

# Panorama

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Investing in 2023 | UBS Asset Management

## Investing through change

Picture the opportunities



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turn choppy

02 | Impact of  
a longer late cycle

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for equity long-  
short alpha?

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policy outlook

In this edition of Panorama, our investment experts recap on the past investment year and explore where the challenges, opportunities and surprises might spring from.

The following pages offer distinct viewpoints and investment insights across our global capabilities.

For additional content and previous editions of Panorama, including videos and additional in-depth investment insight, visit [ubs.com/panorama](https://ubs.com/panorama) or scan the below QR code.



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**Barry Gill**  
Head of Investments

## Calm waters turn choppy

Investors have endured a tough year. Barry Gill, Head of Investments, UBS Asset Management, introduces the year-end edition of Panorama and discusses the issues facing investors over the months ahead.

**Wow!** What a tumultuous period this has been. It seems as if we have been riding a tidal wave of the unexpected since 2020; one that (hopefully?) reached a crescendo this year. Having enjoyed such calm waters for many years, we are now being challenged to imagine a world where unpredictability features permanently. Somewhat ironically, our list of potential items that investors may not be prepared for in the year ahead, feels more mainstream than in prior years; but that is likely a function of a change in our perception of what is within the bounds of *normal*.

As we entered this year it looked like the historic diversification benefits of the traditional 60/40 portfolio might come unstuck as inflation started to take hold. Few could have quite imagined the extent to which this would materialize – equities at one point were squarely in bear market territory, while bonds experienced the biggest sell-off since 1994. The question now is what happens going forward? Have valuations reset enough and is there enough yield in bonds to make the 60/40 mix appropriate again. We explore this in our latest Panorama.

Notwithstanding the obvious debt-servicing challenges to households, companies and governments, we now have attractive coupons across the entire fixed income stack for the first time since the Great Financial Crisis 2007-2008. While credit spreads are not particularly wide, some investors may consider that yields are sufficiently high on short duration bonds that they don't have to take a big bet on duration. Our team examines where the best opportunities might be found.

After so many years of tech dominance, will investors finally find an appreciation for other types of equities? Will equities have to look a little like bonds to be attractive? Could dividend yields be back? Time will tell, but what is certain is that these types of rotations in the equity markets can create wonderful alpha opportunities, particularly where the institutional mix of shareholders is low. Our O'Connor hedge fund team examines how they aim to identify alpha in a period when generating it is likely to need to take on a more meaningful contribution to equity returns than over the past decade.

Bull markets are typically born when investors ignore good news, but the fear of missing out (FOMO) seems alive and well. This suggests there is more pain to go before markets are really investible again. It feels like more stuff needs to break. Warren Buffett colorfully mused that it is only as the tide goes out that you find out who has been swimming naked. Today's tide is the rapid rise in interest rates to combat inflation. Where will the weaknesses in the markets be exposed? At the time of writing elements of the crypto market are in turmoil. What will be next? Could yield curve control be abandoned in Japan, and what would that mean? This outcome is one of the more negative surprises we speculate about in this edition of Panorama.

As always, our team is here to support you in your investment journey and help you peer through the fog of uncertainty.

Faithfully,

Barry

# Job market resilience could prolong the late-cycle

Investors may be surprised at the resilience of the global economy in 2023. Here, the Investment Solutions team discuss how the Fed’s desire to keep financial conditions tight means risk assets are not out of the woods.



Evan Brown  
Head of Multi-Asset Strategy

Ryan Primmer  
Head of Investment Solutions

So far this year, the US Federal Reserve has raised rates over six straight meetings by a total of 375 bps. Assuming the Fed follows through with an expected 50 basis points hike in December, it will have delivered the most cumulative tightening in any calendar year since 1980. The speed and magnitude of rate hikes is, by design, weighing on the US economy in order to bring inflation down.

Amid this backdrop, over 75% of fund managers think a recession is likely over the next 12 months – a level roughly on par with peak pessimism during the global financial crisis in 2009 and the COVID-19 pandemic in 2020<sup>1</sup>.

While a recession is a very real possibility, investors may be surprised by the resilience of the global economy – even with such a sharp tightening in financial conditions. The labor market will certainly cool, but healthy household balance sheets should continue to support spending in the services sector (Tables 1&2). Moreover, some of the major drags on the world economy emanating from Europe and China are poised to get better, not worse, between now and the end of Q1 2023.

Avoiding a recession would clearly be good news; however, it would not signal an all-clear for risk assets. A more resilient economy may also mean central banks need to do more, not less, in order to get inflation durably back to target. And this raises the risks of a harder landing down the road. But, in our view, it is too early to pre-position for very negative economic outcomes. A longer-lasting late cycle environment can persist for some time, and investors will have to be flexible and discerning in 2023 given these potential dynamics.

<sup>1</sup> Bank of America Global Research November 2022 Global Fund Manager Survey, 12 November 2022

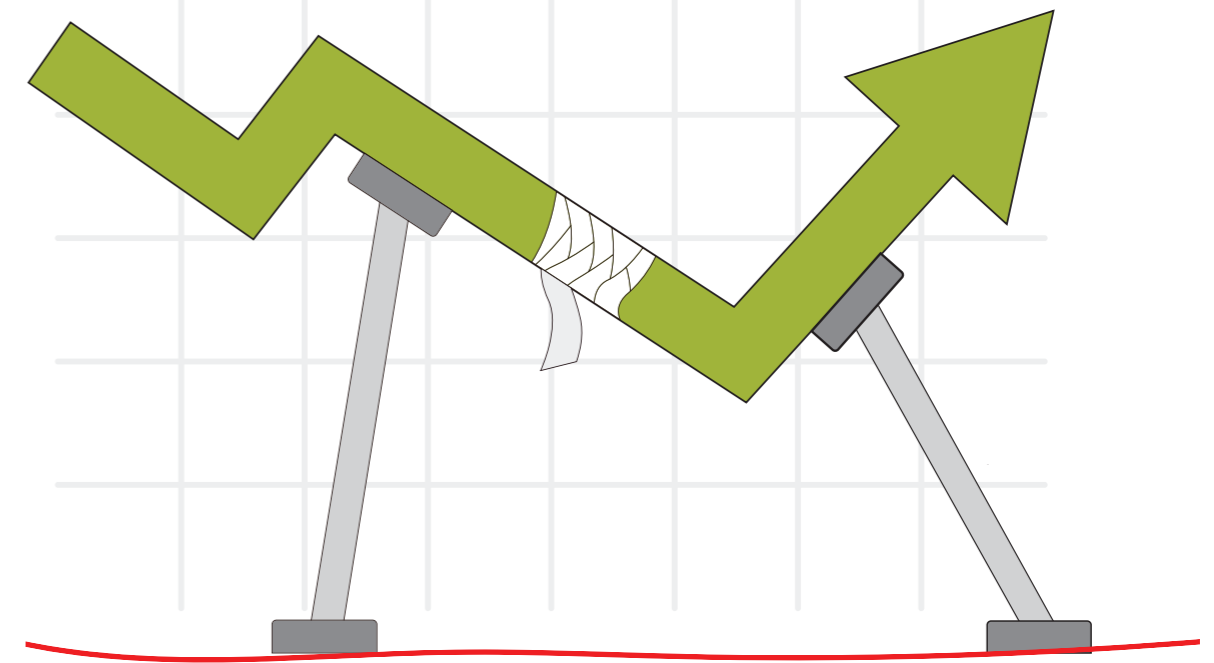


Table 1 – US Labor Market Metrics to Monitor

US Labor Market Metrics to Monitor	Most recent data*	End-2019	Difference
Unemployment rate (U3)	3.7% (Oct)	3.60%	+0.10%
Private Employment Cost Index: Wages and Salaries	5.3% (Q3)	3%	+2.30%
Initial jobless claims	222K (Nov 12)	235K	-13k
Continuing jobless claims	1.5m (Nov 5)	1.9m	-400k
Prime-age employment to population ratio	79.8% (Oct)	80.30%	-0.5%
Aggregate labor income (YoY)	8.7% (Oct)	3.70%	+5%
Private sector quits rate	2.9% (Sept)	2.60%	+0.3%

Source: Bureau of Labor Statistics, Department of Labor. \*Now data: Unemployment rate as of October 2022, Private ECI as of September 30, 2022, Initial jobless claims as of Nov. 12, 2022, Continuing jobless claims as of November 5, 2022, Prime age employment to population ratio as of October 2022, Aggregate labor income as of October 2022, Private sector quits rate as of September 2022

