want to revive domestic demand and have the ability to manage economic policy to favour an implicit 4.5%-5% growth trend in the medium term. The PBOC will also deliver liquidity and ongoing monetary support to revive credit and offer help to local governments.

Growth trend has moderated after globalisation has matured

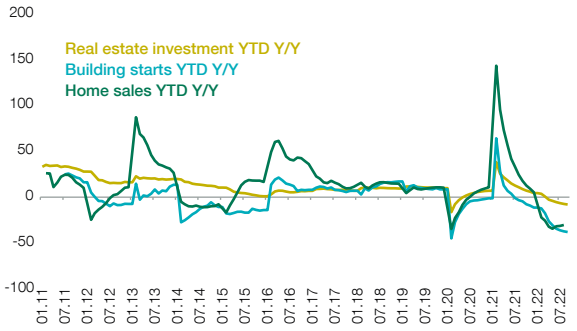
China: economy faces new growth trend



Sources: World Bank, UBP

China housing sector still fragile

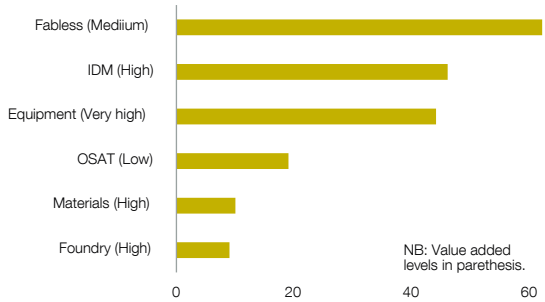
China: inflexion in home sales but real estate invesment remains very contractionary



Sources: NBS, Bloomberg Finance L.P., UBP

AI and IT sector to see fierce competition between US and China

US. market share in global semiconductor supply by subsector (percentage)



Sources: Bloomberg Finance L.P., UBP

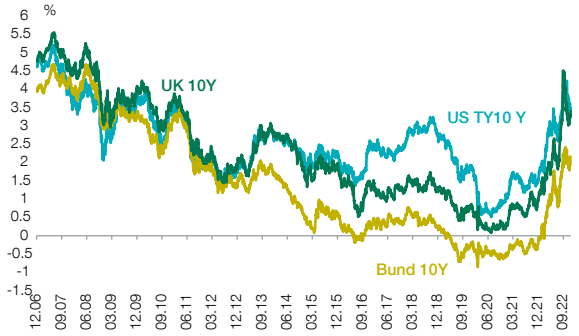
GLOBAL BONDS

ATTRACTIVE CARRY STRATEGY

- Government bond yields previously eased on peaking US inflation and the prospects of a less hawkish Fed. Central banks adopted a slower pace in hiking key rates, but inflation fighting remained a priority justifying higher terminal rates and a longer restrictive monetary policy than expected by the markets.
- Government bonds yields were volatile over the past weeks. After a temporary easing which drove US yields to 3.41% at the beginning of December and the 10y German Bund just below 1.80%, yields have rebounded above 3.5% in the US and 2.20% in Germany as central banks were finally more hawkish than expected.
- Inflation remained a concern in developed countries. With continuing strong labour demand and rising wages in all regions, monetary policy is likely to remain restrictive entering 2023: more adjustments in labour and slower wage growth are required by central banks before adopting any pivot in strategy.
- Higher terminal rates in the US and the eurozone follow on from further rises in key rates, even at a slower pace. As revealed by FOMC dots, US key rates should reach 5.0%-5.25%, and ECB rates could come close to 3% in H1-23. In the UK, the BoE may also drive rates close or slightly above 4%. In addition, the ECB will follow the Fed and the BoE by reducing its balance sheet next year. It will reduce its reinvestments by EUR 15 bn per month in Q2 and will accelerate this pace over the next quarters.
- Government bond yields to remain volatile with ongoing upside risks as central banks are not comfortable with inflation and target high terminal rates. Moreover, the debt ceiling in the US and a strong rise in net issuances in Germany in 2023 could maintain pressure on yields. European peripheral yields could face renewed pressure in this environment.
- Rising yields create opportunities to rebuild carry strategy in the credit segment. Investment-grade corporate bonds, in high quality segments, offer attractive returns and opportunities are also rebuilding in favour of US high yield offering attractive yields and risk reward balance.
- Hedge fund strategies present more opportunities against this backdrop. Rising short-term rates and performance dispersion across sectors and corporates offer a better environment for long-short strategies in the credit space over the next months.

