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Year Ahead 2024: Scenario update

Global financial markets

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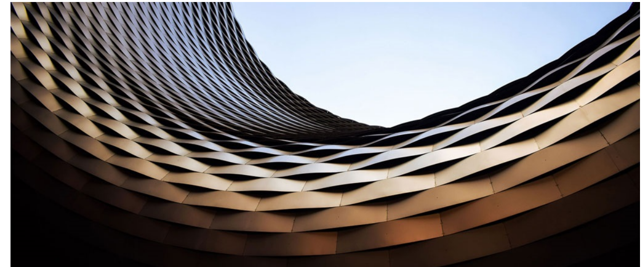
- Equity and bond markets have rallied since we published our Year Ahead outlook in mid-November.
- Inflation has continued to slow, and the Federal Reserve has signaled a greater willingness to ease policy than expected.
- In this report, we revise our potential scenarios for the Year Ahead, and discuss how investors can position. Our base case is for a “soft landing,” and more upside for equity indexes and quality bonds.



Source: Unsplash/Lisa Therese

Since we published our Year Ahead outlook on 16 November, global equities (MSCI All Country World Index) have rallied by 3.8% and high-quality bonds (Bloomberg Eurodollar Aa or Higher, 5–7 Years Index) by 3.5%. The S&P 500 is now up 13.9% from its October low, and the 10-year US Treasury yield is about a full percentage point lower than its October highs.

Growth data have generally been resilient, inflation data have been surprisingly soft, and the Federal Reserve has signaled its willingness to cut interest rates sooner, and by more, than had been expected. As a result, we revise our potential scenarios for the Year Ahead.

Our base case scenario is for a “soft landing,” in which growth slows to just below trend, inflation falls toward central bank targets by the second half of the year, and US interest rates are cut four times in 2024. In this scenario, we would expect further downside for bond yields and modest further upside for global equity indexes.

Our upside “Goldilocks” scenario would see inflation fall, the Fed cut rates six times in 2024, yields stay close to current levels, and growth remain robust. Our downside “hard landing” scenario sees economic growth turn negative, though the recent easing of financial conditions should reduce the potential severity of such a scenario.

We believe successful investing from here will be about finding parts of the market that can deliver attractive returns across a range of potential scenarios, or those companies and sectors that can allow investors to capture further upside if markets continue to move higher.

In fixed income, with rate cuts firmly on the horizon, we reiterate the need for investors to manage liquidity—limiting cash balances and locking in yields. Although yield volatility is likely to remain high in the near term, we expect positive returns for quality bonds across a range of market scenarios in 2024.

In equities, we continue to see quality stocks as a core holding for investors. History shows they tend to outperform in periods of slowing economic growth, as we expect in our base case. We keep a most preferred stance on the US IT sector, home to many quality stocks. By also complementing core holdings in quality stocks with tactical exposure to small caps, investors should be well positioned to capture more upside if markets continue to move higher.

In currencies, while we expect modest US dollar strength in the near term, the Fed’s dovish pivot sets the stage for a weaker dollar over 2024. Meanwhile, we see upside in both oil and gold prices.

This report has been prepared by UBS AG and UBS Switzerland AG and UBS Financial Services Inc. (UBS FS) and UBS AG London Branch. Please see important disclaimers and disclosures at the end of the document.

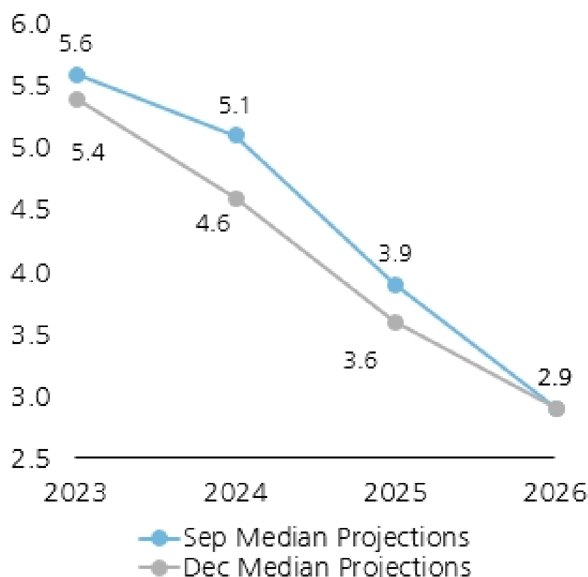
We think a balanced portfolio of equities, bonds, and alternatives is the best way for investors to preserve and grow wealth over time. We expect upside for balanced portfolios in our base case and upside scenario; see diversification, discipline, and rebalancing as key in a fast-moving market; and think the recent rally in broad equity and bond markets means investors need to consider tapping into a broader range of opportunities, including active management and alternatives.