Table 2 – Developed market central banks’ key wage metrics

Central Bank	Key Wage Metric	%YoY Chg (Latest Reading)
Federal Reserve	Private Employment Cost Index: Wages & Salaries (Q3)	+5.3%
European Central Bank	ECB Indicator of Negotiated Wages (Q2)	+2.4%
Bank of Japan	Scheduled Contractual Earnings (Sept)	+1.6%
Bank of England	Average Weekly Earnings Ex-Bonus/Arrears (Sept)	+6.3%
Reserve Bank of Australia	Wage Price Index Ex-Bonus (Q3)	+3.1%
Reserve Bank of New Zealand	Index of Salary & Wages (Q3)	+3.9%
Bank of Canada	BoC Common Wage Index (Q2)	+3.3%

Sources: US Bureau of Labor Statistics, European Central Bank, Japan Ministry of Health, Labour, and Welfare, UK Office for National Statistics, Australian Bureau of Statistics, Statistics New Zealand, Bank of Canada



**The Fed vs. the US labor market**

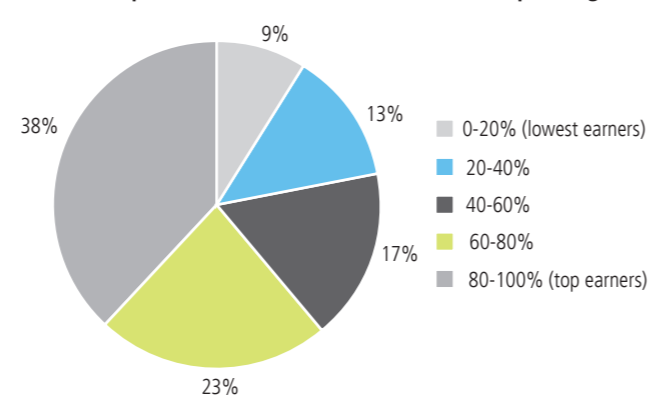
To best understand US economic dynamics, it is necessary to break down the US labor market into lower and higher income cohorts. Lower wage employees, who are disproportionately employed in the service sector, are experiencing very strong wage growth (Chart 1). This is happening in large part because higher income workers still have a lot of excess savings, which they are ready and more than willing to spend in the service sector<sup>2</sup>. While high earners have a lower marginal propensity to consume (that is, they spend a smaller percentage of their income compared to lower earners), they also account for the lion's share of total consumption (Chart 2).

**Chart 1 – US income growth is strongest among the lowest earners**



Source: Macrobond, Atlanta Federal Reserve. Data as of October 1, 2022

**Chart 2 – Top 40% of earners account for 60% of spending**



Source: UBS-AM, Macrobond. Data as of January 1, 2021. United States, BLS, Consumer Expenditure Survey, Expenditures, Total Average Annual Expenditures, Total, Quintiles of Income Before Taxes, USD

It is the Fed's job to cool this situation down, and make sure it doesn't turn into a wage-price spiral. The Fed's tightening of financial conditions has meant some progress in slowing aggregate labor income, cooling the housing market and bringing down goods consumption. But the service spending dynamics mentioned above are unique to this COVID-19-driven cycle and arguably tougher to break. We believe this means the US economy (and earnings) probably don't fall off as sharply as many are projecting, and, however, also the Fed will need to keep rates higher for longer.

In the meantime, China is signaling the relaxation of zero-COVID-19 measures, even in the face of elevated case counts. In our view, this suggests a commitment to such a shift in policy, which should allow for a boost in consumption. The process is unlikely to play out in a straight line, but the direction of travel seems pretty clear, to us. Our confidence that the bottom is in for China is fortified since these adjustments to COVID-19 policy are taking place in tandem with the most comprehensive support for the property sector to date. A rebounding China may provide a needed boost as developed economies slow, but will also likely lead to higher commodity prices. This too may make it difficult for the Fed and other central banks to back off too quickly.

**Asset allocation**

Macro and cross-asset volatility are unlikely to fade away along with the calendar year. And the distribution of outcomes remains much wider than investors became accustomed to in the previous cycle. Our focus is therefore on positioning over the coming months as opposed to the coming year, and we are ready to pivot as the business cycle evolves.

Going into 2023, we expect global equities at an index level to remain range-bound. They will likely be capped to the upside by the Fed's desire to keep financial conditions from easing too much. However, we expect some cushion on the downside from a resilient economy and rebounding China.

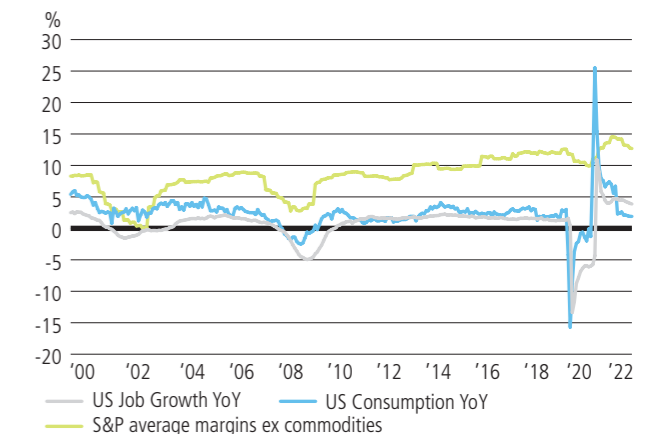
The relative value opportunity set across global equities appears fertile. Financials and energy are our preferred sectors. This is because we believe cyclically-oriented positions should perform if what appears to be overstated pessimism on global growth fades in the face of resilient economic data. Activity surprising to the upside and a higher-for-longer rate outlook should benefit value stocks relative to growth, in our view – particularly as profit estimates for inexpensive companies are holding up well relative to their pricier peers. On a regional basis, Japan is buoyed by a rare combination of accommodative monetary and fiscal stimulus.

We are neutral on government bonds. The Fed is likely to be slow in ending or reversing its hiking cycle as long as the US labor market bends but does not break, while signs that overall inflation has peaked may reduce the odds of over-tightening. However, price pressures are likely to remain stubbornly high – a side effect of a US labor market that refuses to crack. China's reopening should fuel a pick-up in domestic oil demand, offsetting some of the downward pressure on inflation from goods prices. In US and European credit, investment grade bond yields look increasingly attractive as a balance between a potentially resilient economy and more range-bound government bond yields.

We see commodities as attractive both on an outright basis and for the hedging role they serve in multi-asset portfolios. Already low inventories can continue to shrink in an environment of slowing growth so long as supply remains constrained – as is the case across most key commodity markets. Securing sufficient access to energy is not a problem that will be solved at the end of this winter – and may grow more intense as Chinese demand increases if mobility restrictions are removed. In addition, commodities have a track record of strong performance during months when stocks and bonds suffer meaningful declines.

In currencies, we believe we have moved from a strong, trending US dollar to more of a rangebound trade in USD. Our catalysts for a broad turn in the dollar are for the Fed to stop hiking interest rates, China's zero-COVID-19 policy to end, and energy pressures in Europe stemming from Russia's invasion of Ukraine to subside. None of these have fully happened yet, but all three appear to be getting closer. A more rangebound dollar coupled with a global economy that is still growing, but slowing, could provide a very positive backdrop for high carry, commodity-linked currencies. We prefer the Brazilian real and Mexican peso.

**Chart 3 – S&P 500 margins tend to be positively correlated with jobs, spending growth**



Source: UBS-AM, Macrobond. Data as of October 31, 2022

<sup>2</sup> <https://www.chicagofed.org/publications/working-papers/2020/2020-15>

# Will the 60/40 portfolio rise from the ashes?

2022 has so far been one of the worst years on record for a US 60/40 portfolio. Here, the multi-asset team argue that while the longer-term outlook may be more positive, continuing uncertainty increases the appeal of diversifying exposures beyond traditional stocks and government bonds.



Louis Finney  
Research Analyst  
Investment Solutions



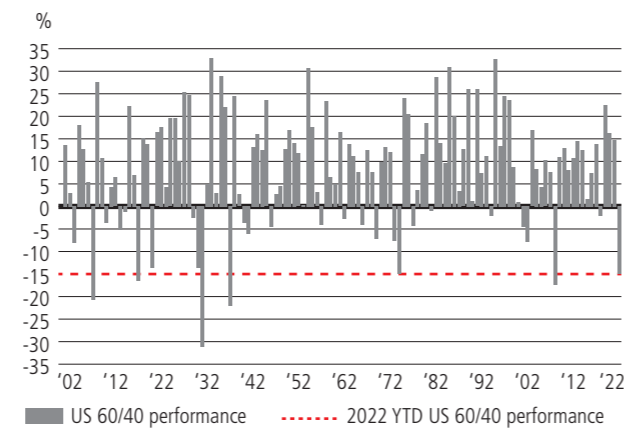
Nicole Goldberger  
Head of Growth  
Multi-Asset Portfolios

For much of the past 25 years, investors have benefitted from a consistently negative correlation between equities and bonds. Simply put, when equities sold off, investors could generally rely on bonds to provide ballast and protection in a multi-asset portfolio.

