



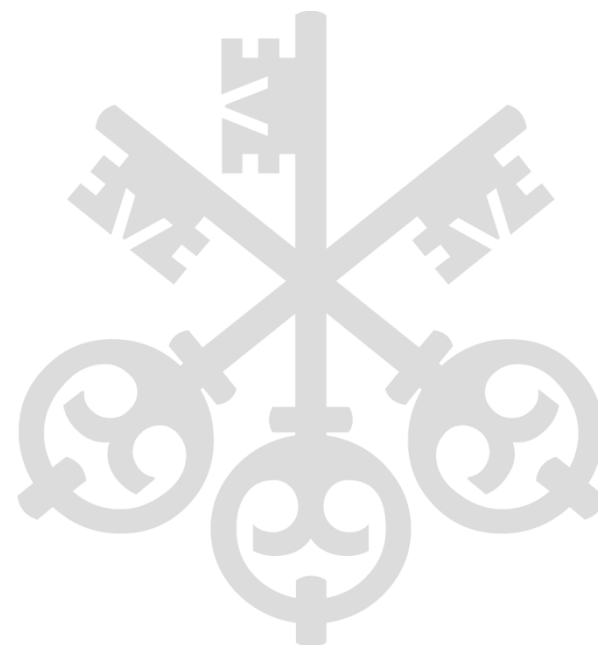
# US equity market outlook

## More room to run

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**Matthew Tormey**

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October 2021



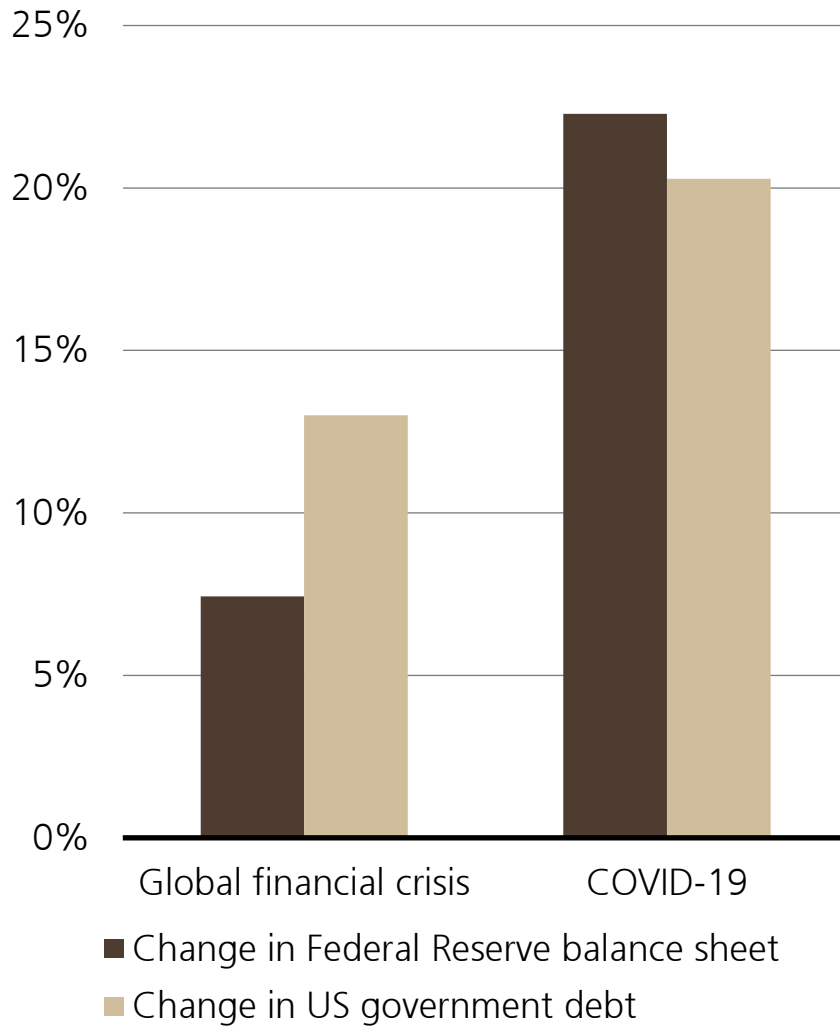
# Key points

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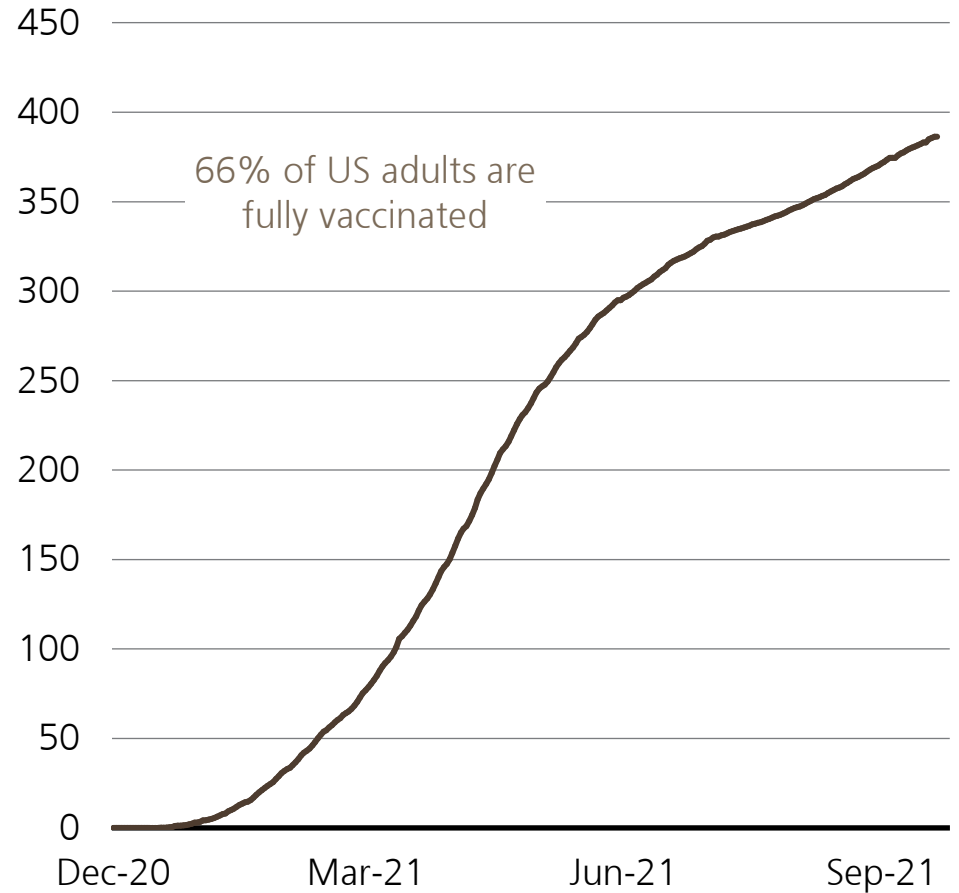
- We expect further equity market gains driven by:
  - Declining COVID-19 daily cases: recent trends in the US are encouraging
  - Solid growth: pent-up demand, strong household finances, rising business spending
  - Still-accommodative Federal Reserve policy: access to capital remains easy
  - S&P 500 price targets: 4,600 in December 2020; 4,800 in June 2021; 5,000 in December 2022
  - S&P 500 EPS estimates: USD 207 (45% growth) for 2021; USD 227 (10% growth) for 2022
- Fundamentals still support value and cyclical segments
  - Value stocks to benefit from solid earnings growth, higher interest rates, low valuations
  - Maintain most preferred on mid-caps
  - Keep a cyclical tilt in our sector positioning
    - Most preferred: Consumer Discretionary, Energy, Financials, Healthcare
    - Least preferred: Consumer Staples and Utilities
- Risks to our outlook
  - The pace of the pandemic
  - Supply chain bottlenecks become even more disruptive
  - Fiscal issues aren't resolved: govt. shutdown, debt ceiling, bi-partisan and social infrastructure
  - The Fed tightens policy sooner and faster than expected if inflation remains hot
  - A sharper-than-expected slowdown after the boom

# Policy response and vaccine progress have been impressive

Change in Fed balance sheet and US government debt, % of GDP, two years from crisis outbreak



Cumulative vaccine doses administered – US (in millions)

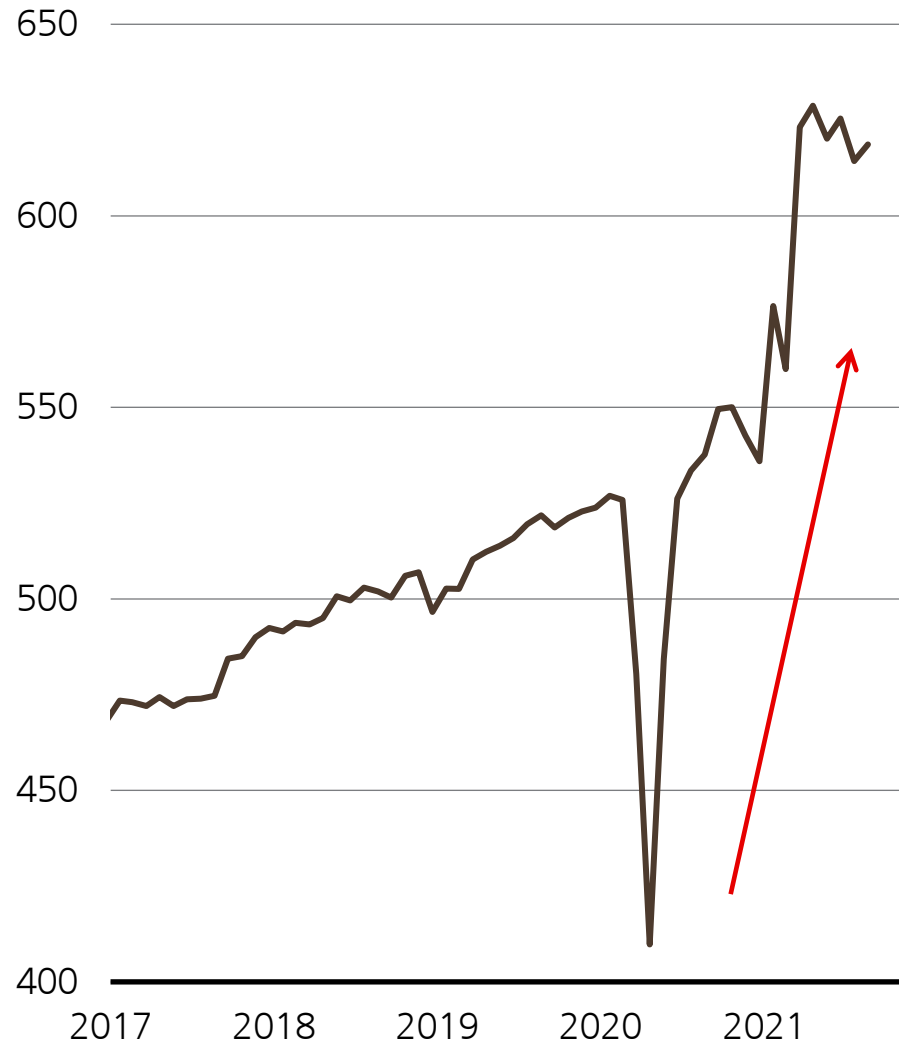


Source: FactSet, UBS, as of 18 July 2021

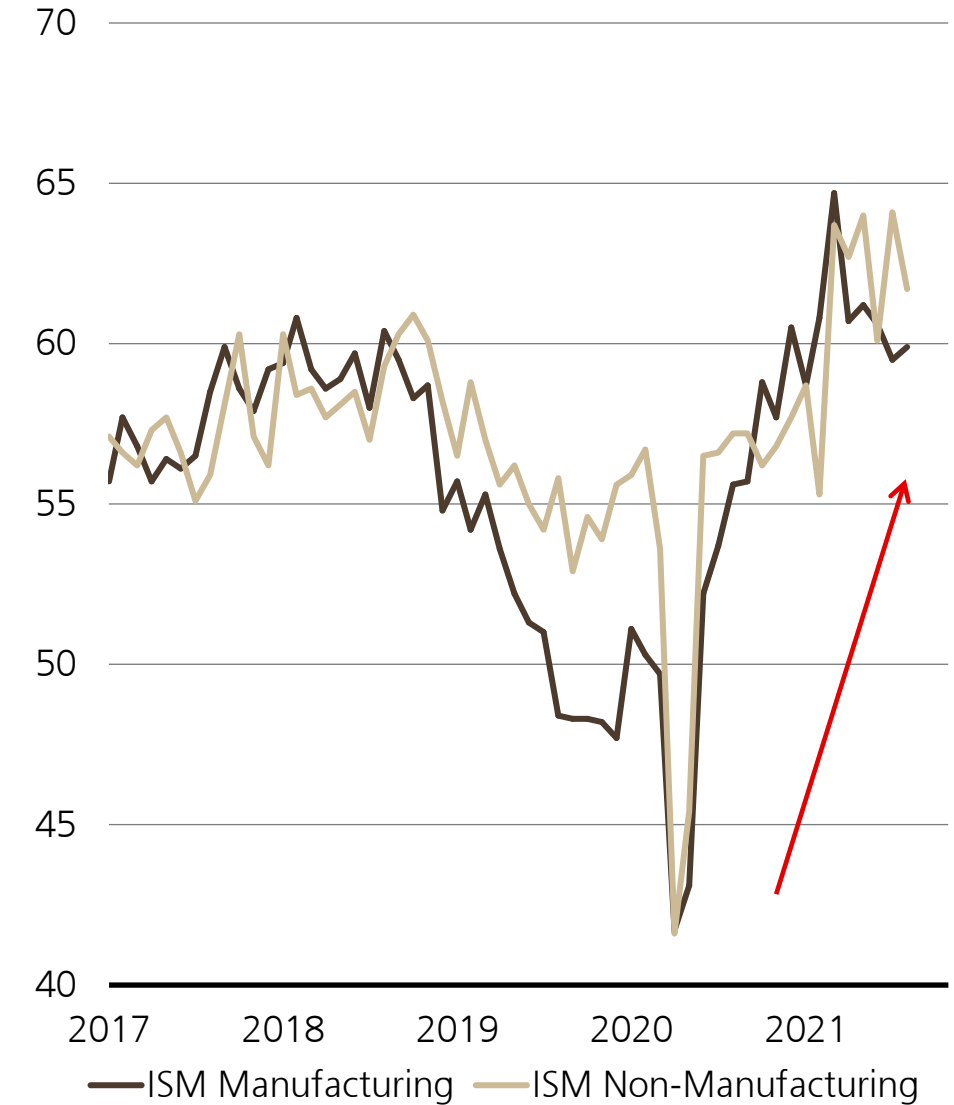
Source: CDC, Bloomberg, UBS, as of 21 September 2021

