Hedging ideas for UBS House View scenarios

Global risk radar

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- Uncertainty around the economic outlook and heightened geopolitical risks leave the door open for a variety of market outcomes in 2024. This report provides ideas for investors who wish to help protect their portfolios against more than one scenario.
- In our main upside case, equities outperform bonds but both deliver positive returns. In our main downside scenario, safe bonds outperform due to a hard landing of the US economy.
- Our hedging ideas for the upside scenario include small-caps, cyclical growth stocks, and Topix call spreads. Our ideas for the downside include long-duration government bonds, gold, and conditional put options on the S&P 500. We also briefly discuss hedging strategies for geopolitical risks.

Source: Getty

Since late 2023, financial markets have been driven by investors' rising conviction that the Federal Reserve will cut rates aggressively over 2024 while avoiding a hard landing of the economy.

Indeed, we expect the US economy to achieve a "soft landing" this year. Growth is likely to slow but only slightly below trend growth over the next 12 months. And consumer price inflation should move closer to the Fed's target by 2H24. This backdrop should support modest further upside for US and global equities, while falling yields should bolster bond markets. Within equities, we see quality stocks as a key holding for investors and hold a most preferred stance on the US tech sector. We also like US small-caps as a complementary tactical position to capture upside in both our base case and upside scenario.

While we see a soft landing as the most likely scenario for 2024, other outcomes are also possible. Elections, geopolitical tensions, further advances in AI, and unforeseen pivots in monetary policy could all push markets sharply in either direction. In the following sections, we describe our main upside and downside scenarios for 2024, their likely market impact, and the investment ideas we think are best to navigate them.

Top hedging ideas

Upside scenario:

- Prefer small-caps and cyclical growth sectors
- Upside exposure to US IT with full or partial downside protection
- Build exposure to Japanese equities with Topix call spreads
- Emerging market equities

Downside scenario:

- Buy long-term safe government bonds
- Prefer the Japanese yen over the US dollar and other currencies
- Protect equities with S&P 500 hybrid put options
- Buy gold combined with an option collar structure
- Hedges against geopolitical risks (see box)

CIO scenarios

In our **main upside scenario,** economic growth in the US remains at or above trend while inflation declines ahead of the Fed's expectations. Central banks—most prominently the Fed—cut policy rates more than in our base case. This results in a Goldilocks scenario in which equities outperform bonds, though both asset classes generate positive returns.

The notable **downside scenario** is a hard landing of the US economy—i.e., a recession—due to the delayed effects of monetary tightening or exogenous shocks such as geopolitical tail risks. The Fed and other central banks would cut rates more aggressively than markets currently expect, but risk assets such as equities would still face significant headwinds. Safe-haven assets—such as high grade bonds, gold, the Swiss franc, the US dollar, and the Japanese yen—should help provide some protection.

Related Reports

- UBS House View Monthly Extended, 18 January 2024
- Year Ahead scenario update, 5 January 2024
- Derivatives strategy: "A guide to portfolio hedging," 7 October 2020
- Derivatives strategy: "Downside protection with options," 27 January 2021

US macro tracking

The Consumer Price Index (CPI) came in slightly above expectations in December with a 3.3% y/y increase. Core inflation (CPI excluding food and energy) fell to 3.9% y/y. Core PCE inflation—the Fed's indicator of choice—has moderated over the past months but remains firmly above the Fed's target of 2%. Strong increases in rents and wages remain a big driving force behind the high inflation figures. Both components need to ease before inflation can fall sustainably back to the target range, in our view.

US economic growth indicators remained mixed in December. Most stabilized or improved month-on-month, but remained weaker than three months prior. Continued strength in consumer confidence and housing starts were the notable exceptions. The ISM composite Purchasing Managers' Index (PMI) fell to 50.3 in December, just above the 50 threshold that separates expansion from contraction.

