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Investment research

Stability amid uncertainty

Our outlook for 2Q

UBS

Contents

Stability amid uncertainty—Our outlook for 2Q
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Editors-in-chief
Kiran Ganesh
Vincent Heaney
Sagar Khandelwal

Charts
Linda Mazziotta

Editors
Abe De Ramos
Thompson Wong

Design
John Choi
Helena Powers

Cover picture
Getty Images

Stability amid uncertainty

The "Year of Inflections" is evolving rapidly. The first quarter of 2023 brought stronger-than-expected economic growth in the US, a faster-than-expected reopening in China, and confirmation that Europe had sufficient energy supplies to avoid a sharp contraction. But inflation has failed to fall as quickly as hoped, and the sudden turbulence in the global banking system demonstrates that higher interest rates are having unintended consequences.

As we approach inflection points in interest rates and economic growth, staying focused on the long term, mitigating risks, managing opportunity costs, and seizing attractive potential returns will be among the key challenges for investors in the months ahead.

What should investors do?

First, **manage liquidity as rates peak**. Many investors have held more cash than usual in anticipation of higher interest rates. But rates could now be approaching a peak. Investors should stay or be sufficiently invested and diversified, act soon to lock in attractive yields, and avoid unnecessary deleveraging.

Second, **buy quality bonds**. We see attractive opportunities in high-quality fixed income given decent yields and the scope for capital gains should an economic slowdown occur. We prefer bonds relative to equities, and prefer high grade (government), investment grade, and sustainable bonds relative to high yield bonds. We also like emerging market bonds. Investors who actively manage their bond portfolios have the potential to take full advantage of the opportunities.

Third, **diversify beyond the US and growth**. We think the outlook for US equities is challenged amid tighter financial conditions, declining corporate earnings, and relatively high valuations. By contrast, we see low-teen total returns from emerging market stocks over the remainder of the year, powered by strong earnings growth, China's reopening, and relatively cheap valuations. We expect growth stocks to underperform value and quality income and see select opportunities in Europe.

Fourth, **position for dollar weakness**. We do not expect the US dollar's recent strength to be sustained as the US economy's growth and interest rate premium relative to the rest of the world erodes. Investors looking to position for a weaker dollar should diversify their dollar cash or fixed income holdings. They could also reduce allocations to US equities, hedge outright, or position in options or structured strategies that could deliver positive returns in the event of dollar weakness. On a relative basis, we prefer the Australian dollar as well as the Swiss franc, euro, pound, yen, and gold.

Fifth, **diversify with alternatives**. Alternative assets provide investors with the opportunity to diversify sources of return at a time of heightened uncertainty in global markets. In hedge funds, we like macro strategies, which can profit from inflections in economic trends. Meanwhile, private market secondaries and distressed strategies could be well positioned to buy distressed assets at attractive valuations.

Sixth, **invest in real assets**. Exposure to "real assets"—including commodities, infrastructure, and select core real estate—can provide investors with additional portfolio diversification and income, as well as the potential for long-term inflation mitigation. We currently see particular appeal in direct and indirect infrastructure exposure and direct commodity exposure. We stay selective in real estate.

Last but not least, **go sustainable**. Green investment is stepping up in response to the US Inflation Reduction Act, the EU Green Deal, and similar domestic spending plans in China and around the world. This should particularly benefit innovative companies focused on improving resource efficiency, including energy and water, as well as those actively addressing the circular economy and decarbonization. Meanwhile, sustainable bonds offer high-quality fixed income exposure. We also see a growing opportunity set to implement hedge funds and private markets within sustainable investment strategies, for example in the areas of education and health.

Manage liquidity as rates peak

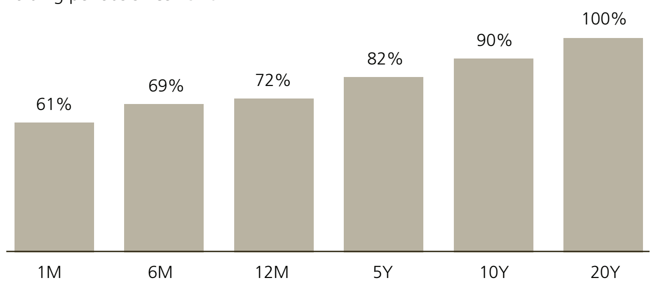
Many investors have held more cash than usual in anticipation of higher interest rates. But rates could now be approaching a peak. Investors should stay or get sufficiently invested and diversified, act soon to lock in attractive yields, and avoid unnecessary deleveraging.

