

# UBS House View

Monthly Letter | 9 November 2023 | Chief Investment Office GWM, Investment Research

## Earning through quality

We expect companies with “quality” attributes to be well placed to generate earnings in an environment of weaker economic growth.

## Tech opportunity

Corporate fundamentals are improving for the US tech sector, and we see AI as a compelling long-term growth driver.

## Lower yields ahead

We expect bonds to rally in 2024, and believe lower bond yields should be supportive of stocks.


## Asset allocation

Fixed income remains our preferred asset class. Within equities, we upgrade the US market to neutral, and the US IT sector to most preferred.



## Mark Haefele

Chief Investment Officer  
Global Wealth Management

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## Equities in the year ahead

Next week, we will publish our *Year Ahead 2024* outlook, including our views across economies and asset classes, and answers to some of the key questions investors will face in the year to come. In this letter, we provide a glimpse of key views ahead of that publication and take a deeper look at equities, including changes to our positioning in the asset class.

Global stock market indexes have had a volatile ride over the course of 2023—with major indexes rallying in the first half of the year, powered by a few big technology stocks, before giving up some of that ground in the second half on a combination of fears about high interest rates and a slowing economy.

As we look to the next year, that leaves us with three big questions:

- How should investors adapt stock portfolios to account for slowing economic growth?
- What is the outlook for the technology sector, and how should investors position?
- What will moves in the bond market mean for stocks?

First, while we expect slower economic growth to weigh on earnings growth among cyclical companies, we think quality companies—those with a high return on invested capital, strong balance sheets, and reliable income streams—will still grow earnings despite a tougher operating backdrop. History shows that quality stocks tend to outperform in environments of slowing economic activity, when the economy is in “late cycle.”

Second, we like the US information technology sector and upgrade it from neutral to most preferred. This partly reflects our bias for quality stocks; many of the companies with the highest returns and the strongest balance sheets are in the IT sector. But it also acknowledges the signs from the latest earnings season that smartphone and PC demand is improving. The sector also offers exposure to one of the most compelling long-term investment opportunities today: artificial intelligence (AI). Concurrent with this move, we upgrade the US from least preferred to neutral within our regional preferences.

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Third, in our base case we expect bonds to rally further in the year ahead. We believe that lower bond yields should be supportive of stocks, provided they do not coincide with a particularly sharp slowdown in economic growth.

Fixed income remains our preferred asset class, given the combination of attractive yields and the potential for capital appreciation if interest rate expectations fall. But we also see upside for equity indexes, supported by earnings growth among quality companies. Overall, we believe 2024 should be a good year for investors who put their money to work in balanced portfolios, with positive prospective returns across stocks, bonds, and alternative investments.

Global economic growth is likely to slow in 2024.

### Earning through quality

In 2024, we expect global economic growth to slow. US consumers' propensity to spend is likely to decline as they deal with high interest rates, the end of childcare subsidies, the trimming of Medicaid rolls, and the resumption of student loan payments. European growth is likely to remain sluggish against a backdrop of falling bank lending. And China's growth looks likely to settle at a "new normal" level between 4% and 5%.

Investors will therefore need to be more discerning in their equity selection. In 2024, some companies will face a challenging combination of downward pressure on revenues and higher financing costs. But we believe those with a high return on invested capital (ROIC), a history of stable earnings growth, and low financial leverage should be better positioned to deliver returns.

Quality stocks have historically outperformed during periods of weaker economic growth.

Historically, companies with these "quality" attributes have done better than the broader equity market during periods when growth has been slowing but staying positive—the environment we expect in 2024. The MSCI ACWI Quality Index, for example, has outperformed the MSCI All Country World Index by 1 percentage point over six-month periods since 2012 in which such growth conditions existed (as depicted by the Atlanta Fed GDPNow survey). Quality stocks also tend to outperform in periods of economic contraction, which should offer portfolio protection in case the economy slows more than we expect.