# Key economic indicators are normalizing after rising sharply

US retail sales, USD bn



ISM manufacturing and nonmanufacturing surveys

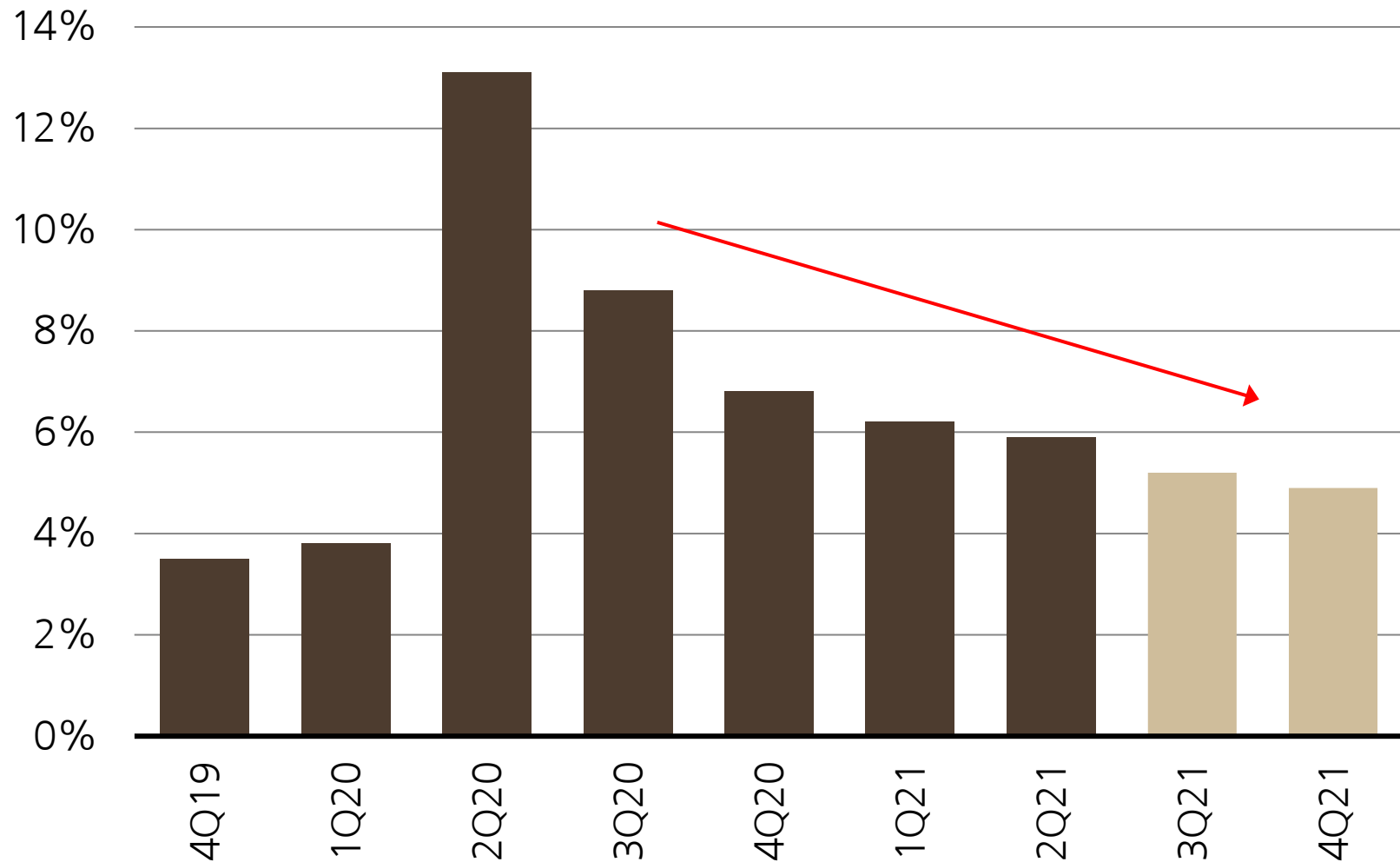


Source: Bloomberg, UBS, as of 31 August 2021

Source: Bloomberg, UBS, as of 31 August 2021

# Labor market trends are improving

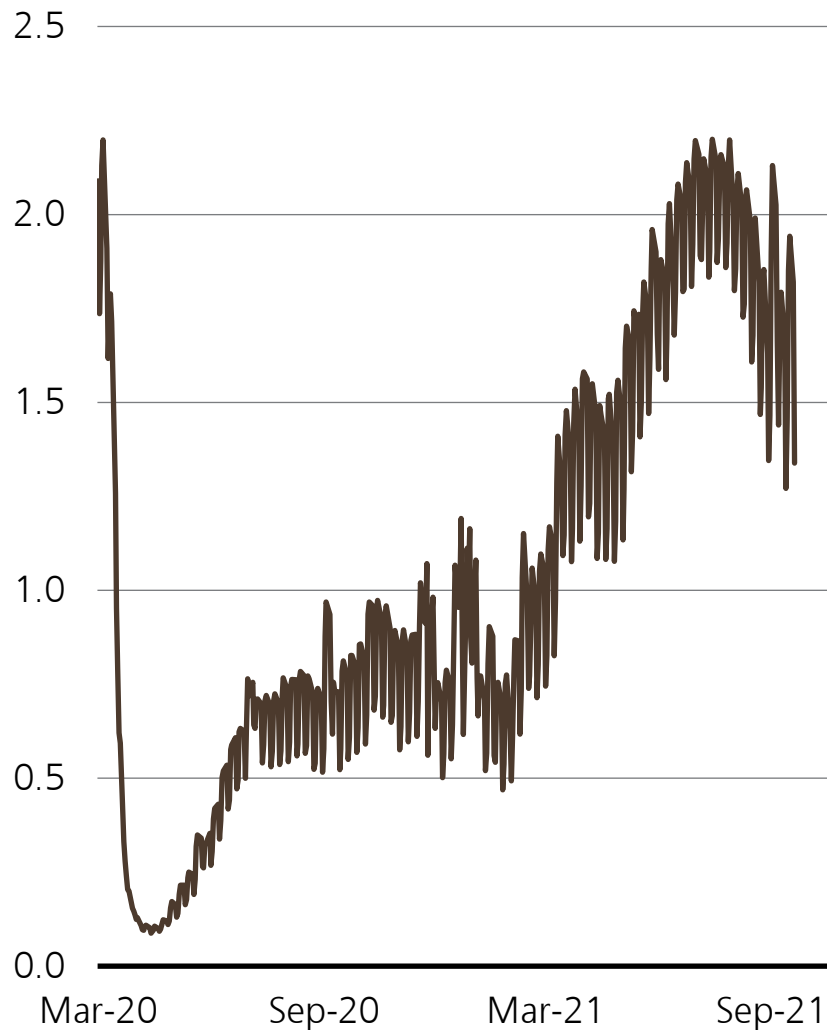
Actual and median consensus unemployment rate forecast (%)



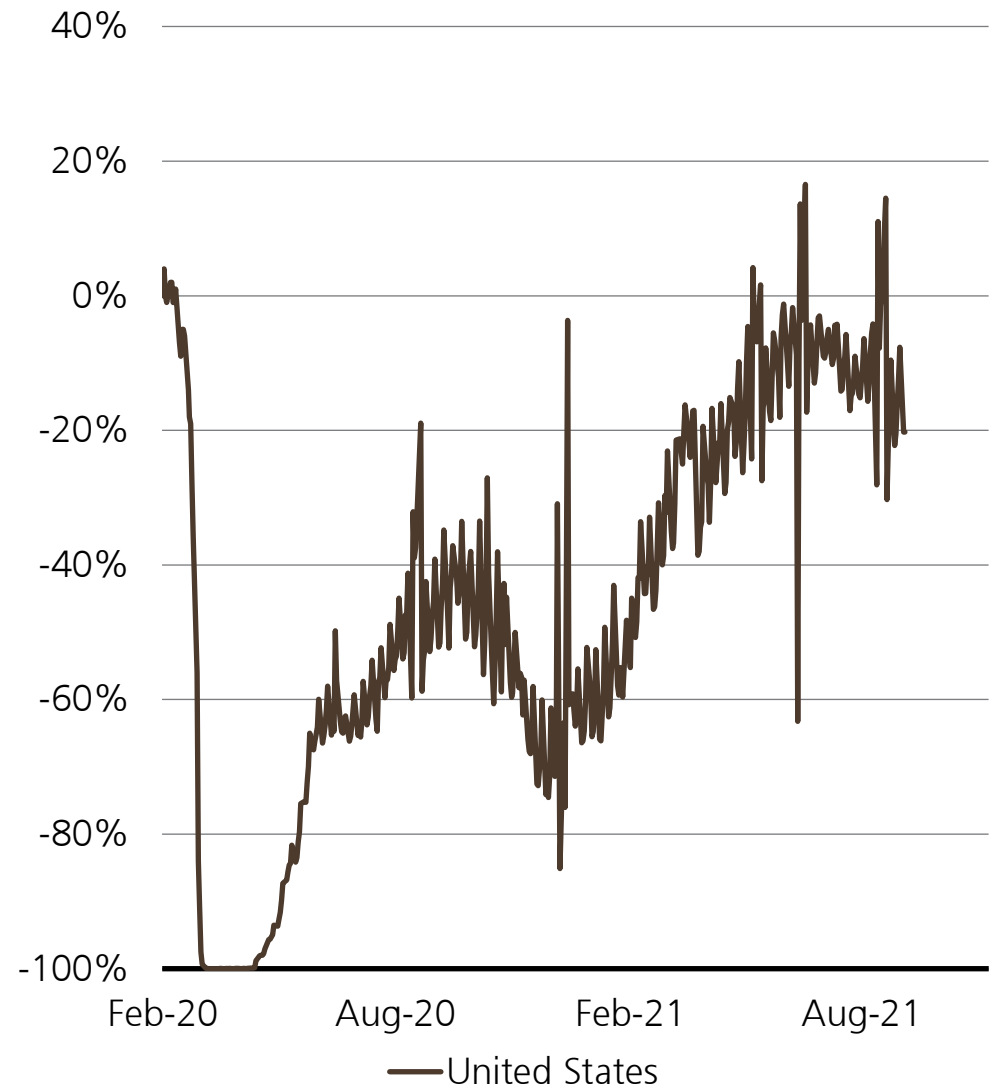
Source: Bloomberg, UBS, as of 22 September 2021

# Hard-hit segments may be feeling delta's effects...

TSA passenger throughput, millions



Seated diners, y/y change in %

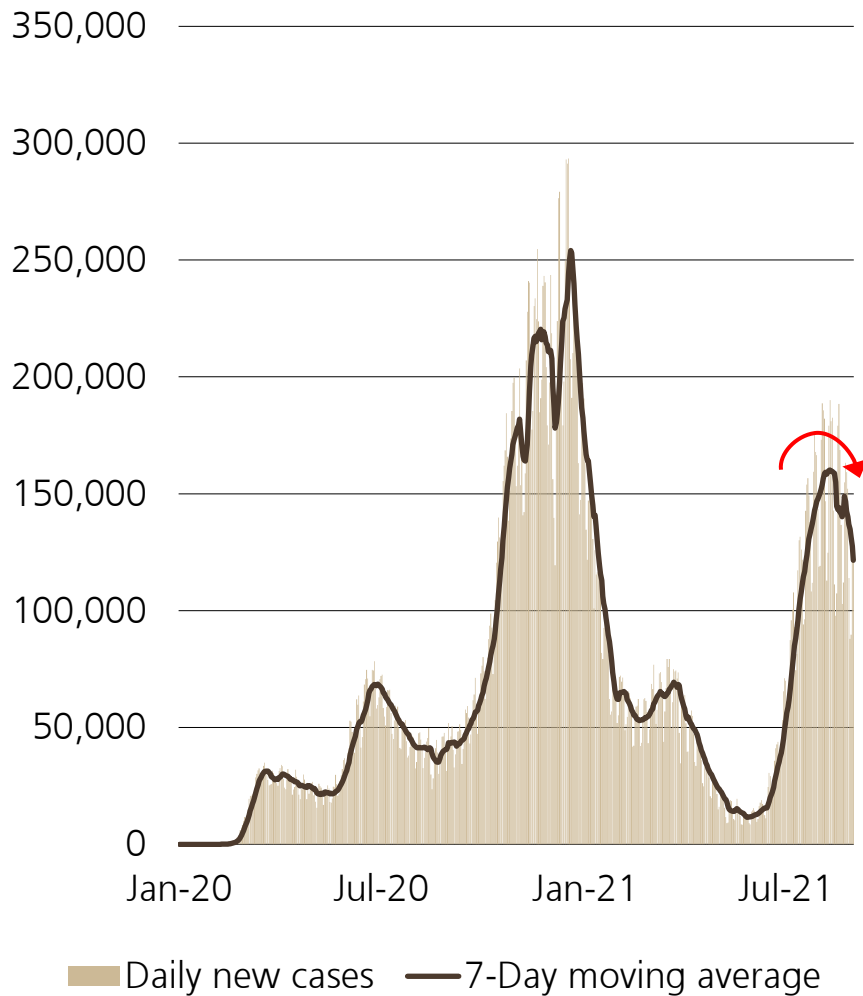


Source: TSA.gov, UBS, as of 21 September 2021

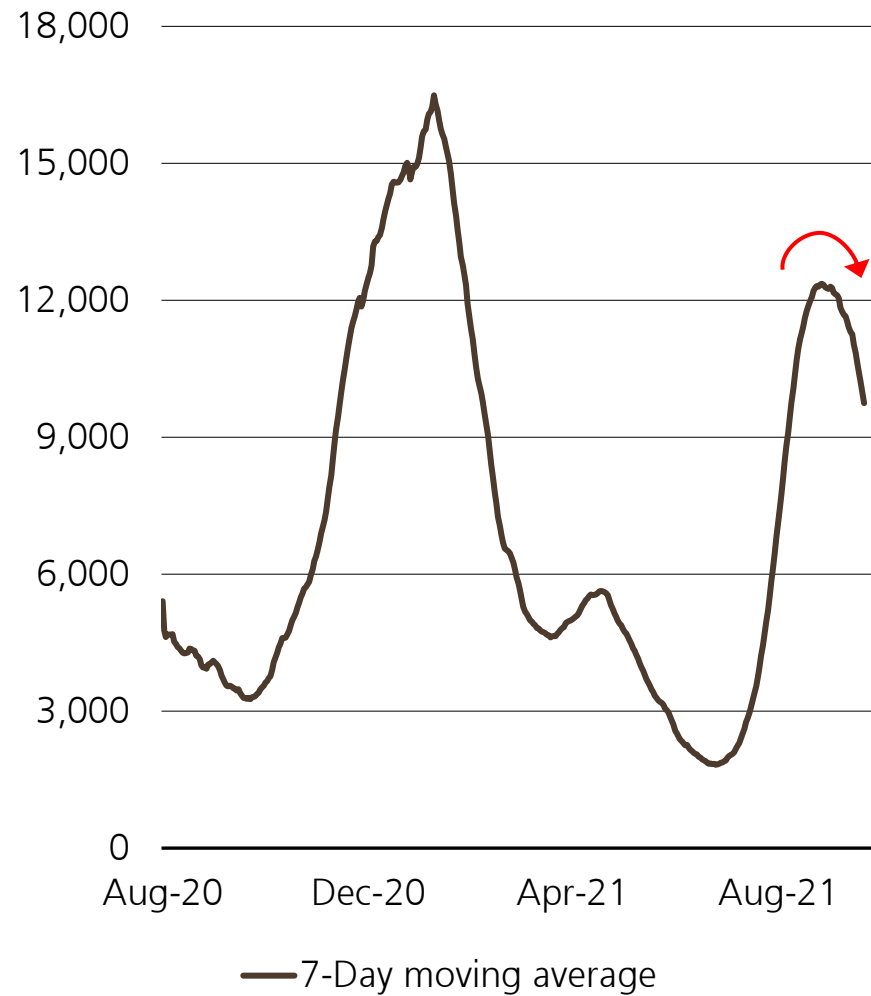
Source: Opentable, UBS, as of 21 September 2021

# ...although cases and hospitalizations likely peaked

US daily new COVID-19 cases



US new hospitalizations



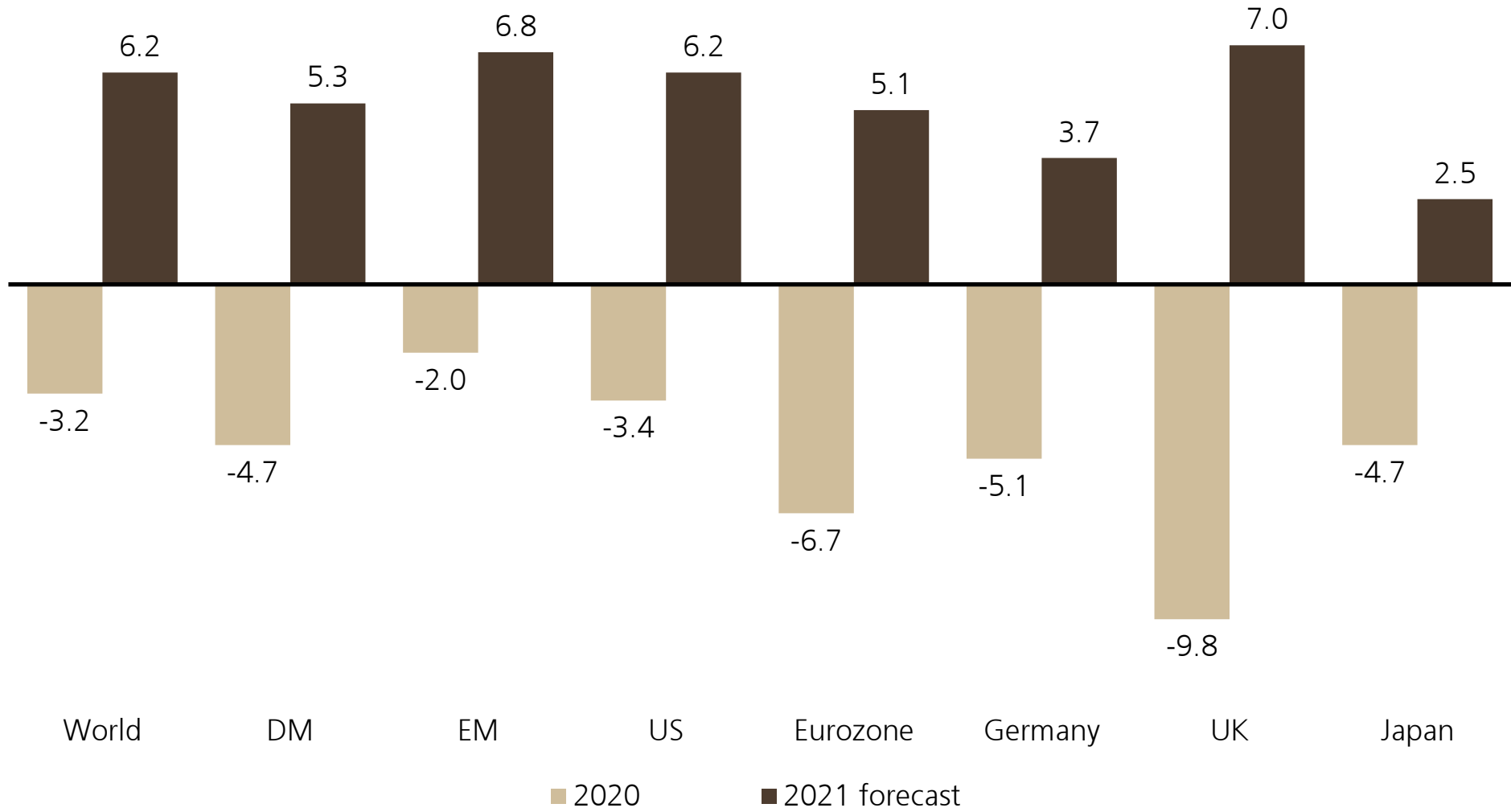
Source: CDC, UBS, as of 22 September 2021



Source: CDC, UBS, as of 21 September 2021

# Economic rebound is unfolding

Real GDP growth expectations, (% , year-over-year)



