21 March 2024
Chief Investment Office GWM
Investment research

The next stage

Our outlook for 2Q

The next stage—Our outlook for 2Q
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The next stage

Equity markets are buoyant. Optimism about the potential for artificial intelligence (AI) to bring about a profit boom has continued to grow. A soft landing for the US economy is now widely expected, and markets have dialed back their expectations for interest rate cuts. And while the geopolitical situation is still uncertain, volatility has stayed low across asset classes. Looking ahead to the second quarter, we see the next stage of two primary market drivers playing out: the start of rate-cutting cycles by major central banks, and the broadening-out of AI adoption and implementation across a wider range of companies.

Against this backdrop, our outlook for the second quarter of 2024 focuses on the topics of technology, income, and risk management.

Technology: Optimize and diversify
The AI revolution is here, and investors cannot afford to be underinvested in the technology sector.

To *optimize tech exposure*, we think investors should have a diverse strategic exposure that strikes a balance between the beneficiaries of tech disruption on one hand and sector leaders, including “Asia’s Super 8,” on the other. At the same time, amid today’s environment of high interest rates and low volatility, investors have the opportunity to use structured solutions to position for further upside while protecting against downside.

Of course, following the extraordinary share price growth of some tech companies, investors need to be mindful of the risk of overconcentration. For investors looking for *opportunities beyond technology*, we see particularly attractive risk-reward in quality stocks (including regional champions in Asia and Europe); companies leading the disruption in energy and healthcare; and small- and mid-cap stocks in the US and Europe. Exposure to these ideas can also be built up through structured investments.

Income: Seek durability
Although the US job market has remained strong and inflation has surprised to the upside this year, we think the Federal Reserve will find sufficient evidence of cooling in both inflation and the labor market to start cutting rates by midyear. We also expect cuts around the same time from the European Central Bank and the Bank of England.

Falling interest rates mean that cash will progressively deliver lower returns, creating a risk for investors who do not proactively *manage liquidity*. We believe investors should build a liquidity strategy beyond cash and money market funds in favor of a combination of fixed-term deposits, bond ladders, and certain structured investment strategies.

We also have a preference for *quality bonds*. Robust economic growth and elevated inflation have kept bond yields high in recent months. However, we expect yields to fall over the balance of the year as growth and inflation moderate and interest rates come down. We therefore think that now is an attractive time to lock in yields, benefit from potential capital gains if yields fall, and diversify portfolios against risks.

Changes in interest rates can also often lead to volatility in currency exchange rates. Still, we believe that major currency pairings will

continue to trade in established ranges as the major central banks cut rates in tandem. This presents an opportunity to *generate income with currencies and commodities*.

Risk management: Get in balance

With broad equity market benchmarks trading close to all-time highs against an uncertain geopolitical backdrop, managing risk within portfolios should be a major goal. This does not mean staying away from markets. While lofty equity valuations can make it tempting to take profits or step to the sidelines, history has shown that staying invested and hedging risks is preferable to selling out or being uninvested.

A key principle is to *get in balance*. Today's strongest market forces—technological change, shifting rate expectations, and geopolitical uncertainty—require us to frame our global outlook in terms of scenarios and not linear paths. In line with this approach, we think only by allocating across asset classes, regions, and sectors can investors fully manage the tension between navigating short-term market dynamics and growing long-term wealth.

This includes *diversifying with alternatives*. Alternative assets including hedge funds, private markets, and infrastructure can help expand sources of return beyond stocks and bonds while smoothing out portfolio returns. We currently like strategies that offer unique return opportunities (credit hedge funds), provide access to fast-growing companies (private equity), and align with powerful long-term trends like digitalization and decarbonization (private infrastructure and thematic private equity funds).

A historic year for markets

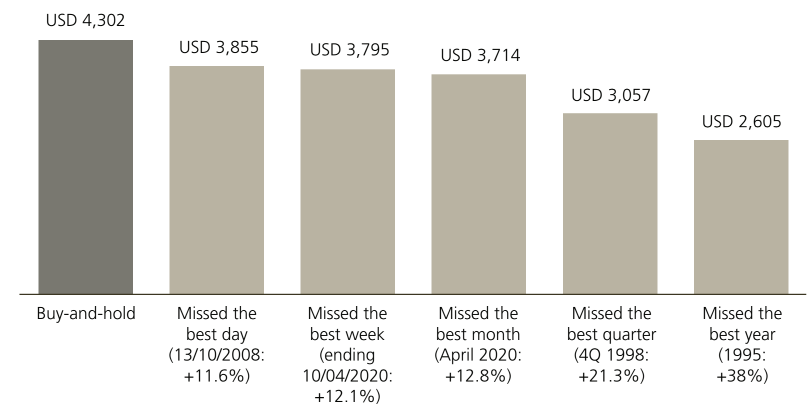
2024 looks set to be a historic year for financial markets as it is poised to deliver major technological developments, a turn in the interest rate cycle, and a contentious election in the world's largest economy.

Amid the short-term noise, investors need to stay grounded in core principles: developing and implementing a long-term plan; diversifying across asset classes, regions, and securities; and remembering that time in the market—not timing the market—is what history has shown to deliver the most powerful results.