Be invested and diversified. For investors with a longer-term time horizon, holding excess cash comes with risks. A balanced portfolio of equities and bonds has historically outperformed cash over most time horizons. And while cash rates are attractive today, it is important to consider reinvestment risks. For example, in our upside scenario, in which inflation falls more quickly than expected, stocks end the year 18% higher, with US 10-year Treasury yields at just

Figure 1

A diversified portfolio beats cash most of the time

How often a 60/40 portfolio (US large-cap stocks and intermediate-term government bonds) has outperformed 3-month Treasury bills, based on various holding periods since 1926



Source: Ibbotson, UBS, as of March 2023

2.5%. If this materializes, investors holding excess cash would have to choose between holding lower-yielding cash or paying a higher price for stocks and long-term bonds—a damaging situation for longer-term wealth growth.

To balance short-term risk and long-term growth, we recommend that investors set aside the resources they need for the next three to five years in a Liquidity* strategy, invested in cash and high-quality bonds, with the remainder of their wealth invested in a diversified portfolio with a focus on long-term appreciation, including assets like stocks, longer-term bonds, and alternatives.

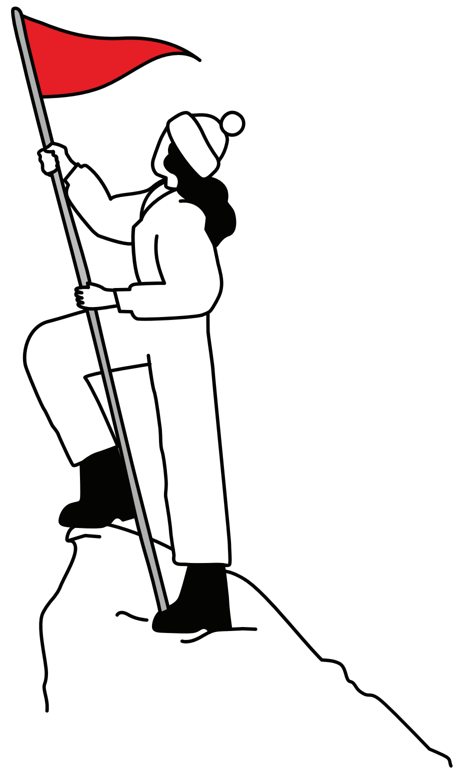
Lock in attractive yields. For investors holding cash, or those with upcoming bond maturities, we advise against waiting for the "final rate hike" before locking in current yields. As the negative effects of the interest rate hikes so far become more apparent, we believe markets will increasingly start to price in the possibility of future interest rate cuts.

Markets are already pricing a "pivot" in the Federal Reserve's policy starting in July. Such a pivot could come sooner if economic growth starts to show weakness, inflation abates faster than expected, or further risks to the financial system emerge. This would make attractive fixed-rate returns on cash and fixed income assets harder to come by in the future.

Rate cutting cycles have historically been completed over shorter periods than hiking cycles, and in the past two recessions the Fed cut interest rates close to zero, while other central banks cut rates into negative territory. Investors can manage timing risks by progressively locking in yields—averaging into markets and by bond maturity.

Avoid unnecessary deleveraging. Higher interest rates pose a particular challenge for investors with mortgages, portfolio loans, or other debts. All else equal, higher interest rates may require investors to reduce debt balances. But deleveraging should not be an automatic decision. Maintaining sufficient liquidity is important, particularly during times of market stress. And borrowing costs may fall in 2023. In our base case, we expect swap rates, based on which many mortgages are priced, to fall by the end of the year. The market is also expecting central bank rates, the basis for many floating-rate loans, to start declining later this year.

In our view, what is most important is to keep a long-term perspective on both the cost of debt and potential portfolio returns, and to consider debt in the context of an overall wealth plan. In this context, floating rates on debt may now offer better value than locking in currently high fixed rates. Of course, as with all debt, risk is a primary consideration, and investors should only hold as much debt as they are able to service.



*Time frames may vary. Strategies are subject to individual client goals, objectives and suitability. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved.

Buy quality bonds

We see attractive opportunities in high-quality fixed income given decent yields and the scope for capital gains in the event of an economic slowdown. We prefer bonds relative to equities, and prefer high grade (government), investment grade, and sustainable bonds relative to high yield bonds. We also like emerging market bonds. Investors who actively manage their bond portfolios have the potential to take full advantage of the opportunities.