However, persistently elevated inflation and aggressive central bank tightening campaigns have put financial markets under significant pressure this year. Investors have had virtually nowhere to hide: the total return from global stocks is -21% through the first 10 months of the year. Global sovereign bonds and credit have also performed poorly, with total returns of -22% and -21% respectively, over this same period<sup>1</sup>.

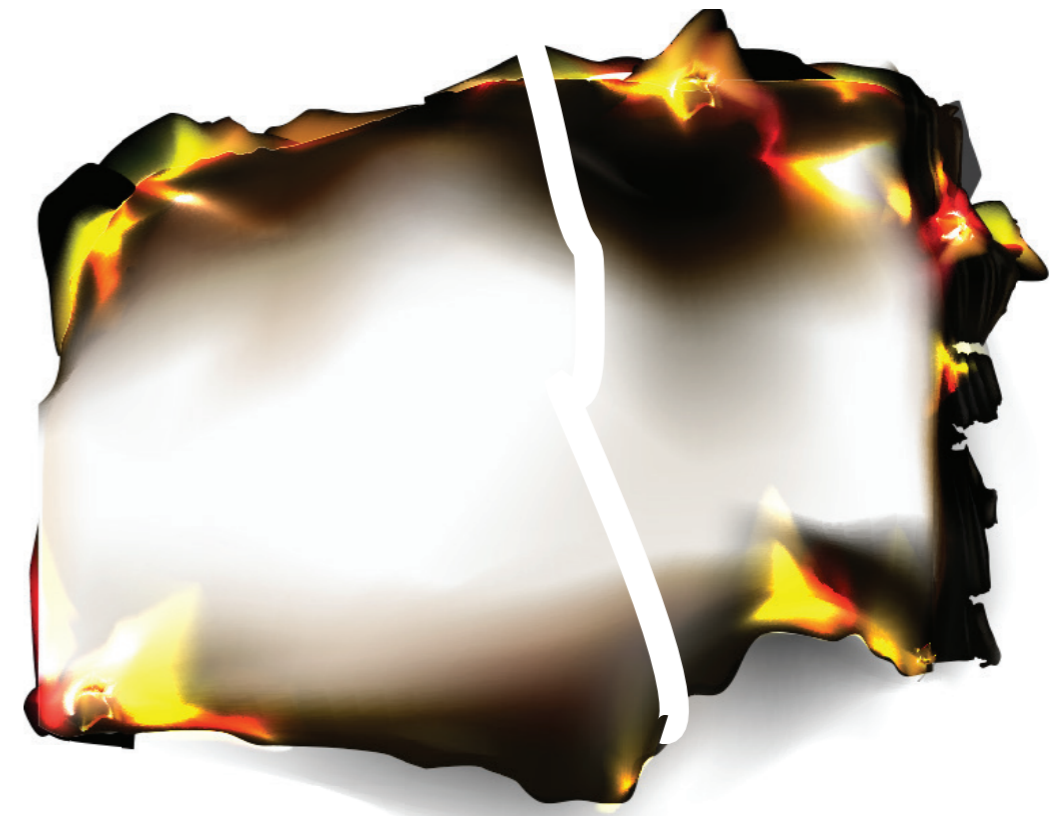
This has seen the typically negative stock-bond correlation turn positive. As of mid-November, the year-to-date return from a portfolio with a 60% weighting to US stocks and 40% weighting to US Treasuries is -15% (Chart 1). There have only been five calendar years on record in which the annual performance for this traditional portfolio structure has been worse – and besides the 2008 global financial crisis, all were more than 80 years ago.

**Chart 1: 2022 has been one of the worst years on record for a US 60/40 portfolio**



Source: Goldman Sachs Investment Research Division, as of 16 November 2022. Based on performance of S&P 500 and US 10-year Treasury note, rebalanced daily.

<sup>1</sup> Source: MSCI ACWI Index, Bloomberg Global Aggregate Treasuries Total Return Index, Bloomberg Global Agg Credit Total Return Index, to end October 2022

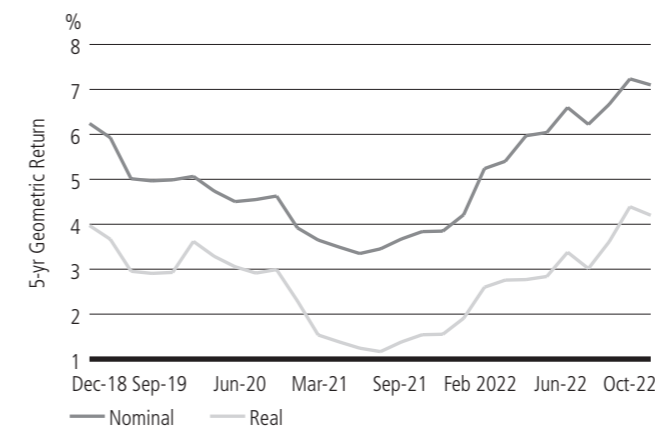


## Good news about bad markets

We acknowledge that the near-term macro outlook is unusually uncertain. But regardless of what 2023 brings, we believe the inflation, growth, and geopolitical factors that have caused market strife in 2022 are increasing the potential rewards for medium- and long-term investors willing to bear these risks. This is the good news about bad markets.

We develop capital market expectations, which are projections for how different asset classes will perform over five years given our assumptions for growth, inflation, monetary policy, and other key macro factors. These estimates indicate that now is a much more attractive investing backdrop compared to 12-15 months ago. In our baseline scenario, expected five-year annual returns for a global 60/40 portfolio are now 7.1%, vs. 3.3% in July 2021, while real (that is, inflation-adjusted) returns are 4.2% vs. 1.2% (Chart 2).

**Chart 2: History of five-year expected annual returns for a global 60/40 portfolio**



Source: UBS-AM, as of 31 October 2022. Note: the Y axis shows the annual 5-year geometric return (%) in USD terms. Nominal returns are in current dollars, while real returns are inflation-adjusted. The reference indexes are MSCI All-Country World Index (unhedged USD) and Bloomberg Global Agg (hedged USD).

This is the best outlook for returns since at least the fourth quarter of 2018. For investors who embrace diversification and augment portfolios with additional asset classes, the prospective return profile is even better. This is particularly pertinent in the current environment, where investors have to entertain the possibility that more inflationary macroeconomic regimes endure for some time.

## Valuations improve

The main driver of better expected returns across asset classes is the improvement in valuations relative to those embedded in our capital market assumptions from mid-year 2021. More favorable valuations, while retaining a similar outlook for real activity, naturally entail higher return expectations, all else being equal. Our expected return on cash has increased substantially, from less than 1.0% to 3.8%, following substantial interest rate hikes by central banks.

The extent of monetary tightening is linked to another change in our estimates: the average outlook for inflation over this horizon, which has risen from near 2% to close to 3%. Importantly, while more robust price pressures help improve nominal expected returns, expected real (inflation-adjusted) returns across asset classes have also improved materially.

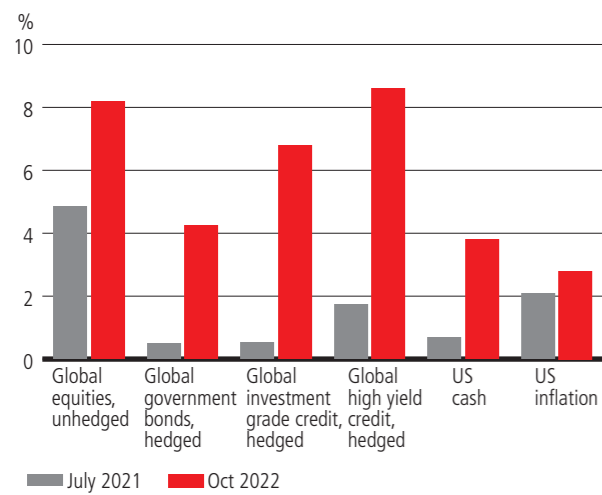
Currencies are another key consideration. The US dollar has become even more expensive over the past year, which in our projections increases the expected depreciation of the US dollar over time as it reverts towards fair value. We believe this is poised to boost returns for USD-based investors who hold international assets over a five-year horizon.

**Coupon-paying assets**

Across the major liquid asset class of equities, government bonds and credit, our baseline outlook for expected returns is meaningfully higher as of October 2022 than in July 2021 (Chart 3). The improvement in the return profile is most evident in assets that pay a coupon – government bonds and credit. This is a function of the higher starting point for risk-free rates thanks to central bank tightening.

With this regime shift, it is finally possible to earn some income in bonds. Perhaps this development is best illustrated by the dwindling stock of negative-yielding debt globally (Chart 4). Credit markets, across both investment grade and high yield, are looking particularly attractive too. For example, the expected return of global investment grade credit has seen a huge jump, rising from a mere 0.5% to 6.8%. We believe this leads to the end of the TINA era (“there is no alternative” besides stocks). This should be a good-news story on the outlook for diversified multi-asset portfolios. We believe diversification beyond a broad 60/40 portfolio matters now more than ever with positive expected returns across asset classes and a less reliable negative stock-bond correlation.