Figure 1

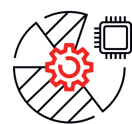
Trying to time the market has a cost

Growth of USD 100 invested in the S&P 500 (total return) in April 1988, buy-and-hold strategy vs. missing gains as a result of exiting the market.



Source: Bloomberg, UBS, as of March 2024

Glacial rivers (Iceland) / Shutterstock



Optimize technology exposure

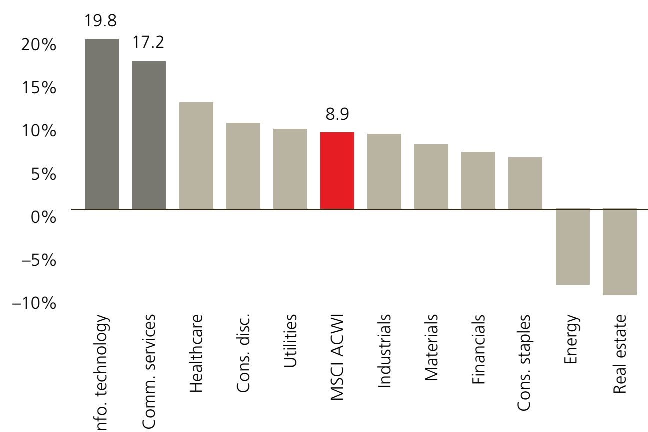
The AI revolution is here. Investors can't afford to be underinvested, and optimizing exposure to technology is key. We think this involves a diverse strategic exposure to the sector, balancing a focus between the beneficiaries of tech disruption and sector leaders including "Asia's Super 8." The current environment of high interest rates and low volatility also presents an opportunity to use structured solutions to position for further upside while protecting against downside.

Global technology. The technology sector has led equity markets higher so far in 2024, rallying 12% as of the 20 March close based on the MSCI ACWI IT index. The sector's forward price-to-earnings (P/E) ratio sits at 26.8x, a roughly 37% premium to the 10-year average (19.5x). But we expect technology earnings to grow 18% this year, higher than any other sector, partly on the back of our forecast of an extraordinary 72% annual growth in AI demand over the next five years (or a fifteenfold cumulative increase). While valuations are elevated, investors need to be aware that the rising excitement over AI and its implications could lead to a "fireworks" scenario in which future gains are "frontloaded" or priced during the early part of the forecast horizon. As a result, we recommend diversified exposure to tech.

Figure 2

Tech sector earnings expected to outpace other sectors

Consensus estimates for 2024 earnings growh for MSCI ACWI, by sector, y/y



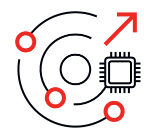
Source: Refinitiv, UBS, as of March 2024

Tech disruption. In our view, the largest technology companies are well positioned to capture significant value from tech disruption given their dominance across the AI value chain, deep pockets to invest, access to monetizable data, and ability to attract talent. But the second-round effects of AI should also benefit a broader range of industry players. On the whole, we like AI infrastructure companies with strong pricing power and competitive positioning, as well as platform and application providers that are well placed for AI-related use cases.

"Asia's Super 8." While the "Magnificent 7" in the US have generated the most headlines, we also see significant potential in a group of technology companies in Asia—which we call the "Super 8"—that look set to ride the global surge in demand for AI infrastructure, semiconductors, and software. These companies have dominant market positioning and strong pricing power, which should result in solid growth in both sales and earnings. Consensus estimates for "Asia's Super 8" are an average sales growth of 13% over the next two years, and an average earnings growth of 36% this year and 29% next year (compared to around 20% for the Magnificent 7 over each period).

Capture upside and protect against downside on tech stocks. The year-to-date rally in technology stocks has left some investors weighing between profiting from the gains and keeping exposure for further potential upside. Meanwhile, those who have missed the rally may feel both a tinge of regret and trepidation about adding exposure after such a strong run. For these investors, certain structured strategies can provide a potential solution: The current high rate and low volatility environment is favorable for the pricing of strategies that are structured to give exposure to further upside in tech stocks while reducing sensitivity to a correction.

White quartz Olga Thelavart / Unsplash



Opportunities beyond technology

While we hold a constructive view on technology, investors need to be mindful of concentration risks and overexposure. For those diversifying beyond technology, we see opportunities in quality companies (including regional champions in Europe and Asia); the energy transition, healthcare disruption, and water scarcity; and small- and mid-cap stocks. Exposure to these ideas can also be built up through structured investments.