High grade, investment grade, sustainable bonds. Concerns about higher inflation weighed on returns last year, but as inflation fears recede and growth fears rise, we expect high grade (government), investment grade, and sustainable bonds to deliver good returns over the balance of the year.

We recommend investors approach bonds selectively and actively, and prefer higher-quality resilient credit given the potential growth risks ahead. We also think there are opportunities to generate alpha through more active duration management in light of the volatile interest rate environment.

Select financial senior bonds. Additional Tier 1 (AT1) bank bonds and financial senior bonds have come under pressure in recent weeks. We believe AT1 investors should not sell off existing positions in solid banks into a less liquid and stressed market, but rather hold on to these for now. Meanwhile, we reiterate our preference for senior bonds of major banks with solid financial positions, as they remain well protected by ample amounts of loss-absorbing capital. We think that larger, well-capitalized banks should be in a good position to withstand the current uncertainty and market fragility, especially those that have strong balance sheets, stable well-diversified deposit bases, and healthy credit metrics.

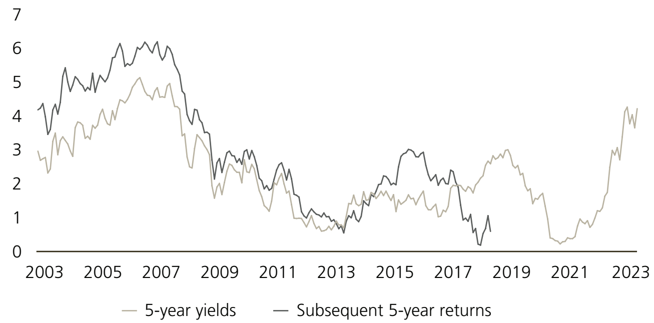
Emerging market bonds. Among riskier classes of bonds, we like emerging market sovereign bonds. Hopes and fears about Fed policy, moves in the US dollar, and the ebbs and flows of risk aversion have left the asset class broadly range-bound this year. Looking ahead, we see supportive factors outweighing the negatives. Improving growth prospects in China should keep credit spreads relatively contained. We also expect the US dollar to weaken and see Fed policy reaching a peak in the coming months. In this context, we see total yields of 8.7% in the EMBIG Diversified sovereign index as representing good value for investors.

We see opportunities to boost returns even further with an active investment approach. In emerging market bonds, the proportion of the sovereign index trading at spreads above 600 basis points remains high, suggesting a broader-than-usual opportunity set among the higher-yielding issuers. In this category, we find value in select issuers that are willing and able to work with international lenders and in select potential restructuring scenarios.

Figure 2

Higher yields signal improved returns in the coming years

5-year US Treasury yield, Bloomberg Barclays Treasury Intermediate subsequent 5-year return, in %



Source: Bloomberg, UBS, as of March 2023

Borrowing to invest in fixed income

During periods of low interest rates and much higher yields on long-term bonds relative to short-term bonds, using floating-rate loans to invest in longer-duration credit was a popular strategy to boost income for some risk-tolerant investors.

Today, economic uncertainty is rising and the yield curve is inverted—meaning that floating rates are in many cases higher than longer-term bond yields. Furthermore, economic risks are rising. So, is borrowing to invest in credit still a good strategy?

Borrowing to invest generally only makes sense if the expected returns of the investment are higher than expected borrowing costs over the planned holding period. Given that the yield curve is inverted, and we don't recommend taking excessive credit risks, it is currently challenging to earn higher fixed income returns than borrowing costs. In our view, long-term investors looking to implement leveraged strategies should consider borrowing against well-diversified multi-asset portfolios, rather than against pure fixed income portfolios.

Diversify beyond the US and growth

We think the outlook for US equities is challenged amid tighter financial conditions, declining corporate earnings, and relatively high valuations. By contrast, we see low-teens total returns from emerging market stocks over the remainder of the year, powered by strong earnings growth, China's recovery, and relatively cheap valuations. We expect growth stocks to underperform value and quality-income stocks, and see select opportunities in Europe. Given ongoing volatility, structured investments and capital preservation strategies could provide ways to attain exposure in a more defensive way.