Hawkish central banks refuel volatility among government bond yields

Government bond yields



Sources: Bloomberg Finance L.P., UBP

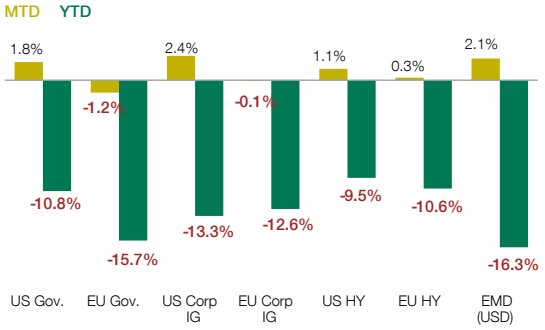
Yields on US investment-grade corporate bonds look attractive

US Investment-grade OAS yield

Sources: BoAML, UBP

Fixed income continued rally across all segments

Fixed income performance



Performance is as end of December 2022
Sources: Refinitiv, UBP

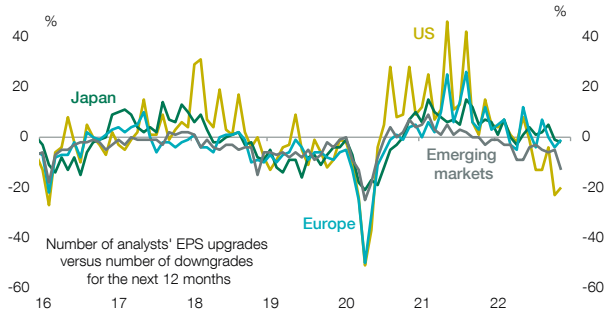
GLOBAL EQUITIES

CORPORATE MARGINS SET TO DECLINE MEANINGFULLY

- Hawkish central banks have dampened the positive mood in equity markets after the rally seen over the past two months. Investors' concerns are progressively shifting away from inflation to growth.
- Earnings revisions continued to be negative, particularly in the US and in China. Earnings momentum was roughly flat in Europe overall, but with major differences between countries and among sectors.
- The growth-inflation mix remains unfavourable to equities. While profits have proved to be resilient in 2022 thanks to strong corporate pricing power and nominal growth, consensus estimates for 2023 of low single-digit EPS growth, which only implies a marginal decline in corporate margins, are much too optimistic.
- Indeed, after only a modest decline in margin this year, rising wages, interest expenses and effective tax rates combined with negative operating leverage will undoubtedly lead to a further normalisation in 2023. On the back of a decelerating global business cycle, tightening financial conditions and the rising risk of recession, negative EPS growth appears highly likely next year.
- Currently, consensus estimates still point to positive EPS growth rates: 5% in the US and 1% for Europe as a whole; that, however, rises to 4% if the energy sector is excluded. For emerging markets in aggregate, the estimated growth rate stands at 2% but with a wide dispersion between countries, from +21% for India and 14% for China to -17% for Brazil. Earnings downgrades look ready to accelerate during the next earnings season in February.
- While equities suffered from a major de-rating this year on the back of a surge in bond yields and the rising odds of a global recession, the scope for a re-rating from current levels appears rather limited while the emergence of a deep recession or a further increase in bond yields would probably push valuation multiples to new cyclical lows.
- In our view, equity multiples are still too high considering the expected deterioration in fundamentals, particularly at a time when fixed income instruments offer attractive yields with much less risk than equities.
- As a result, after having tactically increased exposure to benefit from the bear market rally, we have recently switched part of our equity exposure to buy short-term high-yield bonds.