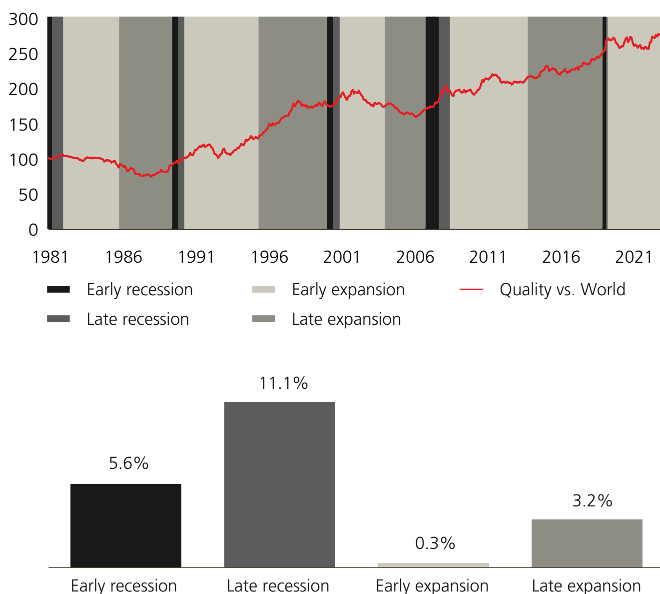
Quality stocks, including regional champions. We believe that focusing on quality companies—those with strong balance sheets, high profitability, and resilient earnings streams—will continue to reward investors in the months ahead. The MSCI World Quality index has rallied 11% year-to-date compared with 8% for the overall MSCI World Index. While many technology companies meet the "quality" criteria, we can also find many that operate outside the technology sphere as the market rally broadens out.

In Europe, for example, a group of highly profitable and innovative companies that are also global leaders in their respective industries make up what we call "Europe's Magnificent 7." With an earnings growth potential of 14% per annum over the next two years, based on consensus, these companies—representing the consumer discretionary, consumer staples, healthcare, industrial, and technology sectors—have similar earnings growth prospects to the Magnificent 7 in the US. And while they are trading at a premium to MSCI Europe, we think this is justified by their superior and sustainable earnings growth profile, strong free cash flow generation, and lower volatility.

Figure 3

Quality can outperform across the cycles

Relative performance MSCI World Quality vs MSCI World (above), relative performance across cycles, annualized (below)



Source: Bloomberg, UBS, as of March 2024

In Asia, we like 10 heavyweight stocks that are driven by strong industry leadership. We expect them to deliver annual earnings growth of 10.3% over the next three years compared with 6.5% for the broader MSCI Asia ex-Japan index.

Energy transition, healthcare disruption, and water scarcity. Investors looking to diversify beyond technology can also gain exposure to other major structural growth themes:

- The global energy transition is driving a new wave of private investments underpinned by stimulus programs in some of the world's largest economies. Our "Greentech goes global" selection highlights companies that we believe should play a key role in this transition, including those engaged in green energy, infrastructure, manufacturing, and mobility. In 2023, the world’s renewable energy capacity saw a record increase of nearly 50%, to 507 gigawatts, based on estimates by the International Energy Agency (IEA). And with the rise of AI adding to electricity demand—AI data centers in the US require up to eight times more electricity than traditional ones, for example—the need for more energy production is an opportunity for the renewables sector to innovate, scale up, and invest in infrastructure.
- In healthcare, companies that can innovate in terms of new drugs, treatments, and delivery methods have an edge in capturing growth by addressing unmet medical needs and improving patient outcomes. Beyond obesity treatment, which has been the subject of much attention, promising developments are underway for the treatment of Alzheimer's, RSV, and influenza. In addition, increased connectivity and computing power are a boost to robotics and miniaturization in the medtech industry, while biopharma is exploring AI-driven methods to enhance drug discovery, diagnostics, and personalized medicine, including in fields like cancer care. Currently, we have a tactical positive view on US healthcare, with a particular preference for the medical equipment and supplies industry; the life sciences tools and services industry (both thanks to strong end-market growth and minimal policy risk); and the managed care sector (where pricing power and lower input costs support profit margins and upgrades to earnings forecasts).
- Investing around water scarcity and the blue economy offers the potential for long-term returns as the world confronts this pressing issue: By 2030, global water demand is expected to exceed supply by 40%, driven by population growth and urbanization, and an estimated

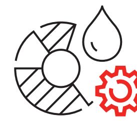
USD 22 trillion in water infrastructure investment is needed by 2050 to address scarcity. Some companies are rising to the challenge and are poised for growth as a result; we especially like those developing water efficiency and treatment technologies. More broadly, we see an investment opportunity in the blue economy, which focuses on sustainably harnessing and healing the world's oceans. The OECD expects the blue economy to reach USD 3 trillion in value by 2030, double its size in 2010. The transition gives rise to thematic investment ideas ranging from plastics recycling, water and waste management, and sustainable aquaculture. We expect these markets to grow in mid-single-digit rates in the coming years.

Small- and mid-cap stocks (US and Europe, ESG engagement). Not to be outdone are US small-cap stocks and select European small- and mid-cap stocks. In the US, we like Russell 2000 companies that have discounted valuations and could benefit from potential catalysts such as interest rate cuts, increased M&A, and strong earnings growth. While 28% of the US small-cap index is not profitable, many are in high-growth sectors like healthcare and technology, and most have sufficient cash to remain operational for years to come.

Smaller European companies (MSCI EMU SMID) have underperformed their larger peers in the past two years but are now trading at appealing price-to-earnings valuations, currently at a 2% discount to the benchmark index compared to an 8% premium over the long run. An improving economic environment, potential interest rate cuts, and promising earnings growth could act as catalysts for better performance.