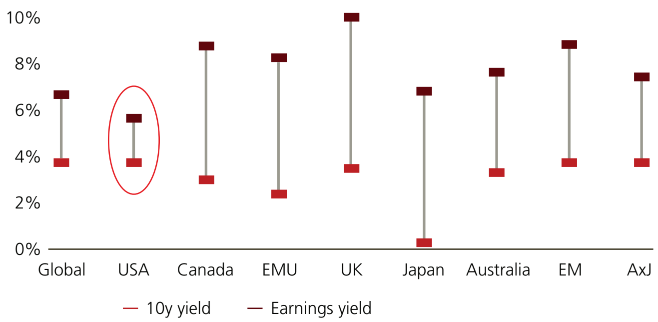
Expect the US to underperform. We expect US stocks to underperform global markets. The probability of a hard landing for the US economy is rising, we expect earnings to contract, and valuations are expensive in both absolute and relative terms. The MSCI USA index is trading at 18x P/E, a 12% premium to its 20-year average (16x) and a 17% premium to the MSCI All Country World Index.

Within US markets, we recommend being selective overall and diversifying beyond technology. We remain positive on stocks with exposure to resilient spending streams such as infrastructure and energy efficiency, and those relatively insulated from inflationary pressures.

Figure 3

US equities look least attractive vs. bonds

Earnings yield vs. 10-year bond yields for selected markets. US 10-year yield used for EM, AxJ, and global equities



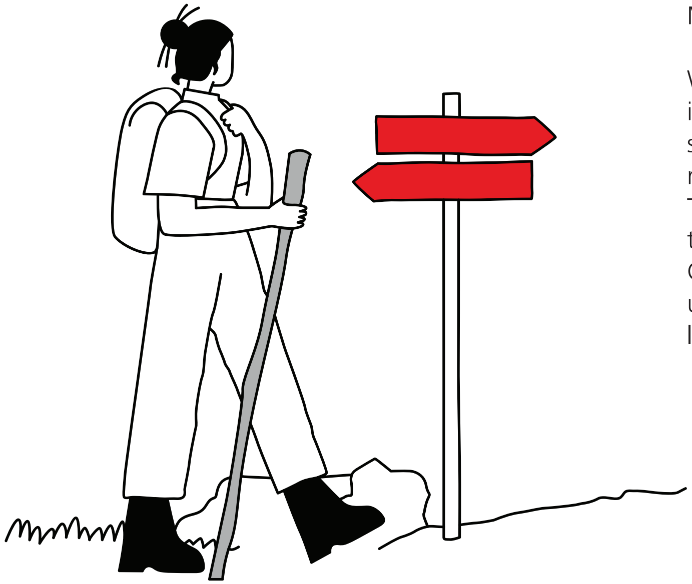
Source: Bloomberg, UBS, as of March 2023

Cautious on growth stocks. We also have a cautious view on growth stocks, even if we see some pockets of opportunity (e.g., Asia's semiconductor industry and in cybersecurity). Consensus expects flat earnings for the MSCI ACWI Growth Index for the next 12 months. And despite a price correction last year and the recent reduction in bond yields, we think the growth index is still expensive based on a P/E ratio of 22.5x. In our view, the market has yet to fully accept that the largest technology companies cannot perpetually grow at the same pace as they did in the past decade. We believe that high-quality stocks with lower valuations, and stocks that provide shareholders with sustainable income, are likely to perform more strongly.

Prefer emerging markets and China. We expect MSCI Emerging Markets to deliver low-teens positive returns this year. Emerging economies should have little exposure to the specific challenges of the US regional banks; the dollar should weaken as the market starts to price a peak in US interest rates; and China's economic reporting provides a tailwind. Altogether, we expect earnings growth of 1%, and valuations are attractive with a 23% discount to the global benchmark.

Within emerging markets, two of our preferred areas are Chinese equities and Asian semiconductors. The rally in MSCI China has slowed amid renewed Sino-US tensions, but the market's current valuation of 10x P/E with 7% expected earnings growth provides a solid platform for a further uptrend. We believe Beijing's supportive policy stance and the expected earnings recovery in Chinese stocks have yet to be fully factored into valuations.

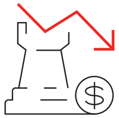
Meanwhile, we think margins at Asian semiconductor companies are likely to recover as supply-demand dynamics improve in the second half of the year. Excess supply is being eliminated as companies reduce prices to bring inventory levels down, and as supply growth adjusts to recent capital spending cuts. We also expect demand to rise with a new product cycle.



Select opportunities in Europe. Various European economies moved faster into a downturn last year, partly due to their heavy reliance on Russian natural gas. But as gas prices have fallen, sentiment should start to improve. Also, given already-tight regulations for the banking sector, Europe is unlikely to see a significant downshift in bank lending in the months ahead. In this context, we see select early-cycle opportunities such as the German market, whose valuations are attractive, in our view: MSCI Germany is trading at 11.8x forward P/E, a larger-than-usual 12% discount to MSCI EMU.