**Chart 3: Five-year expected returns: then and now**



Source: Source: UBS-AM, as of October 31, 2022. Note: returns shown in USD terms. Reference indexes for these asset classes are the MSCI All-Country World Index (unhedged USD), Bloomberg Global Treasuries (hedged USD), Bloomberg Global Credit (hedged USD), Bloomberg Global High Yield (hedged USD), 3-Month Treasury Bill, and US Consumer Price Index

**Chart 4: The disappearance of global negative-yielding debt**



Source: Bloomberg Global Aggregate Negative Yielding Debt Market Value (USD) Index, as of 17 November 2022

**Scenario analysis**

We also explore how sensitive our return expectations are to different mixes of growth and inflation over five-year time frames:

- Deep recession: lower inflation, lower (or negative) growth.
- Stagflation: a sustained period of above-trend inflation and below-trend growth.
- Goldilocks: a moderation of inflation, along with above-trend growth.
- Reflation: above-trend inflation and above-trend growth.

These scenarios (see tables) reflect the economic backdrop that will play out over the first two years of the horizon, followed by a three-year period of mean reversion (that is, baseline annual returns). As shown in the previous section, the global 60/40 portfolio has a nominal expected annual return of 7.1% and a real expected annual return of 4.2% over the next five years in our baseline projection.

Expected annual real returns are 5.5% and 8.0% in the reflation and goldilocks scenarios, respectively. Real expected returns are meaningfully negative in a stagflation scenario (-6.2%), with a positive stock-bond correlation challenging performance in all parts of the 60/40 portfolio. In a deep recession, real projected returns are also modestly to the downside (-0.4%).

**Expected Five-Year Returns by Scenario**

Economic Assumptions	Baseline	Deep Recession	Stagflation	Goldilocks	Reflation
Inflation	2.8%	1.3%	6.0%	2.0%	5.0%
Economic Growth	2.5%	1.1%	1.2%	3.0%	3.0%
Nominal Growth	5.3%	2.5%	7.3%	5.1%	8.2%

		Nominal Terms						
		Starting Yield	Baseline	Deep Recession	Stagflation	Goldilocks	Reflation	
Cash	Cash	4.5%	<b>3.8%</b>	1.5%	6.5%	3.2%	4.9%	
	Fixed Income	Global Government Bonds	3.0%	<b>4.2%</b>	5.5%	2.1%	4.4%	2.1%
		Global Investment Grade Bonds	6.0%	<b>6.8%</b>	8.2%	5.0%	7.0%	6.2%
		Global Agg	3.8%	<b>5.0%</b>	6.0%	3.1%	5.1%	3.4%
		Global High Yield	10.0%	<b>8.6%</b>	5.5%	5.3%	11.0%	10.1%
TIPS	1.7%	<b>4.9%</b>	4.5%	8.5%	3.6%	6.0%		
Equity	Global Equity		<b>8.2%</b>	-1.7%	-1.6%	12.4%	15.1%	
	60/40 Portfolio		<b>7.1%</b>	1.4%	-0.2%	10.1%	10.5%	
	Standard Deviation		<b>10.7%</b>	14.1%	16.4%	8.8%	9.3%	
	Diversified Portfolio		<b>7.4%</b>	1.2%	1.2%	10.5%	11.9%	
	Standard Deviation		<b>10.7%</b>	14.1%	16.4%	8.8%	9.3%	

		Real Terms						
		Starting Yield	Baseline	Deep Recession	Stagflation	Goldilocks	Reflation	
Cash	Cash	4.5%	<b>1.0%</b>	0.2%	0.5%	1.2%	0.0%	
	Fixed Income	Global Government Bonds	3.0%	<b>1.4%</b>	4.1%	-3.7%	2.4%	-2.8%
		Global Investment Grade Bonds	6.0%	<b>3.9%</b>	6.7%	-0.9%	4.9%	1.2%
		Global Agg	3.8%	<b>2.2%</b>	4.6%	-2.8%	3.1%	-1.5%
		Global High Yield	10.0%	<b>5.6%</b>	4.1%	-0.7%	8.8%	4.8%
TIPS	1.7%	<b>2.0%</b>	3.1%	2.4%	1.6%	0.9%		
Equity	Global Equity		<b>5.3%</b>	-3.0%	-7.2%	10.2%	9.6%	
	60/40 Portfolio		<b>4.2%</b>	-0.4%	-6.2%	8.0%	5.5%	
	Standard Deviation		<b>10.9%</b>	14.2%	16.8%	9.0%	10.0%	
	Diversified Portfolio		<b>4.5%</b>	-0.2%	-4.5%	8.3%	6.6%	
	Standard Deviation		<b>10.9%</b>	14.2%	16.7%	8.9%	9.8%	

Source: UBS-AM, forecasts & data in USD terms, as at 31 October 2022. Diversified portfolio consists of 55% global equities (unhedged), 33% global bonds - government, securitized, investment grade, high yield, and 12% real assets - global real estate (unhedged), US Treasury inflation protected securities, and commodities

**A good time to diversify**

We strongly believe that the persistence of unusually elevated macroeconomic uncertainty increases the appeal of diversifying portfolio exposures beyond traditional stocks and government bonds. In particular, adding a larger suite of assets to the portfolio should help address challenges posed by a prolonged period of elevated inflation.

For example, in the Table we also present a more diversified portfolio consisting of global equities, a wider array of bonds such as global high yield, and exposure to real assets that can provide inflation protection. Applying our capital market assumptions, this diversified portfolio offers the same risk profile as the 60/40 portfolio, but with a superior baseline expected return despite a 5% reduction in the global equities allocation. Importantly, this portfolio’s projected returns are meaningfully better than the 60/40’s when inflation runs hot, that is, in the stagflation and reflation scenarios.

**Brighter outlook for longer-term investors**

Our five-year capital market expectations send a clear message: 2022’s pain may be laying the foundation for better future gains. The range of return projections, both at the portfolio level and for individual asset classes, remains wide – particularly in the near term. But for medium- and long-term investors, the outlook is much brighter now than it was in the middle of last year.

We see benefits to diversifying beyond a broad 60/40 portfolio by incorporating additional building blocks in portfolio construction – a wider selection of markets within fixed income such as credit, as well as exposure to real assets. These diversified multi-asset portfolios are likely to be more resilient and better positioned to perform in different regimes, and in particular, more inflationary macroeconomic environments going forward.

# Turning positive? Three reasons to look at fixed income again

After many years of negative interest rates, yields on fixed income assets have finally turned positive. Charlotte Baenninger, Head of Fixed Income, discusses the benefits of positive yields currently available in fixed income markets.

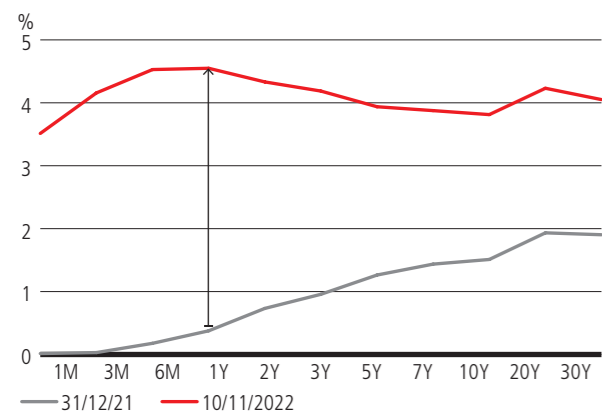


Charlotte Baenninger  
Head of Fixed Income

To say 2022 has been a difficult year for fixed income investors is a gross understatement. With central banks across developed economies responding to inflation reaching 40-year highs, bonds have repriced significantly, causing the largest losses across the fixed income spectrum in many years.

In the US, the yield curve has flattened substantially since the beginning of the year; almost the whole curve now exceeds 4% (Chart 1).