Source: UBS, as of 22 September 2021

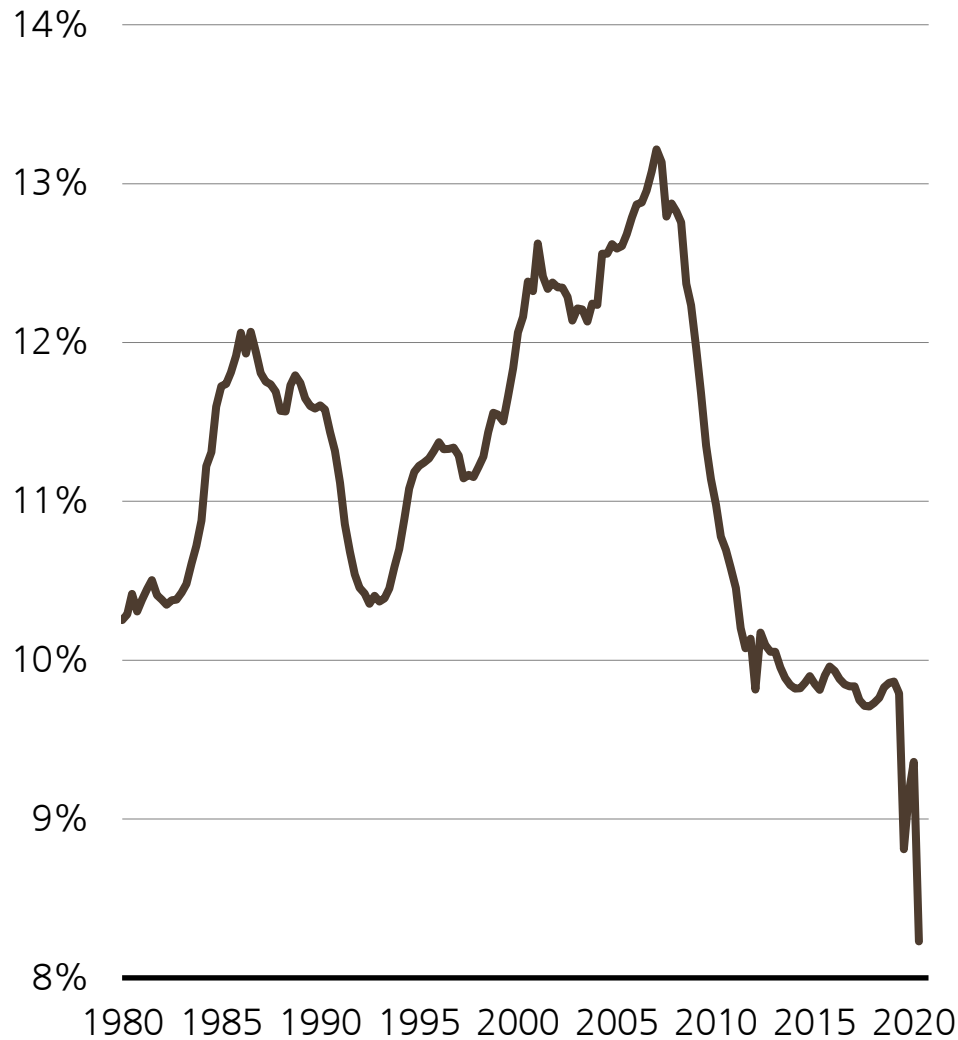


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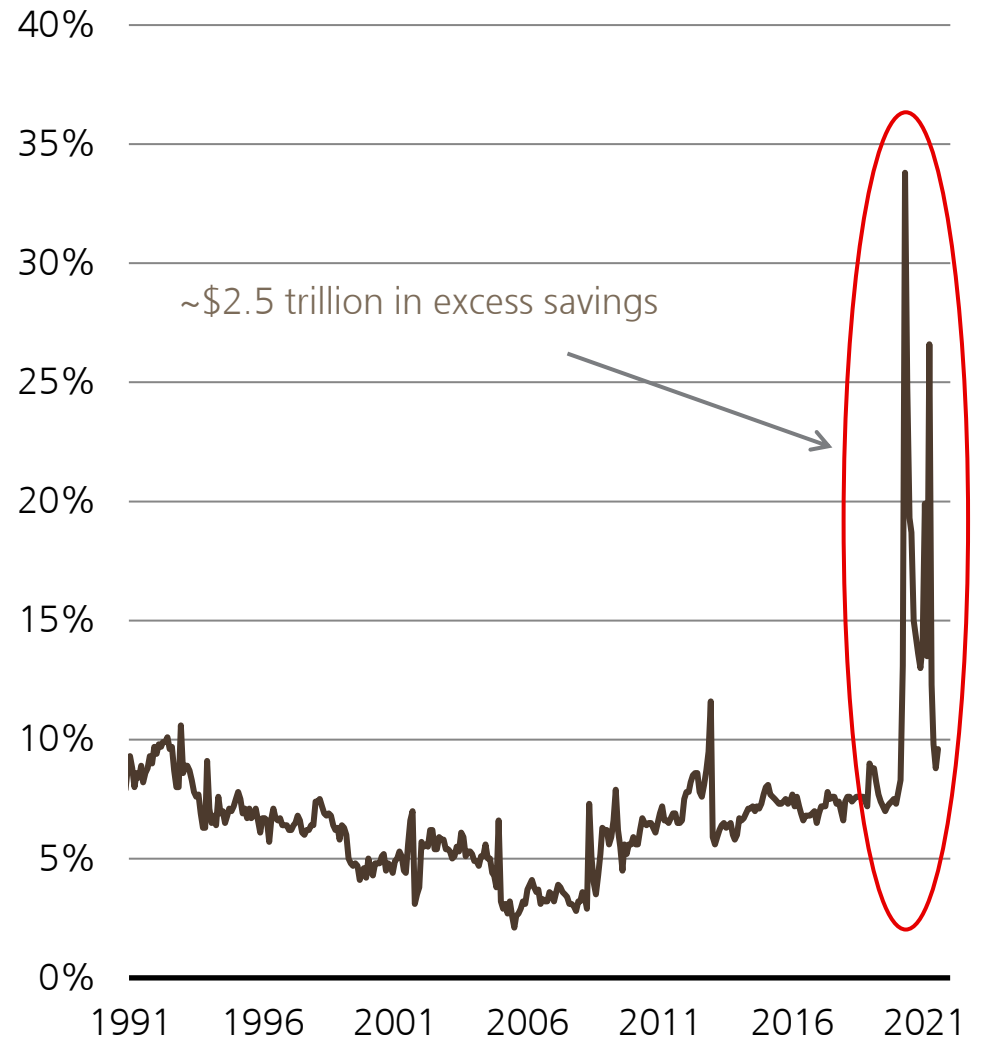
US equity market—solid growth and accommodate Fed  
drives further gains

# Solid growth: consumer finances are in very good shape

Interest payments as % of disposable income



Personal savings as % of disposable income

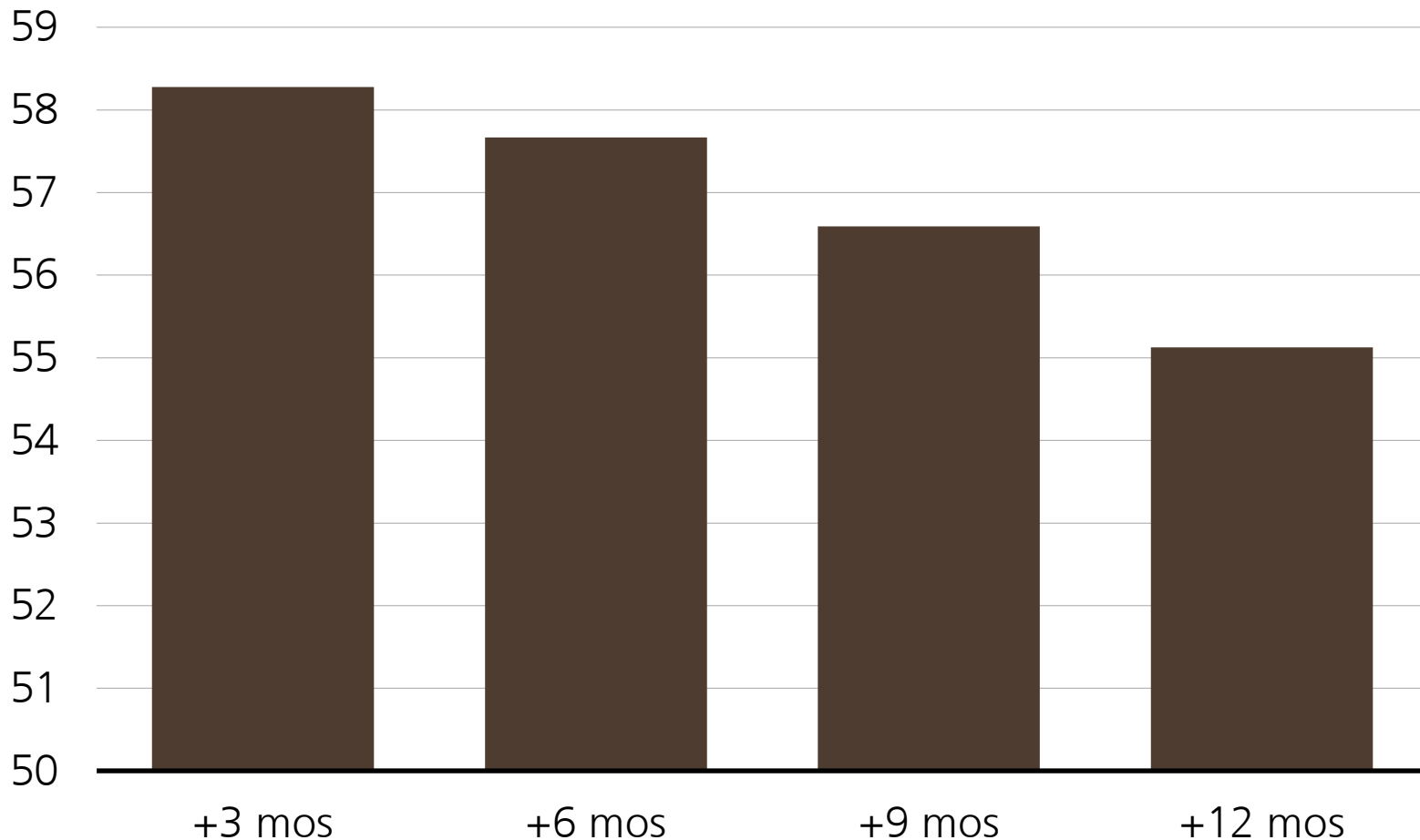


Source: Bloomberg, UBS, as of 31 March 2021

Source: Bloomberg, UBS, as of 31 July 2021

# Solid growth: low inventories suggest business cycle will remain healthy—over 50 denotes expansion

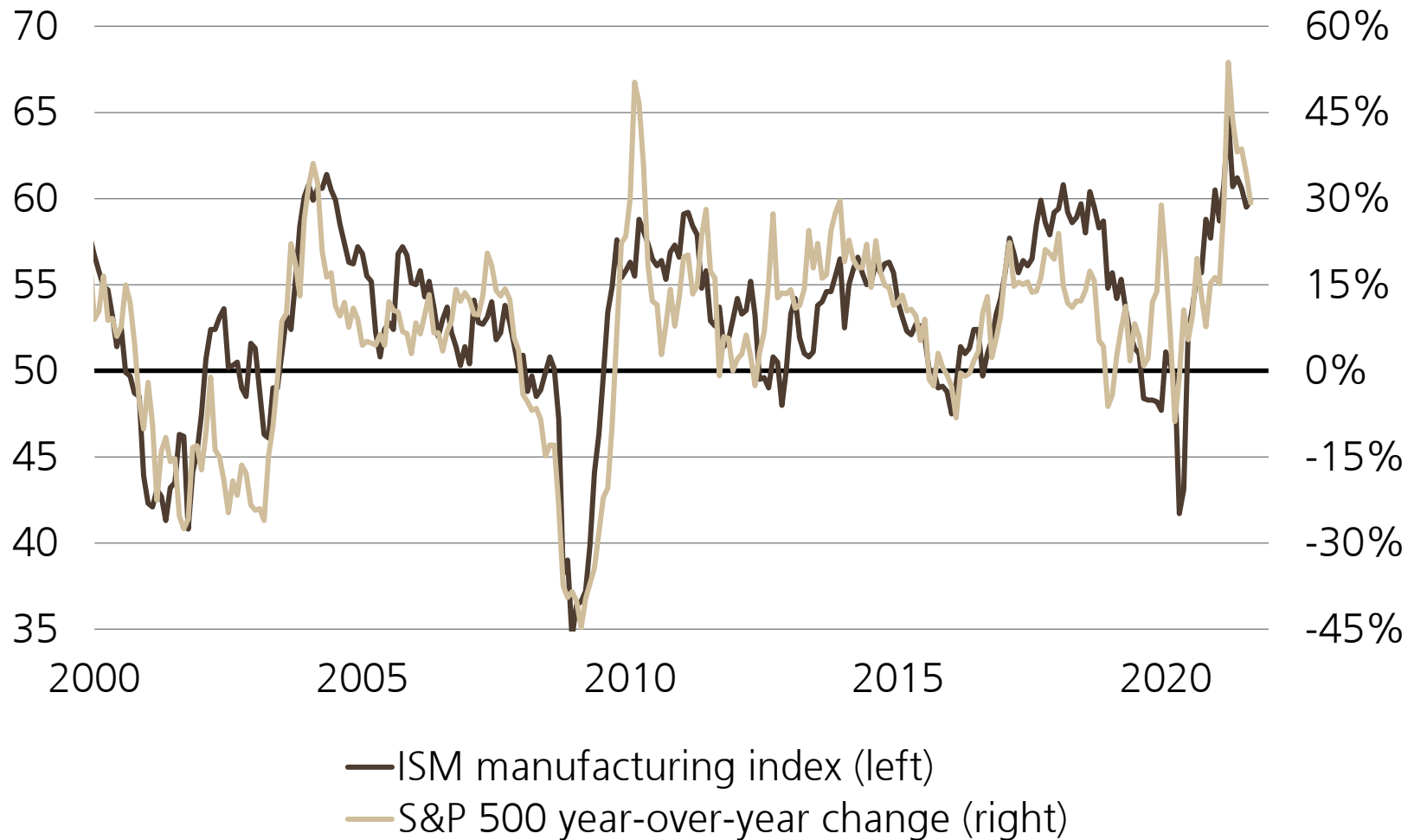
Average headline ISM reading in the months after an ISM customer inventory reading of less than 40 (current: 30.2)



Source: Bloomberg, UBS, as of 31 August 2021

# Solid growth: healthy business cycle drives market gains

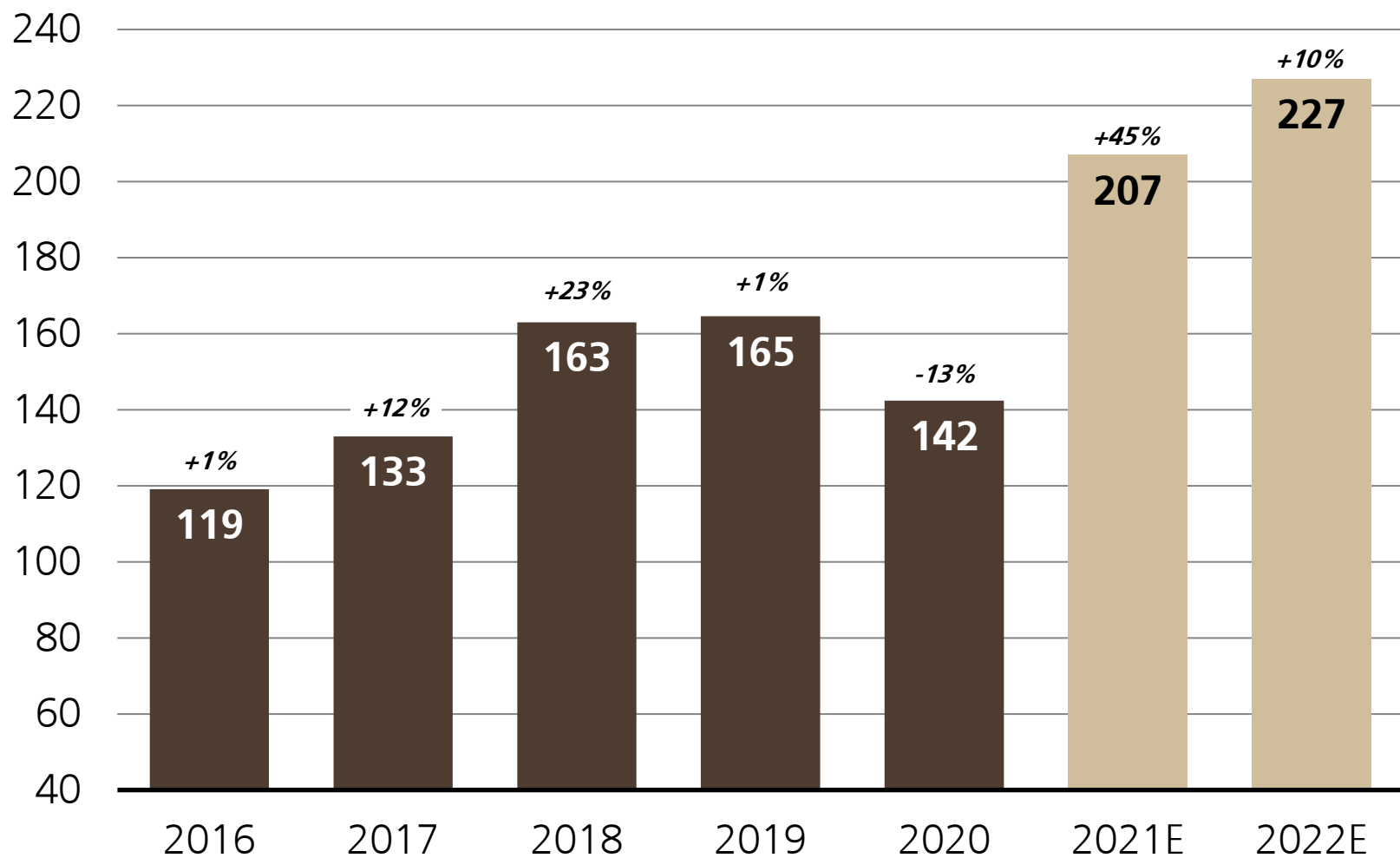
S&P 500 and ISM Manufacturing index



Source: Bloomberg, UBS, as of 31 August 2021

# Solid growth: earnings are recovering sharply

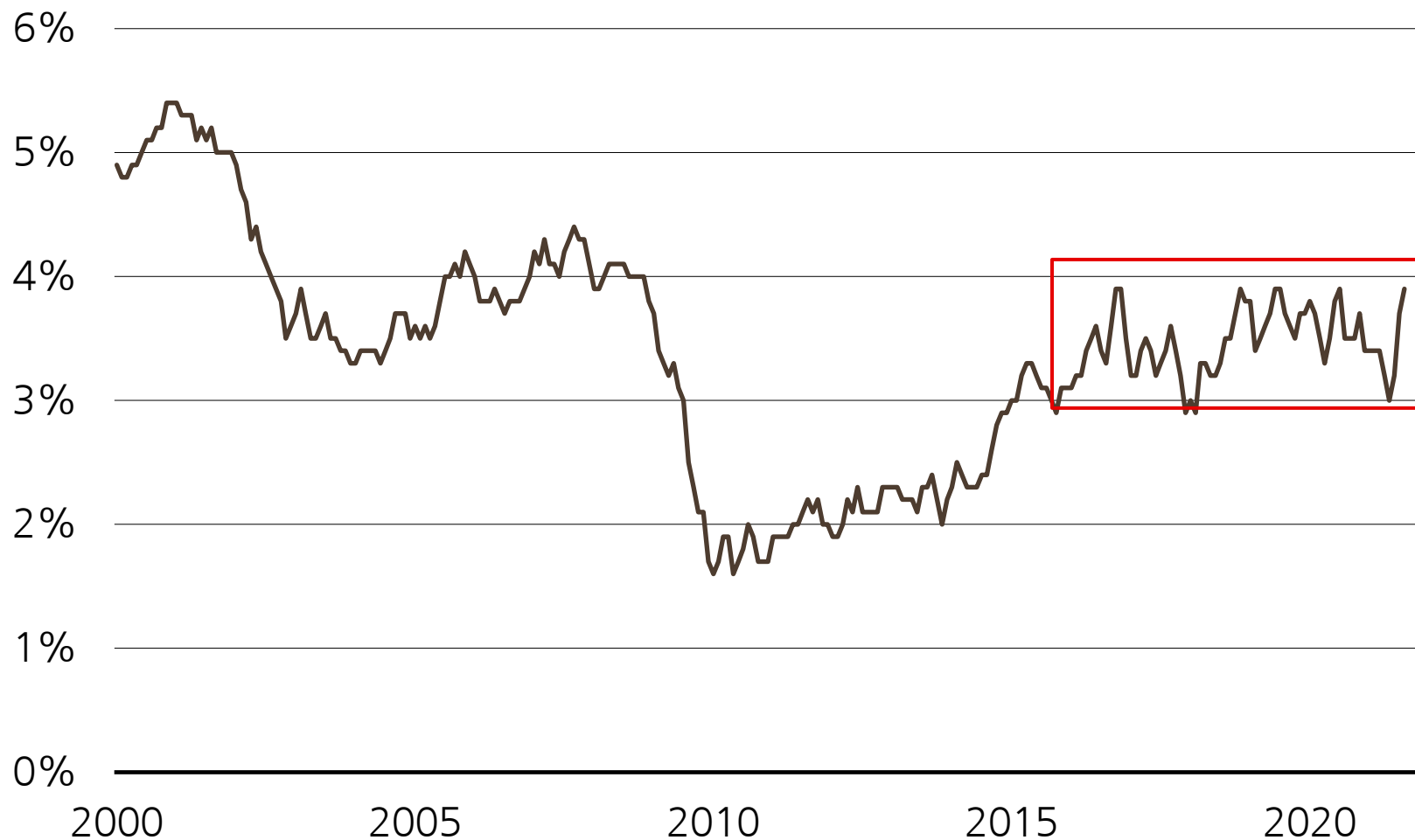
S&P 500 earnings per share (EPS), actuals and UBS CIO estimates; 2022E includes 4-5% drag from higher corp taxes