We also expect European consumer stocks to perform well, in part due to China's recovery. European stocks have the second-highest exposure to China compared to other regions, generating 8% of sales from the Chinese market. This is especially so for luxury brands, which should additionally benefit from a return of Chinese tourists to Europe. Chinese consumers accounted for one-third of global luxury-brand sales prior to the COVID outbreak, but only 17% last year.

Structured investments. The VIX Index has traded at as high as 29 in recent weeks, above its long-term average of 19. Volatility looks set to remain elevated with ongoing tightening and growth concerns. This creates a potential opportunity to sell the volatility on an index level or through thematic investments in the areas we note above. For more defensive investors, capital preservation strategies can allow investors to maintain upside exposure while protecting against potential downside.



Position for dollar weakness

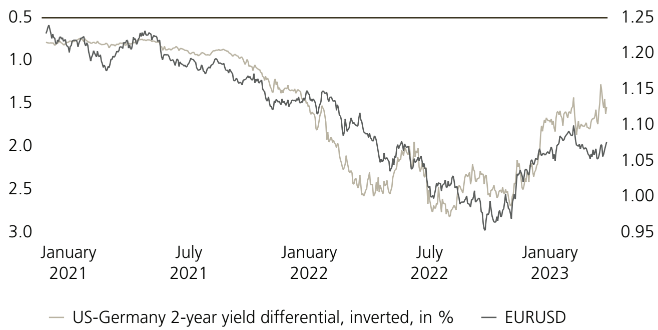
We do not expect the US dollar's recent strength to be sustained as the US economy's growth and interest rate premium relative to the rest of the world erodes. Investors looking to position for a weaker dollar should diversify their dollar cash or fixed income holdings, reduce allocations to US equities, hedge outright, or position in options or structured strategies that could deliver positive returns in the event of dollar weakness. On a relative basis, we prefer the Australian dollar as well as the Swiss franc, euro, pound, yen, and gold.

Expect US dollar to weaken. The Fed is coming closer to the end of its rate hike cycle and markets are pricing in a cut in July. The exact timing remains uncertain, and there-

Figure 4

USD rate advantage is fading

US-Germany 2-year yield differential, in % (lhs), and EURUSD (rhs)



Source: Bloomberg, UBS, as of March 2023 fore investors need to prepare for volatility, as seen in recent weeks. Still, US inflation continues to fall and is forecast to reach 3.2% by December, while economic growth is likely to decline as the effects of higher rates are felt.

Swiss franc and gold: Better safe havens. Investors worried about the risk of a financial crisis can consider diversifying into traditional safe havens like the Swiss franc or gold. The Swiss franc should still fulfil its role as a hedge against global market turmoil, even if the recent banking sector challenges have also affected Switzerland. The Swiss National Bank has continued to raise rates and has signaled that further tightening is likely, given inflation remains high. We think a further hike in June is possible to 1.75%.

We also see gold as an attractive asset for investors seeking to hedge against currency risks. A rising probability of a US recession, fears about financial and geopolitical instability, the prospect of less aggressive Fed policy, and a weaker US dollar should all support gold. We forecast gold prices to hit USD 2,050/oz by year-end, and recommend investors make use of the precious metal's volatility to generate yield or add on dips.

Euro and British pound: Shrinking rate and growth differentials. Market pricing suggests the Fed will end its rate hiking cycle in July, whereas the European Central Bank looks likely to continue into September. This should decrease the interest rate differential between the two blocs from 245bps at the start of this year to 86bps at year-end. The growth differential between the US and Europe should also fall in the coming months, given that various European economies already suffered downturns, whereas the US is only about to enter this phase.

We also expect sterling to strengthen against the US dollar. The pound should be supported by an erosion of the US growth and interest rate premium, while it continues to trade at a meaningful discount to the dollar. In addition, a less volatile UK political backdrop has left fiscal policy back on sounder footing, and relations with the EU are thawing. Both developments substantially reduce the downside risks for investors holding the pound.

Yen: Neutralize short exposure. The Japanese yen was a popular funding currency in 2022 due to the Bank of Japan's relatively loose monetary policy and widespread expectations of yen weakness. However, in the months ahead, we expect the yen to strengthen as the Fed nears the end of its hiking cycle, and the Japanese central bank considers changes to its yield-curve control regime. We expect the yen to recover to 120–125 per dollar in the second half, and recommend using the recent USDJPY bounce to exit yen-short positions.