We also see compelling potential to position for longer-term sustainability development in small- and mid-cap firms. This can be achieved, first, via ESG engagement equities, where fund managers aim to drive sustainability-related improvements that impact costs, revenues, and operational efficiency. Second is via ESG thematic equity allocations in longer-term investment themes where select small- and mid-cap firms may offer exposure to multiyear growth prospects as the world seeks to transition toward more nature-aligned and equitable economic systems.

Defensive structured investments (yield-generating and capital preservation strategies). For those investors looking to add more cautious exposure to markets, we recommend seeking defensive structured investment strategies. For example, for those looking to potentially buy on dips and get a stable cash flow while waiting, select stocks with higher implied volatility could be suitable for yield-generating structured investments. Another option to invest in a more defensive way is by using the currently high rate environment to switch from direct exposure into capital preservation structured strategies.



Manage liquidity

We expect interest rates to fall in 2024. This means cash will progressively deliver lower returns, creating a risk for investors who do not proactively manage cash holdings. We believe investors should build a liquidity strategy beyond cash and money market funds, in favor of a combination of fixed-term deposits, bond ladders, and structured investment strategies to cover expected portfolio withdrawals over the next five years.

Fixed-term deposits. We think interest rates on cash will begin to fall in major economies in the second quarter. We expect the Federal Reserve to begin cutting interest rates in June, as US inflation continues to moderate and economic activity slows in a way consistent with a soft landing. We also expect June to mark the start of the Eurozone rate-cutting cycle. The Swiss National Bank surprised with a March cut, while the Bank of England may potentially delay its first cut until August given more persistent price pressures.

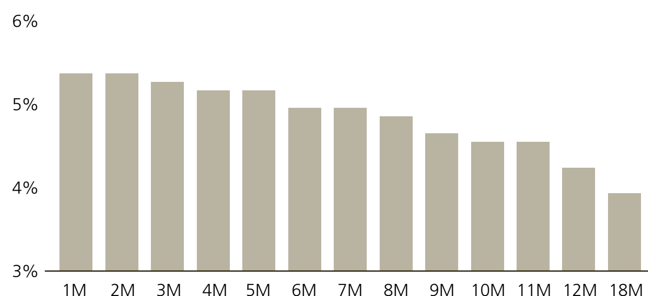
With this in mind, we believe investors should consider using fixed-term deposits to lock in currently high yields on cash and money market deposits for potential expenses and liabilities up to 12 months out. Investing in fixed-term deposits of different maturities can also help match liabilities and reduce interest rate and reinvestment risks. Investors concerned about issuer and counterparty risks can diversify their deposits.

Shattered sheet of ice Hans Isaacson / Unplash

Figure 4

Cash looks set to deliver progressively lower returns

Cash rate (USD) expectations x months from now, based on forwards, in %



Source: Bloomberg, UBS, as of March 2024

Bond ladders. To cover net expected portfolio withdrawals over the next one to three years, investors can consider buying a series of individual short-duration bonds of varying maturities, staggering their expiry to provide a steady stream of income. We see the reinvestment risk from holding cash as greater than the potential gains from waiting for better bond prices, and therefore recommend investors act soon to lock in currently attractive bond yields. Investors can also consider more actively managed bond investment approaches that have the flexibility to invest in a diversified, risk-controlled manner.

Structured strategies with capital preservation features. For cash intended for use in three to five years' time, liquidity and safety concerns need to be balanced with the opportunity costs from potential stock market rallies. Structured investment strategies, which allow investors to take part in market gains but with capital preservation features, can provide a potential solution. Pricing for such strategies are currently favorable. The approach combines a zero-coupon bond with a call option, and higher interest rates make the bond element cheaper while below-average equity volatility reduces the price of call options.

Investors should note that changes in interest rates, implied volatility, and dividend levels can also influence the pricing of structured strategies. Investors should be aware of the added risks they bear when using structured strategies or other options-based strategies, including the possibility that the issuer does not meet its obligations or repay an investor's principal at maturity.

Where next for US interest rates?

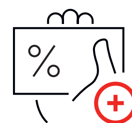
The federal funds futures market is now pricing three Fed rate cuts in 2024, starting at the June meeting. We think this is realistic.

US job growth has remained strong and inflation has surprised to the upside so far this year. But the latest jobs data have also shown signs that the labor market is cooling enough to keep hopes of rate cuts alive. The unemployment rate rose to 3.9% in February, the highest in two years, and average hourly earnings grew at a slower pace. Fed Chair Jerome Powell also stressed that policymakers are "not far" from having sufficient confidence to cut rates.

We think the US central bank will see sufficient evidence of cooling in both inflation and the labor market to start cutting interest rates by its June meeting.

The next question is how far rates will fall. At the time of writing, markets are implying a trough around 3.5% by the end of the rate cut cycle. This is close to our estimate of the neutral rate, though we would expect a (potentially much) lower terminal rate if US economic growth slows below trend.

