MARKETING DOCUMENT | DECEMBER 2023

UBP House View

Union Bancaire Privée

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2023: a year full of surprises

2023 will undoubtedly be seen as a year full of surprises.

Despite all the negative forecasts after 2022, which was a bleak year, risk assets have delivered good-quality returns across most asset classes.

This good performance is, of course, reflected in US and Japanese equities, but also in certain bond segments, with high-yield bonds having risen nearly 9% since the beginning of the year. Of course, dispersion within asset classes is the order of the day, but it shows that cash was not the only investment solution to obtain largely positive returns in 2023. These comments also apply to diversified management, as balanced portfolios provide highly satisfactory performances.

Excessive caution would therefore have been rather penalising at this stage. It would also have failed to recover the lion's share of the losses recorded in 2022. The good news is that markets now offer a wide range of solutions that will need to be implemented intelligently and in an agile way in 2024. This situation leaves us confident about the coming months, despite the low visibility on macroeconomic data, which is expected to improve in the first part of the year.

Key Takeaways

1 GLOBAL ECONOMY

Recession risks are waning in the US and Europe as targeted fiscal stimulus packages stay in place. Inflation should continue to ease towards its target by end-2023. Central banks should stay on the sidelines in H1 24, but rate cuts are more likely in H2 24.

2 CASH VS. FIXED-INCOME STRATEGY

Investors should move from cash to fixed income in order to lock in current attractive yields. We are targeting yields of 2–2.5% on German 10-year Bunds and 4.5% on US 10-year Treasury bonds.

3 OUR FAVOURITE BETS ON EQUITIES

Equities remain a core holdings with preferences for technology and Japan. In 2024, Japan is offering premium, secular earnings growth over European and EM equities. Look to software for earnings growth and attractive valuations. For more cautious investors, rising volatility offers opportunities to generate equity-like returns via structured products.

The opinions expressed in this document are as at 4 December 2023 and are subject to change without notice.

Macroeconomic environment

SOFT LANDING GAINING MOMENTUM

Global growth should be moderate in 2024 and indicators have recently pointed towards a soft landing in the US, associated with a decline in inflation; this fuels hope of a rapid easing of monetary policy. While US growth should continue to normalise, Europe remains stagnant; in contrast, prospects in Japan look more constructive, as they are benefiting from a supportive economic policy.

JAPAN: INFLATION STARTS TO BITE BUT OUTLOOK TO STABILISE

Japan's prospective exit from deflation has indisputably been one of the main themes of 2023

Japan's prospective exit from deflation has indisputably been one of the main themes of 2023. After almost three decades of low growth, inflation (CPI) surged by an average of 3.4% y/y in the first ten months of the year. Much of this can be traced back to the yen's 10% depreciation against the dollar, fuelled by a widening rate differential with the US.

Rising cost-push inflation has also started to influence corporate and household behaviours. Earlier this year, large conglomerates adjusted annual wages by 3.8% – the highest level in 28 years –, but on the downside, they have reduced their capital expenditures to cope with rising costs.

They have also started to pass on rising costs to consumers through price increases. Japanese households are notoriously price inelastic, and we have seen marked declines across durable goods, while services have remained more resilient. Notwithstanding substantial pay increases, average real cash earnings have not kept up with inflation, declining by 2.5% y/y in the first ten months of 2023.

Against this backdrop, Q3 GDP contracted more than expected to -2.1% SA q/q (annualised). Activity will likely stabilise in Q4, while support measures should help to buttress domestic demand in 2024. We are maintaining our GDP growth forecast for 2023 at 1.6%, buoyed by a large net export contribution in Q2. GDP growth will likely moderate to 0.8% in 2024.

POLICY SUPPORT SHOULD REMAIN IN PLACE FOR LONGER

In November, Japan's cabinet approved a package of measures worth some JPY 17 trillion (USD 112 billion). The fiscal stimulus was substantial (at around 2.7% of 2022 GDP) and the prime minister Fumio Kishida justified the move stating that, "wage increases are not keeping pace with price rises". The bulk of this stimulus plan comprises income tax cuts effective from June 2024; it also included an extension of existing subsidies to ease the pressures associated with rising gasoline, electricity, and gas prices until April 2024.

Further changes to yield curve control (YCC) at the Bank of Japan's (BoJ) December meeting remain likely. Although 10-year government bond yields have recently abated, YCC is not providing any flexibility for the BoJ amid higher imported inflation.