What's happened to growth, inflation, and interest rates?

Growth – still robust
In the Year Ahead publication, we wrote: "We expect slower growth for the US economy in 2024 as consumers face mounting headwinds. We expect European growth to remain subdued, and China to enter a 'new normal' of lower, but potentially higher-quality, growth."

Since then, growth data have generally shown resilience. US retail sales beat expectations, with a 4.1% year-over-year increase in the month of November. The labor market has remained robust, with 216,000 jobs added in December, and the unemployment rate holding steady at 3.7%. Data from China have been slightly better than expected, with retail sales and industrial production surprising positively. The picture in Europe is little changed.

The Fed has become more dovish and recently revised its rate expectations lower
Fed September and December dot plots, median rates projections, %



Source: Bloomberg, UBS, as of January 2024

Inflation – trending lower
In the Year Ahead, we said: "Inflation made progress toward central bank targets in 2023, and in 2024 we believe that journey will continue. In our base case, we expect US and Eurozone core consumer price inflation to end 2024 in the 2–2.5% range."

Since then, inflation has trended lower. US November consumer price inflation data confirmed the trend established in October that inflation is on a trajectory to approach central bank targets by the second half of 2024. Headline CPI fell to 3.1% year-over-year, with core CPI at 4%. Eurozone core inflation dropped sharply in November, with year-over-year CPI at 3.6% from 4.2% in October, and fell further to 3.4% in December. China's CPI is negative, at –0.5% year-over-year in November.

Rates – lower expectations
In the Year Ahead, we stated: "Although inflation will likely remain above the 2% targets through most, or all, of the year ahead, we believe policymakers will be sufficiently confident by midyear that inflation is falling sustainably toward target. Our base case is for the European Central Bank and Bank of England each to cut rates by 75 basis points in 2024, while we expect the Fed and Swiss National Bank to ease by 50bps next year."

Since then, rate expectations have fallen significantly. At the December FOMC press conference, Fed Chair Jerome Powell said that further interest hikes are "not likely," and that the Fed is willing to cut interest rates even if the US does not enter recession. In response, markets moved from expecting four rate cuts starting in June at the time of our Year Ahead publication, to, at one point, expecting more than six rate cuts (160bps) starting in March. At the time of writing, markets are pricing close to six rate cuts (144bps) starting in May.

Scenarios

Base case: Soft landing (60%)
End-2024 targets:
S&P 500: 5,000
US 10-year yield: 3.5%
Fed funds rate: 4.25–4.5% (100bps of cuts in 2024)
EURUSD: 1.12

A "soft landing" scenario is the highest probability outcome, in our view. In this scenario, growth slows to just below trend, a US recession is avoided, inflation continues to decline (albeit at a slower pace) and approaches central bank targets in the second half of the year, and the Fed cuts interest rates by 100bps.

On growth, headwinds like housing affordability, the end of childcare subsidies, trimming of Medicaid rolls, and the resumption of student loan payments remain and suggest that growth is likely to fall below trend. However, US retail sales data demonstrate that the middle-income consumer has spending power and a relatively strong balance sheet, and labor markets do not appear to be cracking in a way that will drive higher precautionary savings. This suggests that growth will nonetheless remain firmly positive.

On inflation, recent data have confirmed the falling trend. The details suggest there is no "stickiness" in pricing, even if base effects mean that inflation is not likely to fall as quickly in the first half of 2024 as in the second half of 2023.

On rates, our "soft landing" scenario would see the Fed cut interest rates by 100bps, starting in May—slightly more than in the Fed's dot plot. Though markets are now pricing steeper rate cuts, this scenario would see the Fed trying to balance its desire to help the economy avoid recession with labor market and core inflation data that still suggest a need for somewhat restrictive monetary policy.