A scenario in which interest rates stay higher for longer could arise if the US economy enters a period akin to the "Roaring 20s". Given the accelerating adoption of AI and the push toward green energy, a repeat of this episode is possible. However, even in this scenario, we would expect the neutral rate to be below the current level of interest rates.



Buy quality bonds

We keep a preference for quality bonds. Robust economic growth and elevated inflation have kept bond yields high in recent months. But we expect yields to fall over the balance of the year as growth and inflation moderate. That makes now an attractive time to lock in yields, benefit from potential capital gains if yields fall, and diversify portfolios against risks. Beyond individual bonds, active and diversified bond exposure can provide investors with a convenient way to realize the full return potential of the asset class while managing credit and concentration risks.

High grade (government) and investment grade bonds. High-quality bonds are still a preferred asset class. Yields are still close to decade-highs, and we expect falling inflation to allow major central banks to cut rates three to four times later this year and lead government bond yields to fall from current levels.

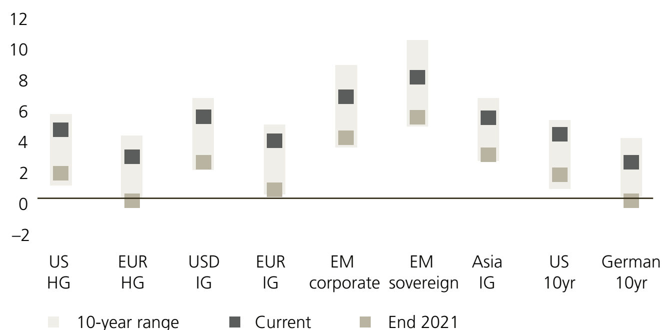
However, tight spreads on investment grade (IG) corporate bonds call for a selective approach to the asset class: US IG spreads based on ICE BofA data at the end of February stood at just the 8th percentile when measured since the beginning of 2010. Our focus is on bonds of quality issuers with maturities in the 1–10-year bracket, as we believe this middle part of the yield curve offers the best combination of high yields, stability, and sensitivity to falling interest rate expectations. For US municipal bonds, our preferred duration is around five years.

Labradorite Terriell Scrimager / Unplash

Figure 5

Yields still attractive

10-year range (grey columns) vs. current yields and their end-of-2021 low, in %

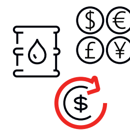


Source: Bloomberg, UBS, as of March 2024

Sustainable bonds. Sustainable fixed income offers an appealing alternative to high-quality bonds. These include bonds issued by supranational agencies and governments, and IG bonds from corporate issuers with mid-to-high credit ratings. We expect a diversified exposure to sustainable bonds to generate returns comparable to a mix of government and IG corporate bonds, while also contributing to positive sustainability goals.

Active and diversified bond exposure. Beyond individual bonds, investors could also consider exposure to actively managed fixed income strategies to improve diversification, gain the convenience of automatic reinvestment, and take advantage of the breadth of opportunity in the asset class.

Active approaches may offer higher potential yields thanks to risk-controlled exposure to higher-yielding parts of the fixed income market (such as US high yield, emerging market debt, and securitized credit), which may be harder for individual investors to access or manage. Actively managed funds may also be able to use derivatives to manage rate and credit risks in ways investors could not on their own. Investors may also be able to use well-diversified fixed income portfolios as collateral for borrowing.



Generate income with currencies and commodities

We believe that major currency pairings are likely to continue to trade in established ranges as most major central banks are set to cut interest rates in tandem. This presents an opportunity for investors to generate added portfolio income by trading the range in currencies, as well as in select commodities.

Sell volatility in key currency pairings. We see opportunities for investors to earn added income by "trading the range" in the US dollar, the euro, the British pound, and the Chinese yuan. Over the next quarter, the USD is likely to remain caught between stronger US growth and imminent Fed rate cuts. But we see scope for the USD to peak in the second quarter and gradually depreciate thereafter as US activity softens and the Fed starts cutting rates. For EUR-based investors, we would use bouts of weakness to sell downside risks in the EURUSD exchange rate, or to position for a reversal later in the year.

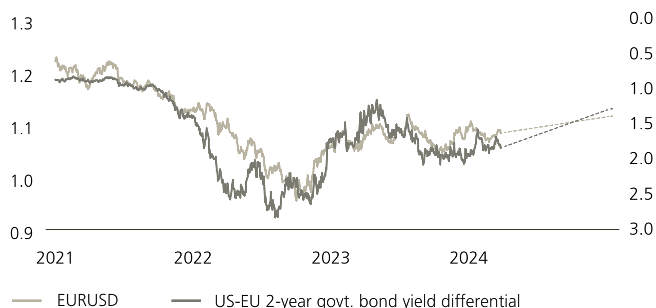
Look for gains in the Australian dollar and Japanese yen. The AUD is among our preferred currencies given our expectation that the Reserve Bank of Australia will be one of the last major central banks to cut interest rates. We expect a floor in the AUDUSD exchange rate around the 0.64–0.65 level, while relative rate differentials support our forecast of a rate of 0.72 by the first quarter of next year.