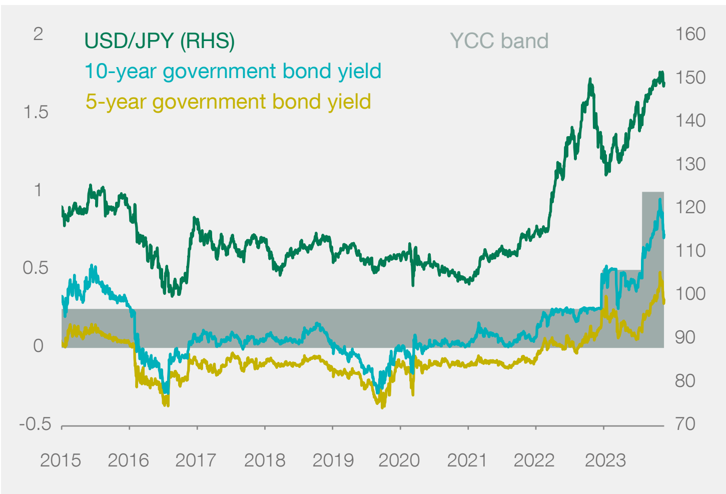
However, uncertainties surrounding domestic sentiment give the BoJ a reason to delay changes to its negative interest rate policy. The decision hinges on next year's "spring wage offensive" (known locally as shuntō). CPI is expected to decline to below the BoJ's 2.0% target, entailing stronger real wage growth in 2024. Regardless of whether or not the BoJ changes its policy, the differential vis-à-vis other developed markets will remain exceptionally large even as financial conditions ease.

Further changes to yield curve control at the Bank of Japan's December meeting remain likely

EMPHASIS ON JAPAN'S THIRD "ARROW"

Former prime minister Shinzo Abe's 2012 "Three Arrows" reforms (or "Abenomics") are behind the improvement in Japanese corporate fundamentals. The weakening yen has helped with profits for large exporters, while the return of animal spirits should support the re-rating, as the Tokyo Stock Exchange continues to forge ahead with corporate governance reforms (the third "Arrow"). As corporate balance sheets approach net cash positions, Japanese corporates should be able to accelerate buybacks.

JAPAN: JGB AND JPY DYNAMICS



Sources: BoJ, Bloomberg Finance L.P. and UBP
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Strategy

An end to Japan's lost decades allows for earnings-growth-focused opportunities in Japan

JAPAN: REALISING BENEFITS OF A DECADE OF RESTRUCTURING AND REFORM

Global equities (ex US) are trading near valuations seen during the 2008/9 global financial crisis, the 2011 eurozone crisis, and the 2020 global pandemic. Some of this can be attributed to the structural economic and geopolitical challenges being faced by Europe and China where challenges remain.

However, while Europe and China are in the relatively early stages of their respective economic restructurings, the benefits of Japan's "Three Arrows" restructuring and reforms begun nearly a decade ago are now being realised.

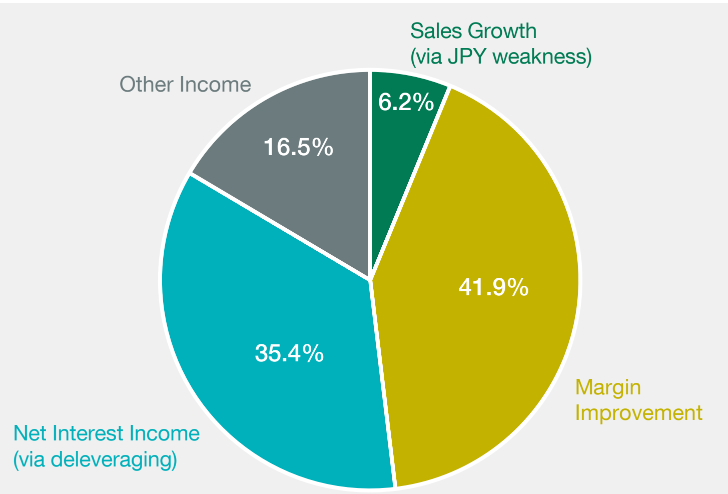
As a result, over the past decade, Japan as an equity market has been transformed from a liquidity-driven one powered by expansion in valuations and subsequent collapses, to one now driven almost exclusively by corporate earnings growth.

Indeed, the MSCI Japan has delivered earnings growth of 10.5% annually since 2012, lagging modestly behind the impressive 11.3% per annum delivered by the US's tech-heavy Nasdaq-100 over the same period.

