Within equities, CIO recommends diversifying beyond the US and growth. (UBS)

Why we favor fixed income over equities

02 May 2023, 7:07 pm CEST, written by UBS Editorial Team

This month, the UBS Chief Investment Office (CIO) offers their perspective on the most robust way to position portfolios given current valuations and the potential growth and inflation scenarios. In short, they see high-quality bonds providing a better risk-reward than broad US equity indexes.

Fixed income remains Most Preferred, and within that space, we prefer high-quality segments, including high grade (government) bonds, investment grade credit, and senior debt from financials.

The preference for fixed Income over equities is predicated on a better return-risk trade-off over the rest of the year for high-quality bonds than for stocks. Our year-end price target of 3,800 for the S&P 500 implies about a –7% total return based on the current level of 4,125. That also implies about a 7% return to our bull case outcome of 4,400.

Even if the US economy achieves a perfect soft-landing, the upside for US stocks is limited. By contrast, investment grade corporate bond yields would have to rise about 60bps from their current levels for them to have a negative total return over the rest of the year. Thus, in a large majority of possible outcomes for the economy, investment grade bonds will outperform US equities, and do so with less risk. The same should also apply to agency MBS. For this reason, we recommend increasing allocations to US investment grade bonds at the expense of US equities.

With the Fed nearing the end of its rate hiking cycle, it's likely that Treasury yields have already peaked. Yields may drift higher in the near term if the market prices in greater probability of more than one hike and fewer implied cuts later this year. But we expect the 10-year yield to end the year at 3% to 3.25%, with yields across the curve drifting lower by year-end. Given that, we recommend that investors adopt a barbell approach to their fixed income portfolio. They should actively manage liquidity portfolios with shorter-duration bonds to prepare for subsequent rate cuts that create reinvestment risk. They should also buy quality bonds with longer durations to hedge against further equity downside.

We did upgrade high yield corporate bonds and senior loans to neutral from least preferred this month. Both asset classes have relatively high correlations with equities, especially in a market downturn, and we think reducing equity allocations versus high-quality bonds offers a more attractive risk-return trade at current valuations and yields.

Within equities, we recommend diversifying beyond the US and growth. Our cautious view on equities is based primarily on US equities, which are still least preferred relative to other regions around the world. We prefer emerging market stocks, where valuations are lower, earnings are proving more robust, and a weaker dollar, lower US rates, and higher commodity prices should be supportive.

For more, read the report **Investment Strategy Guide: What's priced in?** 20 April 2023.

Main contributors: Jason Draho, Michael Gourd, and Danny Kessler

This content is a product of the UBS Chief Investment Office.

Listen to the podcast **Top of the Morning: CIO Strategy Snapshot - UBS House View (May)**