Salt Lakes (Bolivia) / Shutterstock

Figure 6

Major currencies likely to trade in ranges as central banks cut rates in tandem

EURUSD (lhs) vs. US-EU 2-year govt. bond yield differential, % (inverted, rhs), including CIO end-2024 forecast



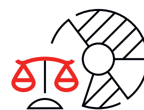
Source: Bloomberg, UBS, as of March 2024

We also see opportunity in the JPY. Interest rate differentials don't appear to justify its current weakness, especially given that the Bank of Japan has now ended its negative interest rate policy. We favor selling JPY depreciation risks in exchange for yield, adding JPY long positions against other Asian currencies, or buying JPY to take advantage of some of our preferred areas within Japanese equities, including banks and real estate.

Sell the risk of falling prices for Brent crude oil. We also like strategies that take advantage of the trading ranges within commodities, and see opportunities in crude oil in particular. While oil prices have remained volatile, we think that resilient oil demand and lower supply from OPEC+ countries will lead to continued undersupply, and therefore expect Brent crude oil to trade in a range of USD 80–90/bbl for the quarter and year as a whole. To implement this view, investors with a higher risk tolerance can consider either selling the risk of falling Brent prices or adding exposure to longer-dated Brent oil contracts.

Hedge geopolitical risk with gold. Uncertainties around geopolitical events are likely to become increasingly prominent in investors' minds as 2024 evolves. These include heightened US-China tensions as the US presidential race intensifies, as well as potential consequences for commodity markets and supply chains from the wars between Russia and Ukraine, and Israel and Hamas.

We continue to see value in gold as a hedge against geopolitical risks. We expect gold to trend higher to USD 2,250/oz by year-end but recommend taking an income generation approach given the metal's strong recent rally, and would wait for price setbacks to gain outright exposure.



Get in balance

Investors today are grappling with a complex financial environment. Some worry that the stock market has reached its peak, leading them to hold too much cash. Others may be overly focused on specific sectors, risking too much concentration in their portfolios. Against this backdrop, getting in balance is a key principle. We believe that only by diversifying across asset classes, regions, and sectors can investors effectively manage the tension between navigating short-term market dynamics and growing long-term wealth.

Being invested for the long term. Most investors know that being invested can lead to wealth creation over the long term. Yet history has shown that being invested and hedging risks is by far preferable to selling out or staying uninvested. Data since January 1960 shows that a USD 100 investment in US stocks would have grown to USD 55,093 by February 2024. Adjusted for inflation, this represents a 52-fold increase in purchasing power, or an annual real return of 6.3% since then.

Systematic strategies can help manage risks. Managing risk over shorter-term periods can be more challenging, however. For example, after the 1929 crash, it took US stocks 15.5 years to recover. To balance long-term returns and short-term risk management, spreading investments across different countries and asset classes is key. Systematic allocation strategies can provide an additional risk management element, by significantly adjusting the equity allocation in response to changing economic and market trends.

Baltic Sea / Shutterstock

Diversification reduces risks. The UBS Global Investment Returns Yearbook, which analyzes financial markets going back to 1900, shows that a portfolio diversified across 21 countries would have experienced 40% less volatility than an average single-country investment. Similarly, a portfolio with a 60/40 split between stocks and bonds has historically been less volatile than one composed solely of stocks. Indeed, a 60/40 portfolio has only delivered a negative return over a five-year horizon on 5% of occasions, and never over a 10-year horizon (compared with 12% and 5% of the time for equity-only portfolios).

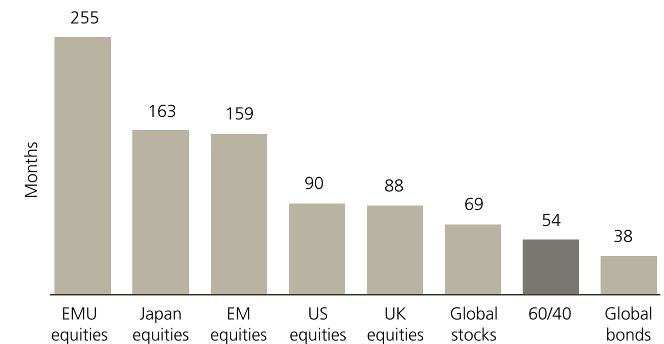
Diversification helps catch the winners. It is also important to remember that diversification is as much about not missing the right stocks as it is about avoiding overexposure to the wrong ones. Over the past year, well-diversified investors have almost certainly benefited from the strong rally in AI stocks. Those with home-biased or concentrated portfolios may have missed out. Diversification is the only way investors can make sure they do not miss the winners. This is particularly important in an era of change.

As financial markets process major technological developments, a turn in the interest rate cycle, and an election in the US, investors need to stay grounded in long-term principles: developing and implementing a long-term plan; diversifying across asset classes, regions, and securities; and remembering that time in the market—not timing the market—is what ultimately delivers the most powerful results.

