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UBP House View

Union Bancaire Privée

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Back to normal

Two years of transition in the money and interest rate markets have made it possible to return to more conventional investment ideologies in financial markets. After many years of zero or even negative interest rates, a more traditional hierarchy of risk premiums among the different asset classes has been restored in 2023.

Risk-free asset remuneration now means that bonds offer enough visibility to investors, while equities are presenting excess return opportunities. This has allowed traditional asset class arbitration mechanisms to come back into play and, as a result, equities have become more volatile. We can expect periods of low volatility (12%) to be a regime of the past, with levels of 15–20% more representative of future earnings uncertainty and exogenous shock risks.

Within bonds, the situation has been critical for the past two years after the complete recalibration of interest rates. 2024 should play to the asset class' advantage, with inflation expectations returning to levels more aligned with market expectations.

In hindsight, the consequences of Covid will have provided central banks with a historic opportunity to reintroduce more orthodox monetary policies via their uncompromising fight against inflation. As a result, investors will have witnessed the "normalisation" of financial markets. However, one major question remains unresolved, namely the capacity of economies to absorb such an interest rate shock.

Key Takeaways

1 HIGH RATE REGIME: SIGNIFICANT IMPACT ON CAPITAL ALLOCATION

As a consequence of the current peak in interest rates, capital allocation decisions are set to move away from the main equity-oriented markets of the recent past. Investors should lock in current yield levels for investment-grade bonds while staying in short-term high-yield bonds.

2 HIGHER RATES ALSO MEAN HIGHER VOLATILITY

The combination of a high interest rate and a high volatility environment is one where structured products should flourish. Investors should favour the use of equity-linked structured products that are able to capture similar returns to equities but with lower expected volatility.

3 HIGH VOLATILITY AND LOW EQUITY RISK PREMIA: TACTICAL ALLOCATION

Excess returns expected on equities compared to bonds are at their lowest level in 20 years. A buy & hold strategy will not be sufficient to generate superior returns. This reinforces the growing importance of tactical asset allocation strategies.

The opinions expressed in this document are as of 7 November 2023 and are subject to change without notice.

Macroeconomic environment

US growth to challenge that of other developed countries in 2024

GLOBAL GROWTH DRIVEN BY US ECONOMY

Global growth is expected to stabilise at a rate of 2.9% in 2024 after a 3% increase in 2023. The global economy is holding up better than expected, but risks still exist due to a fragile geopolitical situation.

As in 2023, the prospects for 2024 appear much better for the United States compared with those offered by other developed countries. The US economy will certainly slow down in Q4 23 and Q1 24 after the strong growth displayed in Q3 23 (4.9%); however, the expected slowdown in consumption should be more of a normalisation than any reversal of trend. Despite rate increases, consumption will still find support in rising purchasing power and job creation, which, even though less buoyant in 2024, should not be reversed. An entry into recession should be avoided with the renewal of the investment cycle supported by public programmes in favour of new industries.

Solid consumption and the recovery of the manufacturing sector provide a basis for growth that other developed countries do not offer, and one on which China is competing with the United States in the race for global pre-eminence.

In Europe, the challenge for 2024 will be to emerge from stagnation. Performances should remain disparate at the start of next year, with Germany still in quasi-recession. However, the German economy has initiated a strategic shift in terms of industrial specialisation, which will take time to produce its effects.

Chinese growth should stabilise at 5.2% in 2023, but the outlook for 2024 remains limited (4.5% expected). The real estate sector is still weighing on growth, justifying the new fiscal recovery plan presented at the end of the year (0.8% of GDP). The return of domestic demand to solid growth remains uncertain and justifies a cautious approach to the Chinese outlook.

INFLATION STILL STICKY BUT EVENTUALLY DECLINING

Global inflation is declining, but future progress looks more difficult after the negative effect of energy, and oil prices might remain volatile due to uncertainties in the Middle East.