Australian dollar: Exposed to China's reopening. The antipodean currency has held up well considering its long-standing sensitivity to global risk, the spread between short-dated US and Australian government bonds, and commodity prices. That said, we think it will find underlying support against the US dollar from Australia's trade surpluses, thanks in part to China's recovery. We see the current market expectation of a 25-basis-point cut to the Australian cash rate in July as inconsistent with record-low unemployment and elevated inflation. We therefore maintain our AUDUSD target of 0.72 by midyear.

Diversify with alternatives

Alternative assets provide investors with the opportunity to diversify their sources of return at a time of heightened uncertainty in global markets, if they can tolerate the risks involved. In hedge funds, we like uncorrelated strategies such as macro, which can benefit from inflections in economic trends. Meanwhile, private market secondaries and distressed strategies could be well positioned to buy assets at attractive valuations.

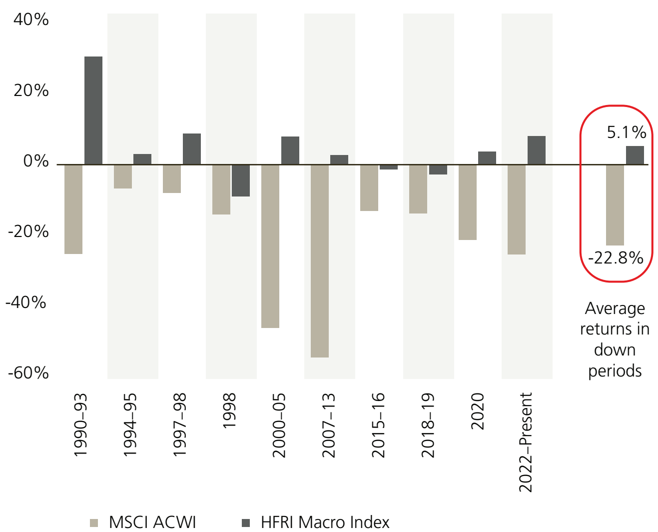
Hedge funds. In a year when uncertainty and macro risks are likely to stay elevated, investors should consider strategies that can capitalize on market dislocations while providing stable diversification benefits. Historically, macro hedge funds have shown an ability to take advantage of tighter monetary policy, higher volatility across asset classes, and identify opportunities in uncertain economic environments. Macro funds can also quickly moderate risk in an uncertain economic environment, although we note that the unexpected events of March caught many managers off-guard, especially those with short directional positions on US front-end rates.

Equity dispersion remains high, so we continue to favor uncorrelated strategies such as low net equity long-short strategies. These funds have historically shown they can benefit from market dispersion, mitigate market directionality, and complement traditional equity positions.

Figure 5

Hedge funds: Macro funds tend to offset some of the declines in equities

Global macro vs. global equities, during equities' worst down periods



Source: Bloomberg, UBS, as of March 2023

Finally, we think multi-strategy funds, which combine different hedge fund strategies, remain a key component of portfolios. They can provide investors with highly attractive risk-return characteristics and strong portfolio effects in periods of market turmoil.

Investors should note that alternatives can carry unique risks, including reduced liquidity, high costs, and various complexities. Following the US banking sector stress, hedge funds' access to funding is a factor to watch.

Private markets

Venture capital. Entering 2023, venture capital (VC) startup companies were already under funding stress as capital-raising activity had become increasingly difficult. The difficulties at US regional banks that were significant providers of VC debt and credit lines, along with the negative impact on sentiment toward the VC sector, are likely to reduce their funding options. To attract new capital, entrepreneurs will have to accept lower valuations, which should be seen as a risk in the short to medium term, but could also potentially open attractive long-term investment opportunity. Investors, however, need to be more selective with capital deployment, focus on companies that have sustainable and credible financials, and have a clear path to exit.

Private equity. Generally, we prefer accessing growth opportunities through buyout and growth equity strategies, which should be less affected by the recent banking stress. Leveraged buyout (LBO) managers and LBO-backed companies have a wider range of funding options, including direct lenders. High interest rates, however, are impacting the cost of debt and weighing on interest coverage ratios. So, we think a downward repricing of private equity multiples is likely in the next few quarters, albeit to a lesser degree than public markets and startups.