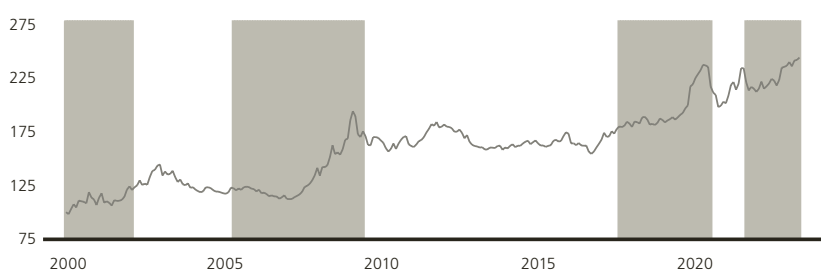
Further demonstrating this point, since 2000, in periods when the spread between 2-year and 10-year US Treasury yields has been less than 75 basis points, or when the US economy has been in recession, companies in the top third of the Russell 1000 index, ranked by ROIC, have outperformed those in the bottom third (Figure 1).

Quality stocks often trade at a premium to the broader equity market, and that is also true today. But overall, we think quality is worth paying for in the current environment.

Figure 1

### In the current environment, focus on high-quality stocks

Performance of high ROIC (top third of Russell 1000) relative to low ROIC (bottom third), sector neutral



Note: Shaded areas denote periods when the yield on 10-year Treasury minus the yield on 2-year Treasury is less than 0.75% or the economy is in recession. ROIC = return on invested capital

Source: Bloomberg, UBS, as of November 2023

We upgrade the US IT sector to most preferred.

Third-quarter US tech earnings are beating expectations.

### The technology opportunity

One sector in which investors can find quality companies in relative abundance is tech, and this month we upgrade the US IT sector to most preferred from neutral.

Technology offers the highest ROIC of the 11 US equity sectors: 19% over the last 12 months (compared with just 4% for utilities or real estate). Tech sector balance sheets are also the strongest, with a net-debt-to-EBITDA ratio of just 0.5x. And with business models that combine subscription-based revenue streams with a presence in high-growth segments, we think tech companies look poised to deliver healthy earnings growth next year.

Based on results reported so far, US tech earnings are on pace to grow 11% in the third quarter, better than market expectations of 4% before the start of earnings season. We expect the sector to sustain low-double-digit growth in 2024, making tech one of the sectors with the highest earnings growth within US equities. Its forward P/E ratio has fallen from 28x in July to 25.5x today. While the sector is still trading close to a 30% premium versus its 10-year historical average, we believe this is

## Investing in AI

2023 has been the year when AI entered the investment mainstream. Most notably, a handful of AI-related mega-cap growth stocks—the so-called “Magnificent 7”—have driven more than 80% of the gains in the S&P 500 this year.

We view AI to be an important, disruptive, potentially transformative technology. Like other technological breakthroughs—from the steam engine to the internet—we see AI creating value in adjacent sectors over time. Below we use a four-part framework, derived from historical experience, to illustrate how this value creation will play out within the AI sphere. (For a fuller exposition, including comparisons with past technological developments, see *Year Ahead 2024*, “A new world,” to be published 16 November 2023):

- **Infrastructure and input providers (cloud)**

Cloud computing is a crucial input for generative AI because it provides the computing power needed to both train and make generative AI applications work.

- **Hardware manufacturers (GPU chipmakers)**

Graphics processing units (GPUs) are chips that are crucial to the training of neural networks, a cornerstone of AI, and the leading companies in this space are already seeing a surge in demand, strong pricing power, and significant share price appreciation.

- **Operators and enablers (large language models)**

Large language models (LLMs) can be thought of as among the key “enablers” of the AI ecosystem.

Developing a leading LLM requires significant scale to leverage the required human, financial, and technical resources.

- **Application beneficiaries (text generation, programming, image/video generation)**

ChatGPT is the first headline-grabbing example of an AI application, but broader use-cases are already taking shape. We see significant opportunities over the next few quarters in the integration of AI “copilots” in office productivity software, in the rising demand for AI analytics, and in AI integration in image, video, and other enterprise applications.