A divergence is appearing between the prices of industrial goods and those of services: the former are falling as bottlenecks in manufacturing are being resolved, and the latter, while more volatile, are also more resilient than before the Covid crisis. As a result, core inflation, which includes rent and services, will take time to return to 2% due to strong demand in some sectors and sustained wage growth.

The absence of recession in the United States should keep inflation up, whereas it is expected to fall further in Europe. In 2024, according to our scenario, inflation should return just below 3% in the US and to around 2.5% in the eurozone.

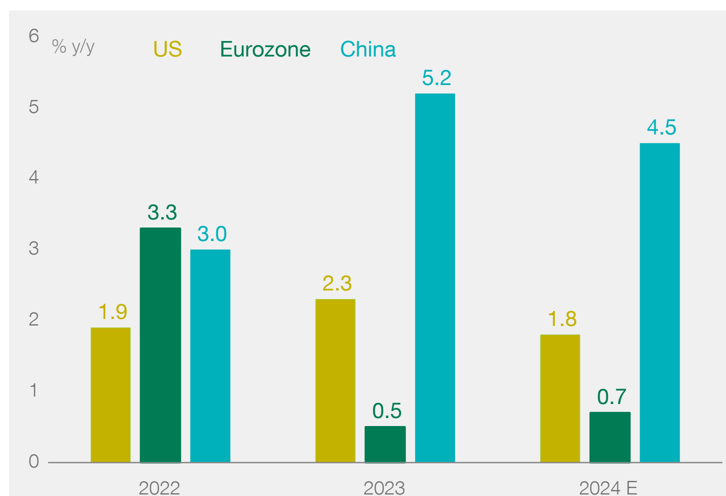
A PAUSE ON KEY RATES AND SUSTAINED BUDGETARY SPENDING

Central banks: a long pause before lowering key rates

2022 and 2023 saw the return to a restrictive monetary regime to combat inflation; central banks have now opted for a pause on key rates. Their communications still include a hawkish bias, but the bar for raising their rates again now seems higher. A pause on rate hikes does not mean an easing of policies, because banks' balance sheets will continue to shrink in 2024, and a rate cut is not expected before the end of Q2 24.

Fiscal policies will continue to expand and no return to austerity is expected. Overall support for the economy will give way to more targeted actions in favour of strategic sectors such as climate, reindustrialisation, and new technologies. The US presidential and European Parliament elections should leave spending high. The reduction of public debt will be slow, as debt servicing will increase further due to the rebound in interest rates.

GLOBAL GROWTH: MAIN COUNTRIES



Sources: OECD, UBP
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Strategy

BOND YIELDS TOPPING IN THE US AND GERMANY…

US/German yields are topping, opening a window to deploy cash into bonds and relieving pressure on equity valuations

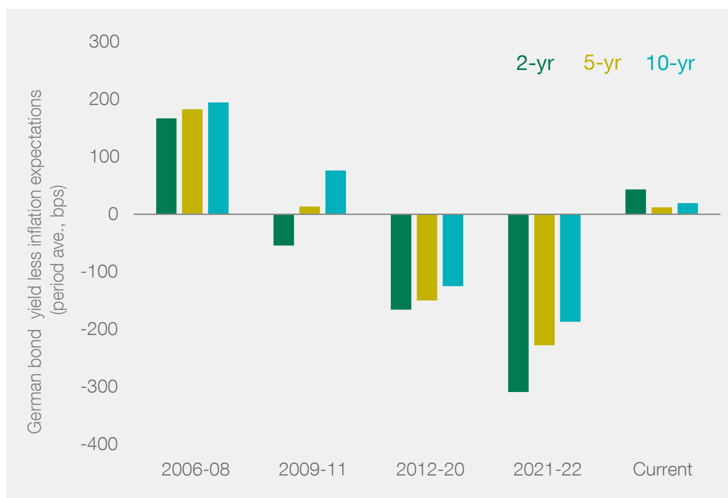
With bond yields in the US and Germany having rapidly approached our target ranges of 4.5–5.0% and 3.0–3.5%, respectively, we believe yields have entered a topping phase on both sides of the Atlantic.