Chart 1: US yield curve flattens over 2022



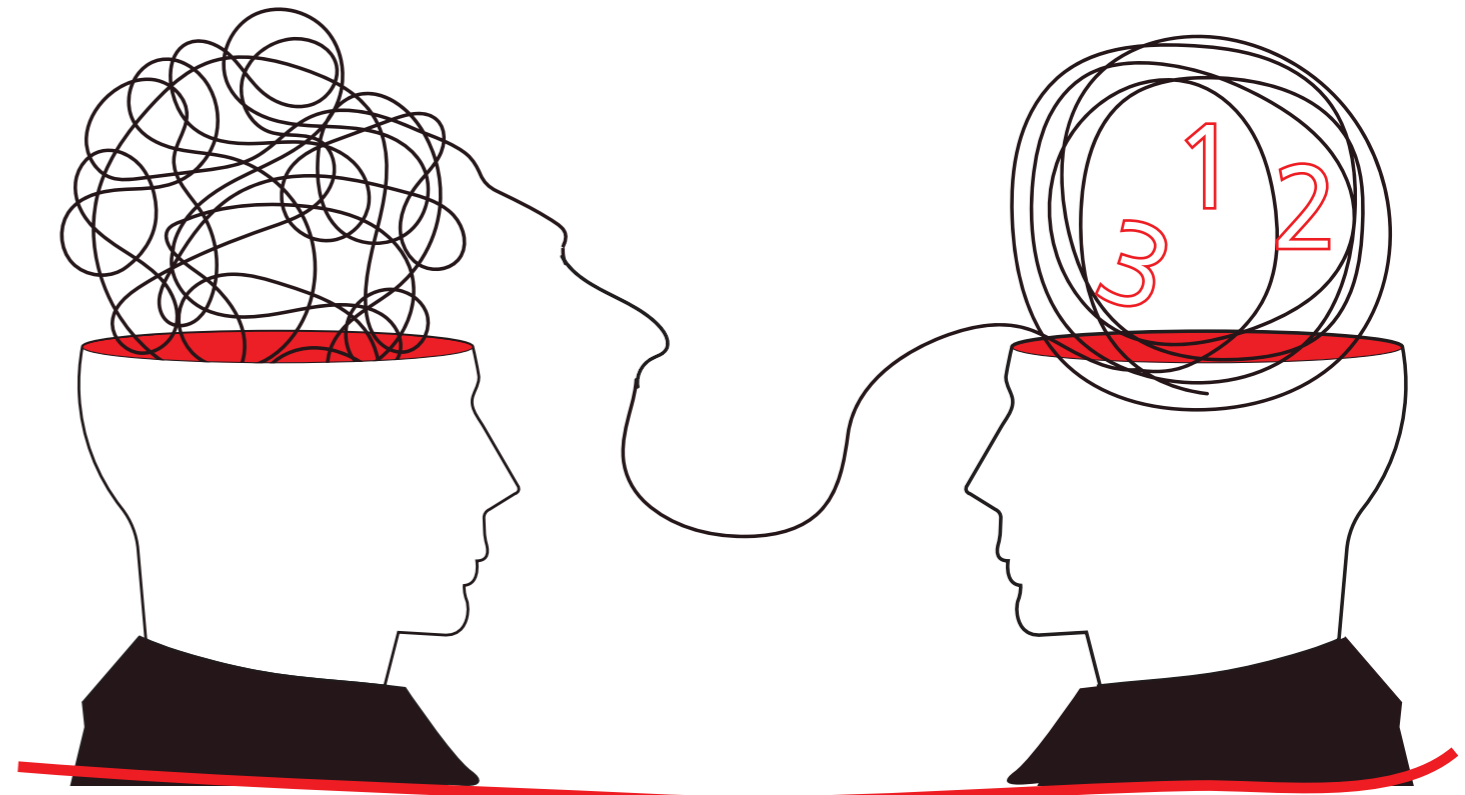
Source: Bloomberg, as of 10 November 2022

In the UK, intermediate (7-10 year) gilts have been a significant underperformer, selling off by more than 260 bps to get to a current yield level of 3.54%, while returning -16.9%. For those investors who either track a benchmark or had a low flexibility tolerance and had to own negatively yielding bonds in markets such as Germany, they also felt a lot of pain. German intermediate government bond yields rose 235 bps to +2.06%, resulting in a negative return exceeding 16%.

The flip side to these market moves is that not only are the yields on offer in most fixed income sectors considerably higher today than in the past, but the amount of negatively yielding debt has all but evaporated. From a high of USD18 trillion at the end of 2020, now there is less than USD 2 trillion of negative yielding debt outstanding.

**With income finally back in fixed income, we outline three factors for optimism:**

1. Over the long-term, yield is by far the most stable and reliable component of total return for bonds.
2. Higher break-evens (from higher yields) act as "shock absorbers".
3. Investors no longer need to reach for yield by taking unnecessary credit risk.

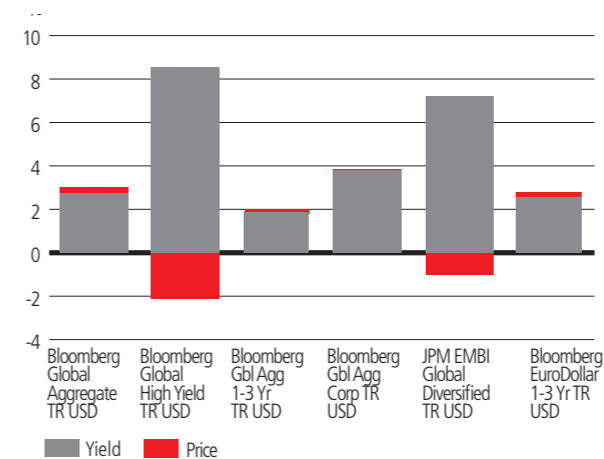


**1 Over the long-term, yield is by far the most stable and reliable component of total return for bonds**

Over the past 20 years, yield (income) has been the dominant driver of total returns in bond portfolios. For certain asset classes such as high yield and emerging markets, price return has been negative over the long term yet performance has been positive and very strong, demonstrating the power of yield (Chart 2).

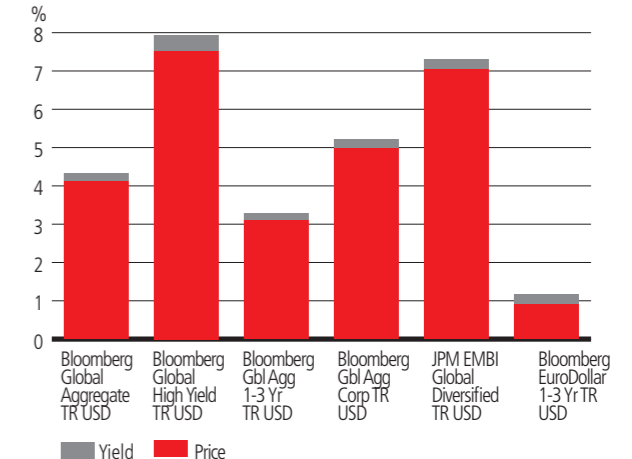
Despite the large role yield plays in total return, it only contributes a minor proportion towards total return volatility. Looking at Chart 3 – which simplistically displays yield and price as a proportion of total return volatility – we can see that while yield has contributed the most to total return over the past two decades, it has done so while contributing a lower percentage to the overall volatility.

Chart 2: Fixed income sub asset class returns broken down by price and yield over the past 20 years



Source: Bloomberg, data period from 2 February to 31 October 2022. Returns are gross of fees

Chart 3: Fixed income sub asset class volatility broken down by price and yield over the past 20 years



Source: Bloomberg, standard deviation data period from 2 February to 31 October 2022

**2 Higher break-even rates (from higher yields) act as ‘shock absorbers’**  
 Break-evens in this context simply refer to the magnitude of rate increases needed to wipe out the head-start provided by yield income from a total return perspective. In general, the higher the level of yield, the larger the magnitude of rate increases required to generate a negative total return (i.e., wipe out positive contribution from income). In Table 1, we show break-evens for major fixed income asset classes and how much they have changed since the beginning of the year.

Looking at the Bloomberg Global Aggregate Index, break-evens were at 17 bps at the beginning of the year; they are now at 57 bps. The Global Aggregate Corporates Index has risen from needing 25 bps of yields rising to 92 bps before negative total returns set in. The short duration sectors are really shining: this is because curves have flattened, and short duration assets have much less interest rate sensitivity. At the end of 2021 the Global Aggregate 1–3 Year Index required just a 38 bps rise in bond yields to generate a negative return. More recently, this same benchmark now requires nearly 190 bps of yield increases to erase its higher yield advantage.