Revisiting our base case scenario

Year Ahead Base case	What's changed?	Base case revisited
Price targets December 2024:		Price targets December 2024:
S&P 500: 4,700 US 10-year: 3.5% EURUSD: 1.12	• October and November US inflation surprise to the downside. • Signs of continuing US consumer resilience in spending data. • Fed signals end to rate hikes and willingness to cut in 2024 without a US recession. • We now expect 4 Fed rate cuts in 2024 (up from 2-3).	S&P 500: 5,000 US 10-year: 3.5% EURUSD: 1.12

Source: UBS

Market outcomes
In this scenario, although the Fed would cut short-term rates by less than the market expects, we would expect moderate further downside for medium- and longer-term bond yields as medium-term interest rate expectations have further to fall.

Meanwhile, we would expect positive economic growth, falling inflation and interest rates, and lower bond yields to support further modest upside for global equity indexes over the course of the year.

Upside scenario: Goldilocks (20%)
End-2024 targets:
S&P 500: 5,300
US 10-year yield: 4%
Fed funds rate: 3.75–4% (150bps of cuts in 2024)
EURUSD: 1.15

In a "Goldilocks" scenario, growth remains robust, inflation continues to decline, and the Fed cuts interest rates preemptively, with six rate cuts in 2024, potentially starting as early as March.

There are three key differences between our "Goldilocks" scenario and our "soft landing" scenario:

First, our "Goldilocks" scenario would see no material slowdown in growth, which would remain at or above trend. In addition to the recent strong consumer and labor market data, this thesis could be further supported by the significant easing in financial conditions experienced in recent weeks. US mortgage rates are at their lowest since June, stimulating housing activity, and gas prices are down 20% in the past three months, providing a "tax cut" for consumers.

Second, a different Fed reaction function may lead to more preemptive rate cuts. We note that the Fed has not commenced a rate-cutting cycle during an election year since 1984, and Fed members may want to avoid starting a rate-cutting cycle too close to November's presidential election, to avoid accusations of political bias. Additionally, when Treasury Secretary Janet Yellen was a Fed governor from 1994 to 1997, she argued that if the Fed didn't endorse what the market was pricing for cuts, downside risks to the economy would increase because the benefit from the priced easing of financial conditions would not materialize.

Third, in our "Goldilocks" scenario, inflation falls more quickly and consistently than in our base case, supplying the Fed further justification to cut rates sooner, and by more than in our "soft landing" scenario.

Market outcomes
In this scenario, we would expect a combination of robust growth and Fed rate cuts to support a meaningful rally in US and global equity indexes. US small caps would likely be particular beneficiaries as fears of a recession and "higher-for-longer" rates ebb.

We would expect the 10-year US yield to stay close to current levels. While in isolation lower Fed rates would suggest lower yields, we think this impulse would be offset by the effects of still-robust economic growth and markets pricing potentially higher terminal interest rates.

We would expect the US dollar to sell off in this scenario as a combination of lower US interest rates, a pro-risk market backdrop, and decent growth leads investors to reduce dollar holdings in favor of more cyclical currencies.

Downside scenario: Hard landing (20%)
End-2024 targets:
S&P 500: 3,700
US 10-year yield: 2.5%
Fed funds rate: 1–1.25% (425bps of cuts in 2024)
EURUSD: 1.03

In a "hard landing" scenario, a slowdown in growth—possibly resulting from the cumulative effect of interest rate hikes so far—results in a moderate recession. The potential severity of this scenario would be mitigated by the easing in financial conditions so far and likely sharp interest rate cuts by the Fed in response.

This scenario remains plausible, especially given the significant uncertainty about the magnitude and timing of the effect of interest rate hikes enacted so far, the possibility of exogenous shocks, and the historical record that hopes for a soft landing have often ended in recession. At the same time, however, with every month that passes with incoming data continuing to demonstrate the economy is in relatively strong health, the chance of a rate-hike-induced recession diminishes.

Market outcomes
In this scenario, we would expect equities to deliver sharply negative returns. Bonds would likely deliver strongly positive returns as safe-haven assets attract inflows and as investors price lower interest rate expectations. We would expect EURUSD to fall toward parity in this scenario, as the dollar would benefit in a risk-off environment.

Alternative scenarios
With inflation falling and interest rate cuts firmly on the agenda, we think it now looks less likely that a "higher-for-longer" interest rate scenario materializes, and we also see it as unlikely that the Fed embarks on a renewed set of interest rate hikes.