Inflation-adjusted yields in Germany are positive across the yield curve for the first time since before the global financial crisis. In the US, inflation-adjusted yields across the yield curve now sit above 2%, i.e. levels more consistent with "real" yields seen in the late twentieth century.

Though risks exist that could push yields even higher, including oil supply disruption or heavy US election-related fiscal stimulus going into 2024, at current yields the overall risk–reward has shifted from the asymmetrically skewed risk of higher yields outlined a year ago to one now skewed towards moderately lower yields looking into 2024.

As inflation expectations ease, we can expect high real interest rates in the US to allow nominal 10-year yields to retreat back towards 4.5%, and in Germany towards 2–2.5% in 2024. For investors who have been capitalising on high yields in deposits throughout 2023, an opportunity is emerging to begin deploying cash in high-quality USD and EUR bonds in 2024.

POSITIVE GERMAN AND US* INFLATION-ADJUSTED YIELDS SUGGEST A PEAK IS ON THE HORIZON



Sources: Bloomberg Finance L.P. and UBP
*US inflation-adjusted yields not pictured
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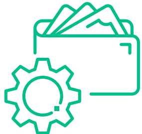
…LIKELY EASING GLOBAL EQUITY VALUATION COMPRESSION

The move since mid-2023 to a new, higher range in US and German risk-free yields has driven a 10% valuation compression in global equity markets. Thus, as yields peak in the months ahead, the pressure on global equity valuations should likewise abate.

In equities, investors should focus on earnings recovery in 2024 to drive returns following the 2023 earnings recession. The earnings-led recovery in software and technology should be buoyed by AI spending, while quality laggards outside technology offer an opportunity to access strong balance sheets and reliable earnings growth.

Asset allocation



Reinforce the importance of tactical asset allocation strategies in portfolios

Federal Reserve likely to cut in the second half of 2024

Favour the use of equity-linked structured products

INVESTMENT BACKDROP

A higher interest rate environment is here to stay. Consequently, capital allocation decisions are set to change from the limited alternatives to equities of the recent past.

Increased equity market volatility is also set to become the new normal as a result of higher rates. This creates new opportunities and reinforces the importance of tactical asset allocation strategies in portfolios.

BUY & HOLD STRATEGIES IN BONDS WITH TACTICAL OPPORTUNITIES IN EQUITIES

Based on UBP's 2024 macroeconomic scenario, we see attractive returns within fixed income, which should finally end its two-year bear market, as rates are peaking and the Federal Reserve is likely to cut rates in the second half of 2024.

We prefer investment-grade bonds with an intermediate duration (3–5 years) as well as short-dated high-yield bonds (1–3 years duration). We are refraining from investing in longer-duration bonds, as 10-year yields have limited downside in a resilient macroeconomic environment, whereas US deficits will remain a long-term concern for investors.

Despite higher volatility, we are maintaining a neutral allocation to equities which remains one of the few asset classes to offer uncapped returns. After two years of limited growth in earnings, we believe the double-digit earnings picture expected in 2024 is achievable. With a resilient macroeconomic backdrop, as well as persistent inflation, US companies will see accelerating revenue growth in 2024. With global equities now trading below their historical valuation averages, any excess on the downside will provide opportunities to add exposure.

The higher volatility regime is also an environment where investors should favour the use of equity-linked structured products that are able to capture similar returns with lower expected volatility.

We are maintaining a neutral exposure to hedge funds and gold, as these asset classes have proven to be a valuable source of diversification within portfolios, particularly during periods when both bonds and equities experience simultaneous declines.