**Table 1: Change in break-evens for major fixed income asset classes in 2022 YTD**

Index	Break-even at end Dec 2021 (bps)	Break-even at end Oct 2022 (bps)	Extra cushion to absorb rising yields (bps)
Bloomberg Global Aggregate Index	17	57	40
Bloomberg Global Aggregate 1-3 Year Index	38	189	152
Bloomberg Global High Yield Index	114	242	128
Bloomberg Global Aggregate Corporates Index	25	92	66
ICE BofA 1-3 Year Eurodollar Index	63	283	220
JPM EMBI Global Diversified Index	66	148	82

Source: Bloomberg, JP Morgan, ICE BofA, as of end October 2022

**3 Investors no longer need to reach for yield by taking unnecessary credit risk**

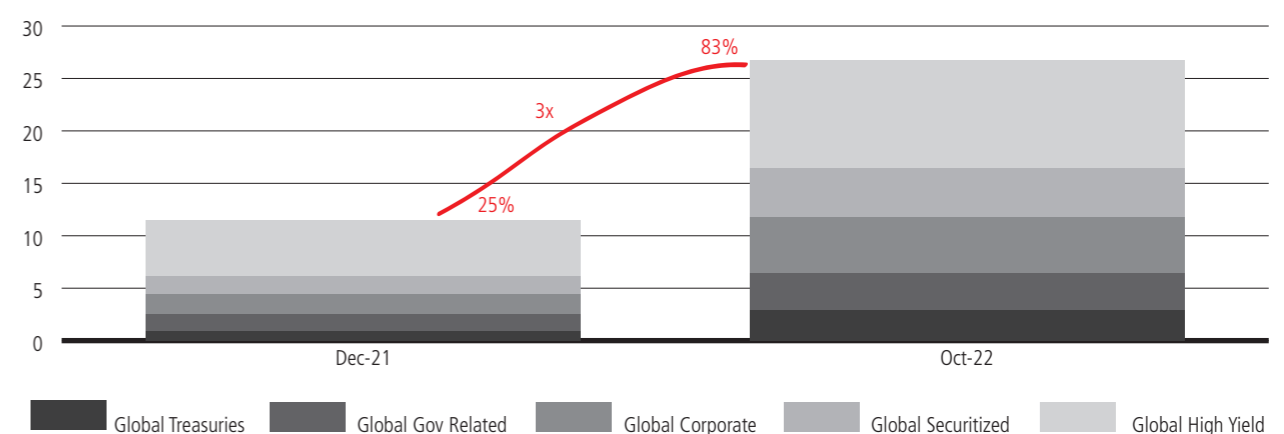
In a regime of ultra-low government bond yields and steep yield curves, investors in developed markets bonds were faced with a rather difficult trade-off: generate higher yields by going out further on the maturity curve and taking on more interest rate risk, or take on more credit risk by moving down the credit quality spectrum.

As Chart 4 shows, at the end of last year, only a quarter of the market offered yields of more than 2% (in USD). Today, this universe has more than tripled to 83%. We would argue that this development allows for a much better starting point for investors to achieve their investment goals, with an ability to build a much more diversified portfolio in terms of both issuers and sectors.

**Risks in a world of rising yields**

Investors now have much greater flexibility to achieve their yield targets, but clearly, while there are benefits to having higher yields today, we should keep in mind that, with the Federal Reserve and other central banks focused on stamping out persistently high inflation, markets are likely to remain volatile over the short-to-medium term. However, for long-term investors, bonds are arguably better placed today to handle any further price declines than in the past.

**Chart 4: The growth in the proportion of the fixed income market yielding 2% or more**



Source: Bloomberg, as of end October 2022  
 The Global fixed income universe is proxied by the Bloomberg Multiverse Index. The Bloomberg Multiverse index provides a broad-based measure of the global fixed income bond market: The index is the union of the Global Aggregate Index and the Global High Yield Index as it represents investment grade and high yield bonds in local currency terms



# A new paradigm for equity long-short alpha?

We appear to be entering a new paradigm in financial markets: the implications for equity long-short are potentially significant. Here, Bernie Ahkong, Head of UBS O'Connor in Europe and Co-CIO of O'Connor Global Multi-Strategy Alpha, gives his outlook for this strategy.



**Bernie Ahkong**  
Head of UBS O'Connor in Europe  
Co-CIO of O'Connor Global Multi-Strategy Alpha

The last two years have been very difficult for global equity long-short alpha strategies, compared to the previous decade. Dramatic shifts in the macroeconomic environment have challenged long-held microeconomic assumptions and global equity long-short strategies have struggled.

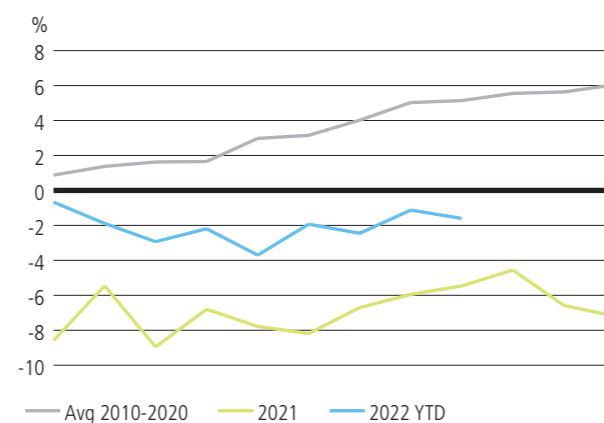
Inflation has moved up to levels not seen since the 1980s and central banks have aggressively tightened monetary policy. As a result, higher valued companies have been disproportionately impacted as they are typically the higher growth or higher quality companies that equity investors are positively biased towards. A sustained and persistent increase in interest rate volatility has also led to higher factor volatility, influencing equity prices more frequently and heavily, which is not something fundamental equity long-short managers are accustomed to.

Chart 1 shows data from Morgan Stanley Prime Brokerage, illustrating the average global alpha generated by their hedge fund client base during the 2010-2020 period compared to 2021 and 2022 YTD.

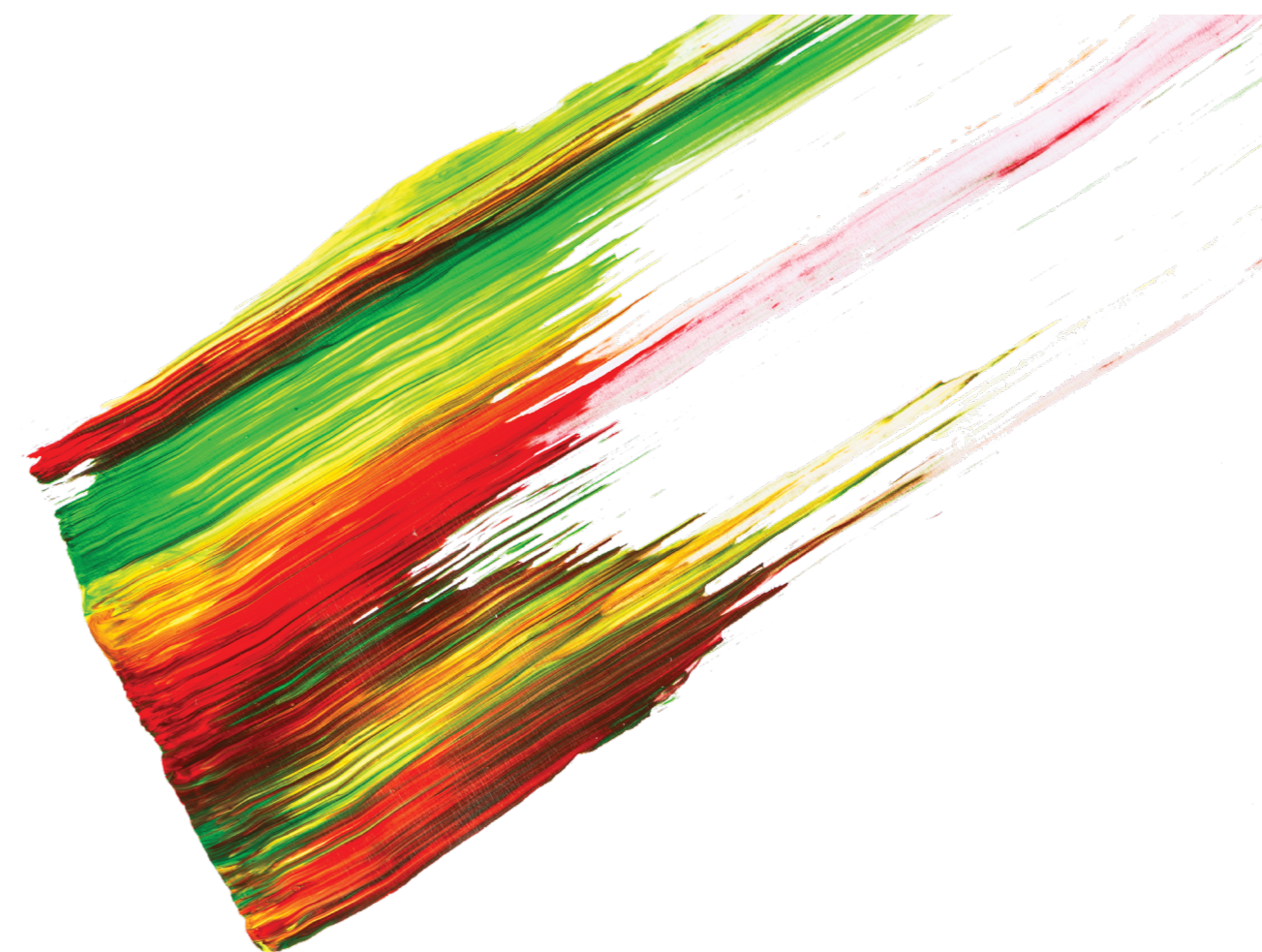
Cyclically, we could see some mean reversion from here given the scope for rate volatility to move lower from an elevated starting point.