JAPAN EQUITIES: MULTIFACETED EARNINGS DRIVERS

Though many will cite a weak yen as the key driver for Japan equities' performances, in fact, it has been widening margins and the deleveraging of balance sheets that have accounted for nearly 77% of corporate profit growth over the past decade. The weak yen, we estimate, has accounted for 6–7% of corporate profit growth.

77% OF JAPAN'S CORPORATE PROFIT* GROWTH SINCE 2012 HAS COME FROM MARGIN IMPROVEMENT AND DELEVERAGING



Sources: Japan Ministry of Finance, Bank of Japan and UBP
Corporate profit data excluding financials and insurance.
Past performance is not a guide to current or future results. Any forecast, projection or target, where provided, is indicative only and is not guaranteed in any way.

Looking ahead, with corporate margins near levels not seen the 1960s/early 1970s, further margin expansion may be overly optimistic. However, these wide margins should now generate consistent cash flow to allow the deleveraged balance sheets of Japan's corporate sector to focus on dividends and expanding buybacks to drive shareholder returns.

Admittedly, Japan equities have delivered an impressive 29.6% return in 2023, with earnings growing by nearly 16% and valuations expanding by nearly 9% through end-November. Despite this, performance valuations sit near 10-year averages, meaning investors can lean on non-cyclical earnings, dividend, and buyback drivers to underpin total returns looking ahead.

Asset allocation

Fixed income remains our preferred asset class

INVESTMENT BACKDROP

UBP's investment backdrop for 2024 calls for a resilient macroeconomic environment, associated with declining inflationary pressure and central banks adjusting interest rates from the second half of 2024 onwards.

With inflationary trends currently easing faster than expected, the investment environment remains positive for both fixed income and equities, which justifies our underweighting cash to 0% in UBP's USD-balanced reference portfolio.

Nevertheless, many assets are now pricing in a soft landing, justifying our neutral stance on risks in portfolios. We are favouring asset class diversification over concentration, given our risk-adjusted expected returns for 2024.

We are maintaining positive strategic views on US equities and prefer Japan over Europe

FAVOUR HIGH-QUALITY FIXED INCOME OVER EQUITIES

We favour asset classes that will generate higher risk-adjusted returns, such as high-quality fixed-income and structured products, while maintaining a neutral allocation to equities for the start of 2024.

Given UBP's 2024 macroeconomic outlook, fixed income remains our preferred asset class and we still prefer investment-grade bonds with an intermediate duration (3–5 years).

Our neutral allocation to equities is based on a resilient macroeconomic backdrop associated with disinflationary trends, counterbalanced by the recent rebound which leaves a modest upside for 2024.

We maintain a positive strategic view on US equities and prefer Japan over Europe. Japanese equities should see continued market outperformance on the back of improving corporate governance and the return of a reflationary environment (supportive to earnings).