Figure 7

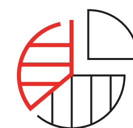
A balanced portfolio can reduce risk during market downturns

Maximum time under water in months, for different asset classes



Note: 60/40 portfolio (MSCI ACWI local currencies/Bloomberg Global Aggregate, MSCI indexes for equity markets), in months. Data since 1995.
Source: Bloomberg, UBS, as of March 2024

Quartz crystal / Shutterstock



Diversify with alternatives

Alternative assets should be a key component of long-term portfolios, in our view. They can help diversify return sources and smooth portfolio returns. We currently see opportunities in strategies that offer unique return sources (credit hedge funds), provide access to fast-growing companies (private equity), and align with powerful long-term trends like digitalization and decarbonization (private infrastructure and thematic private equity funds).

Infrastructure

Infrastructure is a key element of the alternative investment universe. Many of the trends highlighted in our *Decade Ahead*—including deglobalization, digitalization, decarbonization, and high government debt burdens—will need increased private investment in infrastructure. For example, we currently see significant focus on areas such as data centers to support digitalization and AI developments, as well as green energy.

For investors, the consistent inflation-linked cash flows provided by private infrastructure assets may appeal to both those seeking income and capital gains with long time horizons. At the same time, infrastructure assets can help diversify portfolios. Between 2005 and 2022, they had correlations of between –0.2 and 0.6 to other investments, according to Cambridge Infrastructure Index data.

Hedge funds

Credit hedge funds. Specialist credit hedge funds, which aim to take advantage of the differences in creditworthiness and spreads between various borrowers, rallied around 11% last year. This represented the strategy's strongest performance since 2019. We see continued scope for this strategy to enhance portfolio returns in 2024 given spread dispersion: The difference between the strongest and weakest CCC borrowers remains elevated, in the 66th percentile over the past 25 years' data.

Equity long-short with low net exposure is another preferred strategy. Equity long/short strategies have historically delivered excess returns over the S&P 500 (alpha) of 5.2% a year in periods where correlation between stocks is low and dispersion of stock returns is high. And today, the three-month implied correlation for the S&P 500 stands at the lowest level in 18 years, while dispersion in returns has only been higher 20% of the time in the last five years.

We also like *macro hedge funds*, which should be well positioned to capitalize on a turn in the interest rate cycle and help investors navigate geopolitical shifts. Meanwhile, multi-strategy funds that can shift investments between different trading strategies to manage risk and seek returns across various scenarios can help investors build alternatives exposure, given lower minimum investment requirements.

Investors should note that hedge funds can carry unique risks, including reduced liquidity, higher fees, and added complexity.

Private equity and credit

Value-oriented buyout. We like strategies where managers identify appealing middle-market companies, buy them, and use their skills to add operational value. Buying middle-market companies requires less borrowing, and, according to Pitchbook, buyout valuations have fallen. The median North American and European EV/EBITDA has declined more than 12% on a 12-month-trailing basis.

Secondaries. We also like strategies that buy private equity assets in secondary markets. They allow investors to build positions in existing assets quickly, and prices remain discounted. Discounts to net asset value were 15% on average at the end of 2023. We expect volumes to build on last year's USD 112 billion (the highest since 2021), with greater diversity of assets coming to market.

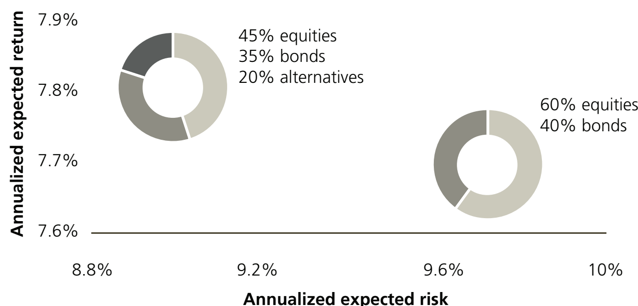
Thematic equity. This strategy also represents an opportunity for investors who want to capture long-term growth in their portfolio, particularly those exposed to long-term trends like digitalization, headlthcare, sustainability, and the energy transition. We expect private equity managers to use their long-term investment horizons and active ownership to deliver 10–12% annual returns throughout the market cycle.

Private credit. We continue to see a place for private credit and direct lending strategies in portfolios as a strategic source of income, diversifier of returns, and potential improver of risk-return characteristics.

Figure 8

Alternatives can enhance returns and help manage risks in a portfolio

CIO's expected average risk and return of a 60/40 portfolio vs. a portfolio with 45% equities, 35% bonds, and 20% alternatives



Source: UBS, as of March 2024

While we are closely watching for signs of both issuer-specific and macroprudential stress in this fast-growing asset class, we believe that experienced private credit investors in well-diversified funds are likely to be fairly compensated for the risks inherent in the asset class.

We also see signs of growing prudence among private credit managers. Newly originated private loan data from JPMorgan shows that the median net leverage for transactions closed in January was at 4.5 times, compared to a median leverage of 4.9 times for all of 2023. Sponsors are putting in more equity in leveraged buyout transactions than at any time since 1997. And loan documents indicate that borrowing terms have become stricter, in what should be a further comfort for investors.

Investors should understand the risks inherent to private markets. These include illiquidity, long lockup periods, leverage, concentration risks, and limited control and transparency of underlying holdings. Allocations to private markets should form part of a well-diversified portfolio and be regularly reviewed as personal and market circumstances evolve.