Table 1 - US Growth Indicators

Indicator	Value	Reference Date	Units	Delta (t vs t-1)	Delta (t vs t-3)
Consumer spending y/y	5.4%	11/2023	percent	●	✗
Consumer confidence	110.7	12/2023	index	✓	✗
Nonfarm payrolls (delta)	216,000	12/2023	thousands	●	✗
Initial jobless claims	205,625	12/2023	thousands	●	✗
Industrial Production y/y	-0.62%	11/2023	percent	●	✗
Capital goods orders y/y	2.0%	11/2023	percent	✓	✓
ISM composite PMI	50.3	12/2023	index	✗	✗
Housing starts	1,460,000	12/2023	thousands	✓	✓

Yellow means the delta is less than 5% of a standard deviation (2000 to latest available). Green means more than 5% of a standard deviation (more growth is good), red means less than.

UBS, Bloomberg, as of January 2024.

Table 2 - US inflation indicators

Indicator	Value(3MMA)	Reference Date	Delta (t vs t-1)	Delta (t vs t-3)
Headline CPI y/y	3.3%	12/2023	✓	✓
Core CPI y/y	3.9%	12/2023	✓	✓
PMI prices manufacturing	46.7%	12/2023	●	✗
PMI prices services	58.1	12/2023	●	✗
Ratio openings/unemployed	1.4	11/2023	✓	✓
Quits	3,471	11/2023	✓	✓
Atlanta Fed wage growth (all)	5.2%	12/2023	●	✓
Oil price (WTI)	$71.90	12/2023	✓	✓

Yellow means the delta is less than 5% of a standard deviation (2000 to latest available). Green means less than 5% of a standard deviation (less inflation is good), red means more than.

UBS, Bloomberg, as of January 2024.

Hedging Ideas

In this section, we offer a selection of hedging ideas for our upside and downside scenarios. Some of our recommendations only comprise traditional assets, while others include derivative instruments. Our final selection is based on screening criteria that include consistency with current UBS House View recommendations, the potential for additional capital gains in a risk scenario, and the criteria laid out in our hedging framework (for a summary, see "A guide to portfolio hedging" at the end of the report).

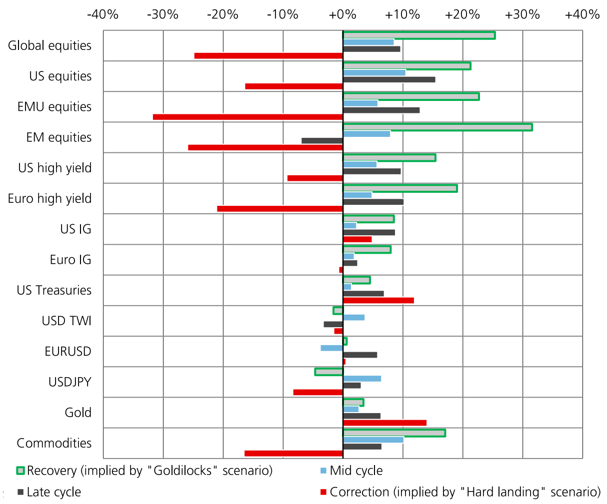
Investment ideas for the downside scenario

Buy long-duration government bonds of developed countries

High-quality bonds remain CIO's preferred asset class for 2024 in a variety of scenarios. We also continue to emphasize long-term, lower-risk government bonds such as US Treasuries and UK gilts as a hedge against the downside scenario of a hard landing. A broad portfolio of US Treasury bonds would have seen annualized returns of around 12% during past economic corrections ("hard landings"); a similar portfolio of US investment grade bonds would have appreciated by around 5% (see Figure 1). This year, in our hard landing scenario, the 10-year US Treasury yield falls to 2.5% by the end of 2024, from just over 4% at the time of writing (see Table 3). This suggests a total return of about 15% based on an average duration of around eight years.

Figure 1 - US Treasuries, gold and the Japanese yen performed well during past economic corrections

Annualized total returns



UBS, Bloomberg, as of January 2024

Business cycle stages as identified by CIO's proprietary methodology. Equities: MSCI indices. High yield: ICE indices. US Treasuries and USD TWI: Bloomberg indices. Commodities: CMCI Composite. A "Goldilocks" outcome is consistent with the global economy transitioning directly to an economic recovery. A "Hard landing" outcome is consistent with an economic correction.