Unlike past technological breakthroughs where the players in each of the four adjacent sectors were often initially distinct, generative AI is historically unusual because, right from its onset, many of the leading tech companies are already operating in multiple layers of this framework. With such an advantage, the large players may be poised to grow larger still.

We believe that investors looking for exposure to AI should seek broad exposure across the value chain, including in cloud, semiconductor, software, and internet names. Of course, while the long-term growth potential is large, investors should prepare for potential volatility or drawdowns. As with other technology booms, an initial surge in demand can often be followed by a “digestion” period. But for long-term investors, such moments could present attractive opportunities to increase long-term exposure.

We advocate diversified exposure across tech subsectors.

reasonable considering that the sector now has a more recurring revenue profile, and investors will likely continue to gravitate to sectors that can produce healthy, sustainable profit growth in an uncertain macro environment.

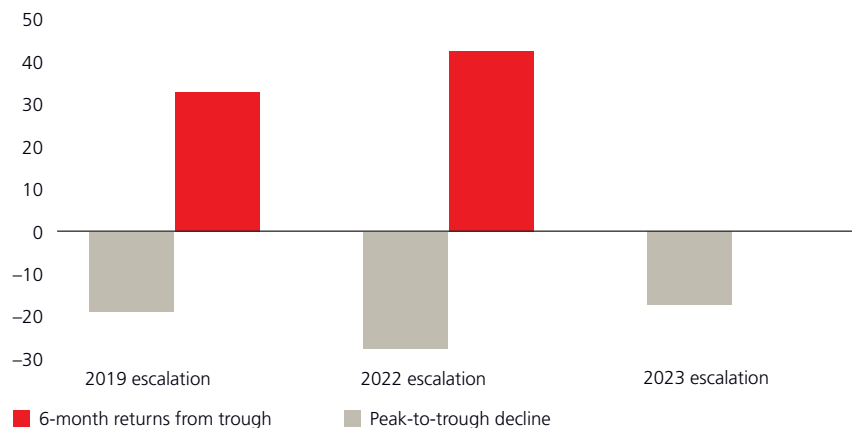
Within global technology, we advocate diversified exposure across subsectors, with a preference for companies with strong operating and free cash flow margins.

- **Software.** The third-quarter results reinforce our long-term positive view on AI and the software industry, which broadly reported better-than-expected earnings thanks to improving pricing power. While software stocks are not cheap—on average trading at a 15–20% premium to broader tech—we believe the premium is justified as more than two-thirds of software revenues are recurring and companies generally have higher profit margins (around 35%, the highest within tech).
- **Semiconductors.** While chipmaker results have been mixed, we believe that fundamentals have troughed. Supply is tight, and the overall industry is benefiting from strong pricing tailwinds. We remain comfortable with our forecast of over 25% revenue growth—based primarily on pricing, with conservative unit growth—and 50% profit growth for the global semiconductor industry in 2024. While US restrictions on chip exports to China have weighed on the sector, we see only a low- to mid-single-digit revenue impact for the industry over the medium term (2025 and beyond). At our profit growth forecast, the industry is trading close to 18–19x forward P/E—a hefty discount to global tech’s 23–24x (based on the five tech industries we track, using MSCI indexes).
- **Internet.** We are more selective on the internet industry in the near term. Advertising is showing signs of improvement, but the outlook remains uncertain. E-commerce profitability is finally showing signs of improvement after multiple quarters of investment. Third-quarter internet industry earnings results showed an unexpected improvement in margins, and looking longer term we expect AI monetization to gradually pick up.

Figure 2

### Semiconductor markets overreacted to recent geopolitical escalations

Performance data for Philadelphia Semiconductor Index (SOX), in %



2019 was Huawei-related.  
 2022 was when AI chips and equipment were targeted.  
 2023 was related to additional AI export controls.

Source: Bloomberg, Factset, UBS, as of November 2023

Higher bond yields have been an overhang for equity markets in the second half.

