



With economic growth likely to slow and inflation moderating, CIO sees the greatest near-term upside in fixed income—especially quality bonds. (ddp)

Brighter outlook after downbeat October

06 November 2023, 01:45 am CET, written by UBS Editorial Team

Global stocks and bonds both retreated in October amid the outbreak of war in the Middle East, a mixed third-quarter earnings season, and continued concerns that US interest rates look likely to stay higher for longer.

The MSCI All Country World Index lost 3% in October, trimming its 2023 total return to 6.7%. The S&P 500 lost 2.1% and at certain points in the month was down more than 10% from its peak in late July—satisfying a common definition of a correction. Rising yields were a major drag on equity markets, generally reducing the relative appeal of stocks. The yield on the 10-year US Treasury continued to climb, hitting 5% for the first time since 2007.

The Hamas attack on Israel was the defining event of October. The outbreak of war added to demand for several traditional safe-haven assets, including gold, which rose 7.3% over the month. The risk that the war could spill over into a broader regional conflict, disrupting oil supplies, initially pushed up Brent crude prices. However, Brent ended the month down 3.1%—reflecting optimism that the war would not draw in more combatants in the region and that OPEC+ oil exporters had the potential to plug any shortfall in oil supplies.

The US third-quarter reporting season, which is still going on at the time of writing, has been robust overall, with just over 70% of companies beating earnings per share estimates. However, with several disappointments from prominent tech-related companies, the season has not been sufficiently positive to shift attention from worries over the Federal Reserve and geopolitical strains.

But, despite a downbeat October, we believe the medium-term outlook for major asset classes remains positive, as earnings growth returns, the US economy heads for a softish landing, and inflationary pressures continue to subside. Against this backdrop, we recommend the following strategies:

Add to diversified portfolios: We see a solid foundation for diversified portfolios over the next six to 12 months—and our base case is for good returns on cash, bonds, stocks, and alternatives. This is a rare conjunction and makes it a good time for investors to bolster their core balanced portfolios. While we do see growth slowing, our base case is that the US economy will avoid the kind of deep contraction that has often followed aggressive monetary tightening by the Fed. The outlook for corporate earnings is also looking up, and we expect 9% earnings growth from S&P 500 companies in 2024. That should contribute to solid returns for equity investors, even if—as we expect—multiples don't expand much from current high levels. The outlook for bonds is even more promising. Market expectations that Fed rates will stay high for longer have gone too far, in our view. As the mood changes, we expect yields—which are at their most attractive level since the global financial crisis—to move lower.

Manage liquidity: Cash rates are currently attractive, but we believe the central bank tightening cycle is close to completion and high rates are likely to prove short-lived. We therefore recommend investors hold no more than two to five years of expected net portfolio withdrawals in a liquidity strategy. The remainder should be put to work in a balanced portfolio. Within liquid holdings, we believe investors can optimize and future-proof yields by using a combination of deposit vehicles, bond ladders, and select structured solutions.

Consider adding exposure to alternatives: Alternative asset classes are a key part of long-term portfolio diversification for risk-tolerant investors, particularly during market environments when stocks and bonds move together. We currently see particular opportunities in specialist credit hedge fund strategies and secondaries in private equity. Higher interest rates can also support return potential for alternative asset managers, given higher yields and returns on offer in underlying assets, including private debt. Investing in alternative assets does come with notable drawbacks, however, including illiquidity risks.

So, we advise investors to avoid overreacting to the recent negative turn in market sentiment. With economic growth likely to slow and inflation moderating, we see the greatest near-term upside in fixed income—especially quality bonds. However, the good return outlook across asset classes over the coming 6–12 months makes it an opportune moment for investors to strengthen their core balanced portfolios, in our view.

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