Historically, this has been positive for relative value long-short equity investing. Chart 2 shows the MOVE Index – which looks at near-term implied volatility across different US Treasury maturities – reached levels during October last seen during the global financial crisis of 2007-2008.

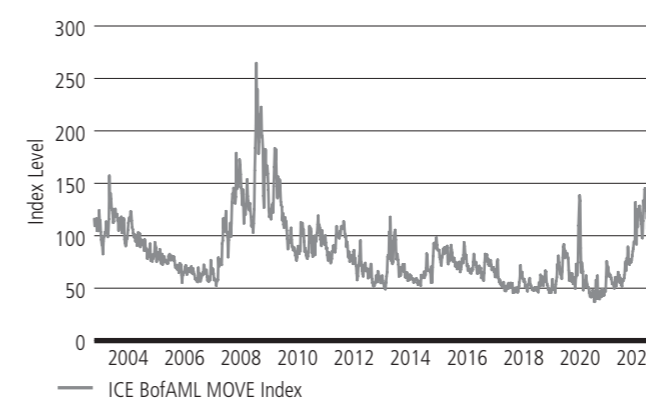
**Chart 1: Global alpha generated by hedge funds**



Source: Morgan Stanley Prime Brokerage, data as of 30 September 2022



**Chart 2: Rising bond market volatility**



Source: ICE BofAML MOVE Index, to 10 November 2022

Many inflation data points have surprised to the upside this year, leading the US Federal Reserve to hike interest rates aggressively and rate volatility to spike. However, regardless of your view on inflation and central bank policy from here, it is difficult to see rate volatility staying this elevated in 2023.

Something has changed structurally, though. Years of accommodative central bank policy and supportive demographics from emerging markets have led to a structurally low interest rate and inflation environment. This helped support a backdrop of backing

high growth companies regardless of valuation, and arguably diluted the skillset of focusing on relative valuation and capital structure differences.

We believe that this potential new paradigm favors teams with: experience through past cycles; a focus on bottom-up fundamental analysis combined with a strong relative value framework; and collaboration between teams across asset classes. There are also areas with structural alpha tailwinds relating to regulatory, policy, geopolitical and thematic change, which relate less to variables like interest rates and inflation. These are areas like China, private credit, event-driven situations, energy transition and trade finance.

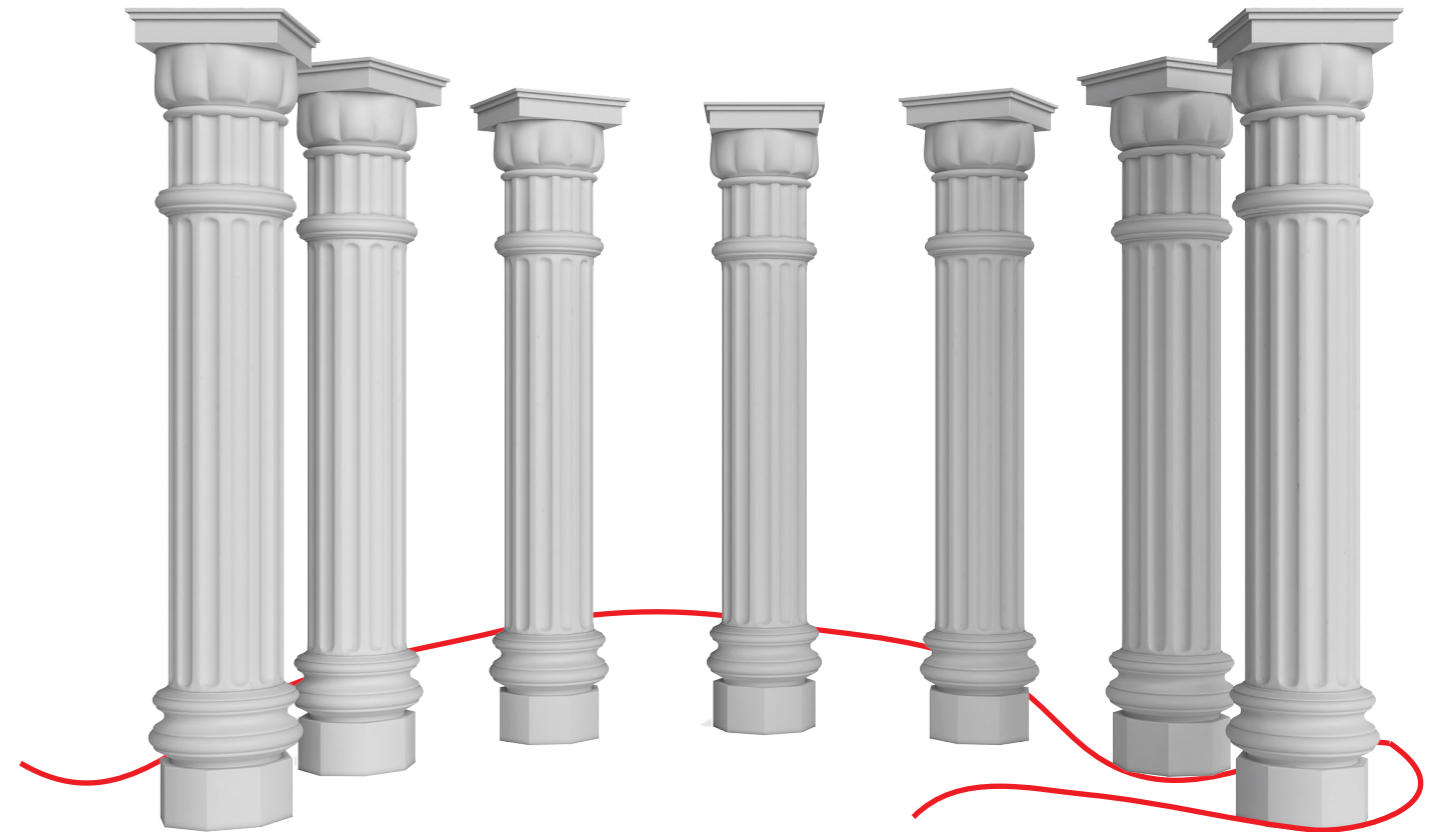
In China we see four supportive factors operating together – high retail participation, low institutional investor interest, low research analyst coverage relative to other major markets, and improving liquidity for institutional investors. We believe this will create a conducive environment for long-short investing regardless of the market environment.

Equity long-short alpha has indeed been more challenging of late, and will require capabilities that not all investors are equipped with. Yet there are cyclical and structural reasons for investors to be more constructive on the opportunity set as we move into 2023 and beyond.

# What next for central bank policy?

Will central banks stick to their goal of raising rates until inflation is back under control or will rising debt servicing costs make tolerance of inflation a more attractive choice? What does this mean for fixed income investors?

Author:  
Fixed income team



**W**e are in an unusual situation: central banks are tightening monetary policy to curb record levels of inflation, not when economic growth is strong, but as economies are already slowing dramatically and some are heading for recession (Charts 1&2). What does this mean? Will the fixed income strategies deployed over the last 10 years work again?

Central banks in many areas, including the US, Eurozone and the UK, are likely to face a very stark choice as 2023 progresses: either keeping to a path of deflation (effectively tipping their economies into recession to help tackle inflation),

or accept devaluation (effectively accepting inflation running at higher levels than they target, for longer).

Central banks, keen to reestablish their inflation-fighting credentials, will be determined and keep going down the deflation route, deploying hawkish rhetoric along with big rate hikes. But as recession looms, that may become a tough line to stick to.

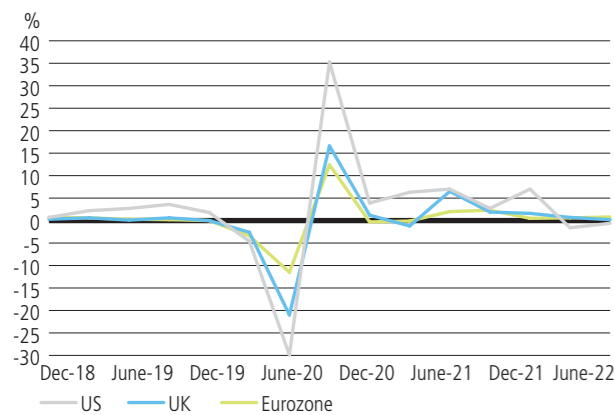
### Controlling inflation

In trying to turn around economies for over a decade, central banks aimed for inflation that was close to or below target. A wide range of policy tools were brought to bear, at enormous

scale but arguably with very little effect. Despite deploying zero or negative policy rates in many countries and creating trillion-dollar balance sheets, central banks found it was extremely difficult to bring inflation back to target.