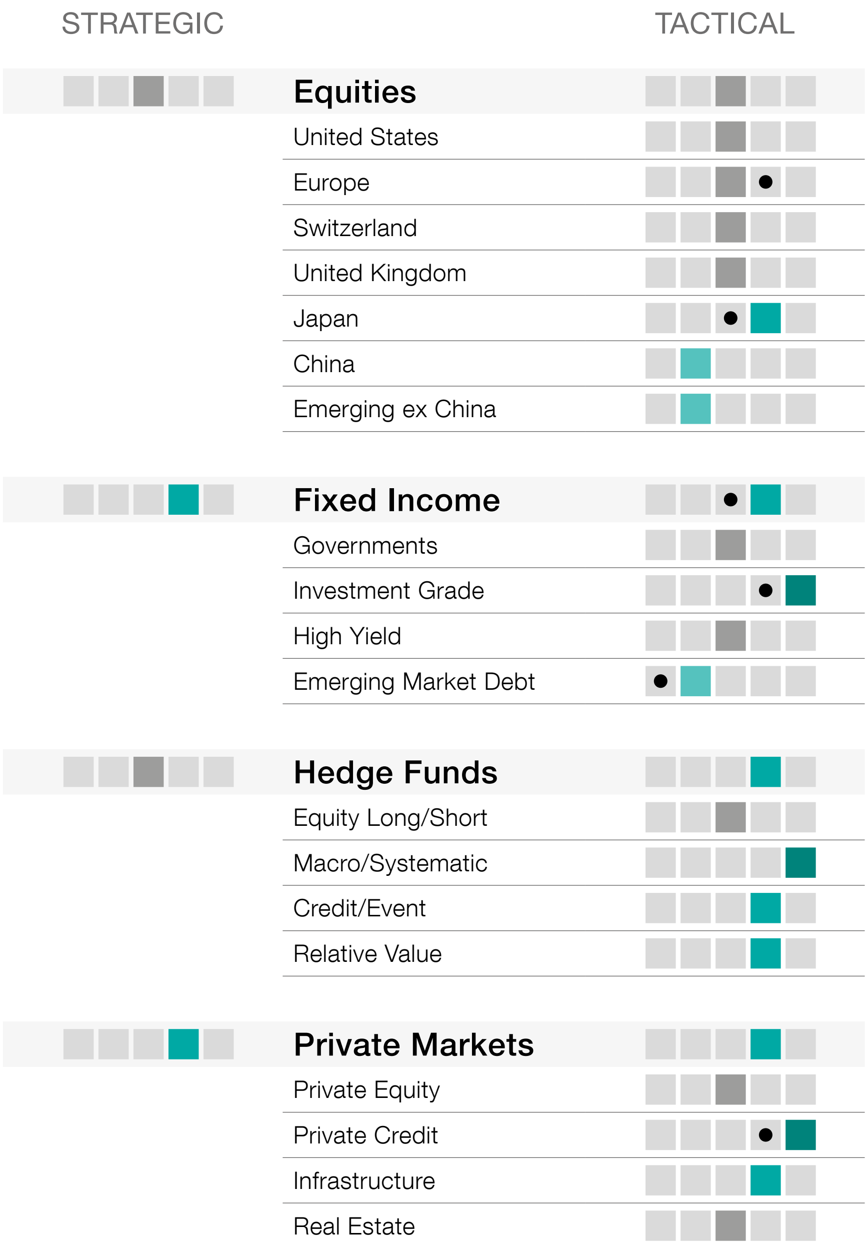
We are maintaining a neutral exposure to hedge funds and gold, as these asset classes have proven to be valuable sources of diversification within portfolios, particularly during periods when both bonds and equities experience declines simultaneously.

Directional views

LOW CONVICTION | BASE LINE ALLOCATION | HIGH CONVICTION

PREVIOUS VIEW ● (no dot means no change)

Strategic (long-term view) and tactical (1–6 month) on broad asset classes, December 2023



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Asset classes

EQUITIES

NEUTRAL VIEW MAINTAINED

Global equities recently welcomed the accelerating disinflationary trends and the declining interest rate environment. This, unfortunately, leaves more muted expected returns for 2024 which strengthens our neutral allocation to the asset class for next year.

On the positive side, the end of the earnings recession in the US has finally occurred, with Q3 earnings up 4% following three consecutive quarters of negative growth. This is encouraging for the earnings picture in 2024 and the 11% (S&P 500) earnings growth expected next year.

US buybacks are in full swing for the end of the year, supporting the current year-end rally. However, we see limited upside on equity valuations following the recent re-rating of the S&P 500 to 19x forward 2024 EPS of USD 240.

We remain overweight US and Japan, while continuing to favour the technology and US software sub-sector as a core allocation in our strategy.

BONDS

INVESTMENT-GRADE BONDS: THE BEST TOTAL AND RISK/REWARD-ADJUSTED RETURNS

Investment-grade bonds have rarely offered such high yields outside of significant periods of stress. As we approach year end, supply is expected to slow down and investors should start rebalancing from money market funds to bonds.

We thus remain concentrated in the belly of the investment grade curve (3–5 years) where we see the best opportunities to outperform in 2024. Any marginal spread-widening will be more than offset by healthy carry and falling rates.

To add yield via higher-beta instruments, we still favour short-term high yield.

CURRENCIES

THE USD APPEARS MODESTLY OVERSOLD

Coming into December, the USD appears to be oversold compared with rate spreads and data momentum, giving scope for a modest rally coming into year end. A EUR/USD downwards move back to levels of around 1.08 is feasible in December, although the stage is set for further, modest USD weakness in 2024 – on a slowing growth and inflation dynamic – which should manifest itself from late Q1 24 onwards.

ALTERNATIVE INVESTMENTS

HIGHER RATES AND VOLATILITY MEAN OPPORTUNITIES

At strategy level, we are maintaining our high conviction on the global macro strategy. After a challenging Q1, 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 in general are facing. Relative value funds were not completely immune to the wild swings in rates in Q1, but those mark-to-market moves were recouped over the following months. The strategy should continue to perform well, as dispersion remains elevated.