**Valuations and yields**

The impact of higher bond yields on equity markets has been an overhang on both the technology sector and the broader market in the second half of 2023. The empirical evidence of a link between bond yields and equity market valuations is not clear-cut. Historically, if yields have risen because growth is strong, the relationship with equities tends to be positive. If yields have risen because inflation is high, the relationship tends to be negative.

However, higher bond yields do increase competition for equity market investment and have a theoretical negative impact on fair valuations. To provide some context on the scale of the risk from higher yields, we can use a Gordon growth model, a variant of the dividend discount model. If the discount rate were to increase by 100bps from current levels (4.5%) and assuming long-term dividend growth of 3%, then all else equal, the fair value for stocks would be 15% lower than current levels. For the S&P 500, this would equate to a level of 3,725.

But we think it unlikely that yields will move higher in 2024. Since the start of November, announcements from the Treasury Department and the Federal Reserve have contributed to the 10-year Treasury yield falling by around 40bps:

- The Treasury decided to slow the growth in issuance of longer-dated bonds in response to the rise in 10- and 30-year government bond yields to the highest levels since 2007. Instead, it will skew new issuance more toward the 2- and 5-year bonds.
- The Fed kept policy rates on hold at its November meeting and raised hopes that the hiking cycle could be at an end. The FOMC observed that “tighter financial conditions” would weigh on the economy, reinforcing recent remarks from Fed governors that higher government bond yields could reduce the need for additional rate increases.

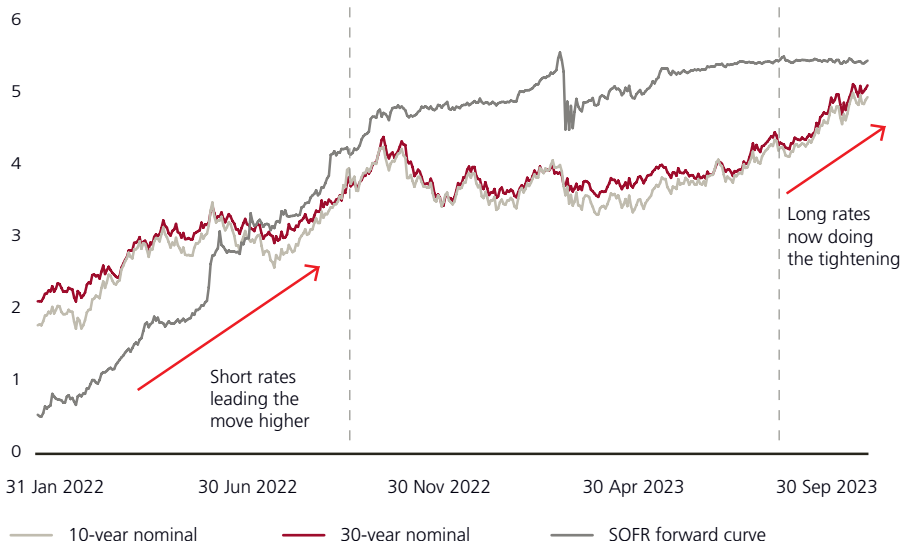
We expect bond yields to fall in 2024.

Our base case is that the 10-year Treasury yield will fall to 3.5% in December 2024 as interest rate expectations fall. For equities, this should represent a supportive environment. Economic growth will likely be weaker, but earnings growth and lower yields should help support stocks.

Figure 3

**Ten-year yields have been rising despite peaking short-term rates**

US Treasury 10-year and 30-year nominal rates and SOFR forward curve, in %



Source: Bloomberg, UBS, as of November 2023

## The year ahead

We will publish our *Year Ahead 2024* on 16 November, where you will find why we have called it “A new world”; get answers to key questions for both the year and decade ahead; see our top ideas and scenarios; and take a deeper dive on AI.

In the meantime, you can find some of our current investment thinking below:

### Asset class views for the year ahead

We see moderate upside for equities in the year ahead.

