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Ask CIO – Inflections, the US dollar, and alternatives

08 May 2023, 8:31 pm CEST, written by UBS Editorial Team

Navigating inflection points in GDP growth, monetary policy, and inflation remains a key topic for investors as 2023 evolves. With the US economy slowing and the Fed near the end of its hiking cycle, how should investors position? Read our "Ask CIO" for our thoughts on this and other key questions.

How can I position for key inflections?
Market narratives around inflection points for economic growth, rates, and inflation have continued to shift as investors assess the latest data. Concerns over the health of US regional banks resurfaced following the collapse of First Republic Bank. Policymakers continue to act decisively to avert a systemic crisis. But we think tightening credit conditions are likely to take a toll on US economic growth. Meanwhile, the lagged effect of the most rapid Federal Reserve hiking cycle since the 1980s is continuing to feed through into the economy.

In an uncertain environment, we see better risk-reward in high-quality bonds than in broad US equity indexes. We do not think the latter are adequately reflecting the risks to the US economic outlook, and believe high grade (government) and investment grade bonds should be better placed as growth slows. Within equities, we recommend diversifying beyond the US and growth stocks in favor of emerging markets, which should benefit from China's rebound and a weakening US dollar. We maintain a most preferred view on gold, and see it as a good portfolio diversifier.

Watch our CIO Monthly video, “What is priced in?” (20 April 2023) for more.

Is the US dollar set to weaken further?
The US dollar's downtrend has paused over the past month. The Dollar Index has risen 0.7%, though it remains more than 10% below its September 2022 peak. But we think the approaching end of monetary tightening and a less appealing US growth picture should still lead to a broadly weaker USD over the remainder of the year. The Fed is likely to cut rates earlier than other major central banks, in our view.

Investors looking to position for a weaker dollar should diversify their dollar cash or fixed income holdings, hedge outright, or position in options and structured strategies. In our global FX strategy, we maintain a preference for the Australian dollar, given its exposure to China's rebound and the Reserve Bank of Australia's recent hawkish commentary. In addition, we hold a most preferred view on the Japanese yen, and forecast the USDJPY falling to 120 by year-end (from 137 at present). On a relative basis, we also expect the greenback to weaken against the euro, Swiss franc, and sterling by the end of the year.

Can alternatives help navigate macroeconomic uncertainty?

Alternative assets—including hedge funds and private markets—can provide investors with the opportunity to diversify sources of return at a time of lower "beta" returns from equities, provided investors can tolerate the risks involved.

In hedge funds, we think strategies that can capitalize on market dislocations while providing stable diversification benefits should be well positioned in an uncertain environment. We like macro managers' ability to take long/short positions across a range of asset classes, regions, and financial instruments; equity market neutral funds' appeal in providing uncorrelated returns; and multi-strategy funds' diversified approach and versatility. In private markets, we think private market secondaries and distressed strategies could be well-positioned to buy assets at attractive valuations.

Investors in alternative assets must be able to lock up capital for longer and should consider risks like reduced liquidity, higher costs, and complexities.

For more topics, see Top 10 questions answered.

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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.