Directional views

■■■■■ HIGH CONVICTION | ■■■□□ BASE LINE ALLOCATION | ■□□□□ LOW CONVICTION

Strategic (12–18-month) and tactical (6-month) views on broad asset classes, November 2023

	STRATEGIC	TACTICAL
Equities	■■■□□	■■■□□
United States	■■■■□	■■■□□
Europe	■■■□□	■■■■□
Switzerland	■■■□□	■■■□□
United Kingdom	■■■□□	■■■□□
Japan	■■■■□	■■■□□
China	■■□□□	■■□□□
Emerging ex China	■■□□□	■■□□□
Fixed Income	■■■■□	■■■□□
Governments	■■■□□	■■■□□
Investment Grade	■■■■■	■■■■□
High Yield	■■■■□	■■■□□
Emerging Market Debt	■■□□□	■□□□□
Hedge Funds	■■■□□	■■■■□
Equity Long/Short	■■■□□	■■■□□
Macro/Systematic	■■■■□	■■■■■
Credit/Event	■■■□□	■■■■□
Relative Value	■■■■□	■■■■□
Private Markets	■■■■□	■■■■□
Private Credit	■■■■■	■■■■□
Private Equity	■■■■□	■■■□□
Infrastructure	■■■■■	■■■■□
Real Estate	■■■■□	■■■□□

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Asset classes

EQUITIES

NEUTRAL VIEW MAINTAINED

Our neutral view on equities is underpinned by a strong US macroeconomic backdrop and a peaking interest rate environment resulting from slowing inflationary pressures globally.

However, we do not expect equity valuations to significantly rise from current levels, as alternatives to equities have emerged and offer similar expected returns with lower volatility.

Our scenario calls for a total expected return of +12% for equities in 2024, of which +10% comes from corporate earnings growth and +2% from dividends/share buybacks.

We continue to remain overweight on US equities and are upgrading Japan from underweight to overweight, as economic and governance reforms should unlock accelerating earnings growth.

FIXED INCOME

FAVOUR CARRY IN HIGH-QUALITY BONDS; REMAIN SELECTIVE IN HIGH YIELD

Both the Fed and the ECB are expected to stay on hold, with limited risks for additional hikes. We are maintaining our neutral duration stance across all currencies, looking for the yield curve normalisation process to develop further.

We continue to favour high-quality bonds, as market technicals remain strong, with high yields, light supply and spreads set to remain range-bound. The 3–5-year part of the curve looks the most appealing to lock in yields and benefit from a steep roll-down.

Credit spreads are only mid-range, and high-yield companies' credit metrics are deteriorating as they approach the refinancing wall. It is too early to add risk, and we prefer to remain selective in the high-yield segment by focusing on short-duration issues.

CURRENCY

USD TO REMAIN FIRM IN Q4

USD exchange rates will remain well supported coming into year-end, reflecting high levels of front-end carry and still positive economic data momentum. EUR/USD should trade at lower levels, consistent with the development of two-year interest rate differentials; a move to 1.02 is feasible.

HEDGE FUNDS

BENEFITING FROM HIGHER RATES AND VOLATILITY

Among hedge fund strategies, we maintain our high conviction on global macro. After a challenging first quarter which triggered a reduction in risk, the strategy recorded strong gains when volatility picked up at the beginning of August.

Within equity long/short, our preference remains with less directional and low net exposure managers given the headwinds that equities might face.

Relative value funds were not completely immune to the wild rate swings in Q1, but those mark-to-market moves were recouped over the following months. The strategy should continue to perform well.