That said, we remain watchful of the risk that a period of higher-than-expected inflation or excess US Treasury supply leads to an increase in interest rate expectations or pushes the 10-year US yield back toward, or above, 5% again. Such a scenario, should it materialize, would be negative for both bond and equity markets, although the recent decline in inflation and Fed rate expectations make it less likely than it appeared late last year.

How do we invest?

Fixed income – attractive risk-reward for quality bonds
In the Year Ahead, we said investors should *Manage liquidity*—limiting cash balances and taking action to optimize yields—given our view that interest rates will fall, creating reinvestment risks for investors with high cash balances. We also said investors should *Buy quality* bonds, focused on the 5-year duration segment, given positive return potential across a range of scenarios.

Chair Powell's comments at the December FOMC press conference, and job openings data that suggest imbalances in the labor market are evening out, reinforce our view that the Fed is highly likely to cut interest rates multiple times in 2024. The market reaction to Powell's comments also demonstrates the urgency with which investors need to act to lock in yields.

Of course, recent sharp moves in the bond market and interest rate expectations mean that bond pricing has become less attractive. At the short end of the curve, markets are also now pricing close to six interest rate cuts—more than we think is likely in our base case. There is also the possibility that the coming weeks could see the 10-year US Treasury yield rise further, particularly given potential policy changes by the Bank of Japan and higher Treasury supply in the new year.

Nonetheless, we think investors with high cash allocations should act soon to reduce cash holdings and lock in bond yields, rather than wait for potentially better bond pricing. We think the most probable risks to our base case view are for more (rather than less) interest rate cuts, and we see opportunity costs and reinvestment risks as greater than the potential gains from waiting for better pricing. We expect the two-year US Treasury yield to end the year lower than the current level of 4.38%.

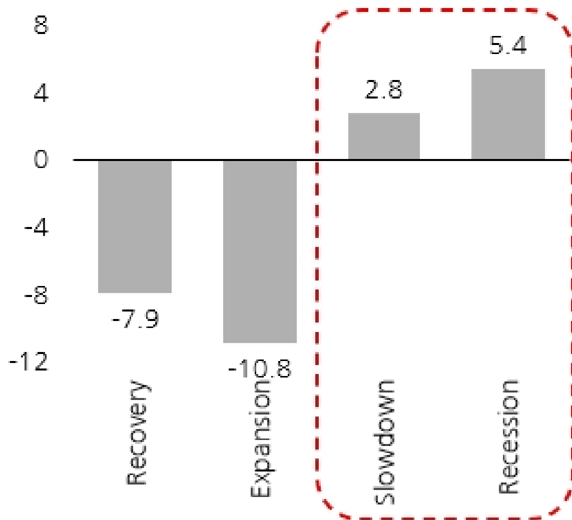
Overall, we think quality fixed income has an attractive risk-return proposition. In a "soft landing" scenario, we expect returns for high-quality, medium-duration fixed income to be in the mid-single digit range. In a "hard landing" scenario, we would expect double-digit returns. Even in a "Goldilocks" scenario (the least favorable for quality fixed income), returns are likely to be positive.

We are also constructive on yield curve "steepener" trades—buying short/medium duration bonds and selling longer-duration bonds. We would expect such trades to deliver good performance in our base case (in which we expect the current 2-year/10-year inversion of –40bps to narrow to –15bps by the middle of the year), but also in case of an aggressive rate-cutting cycle, or in scenarios in which the term premium rises sharply due to short-term supply indigestion.

Equities – complement "quality" with small caps
In the Year Ahead, we said investors should *Buy quality* equities. Quality companies with strong balance sheets, high returns on invested capital, and a track record of delivering earnings tend to outperform the broader market during periods of slowing economic growth and/or recession. We

also discussed our constructive view on the US technology sector, which is home to many "quality" companies as well as *Leaders from disruption.*

Quality stocks have tended to outperform during economic slowdown and recessions
Relative performance of MSCI High Dividend Yield index vs. MSCI World index across economic cycles, since 1995, in %



Note: Recovery = ISM < 50, 3m chg >0. Expansion = ISM > 50, 3m chg >0. Slowdown = ISM > 50, 3m chg <0. Recession = ISM < 50, 3m chg <0
Source: Bloomberg, UBS, as of January 2024

Since we published the Year Ahead, the S&P 500 has rallied 4%, the Nasdaq 2.8%, the Russell 2000 US small-cap index 10.4%, and Europe's Stoxx 600 5.9%.

