(UBS)

Stay invested to navigate the current environment

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Investors should position for equity gains amid a broadening of profit growth, secure portfolio income via quality bonds, diversify with broad commodities, and consider capital preservation strategies as a hedge.

The Iran war is approaching the 12-week mark, and the headlines on the conflict remain mixed. US Secretary of State Marco Rubio said there were “some good signs” that an agreement may be reached, and Iran said the latest US proposal “has narrowed the gaps to some extent.” But US President Donald Trump said he opposed efforts by Iran and Oman to establish a toll system through the Strait of Hormuz, and Iranian Supreme Leader Mojtaba Khamenei reportedly issued a directive that enriched uranium should stay in the country.

Recent market performance has also not made it easy for investors. Global equities are near their record highs amid robust earnings and sustained AI demand, while bond yields have surged to historical levels due to inflation concerns and expectations for central bank rate hikes.

But while risks persist, we believe stocks can go higher still, and the risk-reward outlook for short- and medium-term quality bonds is attractive.

- **Strong earnings are likely to support further gains for stocks over the medium term.** Following a strong first-quarter earnings season, we expect 20% growth in S&P 500 earnings per share this year, and a 62%jump in MSCI Asia ex-Japan profits. While we see a relatively modest increase in European earnings, at 8%, it represents a pickup after three years of stagnation. In our view, such robust earnings should support additional market gains over the medium term. We also expect AI capex to keep rising in the years ahead and believe supply bottlenecks in chips are unlikely to be resolved quickly. At the same time, it is not yet clear how the gains from AI might ultimately be spread across the economy, and there are likely to be periods ahead when realized profit growth is weaker. We therefore advocate staying invested to benefit from rising earnings while diversifying exposure across sectors and geographies.

- **Yield volatility does not undermine the case for quality bonds.** While we recently raised our forecast on yields across the board, we believe the risk-reward for short- and medium-duration quality bonds remains appealing. We now expect the European Central Bank to raise rates in the coming months, but this is more than priced in by markets. We continue to believe the bar for a Fed hike is high, as current policy rates are modestly restrictive and wage growth is slowing. This means markets continue to overestimate the potential extent of rate hikes. On the other hand, if risks to economic growth materialize in a scenario where the Strait is closed for a prolonged period, this could lead to rate cuts from major central banks.

So, we continue to believe that by staying invested with a well diversified portfolio is the most effective way to navigate the current environment. Investors should position for equity gains amid a broadening of profit growth, secure portfolio income via quality bonds, diversify with broad commodities, and consider capital preservation strategies as a hedge.

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