PRIVATE MARKETS

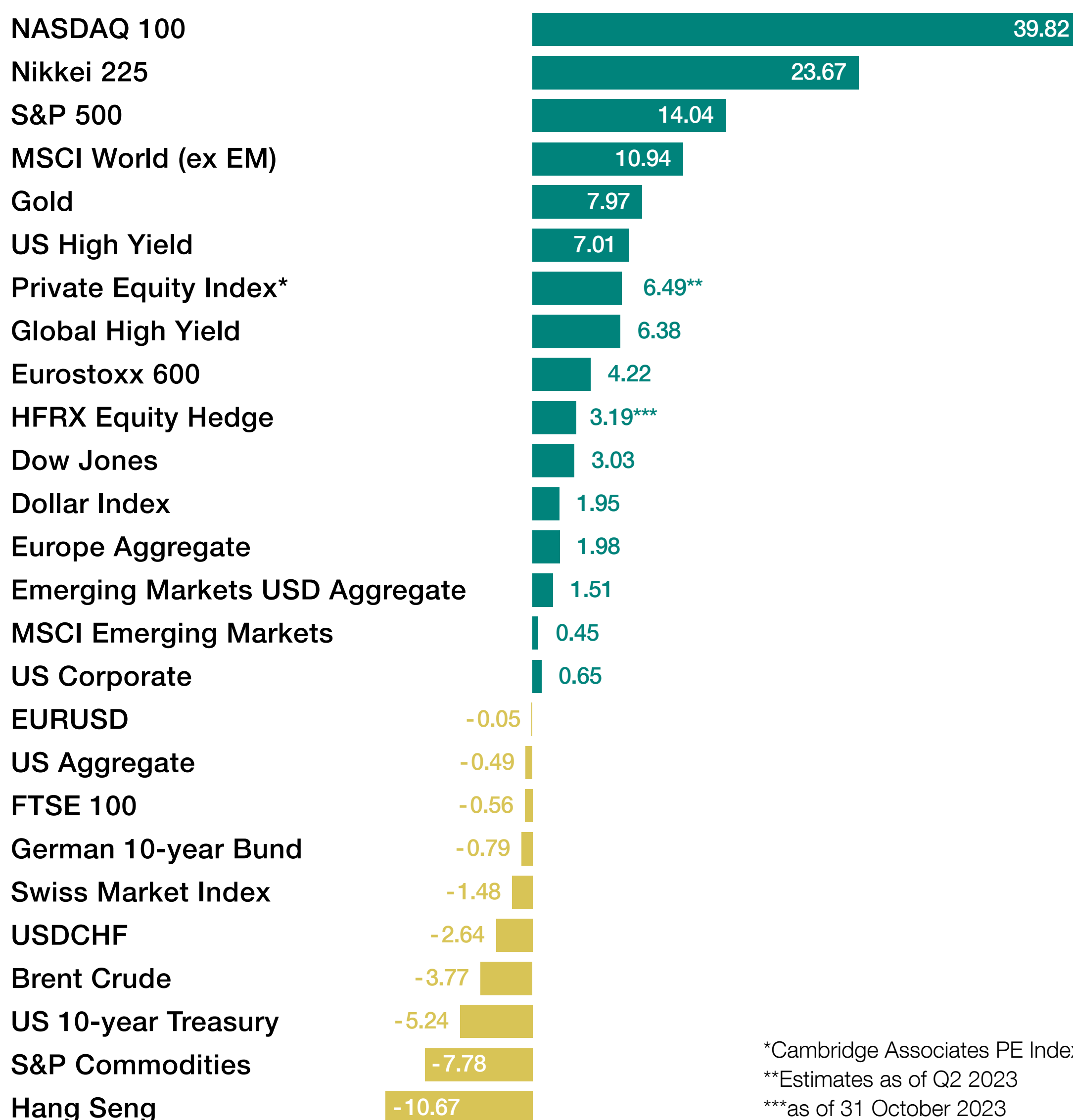
BE CONSTRUCTIVE BUT SELECTIVE

The rapid rise in interest rates has put a dent in some segments of private equity through a valuation reality check on the VC side and a slowdown in exits for buyout managers. However, the long-term outlook remains solid for private markets under the constraints of a thorough manager/deal selection process.

In private equity we are favouring secondaries due to the structural nature of the opportunity, while private credit and its numerous iterations remain the darling of private markets, thanks to banks' continued retreat from lending.

Market performances

2023 YEAR-TO-DATE RETURN, (%)



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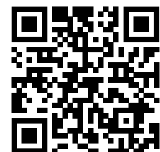

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