Prefer the Japanese yen

Investors who wish to position for the downside scenario of a hard landing in 2024 are advised to increase their allocation to the Japanese yen. During times of economic and market stress, Japanese investors tend to close their overseas investment positions and repatriate capital to Japan, leading to an appreciation of the yen against other currencies. Our business cycle analysis suggests that the yen appreciated by over 8% (on average and on an annualized basis) against the US dollar during past recessionary periods (Figure 1).

Buy gold

Gold is another asset class that tends to benefit in an environment of lower policy interest rates, sharply slower growth, and higher economic uncertainty. Historically, gold performed similarly to broad US Treasuries in past economic correction episodes, returning around 14% on an annualized basis (Figure 1). Our December 2024 hard landing scenario target for gold is USD 2,500/oz, roughly 25% above the current spot level (Table 3). For investors who are worried about downside risks to gold and can implement derivative positions, we would propose a gold structure with downside protection (for more, see further down in this report).

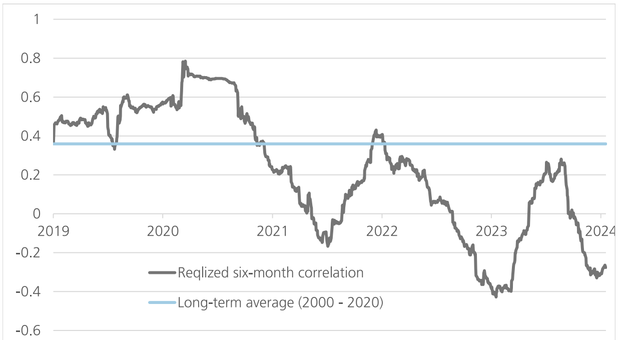
S&P 500 puts contingent on lower rates

In our downside scenario, we see equities and rates moving lower in tandem as slowing economic growth forces the Fed to cut rates more than markets anticipate. This should cause rates to move lower across the curve and risk assets to fall as investors reprice for lower economic growth. This would likely cause the correlation between equities and bonds to turn negative—meaning bonds rise as stocks fall.

Investors looking to hedge against our downside scenario can therefore look at conditional put options on the S&P 500, conditional on lower rates. Such structures benefit from the positive equity-bond correlation we expect to endure in our base case, while the put would benefit if markets fall sharply. Additionally, the recent retracement in rates allows for a better entry point compared to the past months.

Figure 2 - Correlation between equity and interest rates is positive (for now)

Six-month rolling correlation between the S&P 500 and the US 10-year treasury yield



Source: Bloomberg, UBS, as of 23 January 2023

We would set the strike levels at 5% out-of-the-money for the S&P 500 and 50bps below the 10-year forward rate. In terms of tenor, we would consider structures that are 6–12 months.

Long gold with downside protection

We see significant upside to gold across our base and downside scenarios. Investors who wish to build an allocation to gold but seek to decrease its volatility and protect against potential losses could consider overlaying a long gold position with an option collar by selling an out-of-the-money call to finance a put option. We recommend targeting a 6-month tenor for the options. The put strike should be set at around USD 1,900/oz to offset losses past 3–5%. Considering our scenario targets, a call strike in the USD 2,300–2,400/oz price range should provide participation beyond our base case target but still finance the put option at zero cost. The maximum loss of a collar combined with a long position in the underlying corresponds to the difference between the put strike and the spot level plus the total net option premiums.

Additionally, such a structure would profit from gold's specific volatility skew, where out-of-the-money calls typically have a higher implied volatility than out-of-the-money put options. Also, given the relatively elevated levels of interest rates, the forward curve is sloped upwards. Because of these dynamics, calls are relatively more expensive than puts.

