(UBS)

Monthly Letter: That butterfly effect

29 April 2024, 09:11 am CEST, written by UBS Editorial Team

Investors are facing a complex geopolitical and economic environment that is often full of "butterfly effects." In our latest Monthly Letter, we look at how investors can navigate uncertain times, and keep their portfolios on track.

The geopolitical and economic environment has become more complex over the past month. Concerns about an escalation in the Middle East conflict and another upward surprise in US inflation have added to market volatility.

But as investors, we have no choice but to navigate portfolios through an environment that's often full of "butterfly effects" that don't care about earnings forecasts or valuation metrics.

Still, we find that a grounding in scenario analysis, built on understanding the most probable drivers of future market outcomes, is the best tool to help set our asset allocations. In our new Monthly Letter, we discuss our latest scenario analysis and what we think it means for investors:

In our base case, we expect a soft landing for the US economy. Economic growth is likely to moderate this year, and inflation should gradually resume its downward trend. That should allow the Fed to start cutting interest rates in September. We also expect the conflict in the Middle East to stay geographically contained. In our base case, we see the S&P 500 rising to 5,200 by year-end, and the 10-year Treasury yield falling to 3.85% as investors start to price a more meaningful Fed rate-cutting cycle next year. This implies an attractive risk-return outlook for quality bonds.

In a bear case, investors fear an overheating of the US economy. This scenario would see a combination of "too good" US growth, worries about US fiscal policy, and/or a sustained commodity price shock driving the 10-year Treasury yield to 6%. We would expect the S&P 500 to fall to 4,400 in such a scenario, and an allocation to alternative assets would likely be important to stabilize portfolios.

In a bull case, we consider a disinflationary boom in the US and a front-loading of AI growth. A bull case scenario would depend on investors' optimism about artificial intelligence building further, at the same time as US growth stays robust and inflation resumes a downward trajectory. This could support a rise in the S&P 500 to 5,500—despite the 10-year Treasury yield climbing to 5%—helped by better-than-expected earnings growth.

What do these scenarios mean for investors?

Quality bonds (including investment grade) remain our preferred asset class given their attractive yields and the value they offer in a portfolio context.

We see the overall risk-return outlook for equities as balanced, and think investors should hold equity allocations close to strategic benchmarks.

Below the index level, we see opportunities in quality stocks, including those exposed to tech disruption and the AI revolution. For those who are underinvested in these trends, we think the recent market volatility may offer an opportunity to build exposure. Investors looking to diversify existing tech exposure can consider alternative growth themes like the low-carbon transition, healthtech, or the ocean economy; or small- and mid-cap stocks.

We also upgrade the UK equity market from least preferred to most preferred this month given favorable earnings momentum and an improving global manufacturing outlook. We expect earnings growth to accelerate this year and next, driven by improving profits for commodity-linked companies and banks, alongside a strengthening UK economy.

For investors able to tolerate additional risks like illiquidity, we also think now is a good time to diversify into alternative assets.

As markets swing between pricing different scenarios, volatility is likely to stay high. But by diversifying and balancing across global markets and asset classes, investors can manage that volatility and keep their portfolio on track.

Read more in the latest Monthly Letter, "**That butterfly effect**," and watch a short video on these themes **here.**

Important information
As a firm providing wealth management services to clients, UBS Financial Services, Inc is registered with the U.S. Securities and Exchange Commission (SEC) as an investment adviser and a broker-dealer, offering both investment advisory and brokerage services. Advisory services and brokerage services are separate and distinct, differ in material ways and are governed by different laws and separate contracts. It is important that you carefully read the agreements and disclosures UBS provides to you about the products or services offered. For more information, please visit our website at www.ubs.com/workingwithus.
© UBS 2023. All rights reserved. UBS Financial Services Inc. is a subsidiary of UBS AG. Member FINRA/SIPC.
There are two sources of UBS research. Reports from the first source, UBS CIO Global Wealth Management, are designed for individual investors and are produced by UBS Global Wealth Management (which includes UBS Financial Services Inc. and UBS International Inc.). The second research source is UBS Group Research, whose primary business focus is institutional investors. The two sources operate independently and may therefore have different recommendations. The various research content provided does not take into account the unique investment objectives, financial situation or particular needs of any specific individual investor. If you have any questions, please consult your Financial Advisor. UBS Financial Services Inc. is a subsidiary of UBS AG and an affiliate of UBS International Inc.