That said, investing fresh capital in private equity in times of stress has historically rewarded investors with above-average returns, and recent events are likely to prove beneficial for buyout firms still sitting on significant amounts of dry powder. We recommend seeking exposure to value-oriented buyout strategies and expect transaction activity on the secondary market to accelerate. We also see private markets as an effective way to gain direct exposure to infrastructure

assets (see page 16). Investors should seek exposure to long-standing managers with solid track records, experience in navigating difficult environments, and portfolios that are well-diversified across strategies and geographies.

Private credit. We think private debt, particularly direct lending strategies, should prove resilient in the current environment. VC debt accounts for only a fraction of the private credit universe, representing about 1% of total dollar value raised. Direct lending, which represents most private debt assets, is senior in the capital structure and is extended to private-equity-backed companies with recurrent cash flows and solid financials. Current developments, however, reaffirm our view that default rates will pick up from currently low levels toward historical averages over the coming quarters. While this could potentially trigger some credit losses and volatility, total returns should remain positive, in the mid-single-digit percentage range in our base case, supported by the high-income cushion of private loans, based off the Cliffwater Direct Lending Index.

The current environment could prove fruitful for direct lenders to take further market share as bank lenders pull back. Financial stress also offers opportunities for distressed and special-situation funds to trade mispriced debt instruments, provide emergency and rescue funding, and help companies navigate the bankruptcy process. Investors should remain focused on top-tier managers who have experience deploying capital in stressed environments, are well diversified, and apply strict underwriting principles.

Investors should also make sure they are comfortable with the inherent risks involved with investing in private assets, including illiquidity and long lockup periods.

Invest in real assets

Exposure to "real assets," including commodities, infrastructure, and real estate, can provide investors with additional portfolio diversification and income, as well as the potential for long-term inflation mitigation. We currently see appeal in direct and indirect infrastructure exposure and direct commodity exposure. We stay selective in real estate.

Infrastructure including greentech. In an uncertain economic environment, infrastructure-linked assets can help stabilize income generation in a multi-asset class portfolio. High barriers to entry and the monopolistic positioning of many of these assets make them less cyclical. Furthermore, infrastructure assets sometimes operate on long-term contracts tied to inflation, providing a potential degree of inflation mitigation over the long term. Assets linked to digital connectivity, such as 5G, fiber networks, and data storage—as well as those linked to the energy transition, such as renewables, storage, and transmission—are a particular focus at present.

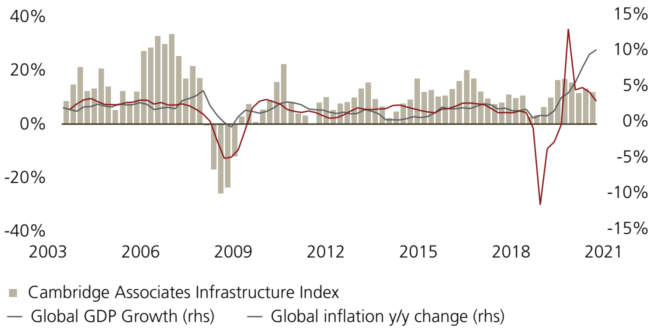
Investors can gain infrastructure exposure directly or indirectly. For individual investors, direct exposure to the cashflows from utility, communication, or transportation assets can be attained via private market vehicles.

Indirect exposure can be attained via bond or equity markets. For example, in the US REIT sector, we like the exposure to communication towers and data centers. Greentech companies are exposed to infrastructure spending on the energy transition, decarbonization, and energy efficiency. We also have a most preferred stance on the global utilities and industrials sectors—both are indirect ways of investing in infrastructure and benefiting from increased infrastructure investment.

Figure 6

Infrastructure assets tend to perform well with high inflation

Infrastructure assets' y/y performance vs. inflation y/y change and GDP growth (OECD countries)



Source: Cambridge Associates 2Q22, OECD, UBS, as of February 2023

Commodities. Concerns over a global economic slowdown have weighed on commodity prices. But we believe the structural case for further upside in energy, base metal, and agriculture prices remains intact. Our view is based on a robust economic recovery in China, a potential inflection point in the Fed's rate hiking cycle, and several unresolved supply-side issues that should keep market balances tight. Tighter US financial conditions could also have the effect of reducing US shale supply. We maintain our most preferred stance on commodities and see total returns of 20% on the CMCI index over the next 12 months.

Like with infrastructure, investors can gain exposure to commodities both directly and indirectly. We currently prefer to take direct exposure. Downward-sloping curves offer roll gains, while higher yields have improved returns on cash collateral. Given the unique characteristics and drivers of individual commodities and structural commodity trends, actively managed strategies enable investors to potentially boost their returns relative to risk.