Investment ideas for the upside scenario

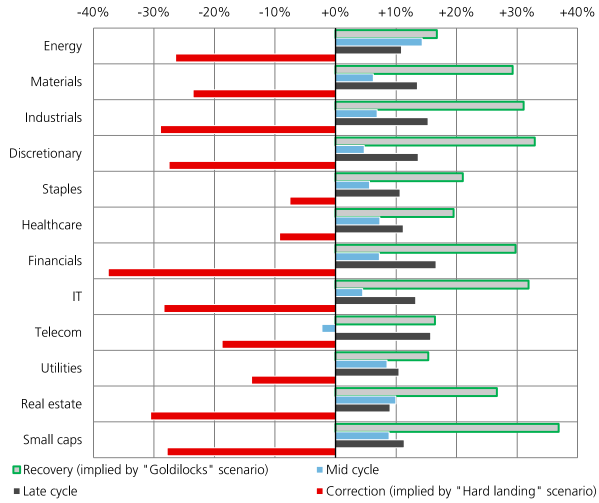
Small-caps and cyclical growth stocks

Our upside scenario of a "Goldilocks" environment is characterized by a combination of stronger-than-expected economic growth and a substantial easing of monetary policy. Within equities, lower policy interest rates tend to favor growth stocks, while stronger-than-expected economic activity is beneficial for cyclical companies. Equity sectors such as consumer discretionary and information technology contain a large proportion of both cyclical and growth stocks and should do especially well in this environment. Investors who are able to implement derivative positions could also consider more sophisticated ways to build upside exposure to the US technology sector (see next section for more). Emerging market equities also tend to benefit under these conditions.

Furthermore, we believe that a Goldilocks outcome in 2024 would favor small-caps in the US and in Europe. In the US, nearly half of the debt held by Russell 2000 companies is floating rate (versus around a tenth for large-cap companies), making small-caps key beneficiaries of lower rates. Relative valuations also look attractive, as the Russell 2000 is trading at a price-to-book discount of around 53% to the Russell 1000, versus a 10-year average discount of 32%. European small- and mid-caps should also benefit from easing lending conditions and bottoming activity.

Figure 3 - Small-caps, discretionary, and tech (IT) stocks benefitted during past economic recoveries

Annualized total returns: MSCI World equity sectors and MSCI World Small-Cap.

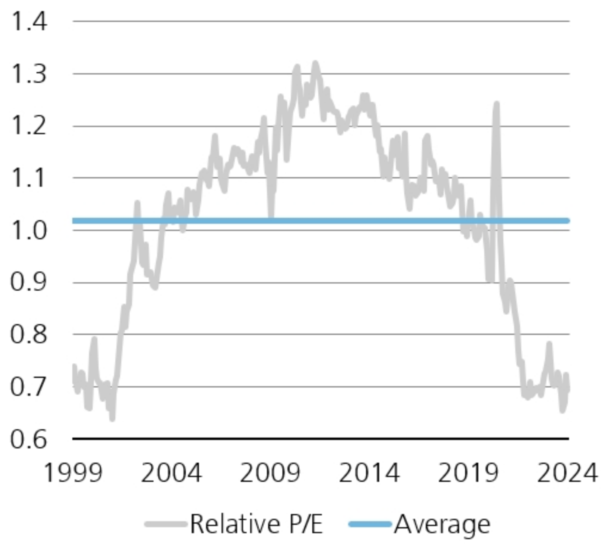


UBS, Bloomberg, as of January 2024.

Business cycle stages as identified by CIO's proprietary methodology. A "Goldilocks" outcome is consistent with the global economy transitioning directly to an economic recovery. A "Hard landing" outcome is consistent with an economic correction.

Figure 4 - US small-caps are historically cheap relative to large-cap stocks

Forward price-to-earnings (P/E) ratio of S&P 600 vs. S&P 500



UBS, Bloomberg, as of January 2024.

Defensive upside on US tech stocks

After a very strong end of the year, the US technology sector extended the rally in the first weeks of 2024. While AI enthusiasm may have calmed down, going forward, the sector should find support from lower interest rates. High-quality companies with strong secular growth prospects should benefit among the most in our Goldilocks scenario, where economic growth remains robust, inflation continues to decline, and the Fed cuts rates preemptively.