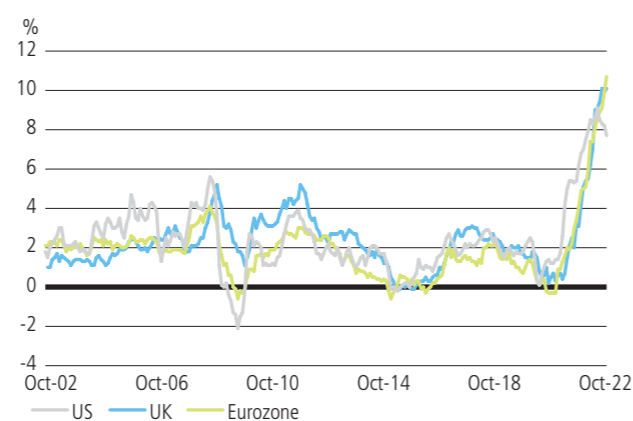
With central banks raising rates in the face of record levels of inflation (Chart 3&4), it would be unwise to underestimate how much might be needed to bring inflation back to target. Cyclical factors will probably help stem the tide of inflation in coming months, but structural factors will also play a part and these could turn out to be much more sticky.

**Chart 1: Real rates of GDP growth flatlining in developed markets**



Source: US GDP: US Department of Commerce; UK GDP: Office for National Statistics; Eurozone GDP: Eurostat. Data as at 30 June 2022

**Chart 2: Inflation in the US, UK and Eurozone see strong acceleration**



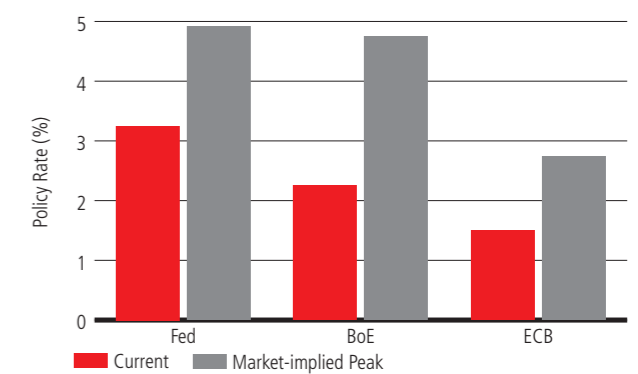
Source: US Department of Commerce; UK Office for National Statistics; Eurostat. Data as at 31 October 2022

**Chart 3 : US core PCE inflation breaches 5%**



Source: US Department of Commerce, Bureau of Economic Analysis, as at 1 November 2022

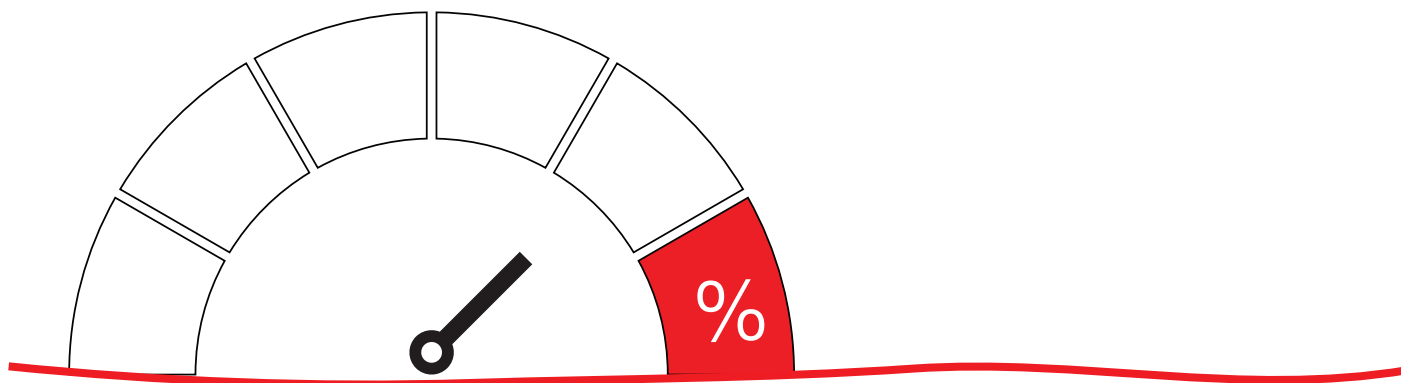
**Chart 4: Central Bank policy rates vs forecast peak**



Source: US Federal Reserve, Bank of England, European Central Bank, as at 1 November 2022

### The changing approach to policy

Central bank policy making has always been subject to change over time. The last Federal Reserve (Fed) rate hiking cycle, which really began in 2016, was overseen by Janet Yellen. Policymaking was forward-looking, preemptive and generally model-based. Rates were raised well before inflation got back to target. And, in fact, it only just got above target in that period.



The ‘Yellen years’ were very different to the world of today. In 2020, the Fed changed its language on inflation in quite an important way, where they emphasized managing average inflation over time. This allows policymakers more flexibility in that inflation can be allowed to modestly and temporarily run above target, or vice versa.

But policy making seems to have changed in a more fundamental way too. Today’s Fed seems more focused on current inflation prints than has been the case historically and therefore is much more reactive than preemptive. It is also less clear what rules or models are informing decision making. A lot has changed, and that includes policymaking.

**Collateral damage**

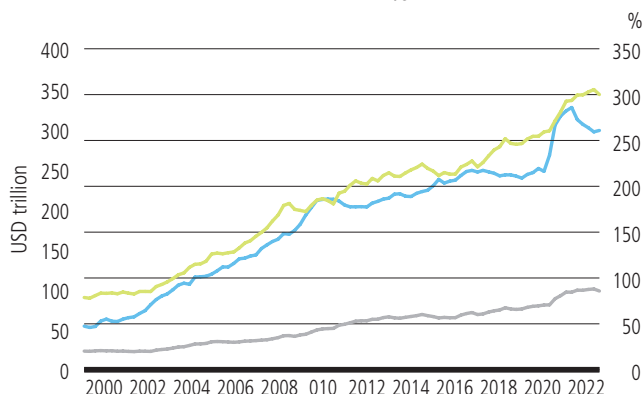
Global debt levels are now around 350% to global GDP; relative debt levels have generally been increasing over the last twenty years, as have absolute debt levels (chart 5). For some commentators, the argument was that this didn’t matter. Why? Because financing costs were generally falling around the world. Central banks were cutting rates, real rates fell and debt service was therefore getting easier, even at higher absolute levels.

But if both real rates and nominal rates are increasing, will these high debt levels start to matter? We think so. Debt servicing is likely to get harder, not only for companies, but also for governments. And it is a fact of life, when debt levels are high, tolerating higher levels of inflation can become a more attractive policy choice.

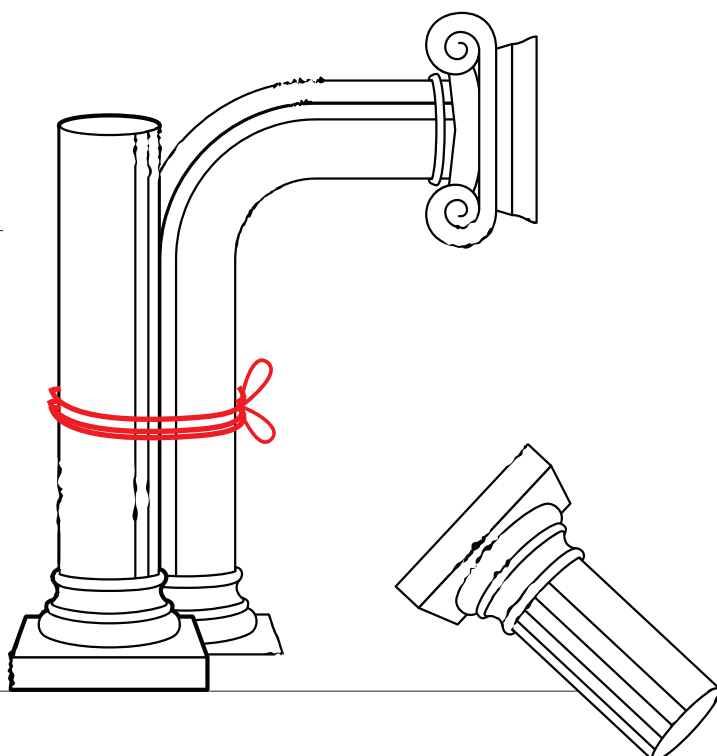
**Implications for fixed income investors**

The themes that we have touched on here are global in nature, and will unfold at different rates in different countries. The policy choices made in Europe are likely to be quite different from the policy choices made by the US in the coming years. And that is going to mean different risks and different returns for those markets. That will be particularly true if central banks are forced to either increase rates much higher than anyone is currently anticipating, or equally if they retreat from the hawkish rhetoric and decide to tolerate higher levels of inflation for longer. In this environment, we believe strategies that are flexible and able to exploit those different opportunities are likely to be the most successful.

**Chart 5: Global debt levels reach 350% to GDP**



Source: IIF. Data as at 1 November 2022



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