Our views on real estate

In direct real estate, we remain positively biased toward semi-liquid and private equity real estate over the medium term, as rental indexation and reversion should support distribution yields. However, current market illiquidity means we hold a neutral view in the near term.

In listed real estate, we have a neutral view globally. Refinancing costs continue to gradually inch up, and markets are still pricing in stock-specific losses in values. However, earnings visibility remains good despite uncertainties around values, dividend payments, and potential rights issues. Valuations are fair, in our view. One exception to this is Swiss-listed real estate funds, which we find attractive considering the severe price correction in 2022, and solid market fundamentals in Switzerland.

Go sustainable

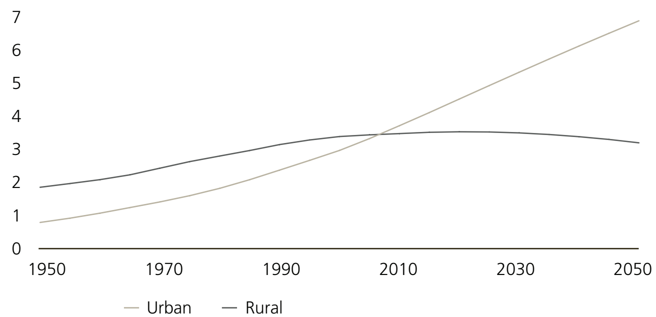
Green investment is stepping up around the world in response to the US Inflation Reduction Act. This should particularly benefit innovative companies focused on improving resource efficiency, including energy and water. We also like sustainable bonds, and see a growing opportunity set to implement hedge funds and private markets within sustainable investment strategies, for example in the areas of education and health.

Equities: Renewables and water scarcity. Following last year's US Inflation Reduction Act, including the biggest climate package in history, the European Commission has responded with the EU Green Deal Industrial Plan for the

Figure 7

Water scarcity: Urbanization and population growth to increase pressure on global water allocation

Urban and rural population, in billions, 1950–2050



Source: United Nations, UBS, as of March 2023

Net-Zero Age. Both landmark initiatives contain spending plans and proposals (such as USD 9bn for consumer rebate programs for home efficiency projects and easier permitting processes for renewable energy projects in the EU) that should provide a tailwind for companies involved in energy production, particularly in the space of energy efficiency, clean air and carbon reduction, and renewables.

Tactically, industrials and utilities are two of our preferred sectors, and we think that the high revenue visibility of water utilities alongside the well-diversified business mix of the water-exposed industrial companies should prove to be relatively resilient in a challenging market environment. Looking more structurally, rising living standards, and industrialization in emerging markets should all increase demand for clean water, while the effects of climate change could intensify the pressure on global water allocation. This creates a growth opportunity for water utilities and industrial companies focused on improving water-use efficiency, in our view.

Bonds: Sustainable bonds. In our global strategy, we currently prefer bonds to equities given elevated yields, the prospect of an end to central bank rate hiking cycles, and as a portfolio hedge against the risk of a deeper economic slowdown. Sustainable bonds include green and sustainable bonds, as well as multilateral development bank bonds. In our view, all these offer similar portfolio characteristics and comparable risk-return profiles to equivalent "traditional" investment grade and high grade (government) bonds, while allowing investors to align their portfolios with their values.

Alternatives: Sustainable hedge funds. It has traditionally been challenging to implement hedge funds within sustainable asset allocations due to a lack of transparency about investment strategies. However, this is now beginning to change. We see a growing number of opportunities to implement hedge funds within sustainable asset allocations, allowing investors to diversify sustainable portfolios more effectively as well as provide access to an additional source of returns. Sustainability-focused hedge funds typically focus on green technologies, carbon certificates, and broader sustainable opportunities.

Alternatives: Private market impact investing. The global focus on advancing social and environmental objectives creates opportunities for early-stage companies operating in private markets. We see promise in the future of healthcare, as techniques like cell and gene therapy can now be used as the basis for innovation across viral and infectious diseases. The post-COVID world creates an opportunity for education-focused technology to enhance student outcomes, with private equity serving as a source of capital for innovation. Resource scarcity underpins the need for investment in the circular economy given companies' and regulators' increased focus on this environmental reality.

Appendix

Nontraditional Assets

Nontraditional 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-US 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 US dollars, changes in the exchange rate between the US 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 US investor.

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