Source: FactSet, UBS, as of 22 September 2021

# Accommodative Fed: average wage increases look normal

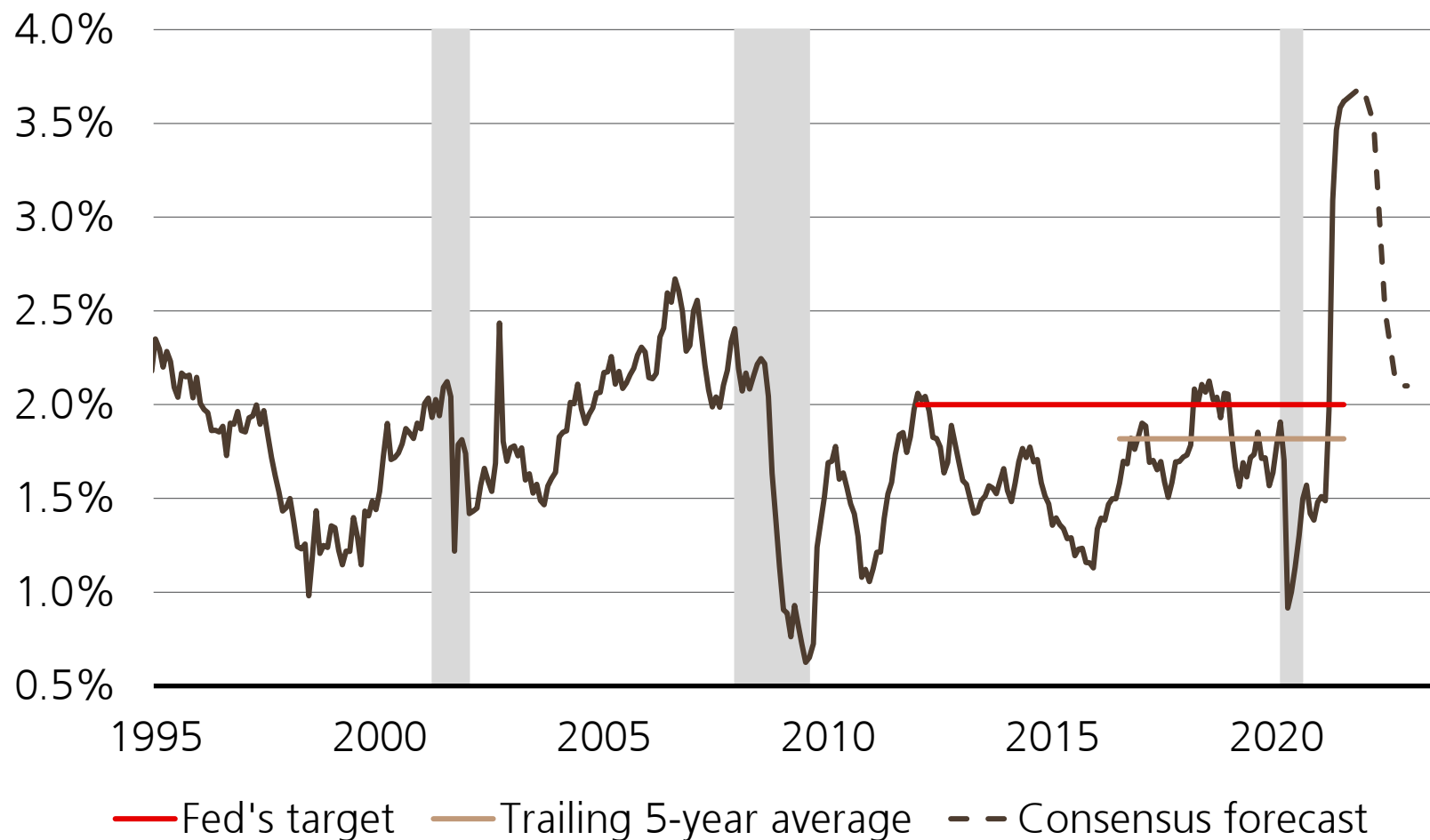
Atlanta Fed Wage Growth Tracker, median wage growth



Source: Bloomberg, UBS, as of 31 August 2021

# Accommodative Fed: inflation likely peaking

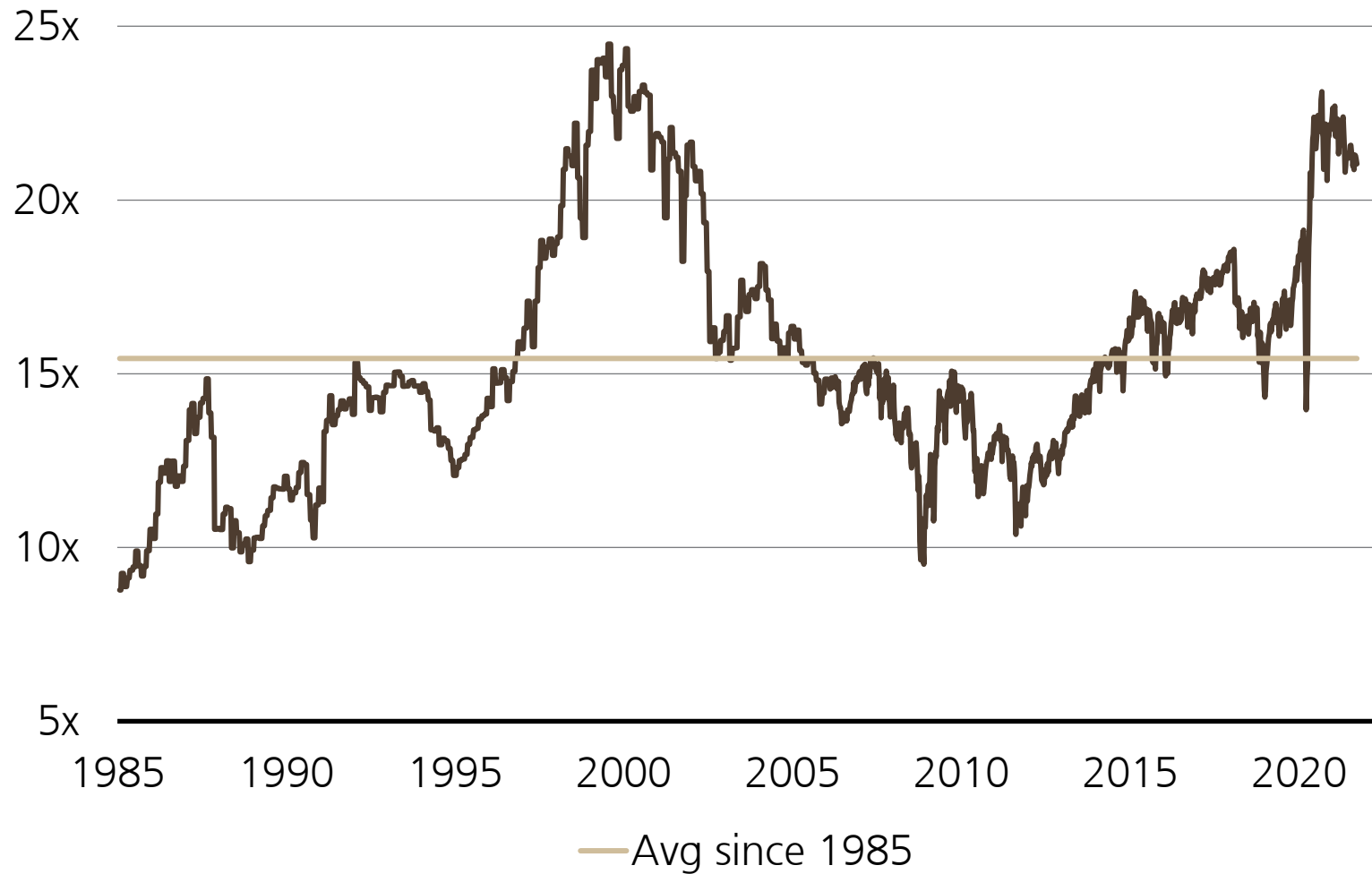
Core personal consumption expenditure price index, year-over-year change



Source: Bloomberg, UBS, as of 31 July 2021

# Valuations: high in absolute terms

S&P 500 forward price-to-earnings (P/E)

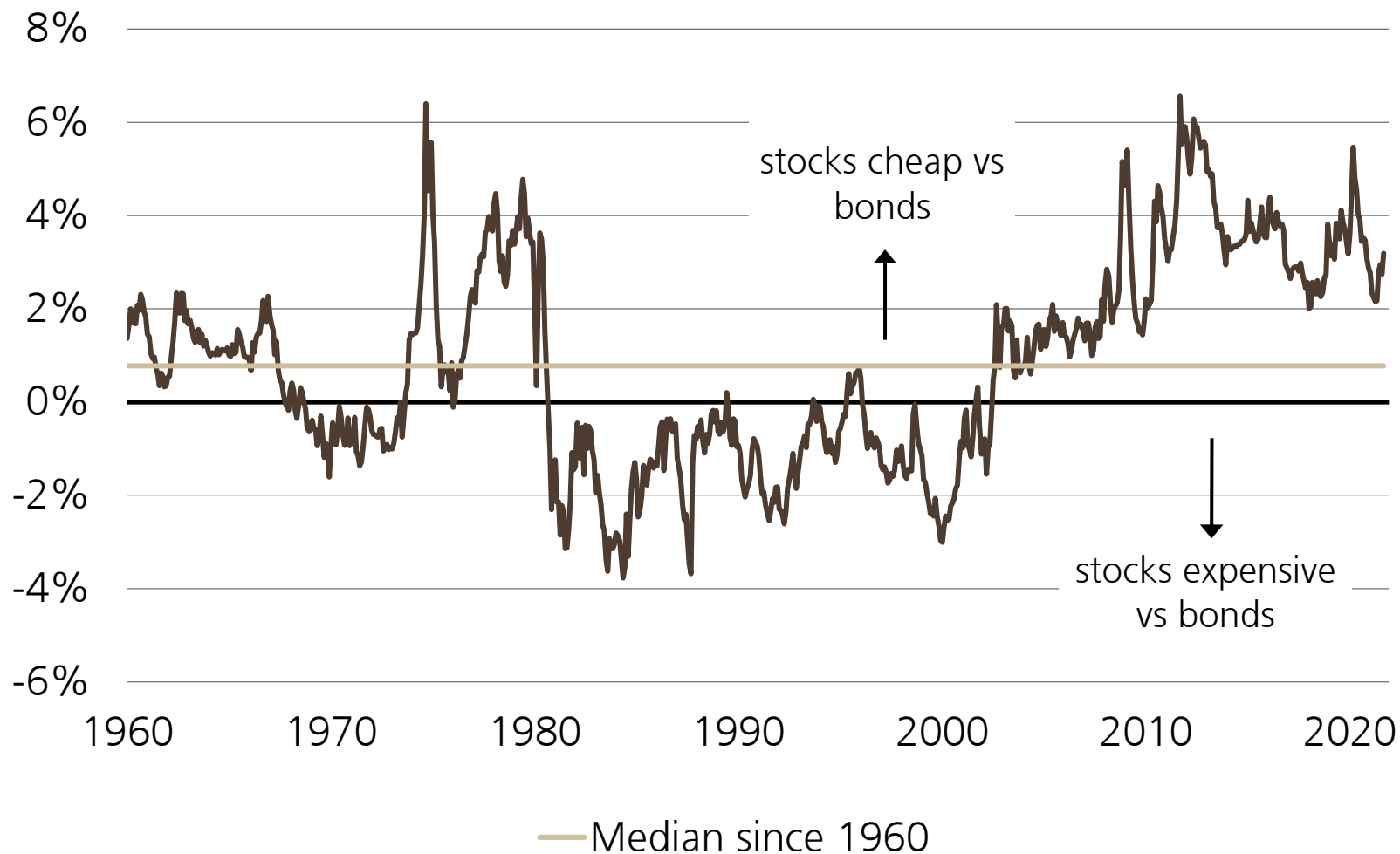


Source: Datastream, UBS, as of 17 September 2021



# Valuations: but stocks do not look expensive vs. bonds

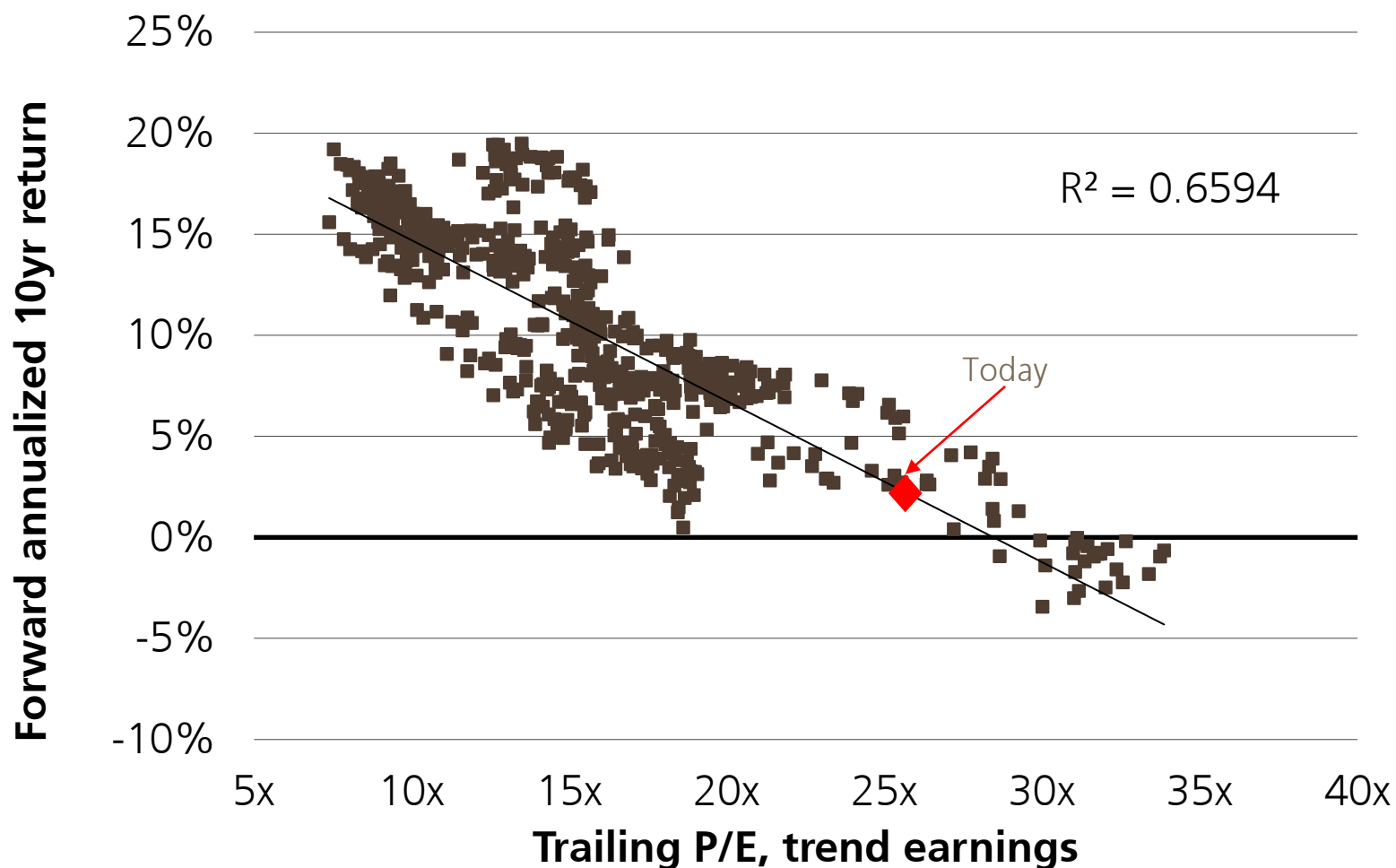
Equity risk premium (S&P 500 earnings yield minus 10-year Treasury yield)