Earnings estimates continued to be revised downward, particularly in the US…

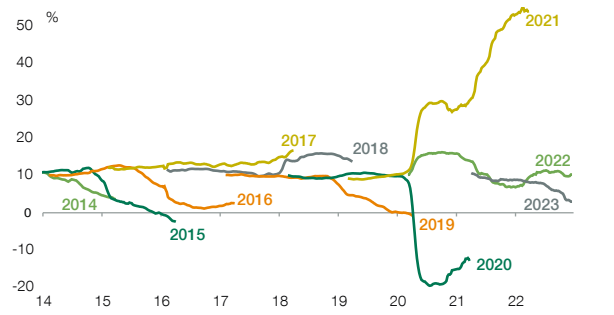
Earnings revision ratio: US, Europe, Japan & EM



Sources: Refinitiv, UBP

… but consensus expectations for next year are still significantly too high

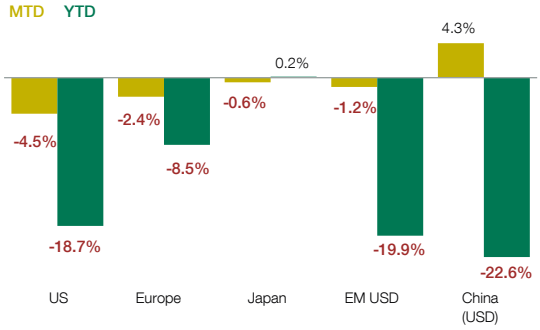
Consensus EPS growth expectations for global equities



Sources: Refinitiv, UBP

China is the only bright spot in December

Equities' performance



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Sources: Refinitiv, UBP

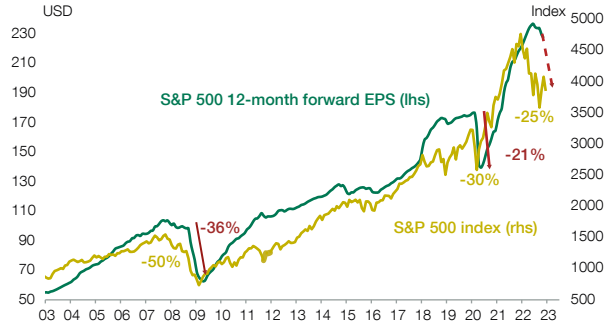
RECENT CHANGES

PIVOTING FROM EQUITIES TO SHORT DURATION HIGH YIELD BONDS AND COCOS

- With the strong market rally in October and November, the S&P's valuation is at a historical high at nearly 18x earnings. Further compression is likely should recession risk materialise looking ahead.
- In addition, market consensus estimates of a 5% earnings growth rate for 2023 seem too optimistic on the back of a significant slowdown in the business cycle. Equity markets are particularly vulnerable.
- In the fixed income space, although the risk of higher yields and wider spreads remains, absolute coupons are increasingly attractive offering 4% risk free and around 8-10% in high-risk segments.
- As result, we reduced our overall equity exposure in favor of short-term high yield bonds and CoCos, without taking on too much in the way of interest rate and credit duration risks.
- A highly selective approach is warranted in credit selection as default rates may well rise in the coming months. Slowing economic growth will take a toll on corporate profitability.
- After having enjoyed our strong overweight of USD in our portfolios over almost the whole of 2022, we reduced our USD exposure last month to neutral against EUR. USD looks set to weaken modestly in the coming quarters, reflecting the expected contraction of EUR-USD rate differentials. Despite our bearish USD view, USD usually outperforms during market stress offering a useful hedge against any equity market sell-off.

Earnings estimates still have to adjust to a more difficult environment for corporates

S&P500 index and forward earnings



Sources: Refinitiv, UBP

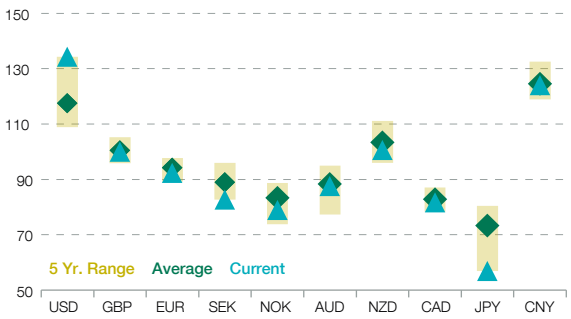
Yields are increasingly attractive especially in short duration high yield bonds

Yield to maturity (%)

Sources: Refinitiv, UBP

USD is expensive after the unprecedented appreciation of this year

REER



Sources: Refinitiv, UBP

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