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Diversification can help navigate market volatility

UBS House View - Daily US

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From the studio:

C1 Podcast: **CIO's Eva Lee and Delwin Kurnia-Limas on US tech, China tech, and AI** (12:30)
C1 Video: **CIO's Sundeep Gantori on navigating tech volatility** (2:17)
C1 Video: **A quick explainer on CIO's updated global equity positions** (2:21)
C1 Video: **Asset allocation amid tariffs with CIO's Mark Andersen** (11:01)
Podcast: **Paul Donovan on whether Germany's chancellor-in-waiting is the comeback kid** (25:00)

Thought of the day

Investors have remained on high alert as relations between the US and its main trading partners continue to deteriorate. On Thursday, President Donald Trump threatened to impose a 200% tariff on wines and other alcoholic products from Europe, if the European Union (EU) maintains a planned levy on American whiskey. This was just the latest in a series of tit-for-tat exchanges that have revived market fears of stagflation—a combination of faster inflation and slower growth. The S&P 500 index was down 1.4% on Thursday, for a fall so far this week of 4.3%.

Such worries have also boosted volatility. The VIX index of implied US stock volatility, a popular gauge of investor anxiety, climbed to its highest level of the year earlier this week, and at 24.66 on Friday is comfortably above the multi-decade average of 20. Fast-moving geopolitical developments and uncertainty over the likely pace of Federal Reserve rate cuts have also been keeping investors on edge.

Staying up to date with such developments is important. But it is also crucial to keep sight of longer-term investing principles that can boost risk-adjusted rates of return—such as diversification. This was one of the key messages from our recent update to the *Global Investment Returns Yearbook*—a survey of market performance of 125 years by Professor Paul Marsh and Dr. Mike Staunton of the London Business School and Professor Elroy Dimson of Cambridge University:

What to watch: 17 March 2025

- US retail sales for February
- February's consumer price data from Italy
- US NAHB housing index for March
- China retail sales, industrial production, urban unemployment for February

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Global equity diversification can mitigate concentration risks. Historical data shows that for US dollar-based investors, risk decreases as the number of countries in a stock portfolio increases. The standard deviation of US dollar real returns for a typical single-country investment is 29.1%, which falls to 18.6% for an equally weighted 21-country portfolio and 17.2% for a capitalization-weighted 21-country world index.

Multi-asset diversification can provide portfolio resilience. While return correlations have been on the rise lately (that is, different asset classes have been performing in increasingly similar ways), multi-asset diversification remains an important principle. Over the long term, the 60:40 US-blended portfolio of US stocks and Treasury bonds has historically delivered an annualized real return of 5.1% in local currency terms (versus 6.6% for stocks and 1.6% for bonds), with lower volatility at 13.4% compared to stocks alone at 19.8% and 10.7% for bonds.

Extending one's toolkit to include gold into a portfolio can help during periods of increased uncertainty and may provide a hedge against inflation, as gold has shown a positive correlation of 0.34 with inflation since 1972. Incorporating alternative investments such as private equity, private debt, private infrastructure, or private real estate can help diversify sources of return and potentially enhance portfolio growth, subject to investors' risk tolerance and careful management of alternative assets' unique risks, such as illiquidity.

Cross-asset diversification can alleviate crises' impact. While stock and country diversification may be less effective during immediate crisis periods, cross-asset correlation can be more impactful. During crises, the correlation between stocks and bonds tends to be negative due to a flight to perceived safe havens like government bonds. This makes highly rated government debt a valuable diversifier that may enhance portfolio diversification when it's most needed.

So, we recommend investors embrace diversification and stay invested despite ongoing volatility. We see continued positive potential returns in the US equity market, artificial intelligence stocks, as well as companies linked to power and resources. We also see scope for investors to hedge equity exposures through the use of tools like structured strategies with capital preservation features or structured solutions that can potentially generate income from higher volatility while systematically buying stocks on dips.

We also still see select opportunities outside the US. In Europe, our "Six ways to invest in Europe" portfolio aims to take advantage of six drivers: 1) A cyclical economic recovery ahead in Europe; 2) post-election beneficiaries in Germany; 3) rising security investments (defense and cyber); 4) rebuilding Ukraine and a recovery in Eastern Europe; 5) beneficiaries of lower energy costs in Europe; and 6) globally active European companies with limited global trade risks. In Asia, we like Indian and Taiwanese equities.

Beyond geographical equity diversification, investors looking to navigate a tense geopolitical environment should ensure their portfolios are well diversified with quality bonds, gold, and alternative investments.

Please read more about this report in the summary (clients only) or explore the full report through NEO

Caught our attention

Ukraine-Russia ceasefire talks continue, but deal still elusive. Russian President Vladimir Putin on Thursday said he "supports the idea" behind a US proposal for a ceasefire in Ukraine, but indicated he expects significant changes and that a deal must "eliminate the original causes of this crisis." US President Donald Trump called Putin's statement "very promising," while Ukraine's president suggested Putin was preparing to reject the proposal despite his comments. Brent crude prices on Friday partially recovered from selling pressure a day prior, suggesting less confidence in a quick ceasefire deal that could pave the way for a return of Russian energy into global markets.

Our view: While mistrust and different objectives may complicate the path to a sustainable ceasefire between Ukraine and Russia, regardless of outcome, we anticipate a surge in European defense spending. If a lasting peace deal is eventually reached, we think Eurozone building materials and industrial companies would likely be among the beneficiaries of reconstruction efforts. After the recent relief rally in the EURUSD—partially on improving peace prospects—we prefer not to chase the single currency higher; instead, we favor selling the upside in the pair. We like crude oil from a volatility-selling perspective and gold from a portfolio-hedging angle.

Market update

14.03.2025

Percent change. For volatility indices, net change in points. For valuation, change in price to earnings per share. For yields, net change in bps

	Current (*)	1D	5D	1M	YTD
VIX Index	24.2	-0	+1	+9	+7
MOVE Index	106	+2	+2	+22	+7
S&P 500	5522	-1.4%	-3.8%	-9.7%	-6.1%
S&P 500 trailing P/E (**)	23.1x		-0.6x	-1.9x	-1.5x
S&P 500 forward P/E (**)	20.7x		-0.5x	-1.4x	-0.8x
S&P 500 forward P/E ex-Mag 7 (**)	19x		-0.4x	-0.8x	+0.1x
Russell 2000	1994	-1.6%	-3.5%	-12.6%	-10.6%
Euro Stoxx 600	541	+0.1%	-2.3%	-2.1%	+6.5%
Shanghai Composite	3420	+1.8%	+1.4%	+2.2%	+2.0%
US 10-year Treasury	4.29	+2	-1	-18	-28
US 2-year Treasury	3.97	+1	-3	-29	-27
Germany's 10-year Bund	2.88	+2	+4	+44	+51
Germany's 2-year Bund	2.19	+1	-5	+8	+11
EURUSD	1.085	+0.0%	+0.2%	+3.5%	+4.8%
EURCHF	0.96	-0.2%	+0.6%	+1.6%	+3.2%
USDCHF	0.88	+0.1%	+0.4%	-1.8%	-2.6%
USDJPY	149	+0.7%	+0.5%	-2.3%	-5.3%
Brent crude, USD/bbl	70	+0.9%	+0.2%	-5.7%	-5.6%
Gold, USD/oz	3003	+0.4%	+3.0%	+4.1%	+13.7%

(*) or last close if not available, (**) weekly update

Source: Bloomberg, Factset, UBS

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:

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