*Equities.* We expect a moderate rally in global equity indexes in 2024 as central banks cut rates, yields fall, and quality companies continue to grow earnings. In our base case, we see the S&P 500 rising to 4,700 by December next year.

Alongside our upgrade of the US technology sector, in our regional preferences we move the US equity market to neutral from least preferred. Elsewhere, we like emerging market (EM) stocks. The MSCI EM index remains attractively valued on a forward P/E ratio of 11x; we expect 16% earnings growth in 2024; lower US bond yields should be supportive; and we have a positive view on China, India, and semiconductors—some of the key constituents of the index. We have a least preferred view on UK equities given weaker earnings performance in the UK than in other regions.

## Messages in Focus for the Year Ahead

<b>Manage liquidity</b>	We believe investors should limit their overall cash balances and optimize yields in the year ahead. War and geopolitical uncertainty may increase the perceived safety of cash, but we expect interest rates to fall in 2024, reducing the return of cash and increasing reinvestment risks. Investors should use a combination of fixed term deposits, bond ladders, and structured solutions to cover expected portfolio withdrawals over the next five years.
<b>Buy quality</b>	We expect positive overall returns for both equities and bonds in the year ahead. But within each asset class, we believe investors should focus on quality. In fixed income, quality bonds (including sustainable and MDB bonds) offer attractive yields and should deliver capital appreciation if interest rate expectations decline, as we expect. In equities, quality companies with strong balance sheets, and high profitability, including those in the technology sector and within ESG leaders, should be best positioned to generate earnings in an environment of weaker growth.
<b>Trade the range in currencies and commodities</b>	In currencies, we expect the US dollar to stay stable around current levels. But as the year progresses, USD weakness may emerge as US economic growth eases relative to other economies. This makes selling USD upside for a yield pickup attractive. In commodities, investors who can afford to wait have the ability to generate potential carry returns, as well as hedge against geopolitical or weather risks. Oil prices should fluctuate in the USD 90–100/bbl range in 2024.
<b>Hedge market risks</b>	Investing against a backdrop of war and geopolitical uncertainty can be challenging, and investors need to prepare for volatility ahead. We believe that investing across asset classes and regions should be most investors’ first defense against potential market turbulence. But investors can also further insulate portfolios against specific risks through capital preservation strategies, alternatives, or positions in oil and gold.
<b>Diversify with alternative credit</b>	We expect high global debt balances to contribute to elevated price and spread volatility, driving investors to seek ways to benefit from dispersion. This is a supportive backdrop for various credit strategies, including credit arbitrage and distressed debt.
<b>Pick leaders from disruption</b>	We expect some of the highest returns in equity markets over the decade ahead to come from those companies that can harness new technologies to grow markets, dislodge incumbents, or slash costs. Successfully identifying these “leaders from disruption” is critical to boosting long-term portfolio potential. We expect the decade ahead to see a wave of disruption rippling across industries, from technology to energy to healthcare.
<b>Capture growth with private markets</b>	A new world will see significant investments made in healthcare, digitalization, and energy. But high government debt levels mean public funding for innovation is likely to be constrained. Private market managers, with their ability to provide equity or debt capital to companies at different lifecycle stages, have a key role to play. The asset class offers attractive return potential and superior access to the real economy, in exchange for lower liquidity. They can also be an effective vehicle for investors focused on driving positive change through impact and sustainability.

Quality bonds should perform well in 2024 as growth slows.

*Bonds.* Quality fixed income remains our preferred asset class given the attractive yields on offer and likely capital appreciation as rate expectations come down. We favor high grade (government) and investment grade bonds, and are neutral on high yield and emerging market credit. In our base case, we expect the 10-year US Treasury yield to fall to 3.5% in December 2024.

*Currencies.* The greenback looks likely to stay well supported in the coming months thanks to relatively resilient US economic data. But as 2024 progresses, the USD may weaken slightly in response to slowing US growth and more flexible Fed policy. We maintain a neutral view on the US dollar, and believe investors should look to sell the dollar on rallies. We have a most preferred view on the Australian dollar, as we see risks of another hike by the Reserve Bank of Australia and expect it to keep rates elevated until at least 4Q24 as it continues to fight inflation.