Source: Bloomberg, UBS, as of 21 September 2021

# Valuations: high valuations mean lower long-term returns

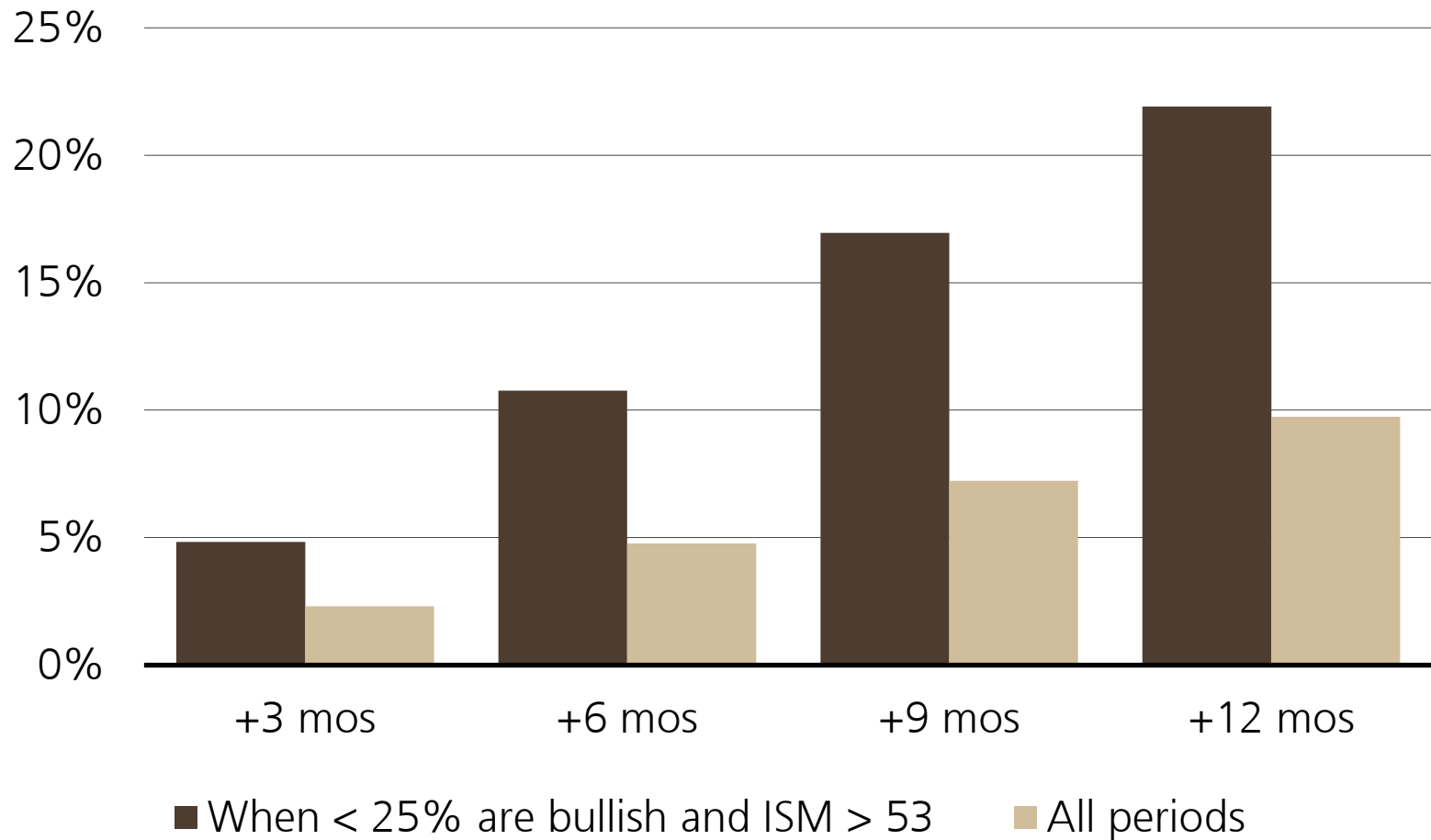
S&P 500 returns and P/E based on trend earnings, since 1960



Source: Bloomberg, UBS, as of 31 August 2021

# Recent low sentiment readings but solid business momentum suggests solid market gains ahead

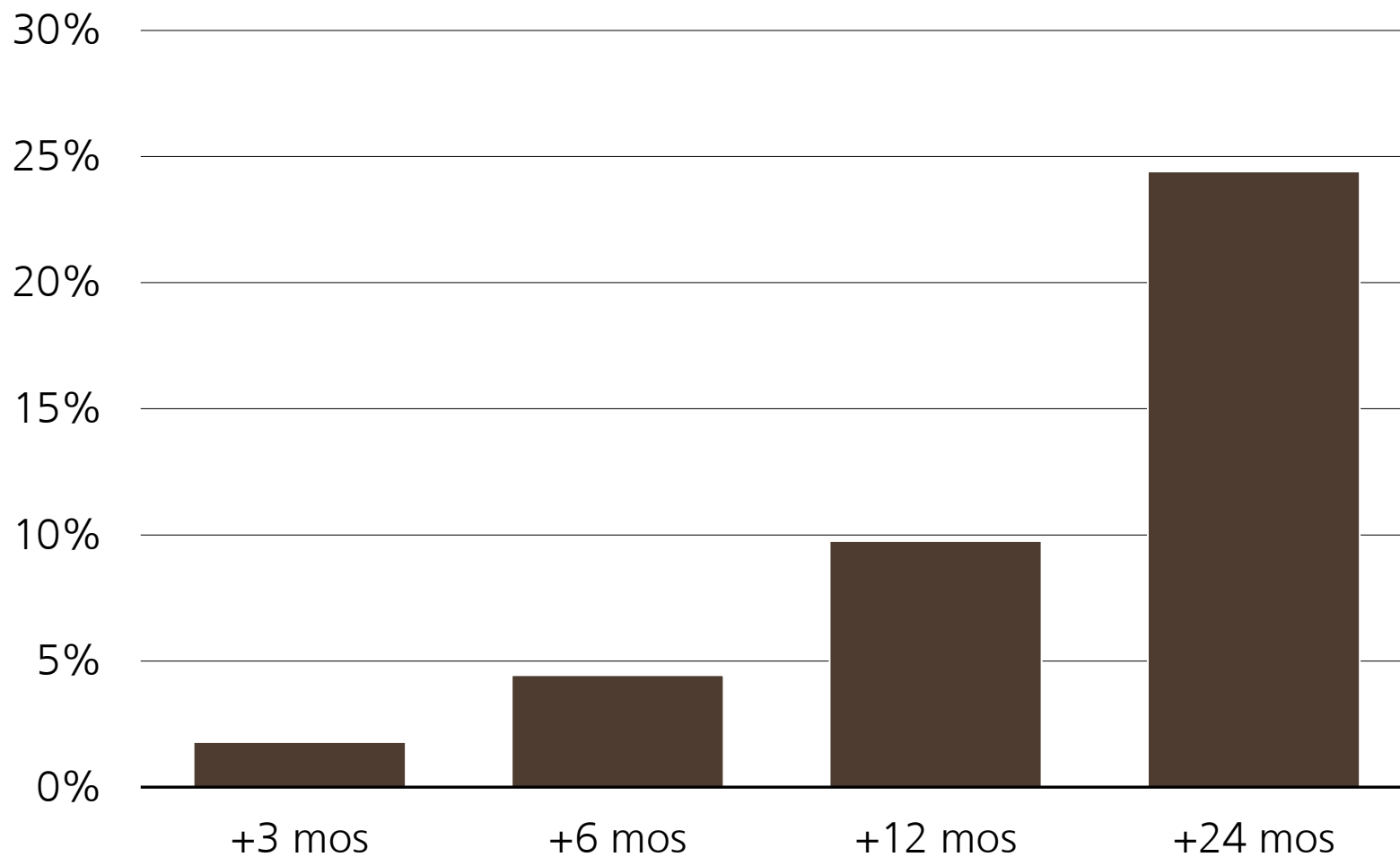
S&P 500 forward returns; black bars show returns when AAll bullish reading is < 25% and ISM Manufacturing is < 53



Source: Bloomberg, UBS, as of 16 September 2021

# No need to fear a high and falling ISM

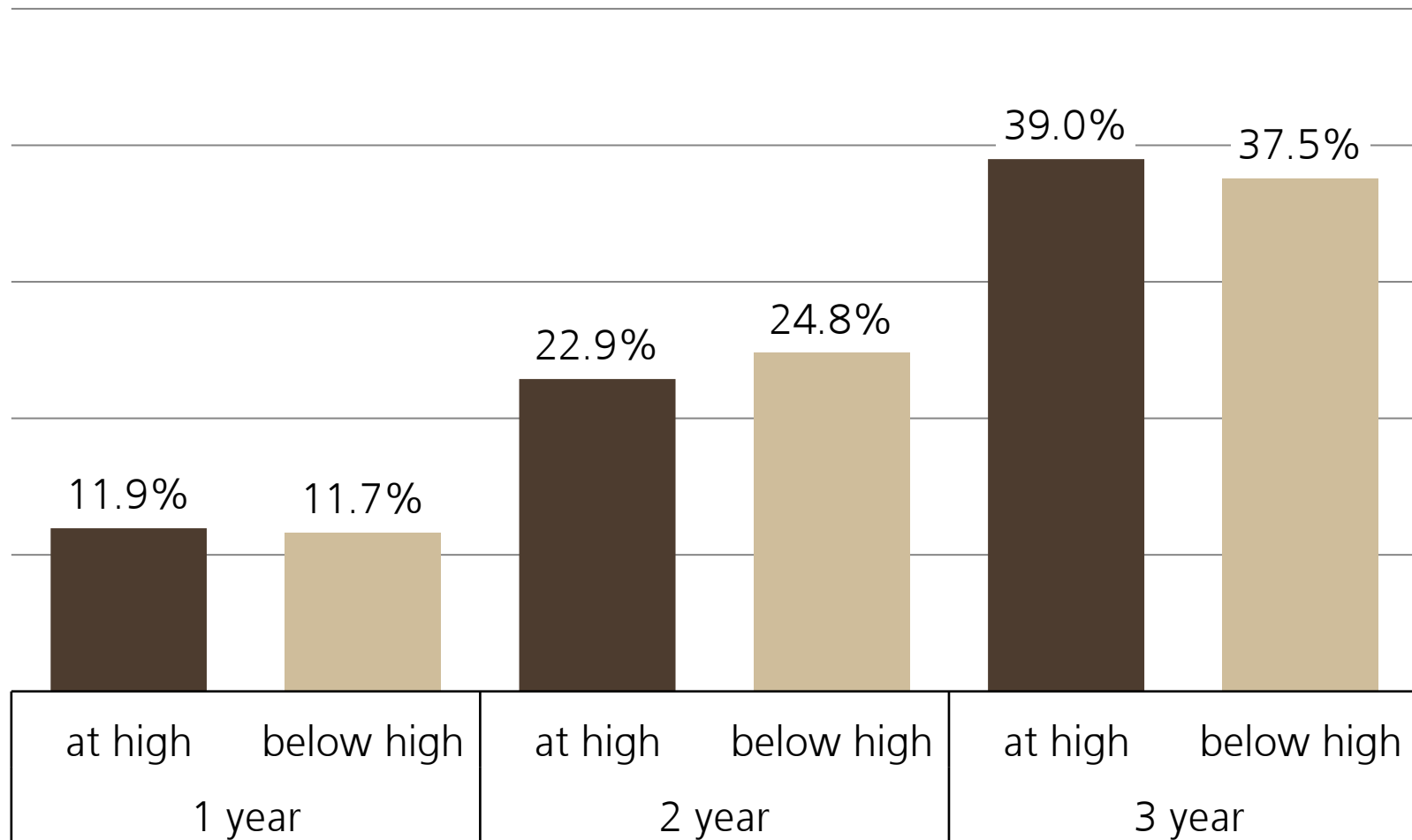
S&P 500 forward return when ISM is below previous 3-month average and above 55 since 1960



Source: Bloomberg, UBS, as of 31 August 2021

# Record highs are no reason to worry

S&P 500 returns following an all-time high, versus all other periods, since 1960



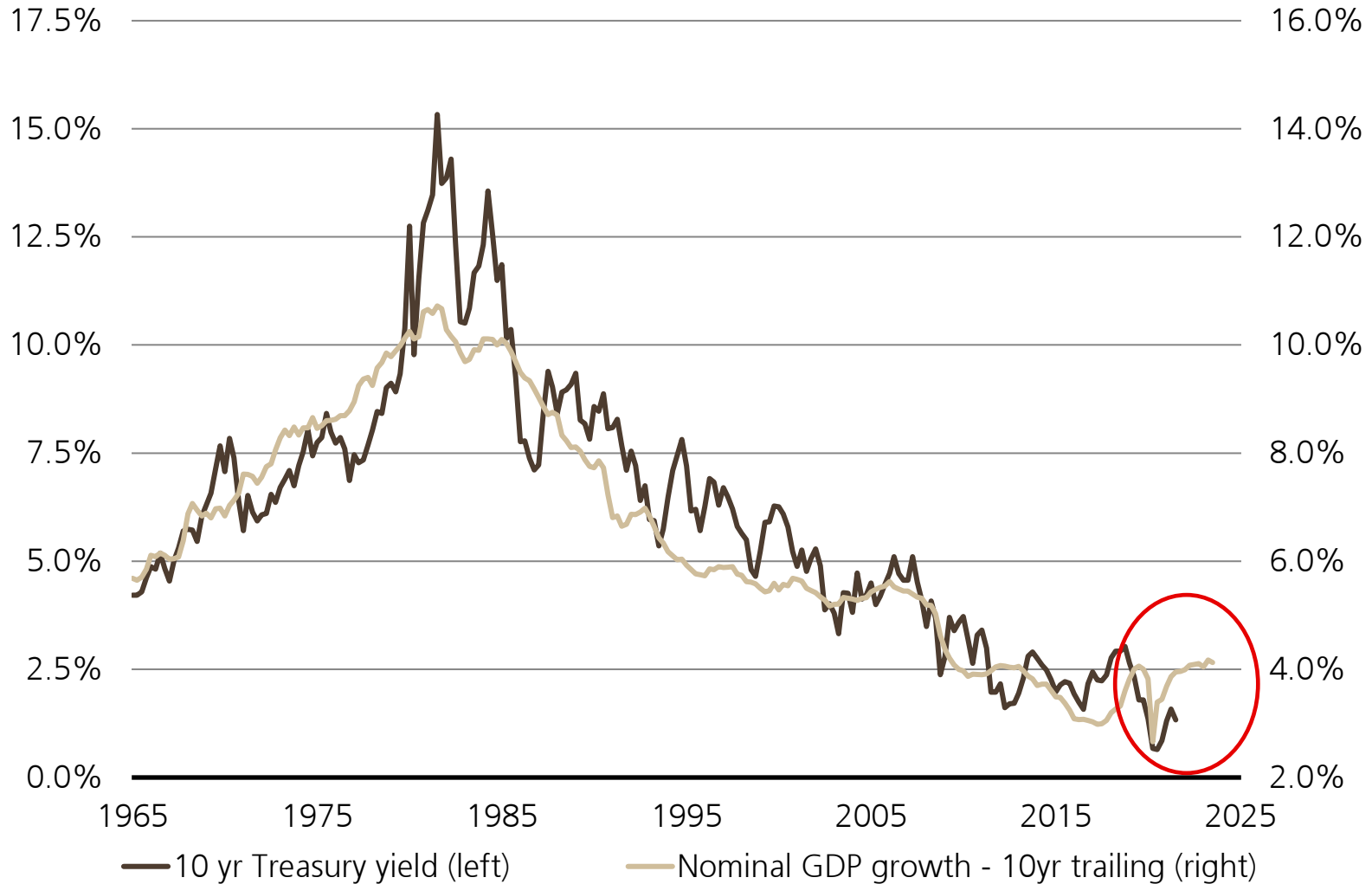
Source: Bloomberg, UBS, as of 31 August 2021

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# Putting interest rates and taxes in perspective

# Interest rates will likely trend higher

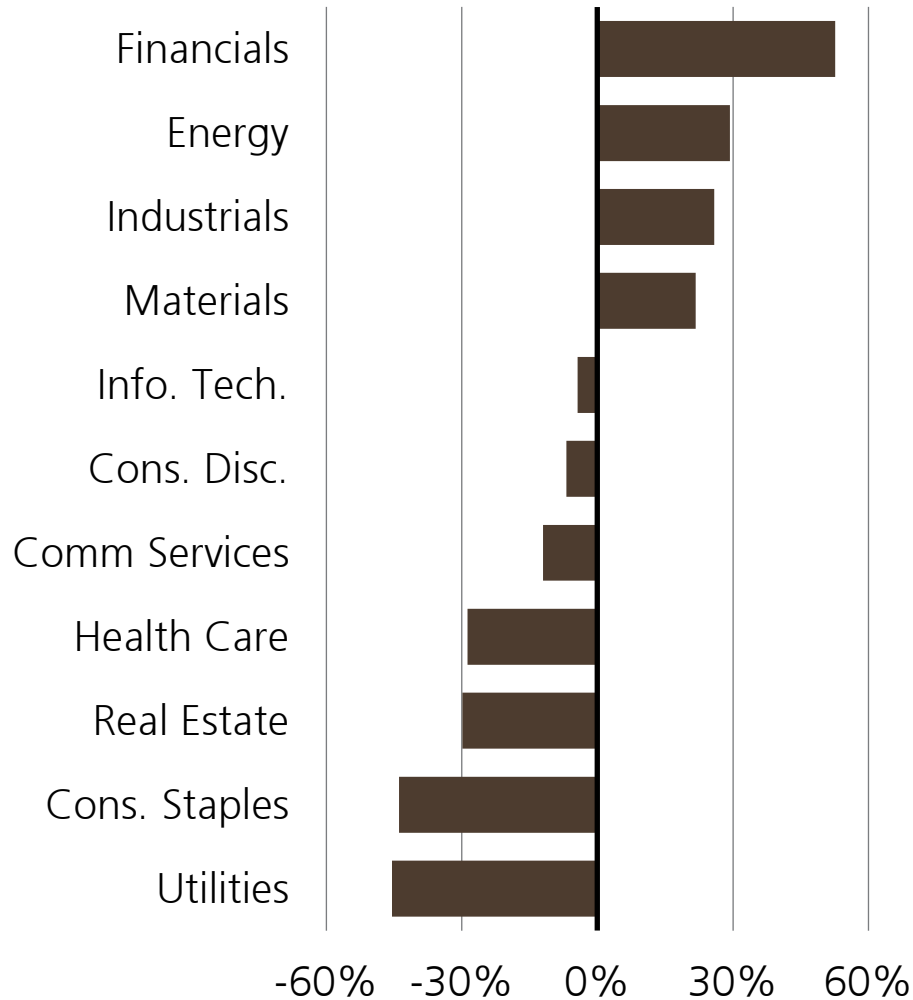
Close relationship between historical nominal GDP growth and long-term interest rates