Don't rush to judgement on the US election

While the outcome of the US presidential election could have a potentially significant effect on public policy, economics, and markets, it is important for investors to avoid making major portfolio shifts based on political views or biases. History shows that picking winning investments based on US elections is not straightforward—and should not be attempted too far ahead of the tally.

Don't get too caught up on national opinion polls—especially earlier in the race. The presidential election takes place in November, but political pundits and investors often start making predictions as early as spring. History suggests this is a mistake. Candidates who lead in the polls in March, April, and May—or even into the summer—don't necessarily win the race. In fact, candidates with an early advantage failed to take the keys to the White House in 1980, 1988, and 1992.

Congress matters, too. American presidents have a large sway over foreign policy and trade. But on domestic issues, they are constrained by acts of Congress. As a result, major economic or social legislation tends to occur only when one party secures control of the White House along with both chambers of Congress, i.e., the House of Representatives and the Senate. This sweep of power allowed the Republicans to pass major tax legislation following their 2016 win. And Democrats approved three landmark pieces of legislation shortly after taking unified control of the government in 2020.

As a result, we could see a larger impact on policy economics and markets if either party captured both the White House and Congress.

America's political parties have more in common than they admit. In the upcoming campaign, we see the most consequential divergence being on regulatory oversight for businesses, an area where presidents have considerable discretion. We would expect stricter antitrust measures and regulatory oversight in the event of a Biden victory, with a particular focus on energy, financials, and healthcare. If Republicans enjoy a clean sweep of power, we could also see the permanent extension of tax cuts introduced in the first Trump term.

However, while there are significant differences between the policies of the two parties, this gulf can be exaggerated. For example, investors expecting President Joe Biden to clamp down on oil drilling have been surprised: Under his presidency, US oil output climbed to record levels, green energy stocks lagged, and oil drillers outperformed by a wide margin. Meanwhile, top defense stocks trailed the market following the election of Donald Trump in 2016.

Our bottom line is that investors can consider adjusting specific security holdings in their portfolios to reflect risks or opportunities presented by the election, but only when there is a clearer reading on the outcome. Broader and more long-term portfolio decisions should remain apolitical. A strong preference for one party or another—while emotionally compelling—can skew the judgement of an investor, leading them to be optimistic or pessimistic at exactly the wrong time.

Global forecasts

Economy

Real GDP y/y, in %

	2023E	2024E	2025E
US	2.5	2.2	1.4
Canada	1.1	0.2	1.3
Japan	1.9	0.5	1.2
Eurozone	0.5	0.6	1.2
UK	0.1	0.2	1.5
Switzerland	0.8	1.3	1.5
Australia	2.1	1.5	2.1
China	5.2	4.6	4.6
India	7.6	7.0	6.8
EM	4.5	4.1	4.4
World	3.3	3.0	3.1

Source: Bloomberg, UBS, as of 21 March 2024, updated bimonthly.

Inflation (average CPI), y/y, in %

	2023E	2024E	2025E
US	4.1	3.1	2.4
Canada	3.9	2.5	2.1
Japan	3.3	2.2	1.8
Eurozone	5.4	2.4	2.1
UK	7.3	2.3	2.0
Switzerland	2.1	1.4	1.2
Australia	5.6	3.3	3.1
China	0.2	0.8	1.6
India	5.1	4.5	4.5
EM	7.4	8.3	5.1
World	6.1	5.8	3.8

Source: Bloomberg, UBS, as of 21 March 2024, updated bimonthly.

Asset classes

	Spot	Dec-24
Equities		
S&P 500	5,225	5,200
Eurostoxx 50	5,000	4,900
FTSE 100	7,737	7,780
SMI	11,619	11,640
MSCI Asia ex-Japan	648	685
MSCI China	55	58
Topix	2,751	2,770
MSCI EM	1,032	1,100
MSCI AC World	940	940
Currencies		
EURUSD	1.09	1.12
GBPUSD	1.28	1.30
USDCHF	0.89	0.87
USDCAD	1.35	1.31
AUDUSD	0.66	0.71
EURCHF	0.97	0.97
NZDUSD	0.61	0.62
USDJPY	151	140
USDCNY	7.20	7.15

Source: Bloomberg, UBS, as of 21 March 2024, updated bimonthly.

	Spot	Dec-24
2-year yields		
USD 2y Treas.	4.60	3.25
EUR 2y Bund	2.92	2.00
GBP 2y Gilts	4.22	3.50
Swiss 2y Eidg.	0.97	0.70
JPY 2y JGB	0.18	0.25
10-year yields		
USD 10y Treas.	4.27	3.50
EUR 10y Bund.	2.43	2.25
GBP 10y Gilts	4.01	3.50
Swiss 10y Eidg.	0.71	0.70
JPY 10y JGB	0.73	0.80
Commodities		
Brent crude, USD/bbl	86	82
Gold, USD/oz	2,161	2,250

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.

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

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

Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, "junk bonds," derivatives, distressed securities, non-US securities and illiquid investments.

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

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

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

Foreign Exchange/Currency Risk: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in 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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