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Monthly Letter: Catching up

26 August 2024, 07:00 am CEST, written by UBS Editorial Team

A volatile start to August raised questions about whether we are on the cusp of a bigger shift for markets, economies, and politics. In the latest Monthly Letter, we look at what has changed over the past month, and how investors should position.

Investors returning from summer vacations might not notice much change in financial markets over the past month. Yet August saw both the largest one-day points fall in Japanese market history and the VIX volatility index spike to its highest level since the onset of the pandemic. This month has also seen a change in the polling around the US election.

All of this raises questions about whether we are at the start of a bigger shift in the trajectory for markets, economies, politics, and interest rates. In our latest monthly letter, we focus on three topics: What's changed over the past month and what it means for the outlook; what the recent volatility teaches us about investing and how to navigate such turbulence in the future; and how to bring both together into a robust investment strategy for the current environment:

The case for Fed rate cuts has strengthened. A more mixed set of US labor data showed that the Federal Reserve now has both the imperative and the leeway to cut interest rates, in our view. US unemployment rose to 4.3% in July, and consumer price inflation slowed to 2.9% year over year. We now expect the Fed to cut interest rates at each of its three remaining meetings in 2024, but think market fears of a US recession are overdone. As returns on cash are eroded, we think investors should consider diversified fixed income and equity income strategies as alternatives to cash.

The probability that Vice President Harris becomes US president is rising. National polls (based on FiveThirtyEight.com) now give Harris around a three-point advantage over former President Donald Trump. We recently adjusted our probabilities to reflect this momentum shift, assigning a 40% probability to a Harris win with a divided Congress and a 15% probability to a "blue sweep." While investors should avoid making outsized portfolio moves based on election outcomes, we do see scope to review portfolio hedges, consider adding exposure to gold and the Swiss franc—which can offer defensive qualities in periods of uncertainty—and manage portfolio overexposure to election-sensitive sectors and currencies (like the Chinese yuan).

Growth uncertainty, geopolitics, and quant investing could drive further turbulence. The rise of quantitative trading has added complexity to market dynamics, amplifying market movements. An uncertain final quarter of the year may augur more market turbulence, but we believe investors should keep a long-term perspective, stay the course, and focus on building a balanced and diversified portfolio. We also recommend that investors maintain "shopping" and "disposal" lists to stay disciplined during turbulent times and be prepared to build strategic exposures at more favorable prices as and when volatility arises.

This month, we make several changes to our asset class preferences. Following strong performance from quality bonds, we are closing our preference for fixed income and for high-grade (government) bonds within the asset class. We continue to recommend that investors shift excess cash into quality fixed income—including investment grade corporate bonds—to prepare portfolios for lower interest rates. Diversified fixed income strategies can also help enhance portfolio yield.

In equities, we recommend focusing on quality companies. Those with strong balance sheets, competitive advantages, and exposure to structurally growing revenue streams should be well positioned to navigate economic uncertainties.

Elsewhere, we see upside for gold prices and the Swiss franc, both of which can also improve portfolio diversification and insulate against risks. Meanwhile, we move the US dollar to Least Preferred and upgrade the euro, the British pound, and the Australian dollar to Most Preferred.

Market swings in the past month have shown how quickly the focus can shift away from fundamentals. Investors who diversify, have a long-term perspective, and a clear idea of what they plan to buy and sell have a better chance of navigating and taking advantage of such periods of volatility in the future.

Read more in our latest Monthly Letter, "Catching up."

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.