PRIVATE MARKETS

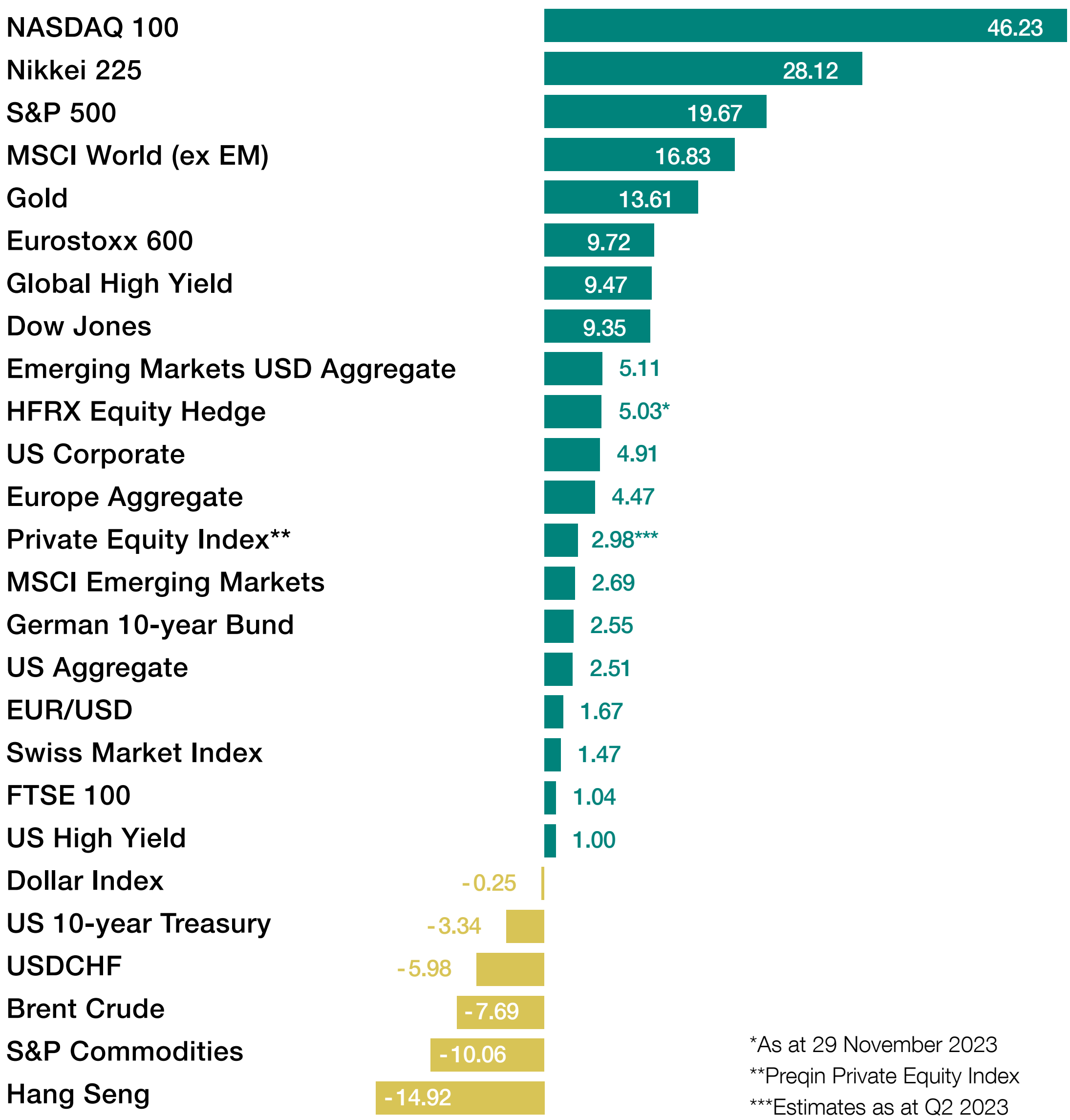
CHALLENGES AND OPPORTUNITIES AHEAD

The redistribution of risk premia has equally impacted private markets. Private equity will have to assess whether or not portfolio companies can service high debt levels, real estate's refinancing operations will become more complex, and direct lending continues to see massive competition compressing margins and lowering covenants.

In this context, our preference continues to be for private equity secondaries given the structural nature of the opportunity; in private debt, we favour non-sponsored structured opportunities on the back of a less competitive landscape.

Market performances

2023 YEAR-TO-DATE RETURNS (%)



*As at 29 November 2023
**Preqin Private Equity Index
***Estimates as at Q2 2023

Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index. Sources: Bloomberg Finance L.P., UBP, and Refinitiv, as at 4 December 2023.
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