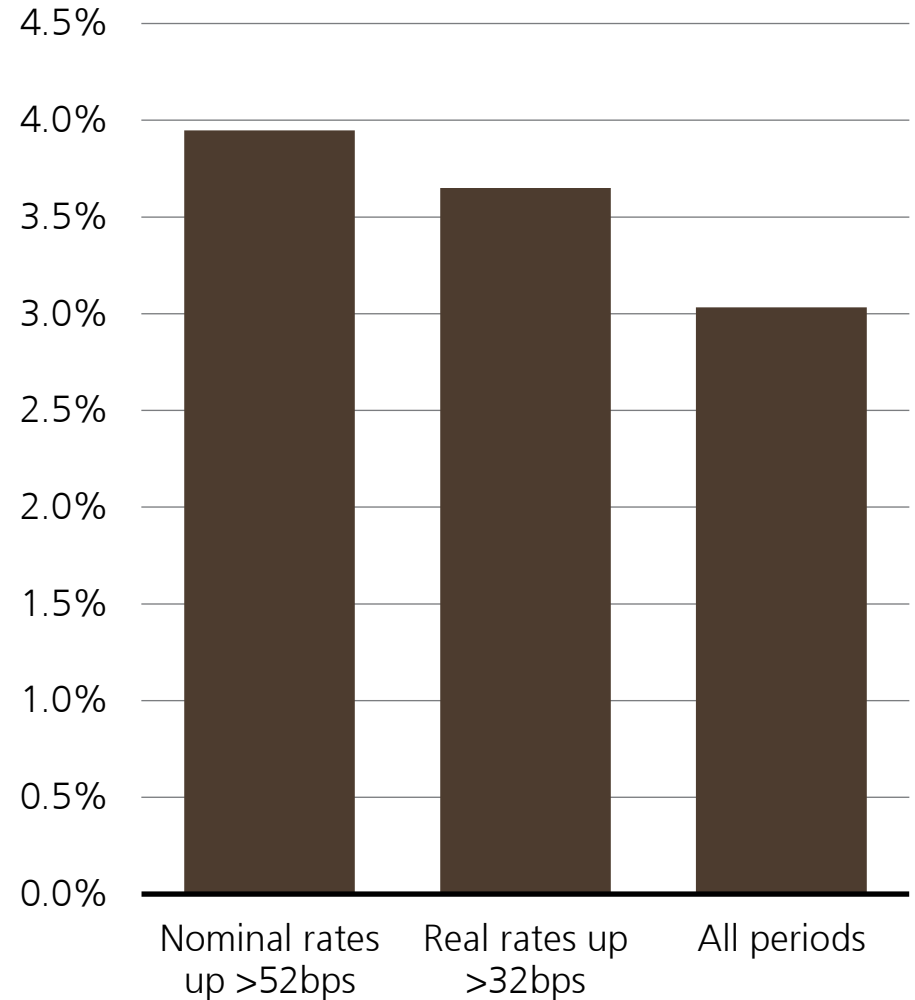
Source: Bloomberg, UBS, as of 21 September 2021

# Interest rates: more important for sectors, not the market

Correlation between relative sector performance and changes in UST 10-year yield



S&P 500 3-month performance when:



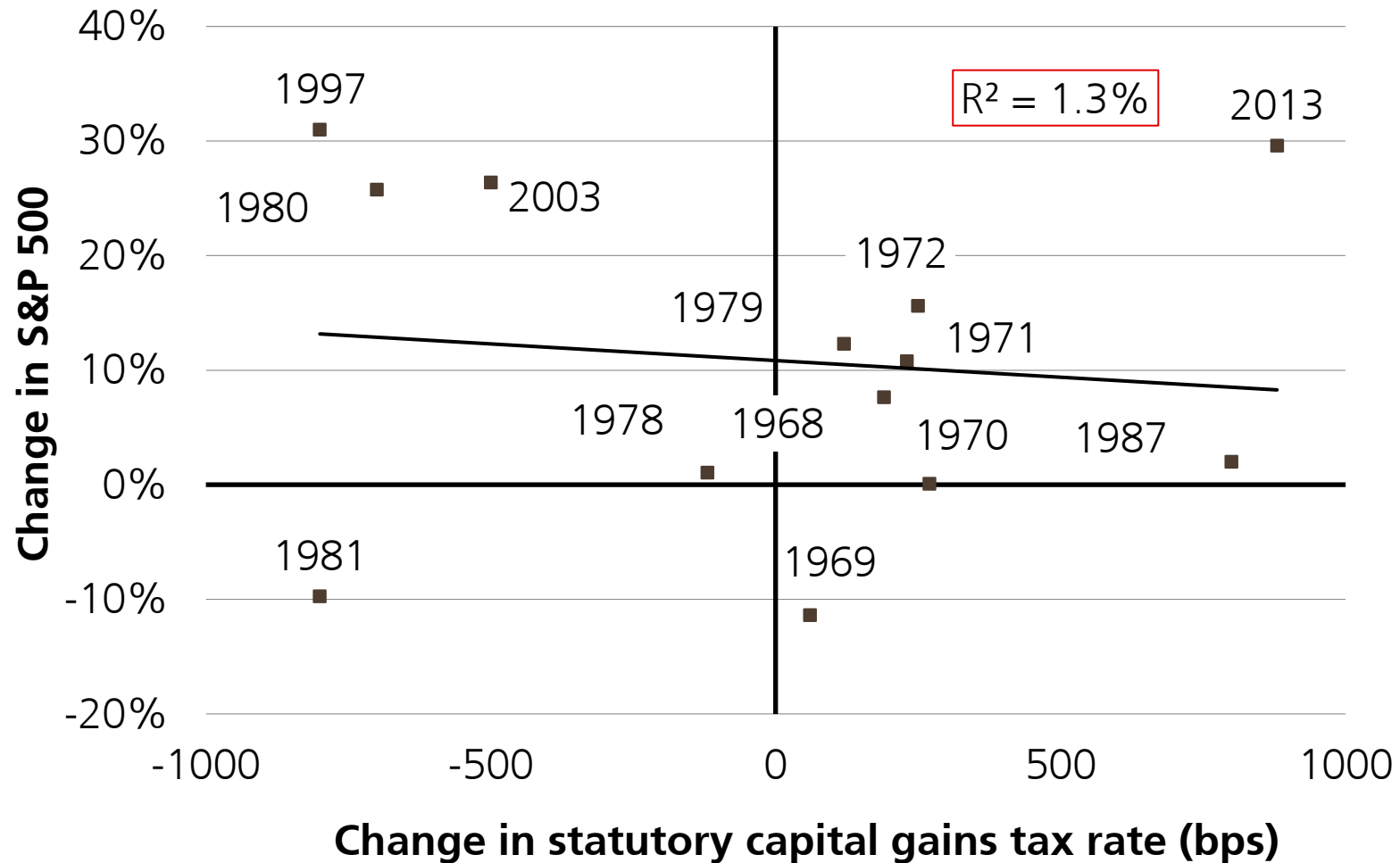
Source: FactSet, UBS, as of 21 September 2021

Source: Bloomberg, UBS, as of 21 September 2021



# Changes in capital gains taxes do not impact returns

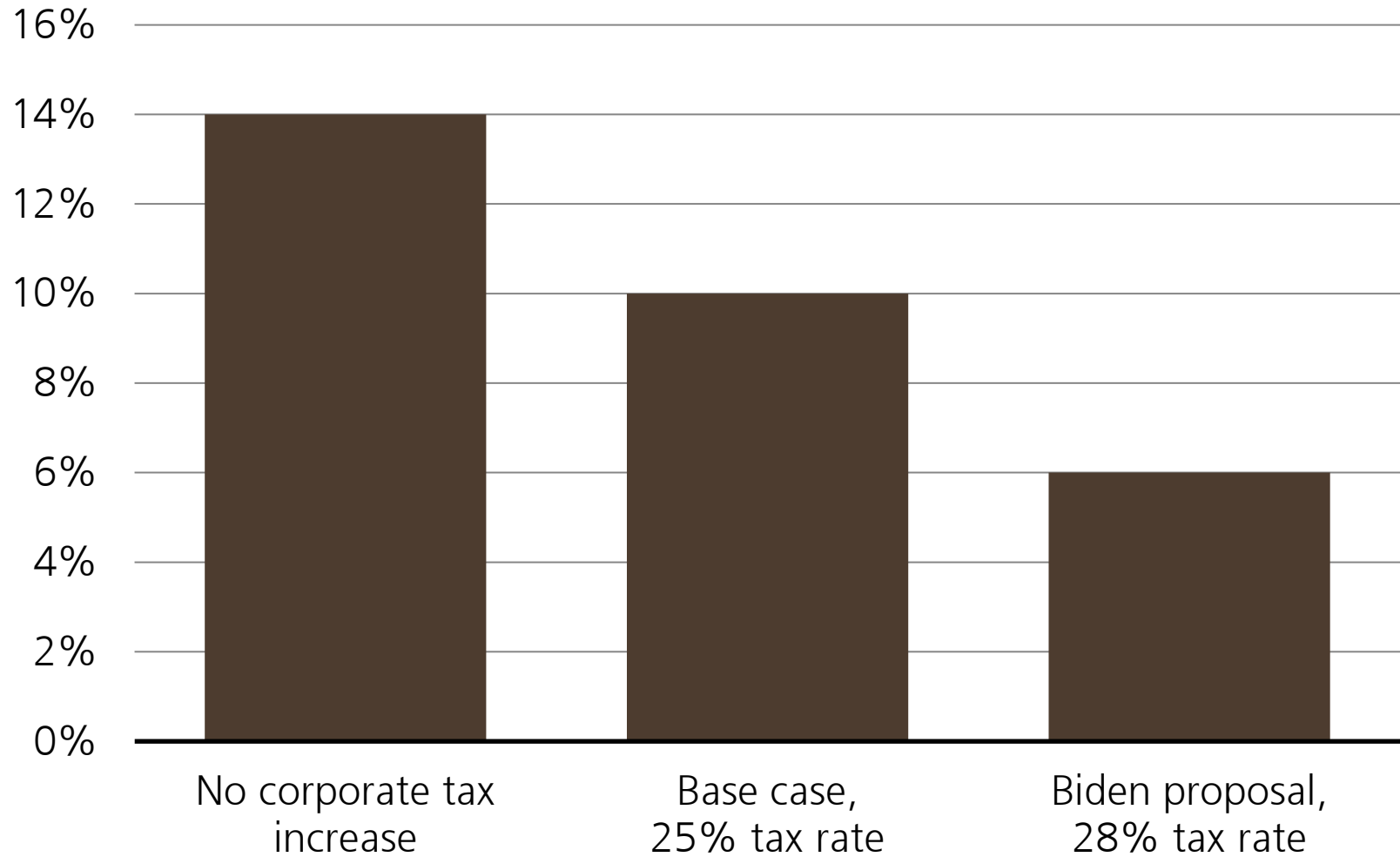
Change in capital gains tax rate (in basis points) and S&P 500 returns



Source: FactSet, UBS, as of 21 September 2021

# Healthy earnings growth despite potential corp. tax increase

2022 S&P 500 EPS growth, UBS CIO estimates



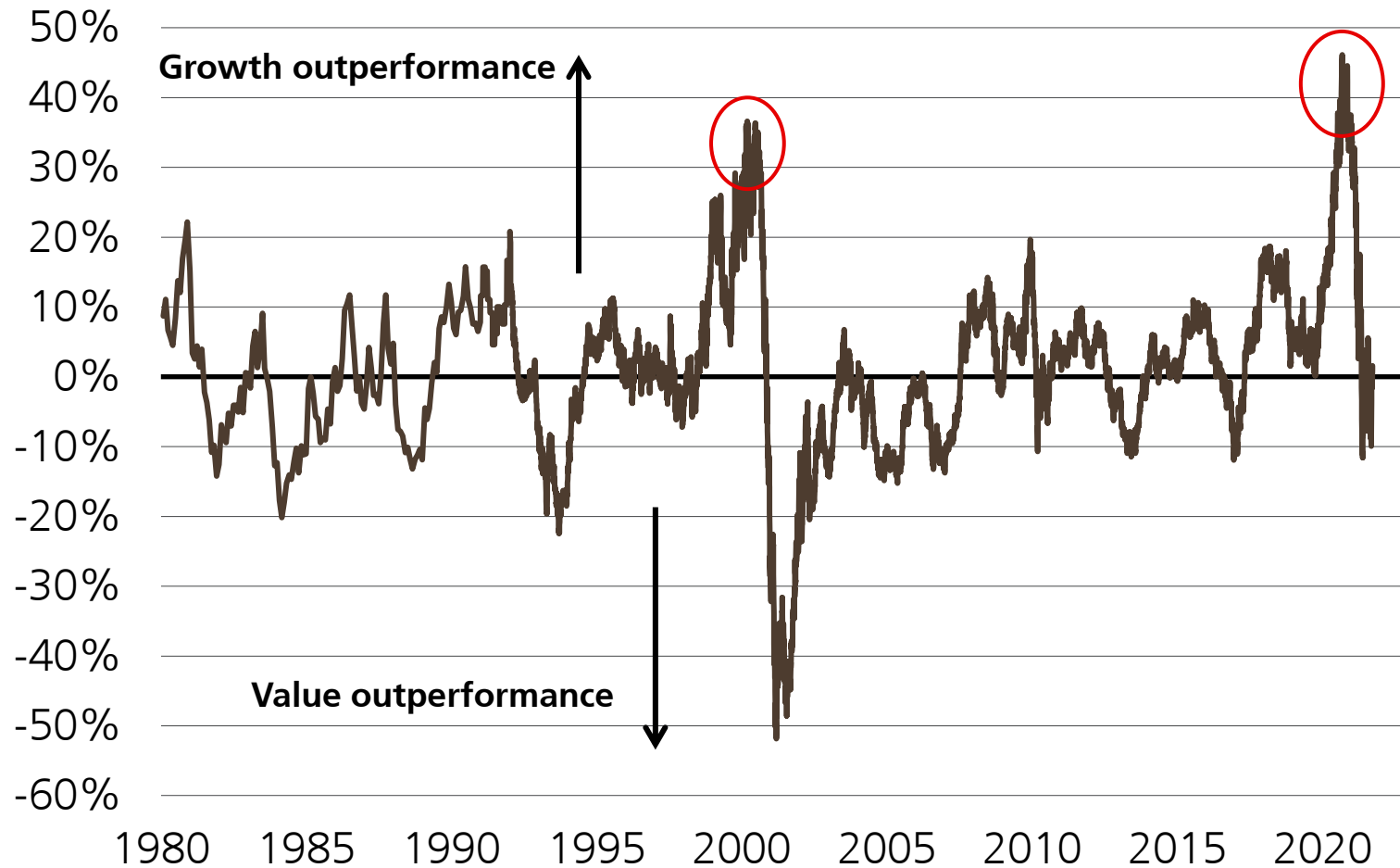
Source: FactSet, UBS, as of 21 September 2021

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Prefer value over growth, mid-caps, and select cyclical sectors

# Growth stock outperformance was extreme last year

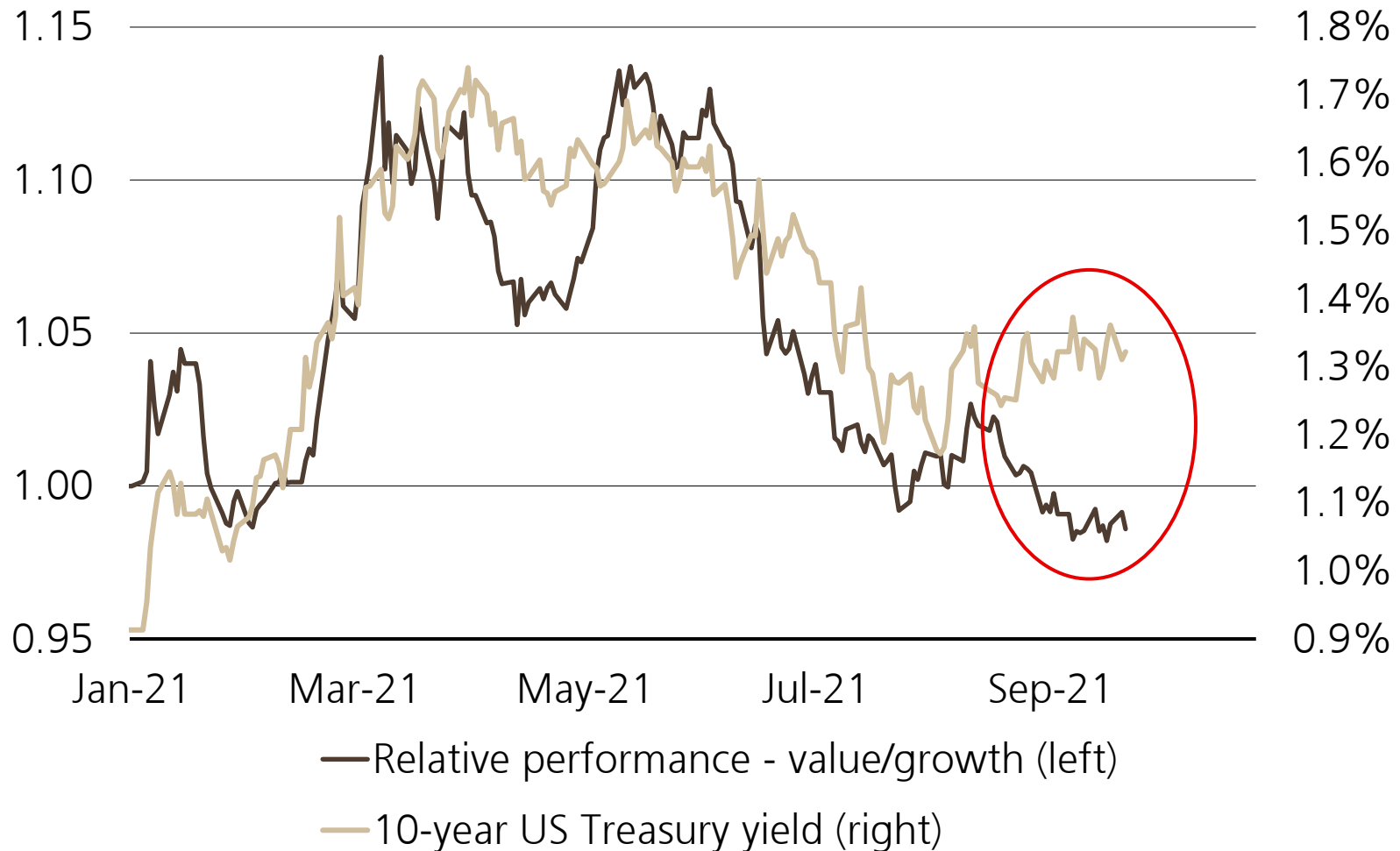
Last-12-month performance of the Russell 1000 Growth index less the Russell 1000 Value index