*Commodities.* We expect the total return for broad commodities in 2024 to be in the mid-to-low teens. Growth in developed economies should slow in 1H24 and weigh on demand for cyclical commodities. However, prices should be supported by China's campaign to boost economic activity, oil producers' supply discipline, and low inventories. Oil is our most preferred commodity and we see Brent crude trading in a USD 90–100/bbl range. Gold remains valuable as a portfolio hedge, in our view.



Mark Haefele  
Chief Investment Officer  
Global Wealth Management

## Global forecasts

## Economy

## Real GDP y/y, in %

	2022	2023E	2024E
<b>US</b>	1.9	2.4	1.1
<b>Canada</b>	3.4	1.1	0.2
<b>Japan</b>	1.0	1.9	0.7
<b>Eurozone</b>	3.4	0.5	0.6
<b>UK</b>	4.3	0.6	0.6
<b>Switzerland</b>	2.7	0.7	1.2
<b>Australia</b>	3.7	1.9	1.6
<b>China</b>	3.0	5.2	4.4
<b>India</b>	7.2	6.3	6.2
<b>EM</b>	4.1	4.3	3.9
<b>World*</b>	3.4	3.1	2.6

\* Excludes Venezuela

Source: Bloomberg, UBS, as of 8 November 2023. Latest forecasts available in the *Global forecasts* publication, published weekly.

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

	2022	2023E	2024E
<b>US</b>	8.0	4.2	2.7
<b>Canada</b>	6.8	3.9	2.5
<b>Japan</b>	2.5	3.3	2.3
<b>Eurozone</b>	8.4	5.5	2.4
<b>UK</b>	9.0	7.4	2.6
<b>Switzerland</b>	2.8	2.2	1.8
<b>Australia</b>	6.6	5.7	3.6
<b>China</b>	2.0	0.4	1.2
<b>India</b>	6.7	5.5	4.8
<b>EM</b>	9.5	7.6	8.7
<b>World*</b>	8.4	6.3	6.0

## Asset classes

	Spot	Jun-24	Dec-24
<b>Equities</b>			
S&P 500	4,383	4,500	4,700
Eurostoxx 50	4,178	4,600	4,700
FTSE 100	7,402	7,860	8,160
SMI	10,595	11,300	11,640
MSCI Asia ex-Japan	606	665	685
MSCI China	58	65	67
Topix	2,306	2,485	2,555
MSCI EM	958	1050	1080
MSCI AC World	805	845	890
<b>Currencies</b>			
EURUSD	1.07	1.10	1.12
GBPUSD	1.23	1.25	1.27
USDCHF	0.90	0.88	0.87
USDCAD	1.38	1.34	1.32
AUDUSD	0.64	0.69	0.72
EURCHF	0.96	0.97	0.97
NZDUSD	0.59	0.61	0.62
USDJPY	151	143	140
USDCNY	7.28	7.20	7.00

	Spot	Jun-24	Dec-24
<b>2-year yields, in %</b>			
USD 2y Treas.	4.93	3.75	3.25
EUR 2y Bund	2.99	2.50	2.00
GBP 2y Gilts	4.60	4.00	3.50
CHF 2y Eidg.	1.28	0.75	0.70
JPY 2y JGB	0.12	0.20	0.25
<b>10-year yields, in %</b>			
USD 10y Treas.	4.49	3.75	3.50
EUR 10y Bund	2.62	2.25	2.25
GBP 10y Gilts	4.24	3.75	3.50
CHF 10y Eidg.	1.06	0.90	0.90
JPY 10y JGB	0.85	1.00	0.80
<b>Commodities</b>			
Brent crude, USD/bbl	80	95	95
WTI, USD/bbl	75	91	91
Gold, USD/oz	1,958	1,950	2,150

Source: Bloomberg, UBS, as of 8 November 2023. Latest forecasts available in the *Global forecasts* publication, published weekly.



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