From here, we believe investors should focus on: a) parts of the market that can deliver performance across a range of potential scenarios, and b) those companies and sectors that can capture a higher share of any further market upside.

With that in mind, we continue to see "quality" as a core theme for investors in 2024. Quality companies have historically outperformed broader indexes during periods of slower economic growth, like we expect in our base case "soft landing" scenario. We would also expect quality companies to deliver substantial outperformance in a "hard landing" scenario.

That said, to capture more market upside in case of a continued equity market rally, we believe investors should complement core quality stock holdings with tactical exposure to US small caps.

US small caps (Russell 2000 Index) trade on relative valuations 10–15% lower than they were prior to the regional banking crisis in March, with the segment suffering from fears that the Fed could hold rates at elevated levels for a prolonged period to bring inflation lower. With around 50% of small-cap debt floating rate (vs. 10% for large caps), the segment is highly sensitive to interest rates, and so would be a particular beneficiary of faster Fed rate cuts.

We retain our most preferred stance on the US IT sector, which aligns with our quality tilt. Tech has the highest return on invested capital of the 11 US equity sectors, at around 20% over the last 12 months, as well as strong balance sheets. With business models that combine subscription-based revenue streams with a presence in high-growth segments including artificial intelligence, we think tech companies look poised to deliver healthy earnings growth this year.

We also recently upgraded our longer-term forecasts for global AI revenues. When we launched our AI industry revenue estimates last year, we expected growth from USD 28bn in 2022 to USD 300bn by 2027—a compound annual growth rate of 61%. We now forecast industry revenues of USD 420bn by 2027—a 72% annual growth rate and a fifteenfold increase in just five years—driven by stronger-than-foreseen demand for AI and greater clarity on company spending plans on AI infrastructure.

Currencies and commodities
In the Year Ahead, we said we expected the US dollar to be stable around current levels (EURUSD was at 1.08 at the time of publication), and for most major currency pairings to trade in ranges over the near term (see table below). In commodities, we said we expected oil prices to fluctuate in a USD 90–100/bbl range and for gold to reach a new all-time high of USD 2,150/oz by year-end.

Currency crosses	Buy at lower end of range	Sell at upper end of range
EURUSD	1.0-1.05	1.10-1.12
USDCHF	0.85-0.87	0.92-0.94
EURCHF	0.94	1.0
GBPUSD	1.19-1.21	1.26-1.30
USDJPY	137-140	152-155
AUDUSD	0.63-0.64	0.70-0.72

Source: UBS, as of November 2023

Currencies
The US dollar has weakened modestly since the publication of the Year Ahead. In the near term, we expect better relative growth in the US versus Europe and a partial reversal

in US rate cut expectations to drive a degree of dollar strength, bringing major currency pairings back into the middle of the ranges published in the Year Ahead. We expect EURUSD and GBPUSD to fall back to 1.08 and 1.23, respectively, and USDCHF to move to 0.88–0.90 again.

That said, the Fed's dovish pivot should also limit the extent of any USD strength in the near term and sets the tone for the USD to weaken into year-end 2024 (with EURUSD trading at or above 1.12, and the risks skewed to the upside versus our forecasts).

We believe investors should keep US dollar long positions unhedged in the very short term, except versus the Australian dollar. Euro long positions versus the Swiss franc should be kept unhedged as well. We think long positions in the Chinese yuan should be hedged, as we expect the CNY to underperform amid weakening economic activity.

In addition, we see current opportunities for investors to sell near-term upside risks in EURUSD and GBPUSD, or downside risks in USDCHF, GBPCHF, and USDJPY in exchange for yield pickup. AUD longs can be added, particularly in the crosses.

Commodities
Oil prices have remained volatile since the publication of the Year Ahead. Brent crude oil fell below USD 75/bbl in December but is now trading at USD 78/bbl (from USD 80/bbl at the time of the Year Ahead publication).

For 2024, we still expect a slightly undersupplied oil market (–0.1 million barrels per day), with OPEC+ holding back production until midyear and only gently adding production in the second half. We expect non-OPEC+ production growth to slow to around 1.3mbpd. We expect oil demand growth of 1.4mbpd, slower than in 2023 but still higher than the average annual growth rate of 1.2mbpd seen since 2000.