Source: Bloomberg, UBS, as of 21 September 2021

# Value stocks have scope to catch-up to rates...

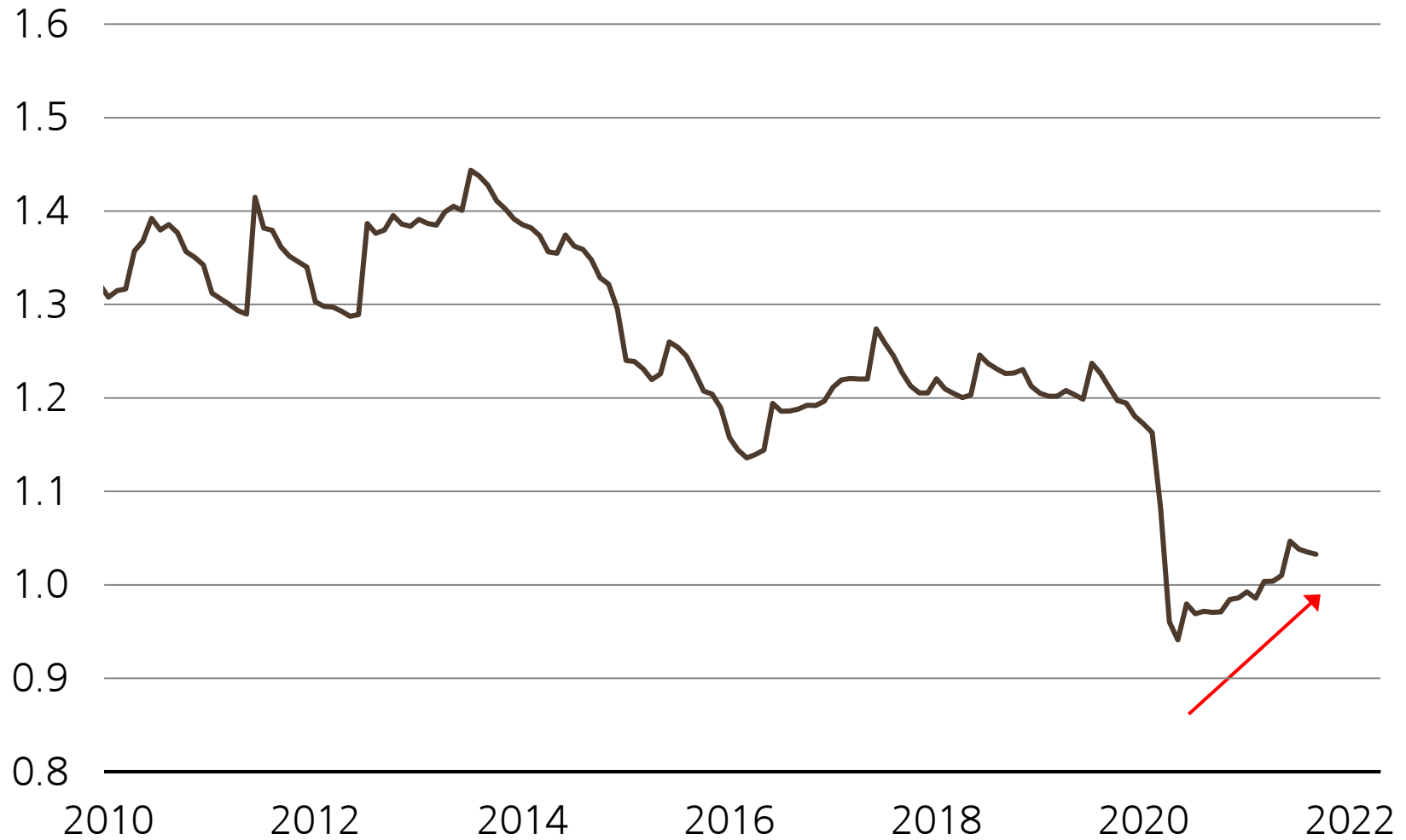
Russell 1000 Value vs. Russell 1000 Growth; 10-year US Treasury yield, in basis points



Source: Bloomberg, UBS, as of 21 September 2021

# ...and fundamentals continue to favor value

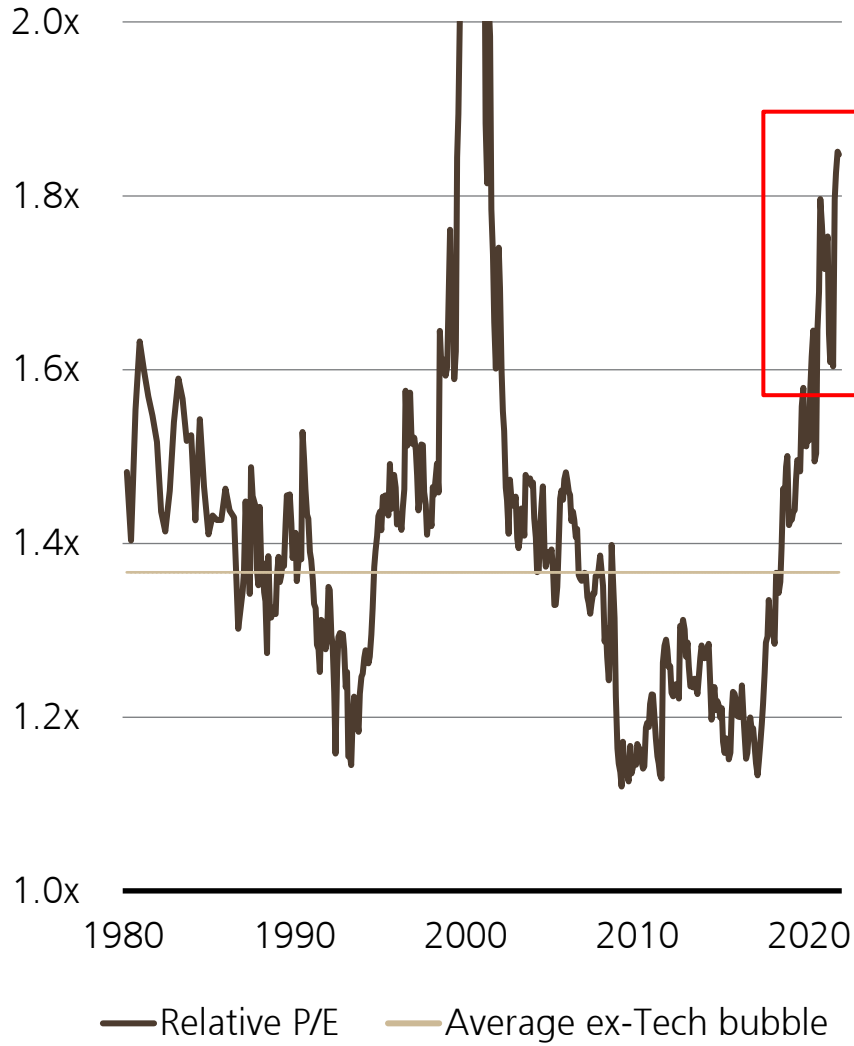
Relative next twelve months EPS - Russell 1000 Value vs Russell 1000 Growth



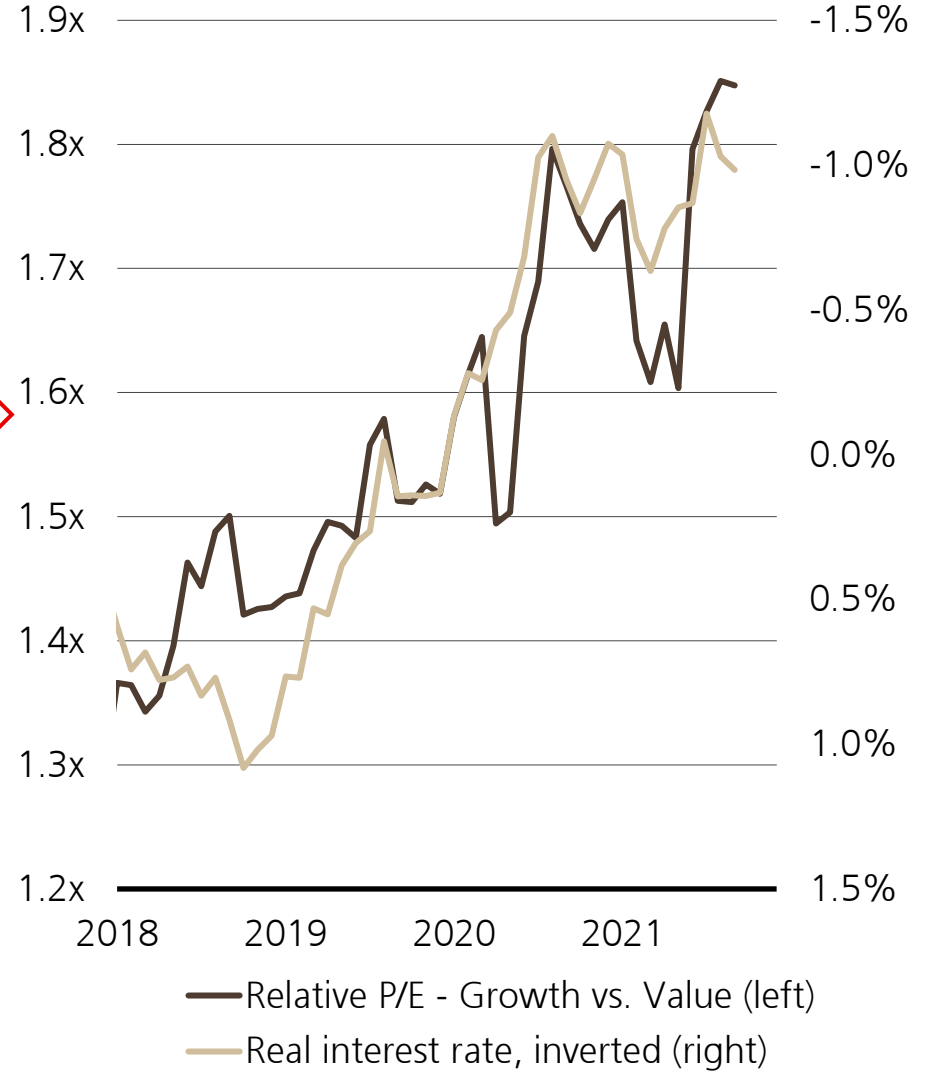
Source: Bloomberg, UBS, as of 21 September 2021

# Growth valuations high and vulnerable if rates rise

Russell 1000 Growth vs. Russell 1000 Value relative P/E



12-month forward relative P/E vs. real interest rate



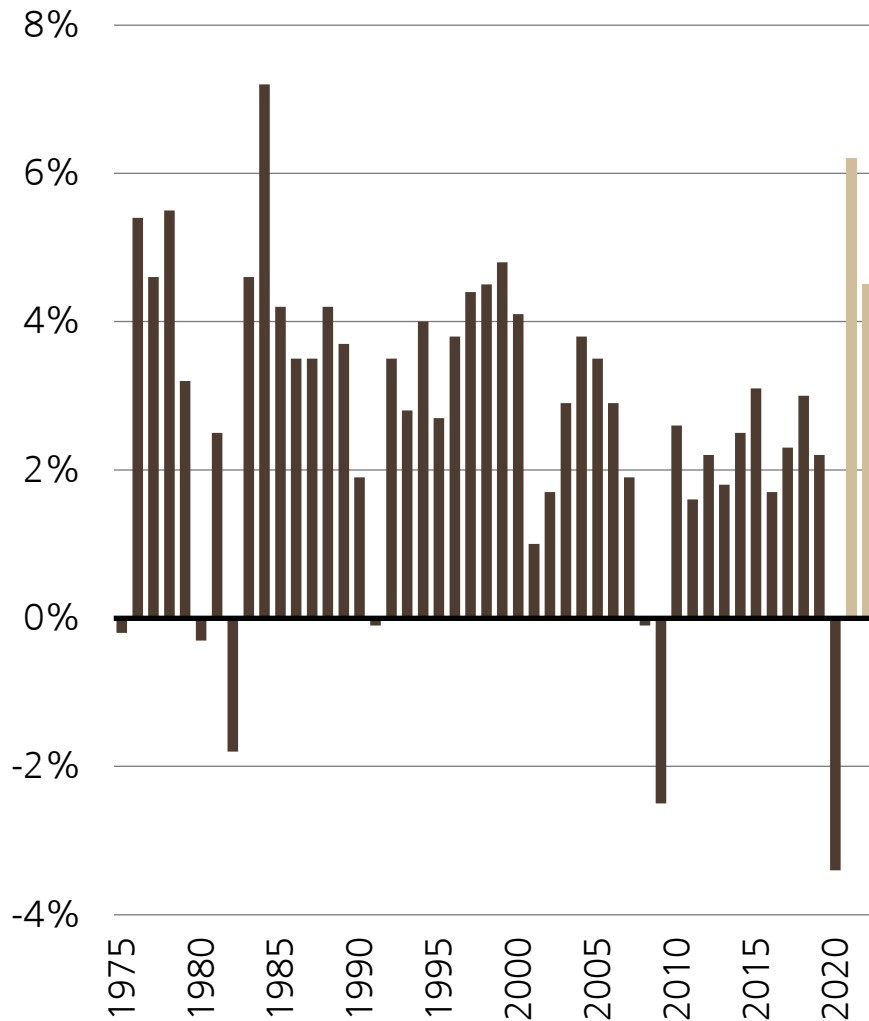
Source: FactSet, UBS, as of 21 September 2021

Source: FactSet, UBS, as of 21 September 2021

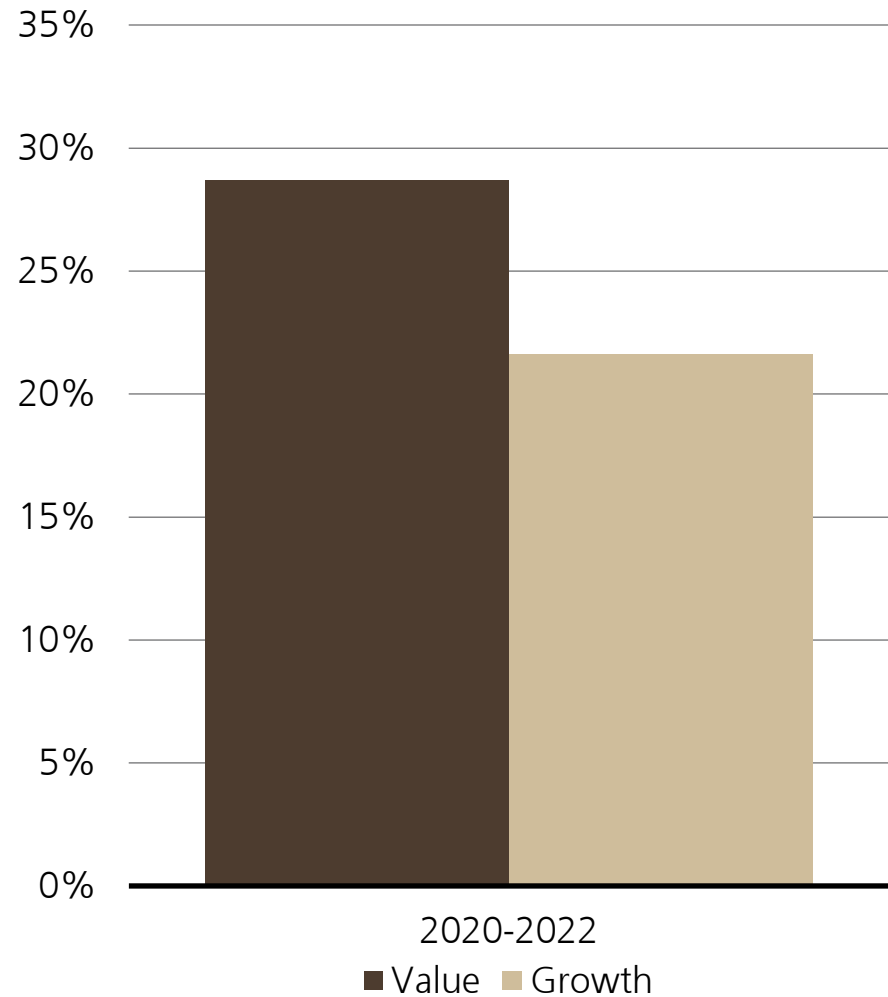
# Rapid GDP growth benefits value over growth

Some of the best GDP growth in decades...