Rich valuations and some degree of crowdedness, however, make tech stocks more vulnerable if interest rates do not decline as expected. We therefore recommend building upside exposure to the US IT sector with full or partial downside protection.

Due to the structurally higher volatility of the sector compared to the broader market, building upside exposure with options is expensive. To position for our upside case with tech stocks, we therefore recommend selling downside price risks to finance upside participation to the Nasdaq 100. Upside participation up to 20–30% can be achieved in one-year participation strategies that limit downside protection to 30% below the current spot. For more details, please consult our CIO Derivatives: Top ideas for the Year Ahead report from November 2023.

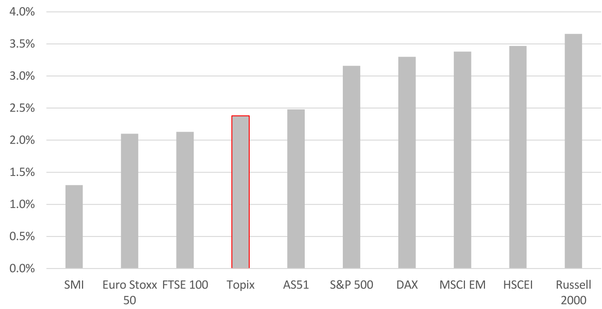
Continued outperformance of Japanese stocks

In 2023, Japanese equities outperformed in local currency terms every developed market and has continued to do so in 2024, with the Nikkei 225 index up almost 10% year-to-date as of 23 January. While in our base case we think it will be difficult for Japanese stocks to match last year's performance, we believe relatively favorable domestic macroeconomic conditions should further support the market. Moreover, in an upside scenario, stronger topline growth for corporate earnings, higher returns on equity, and solid wage growth could trigger further gains in Japanese markets.

Investors who want to benefit from a further potential rally in Japanese stocks, in local currency, should consider buying call spreads on the Nikkei 225 or the Topix with three- to six-month tenors and strikes relatively close to current spot levels (e.g., 2% and 112% out-of-the-money). Low levels of implied volatility and low short-term interest rates make the price of out-of-the-money call options among the cheapest across major equity indexes (see Fig. 5). Investors who prefer buying Japanese equities in other currencies (e.g., EUR or USD) can consider structured strategies with one-year maturity that provide capital preservation with upside participation.

Figure 5 - Cost of Topix upside among the cheapest

Premium (in % of spot) of six-month 102–112 strike call spreads across major equity indexes



UBS, Bloomberg, as of 22 January 2024.

Geopolitical risk

We expect politics to play an outsized role in 2024. The US presidential election, the ongoing Israel-Hamas and Russia-Ukraine wars, and the rivalry between the US and China could all affect markets globally. Investors should prepare for bouts of politically driven volatility and consider hedges.

Arguably the most market-relevant geopolitical events are currently taking place in the Middle East. That said, the impact on markets has so far been marginal. Increased freight costs due to Red Sea attacks have had little impact on inflation, as shipping costs are only a small contributor to goods prices. The oil price has also been little affected so far, although supply shocks could push oil prices sharply higher at any time.

We will cover geopolitics in more detail in an upcoming report.

Geopolitical risks: possible hedges

Hedging against the effects of geopolitical events can be challenging due to their unpredictable nature. Nevertheless, investors can consider strategies to protect their portfolios:

- **Diversification:** Maintaining a diversified portfolio that includes a mix of asset classes, such as stocks, bonds, real estate, and alternative investments, is the best way to protect against market turbulence, in our view
- **Long futures on Brent crude:** If the conflict in the Middle East escalates, Brent crude could climb to USD 120/bbl or above. Long futures positions on Brent crude oil—or options structures that gain when oil prices climb—are ideal for hedging such a scenario, in our view.
- **Gold and precious metals:** Precious metals like gold and silver are often viewed as safe-haven assets during times of instability. We recommend investors maintain or increase their exposure.
- **US Treasuries:** US Treasuries and long-term bonds are also generally considered safe havens, as they usually perform well during periods of market stress.
- **Currency hedging:** Decrease exposure to the Israeli shekel and other economically vulnerable currencies, and increase exposure to save havens like the US dollar (USD), the Swiss franc (CHF), and the Japanese yen (JPY).