That said, with OPEC+ spare capacity higher than before, ensuring that not-too-much supply is added will be a tough balancing act. The risk is that the market narrative shifts toward the idea that supply growth may start to outstrip demand growth. As a result, we have reduced our oil price forecasts and now project Brent crude to trade in a USD 80–90/bbl range in 2024. We continue to advise risk-seeking investors to sell Brent's downside price risks or to add exposure to longer-dated Brent oil contracts, which trade at a discount to spot prices.

Gold prices, meanwhile, have risen since the publication of the Year Ahead, in anticipation of lower US interest rates. With Fed rate cuts likely to materialize in the second quarter, we expect to see exchange-traded fund (ETF) demand for gold turning positive. We now expect gold prices to reach USD 2,250/oz by the end of 2024 (revised up from a target of USD 2,150/oz at the time we published the Year Ahead). We believe investors should add fresh longs in the event of gold prices falling below USD 2,000/oz.

Gold continues to be an effective portfolio hedge
COMEX spot gold prices, USD/oz, including CIO's December 2024 forecast

Source: Bloomberg, UBS, as of January 2024

Back in balance
In the final two months of 2023, balanced portfolios of equities and bonds delivered one of the strongest two-month runs of performance in more than 30 years (comparable with the post-COVID and post-global financial crisis rallies). Yet, we continue to believe that holding a core position in a balanced portfolio is the most effective way for investors to preserve and grow wealth over time.

What are the merits of a balanced portfolio today?

First, we continue to expect further downside for bond yields and upside for equity markets, and see upside over the next year for balanced portfolios in both our base case and upside scenarios. While parts of the US equity market are expensive, most global markets are not overpriced, and we expect earnings growth to be positive in all regions.

In our base case scenario, we expect a 60:40 portfolio of global equities and 10-year US Treasuries to potentially deliver a return of 8.1%. In an upside scenario, returns could rise to 10.7%. In a downside scenario, we would expect strong returns from bonds to partially offset equity market declines, potentially limiting portfolio downside to –3.4%.

Second, holding a disciplined and balanced allocation to a broad range of companies, sectors, and asset classes can facilitate steady upward progress, even as market narratives chop and change. In contrast, investors with concentrated

exposure in individual asset classes are at risk of experiencing higher volatility, and investors trying to trade between asset classes are at risk of being "whipsawed."

Third, the sharp fall in interest rate expectations in the past couple of months has made the potential reinvestment risk of holding too much cash very clear. With rates likely to fall in the next year, and potentially sharply, investors will need to find a way to get invested in longer duration assets. But trying to time entry can be challenging. Balanced portfolios, and phased approaches to market entry, can help reduce market timing risk relative to trying to go "all in" either in equities or bonds.

Fourth, after a sharp rally in traditional equity and bond market indexes, the need for investors to earn alternative sources of return is greater. A balanced portfolio, including a mix of passive and active funds, and an allocation to alternative investments (including hedge funds, private markets funds, and risk parity) can enable investors to tap into a broader range of returns.

Fifth, amid sharp moves in equity and bond markets, and the potential for additional volatility in the months ahead as markets trade around potential scenarios, the potential for a disciplined rebalancing process to add to portfolio performance is greater. For example, Vanguard research estimates that rebalancing can add about 14bps to annualized returns (for a 60% stock/40% bond portfolio), as well as reducing the portfolio's expected risk.

Finally, over the longer term, we remain convinced that a diversified portfolio of equities, bonds, and alternatives is the best way for investors to balance growth and preservation. In our capital market assumptions, using equilibrium return assumptions, we estimate that a portfolio of 45% stocks, 35% bonds, and 20% alternatives could deliver a return of around 5% in excess of cash annually over the longer term, with an annualized standard deviation of around 9%. That translates into an expected return of 2.7–4.3x vs. cash over a 20–30-year timeframe.

Non-Traditional Assets

Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

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

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

- Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, "junk bonds," derivatives, distressed securities, non-U.S. securities and illiquid investments.
- Managed Futures: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- Real Estate: There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- Private Equity: There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- Foreign Exchange/Currency Risk: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer's "home" currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a U.S. investor.

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