Table 3 - CIO scenario targets

Key targets for December 2024	spot*	Upside	Base case	Downside
MSCI AC World	859	970 (+13%)	910 (+6%)	700 (-18%)
S&P 500	4,739	5,300 (+12%)	5,000 (+6%)	3,700 (-22%)
EuroStoxx 50	4,403	5,200 (+18%)	4,700 (+7%)	3,800 (-14%)
SMI	11,149	12,300 (+10%)	11,640 (+4%)	9,800 (-12%)
MSCI EM	958	1,200 (+25%)	1,080 (+13%)	820 (-14%)
Fed funds rate (upper bound)	5.50	4.00	4.50	1.25
US 10y Treasury yield	4.10	4.00	3.50	2.50
US high yield spread**	365bps	370bps	450bps	850bps
Euro high yield spread**	391bps	370bps	450bps	850bps
US IG spread**	92bps	80bps	120bps	200bps
Euro IG spread**	140bps	110bps	150bps	220bps
EURUSD	1.09	1.15 (+6%)	1.12 (+3%)	1.03 (-5%)
Commodities (CMCI Composite)	1,726	2,000 (+16%)	1,850 (+7%)	1,550 (-10%)
Gold***	USD 2,007/oz	USD 2,000/oz (-0%)	USD 2,250/oz (+12%)	USD 2,500/oz (+25%)

* Spot prices as of market close of 17 Jan 2024. Developed market constituents of the MSCI All Country (AC) World index display in the local currency. The MSCI EM index displays in US dollar. Values in brackets are expected percentage changes from the quoted spot levels. Dividends, share buybacks and other sources of carry are not included.
** During periods of market stress, credit bid-offer spreads tend to widen and result in larger ranges.
*** Gold is a safe-haven asset whose price tends to rise when risk assets, such as equities, fall, and vice versa.
Note: asset class targets above refer to the respective macro scenarios. Individual asset prices can be influenced by factors not reflected in the macro scenarios.

UBS, Bloomberg, as of January 2024.

A guide to portfolio hedging

In 2020, we introduced a new framework to help investors protect their portfolios during significant risk-off events in financial markets (see A guide to portfolio hedging, 6 October 2020). We developed a “scoring” methodology to objectively compare different hedging instruments or asset classes that we believe can provide protection during equity corrections. Our approach is based on historical data and is not a forward-looking assessment. Indeed, we wanted to avoid the risk of subjective views and, at the same time, we aimed at quantifying the contributions of hedging strategies in past equity drawdowns.

Here we apply the three pillars of our hedging framework—i.e., sensitivity, costs and reliability—to guide our instrument selection. In our view, the hedging ideas described in the next section strike the best balance between the three metrics across the target scenario (upside or downside) and our base case.

We differentiate between traditional hedges and derivatives. In general, investors can directly take exposure (positive or negative) to an asset specified in a given scenario (see Monthly Letter). The risk, however, is that the position in the asset may perform poorly, should the scenario not materialize—for example, in our base case. We therefore consider a traditional hedge a generic asset that should provide protection in the up- or downside scenario without significantly losing value in our base case. Under derivatives, we consider option-based strategies that have a non-linear payoff and typically use one of the asset classes highlighted in the scenario table as an underlying asset.

Risks inherent in hedging ideas

Like other investments, hedging trades are not without risk. Risk scenarios may not unfold exactly as described in this report, and other unforeseen factors may influence investment performance.

Main risks of investing in options

Unlike owning or shorting a security, option contracts are, by definition, governed by a finite duration. An option buyer faces the risk of losing the entire amount of the premium paid. An option writer, however, faces a higher level of risk, as the potential loss can be significant if the option expires in-the-money. Since options investments usually require less capital compared with an equivalent position in the underlying asset, the losses of an option investor are usually smaller. The exception to this general rule occurs when options are used to provide leverage.

Appendix

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