Real GDP growth (y/y), actual and estimates



...should drive unusually rapid EPS growth for value  
Annualized consensus EPS growth, Russell 1000 Growth and Value



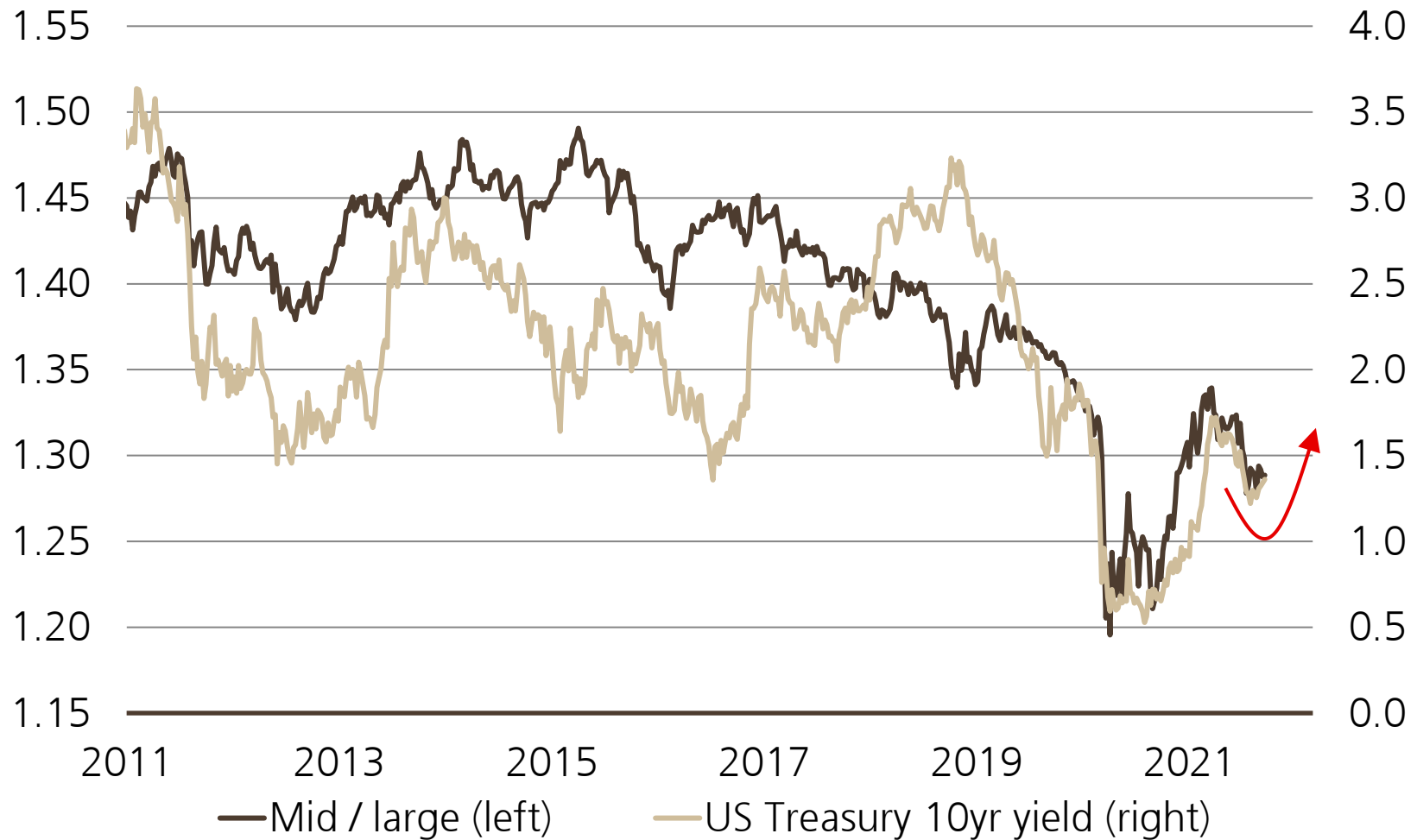
Source: Bloomberg, UBS, as of 21 September 2021

Source: FactSet, UBS, as of 21 September 2021



# Higher long-term rates should support mid-caps

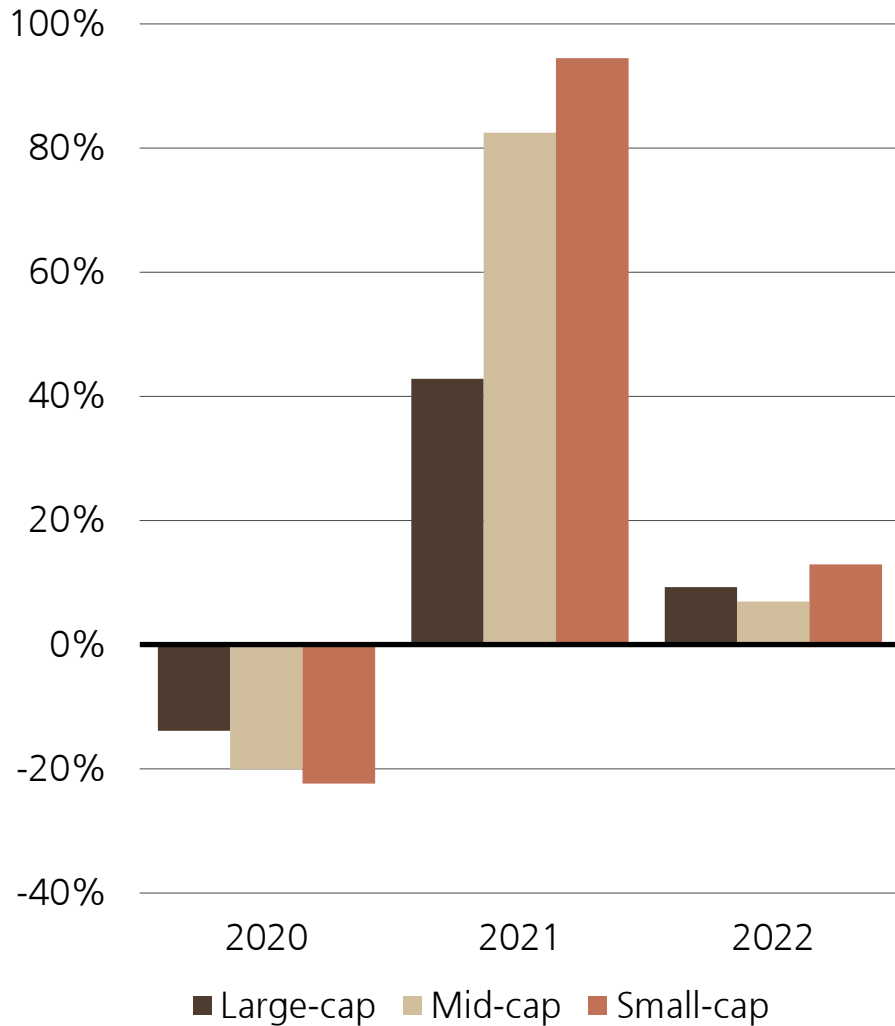
Relative performance Russell Midcap and Russell 1000 Indices vs. US Treasury 10yr yield



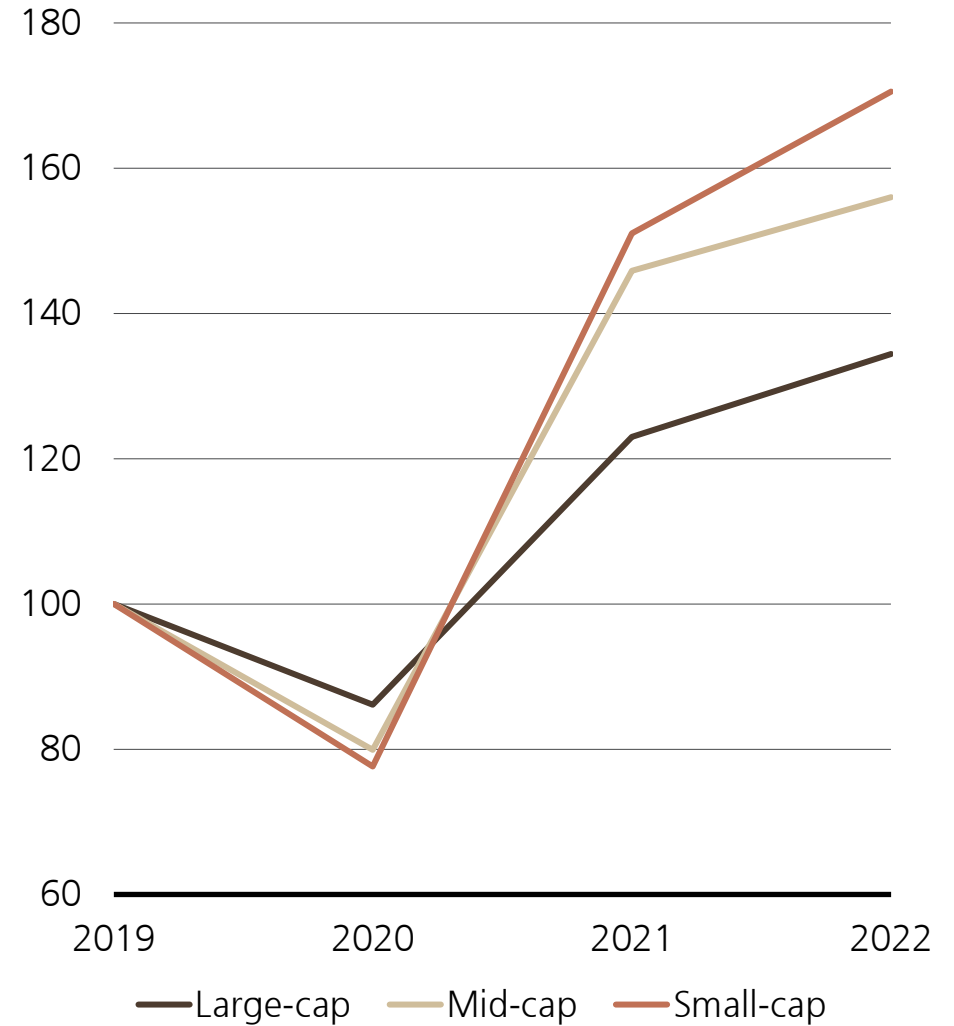
Source: Bloomberg, UBS, as of 17 September 2021

# Strong earnings growth for small- and mid-caps

Rapid growth for SMID...  
S&P size indices



...and it's not just base effects  
S&P size indices



Source: FactSet, UBS, as of 21 September 2021

Source: FactSet, UBS, as of 21 September 2021

# Small- and mid-cap valuations remain attractive

S&P Mid Cap 400 vs. S&P 500



S&P Small Cap 600 vs. S&P 500



Source: FactSet, UBS, as of 21 September 2021

Source: FactSet, UBS, as of 21 September 2021

# We recommend a risk-on, pro-cyclical stance

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UBS Chief Investment Office asset class preferences

## Most Preferred

- US mid-cap equities
- US large-cap value equities
- Japan equities
- Senior loans
- CMBS
- Commodities
- Oil
- British pound

## Least Preferred

- US large-cap growth equities
- US government fixed income
- US IG corporate bonds
- Gold
- Japanese yen

Source: UBS, as of 21 September 2021

# Within US equities, we maintain a cyclical bias

## Most preferred

- **Consumer discretionary:** The sector should benefit from economic recovery, lower mortgage rates, and secular trends in e-commerce
- **Energy:** Relative to oil prices, the sector looks cheap. Free cash flow yields are very attractive, capital discipline has improved, and the sector should benefit as demand recovers
- **Financials:** Earnings should recover as economic growth rebounds and interest rates move gradually higher
- **Health care:** Most risks around drug pricing reform are likely already reflected in share prices. Earnings are growing faster than defensive peers

## Least preferred

- **Consumer staples:** The sector initially benefitted from "panic" buying, but the sector could underperform as economies reopen
- **Utilities:** The sector will likely lag as investors look towards more cyclical opportunities in the market

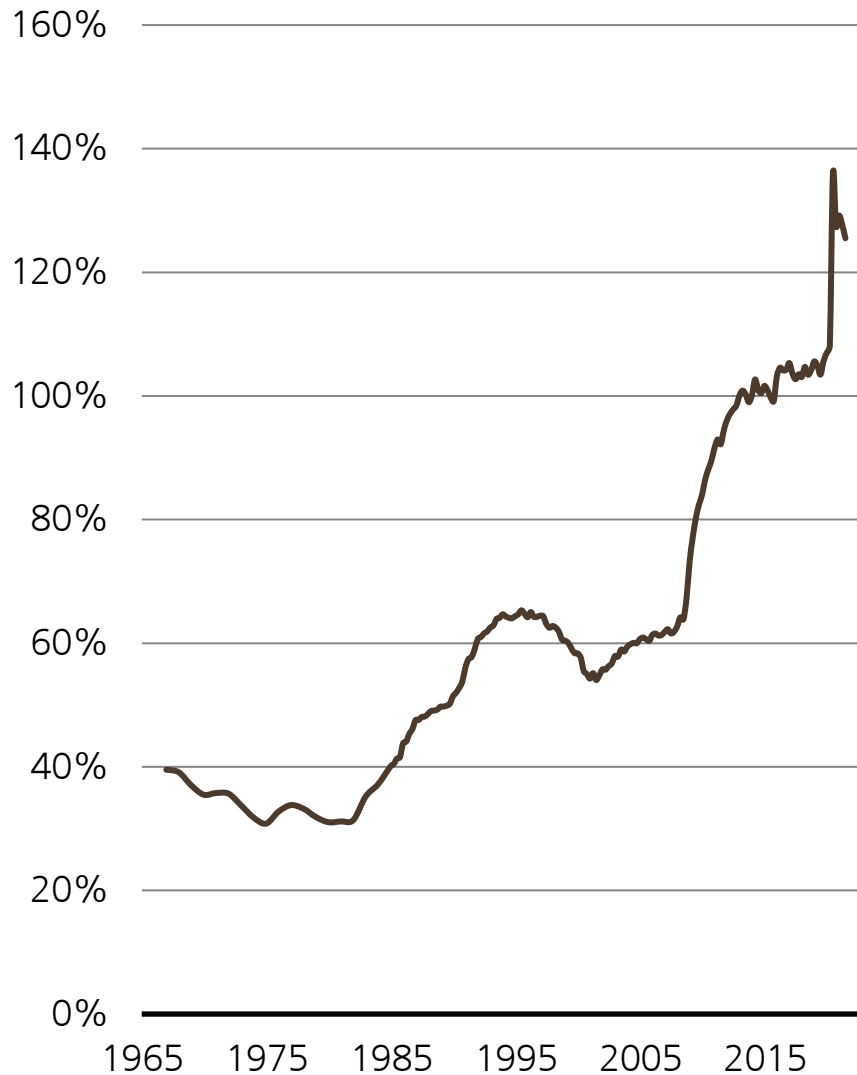
## US equity sector preferences

	Least preferred	Neutral	Most preferred
<b>US Equities</b>			
Communication services		=	
Consumer discretionary			+
Consumer staples	-		
Energy			+
Financials			+
Healthcare			+
Industrials		=	
Information technology		=	
Materials		=	
Real estate		=	
Utilities	-		

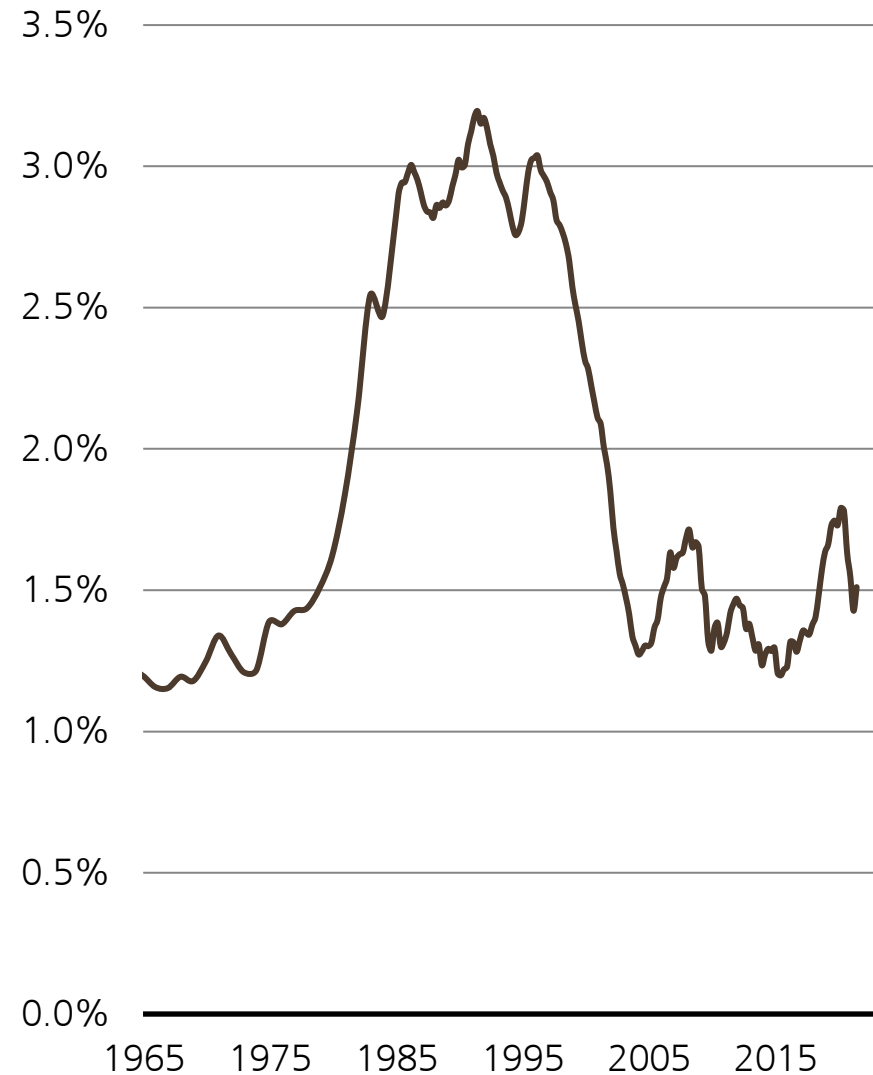
Note: This month, we changed the way we express our sector preferences. Previously, we used three notches (a combination of + and - signs) to express conviction of our Least Preferred and Most Preferred views. Going forward, we will only assign one of three ratings to each sector: Least Preferred, Neutral, or Most Preferred.

# Government debt is high but manageable

US federal debt as a % of GDP



Federal debt interest payments as a % of GDP

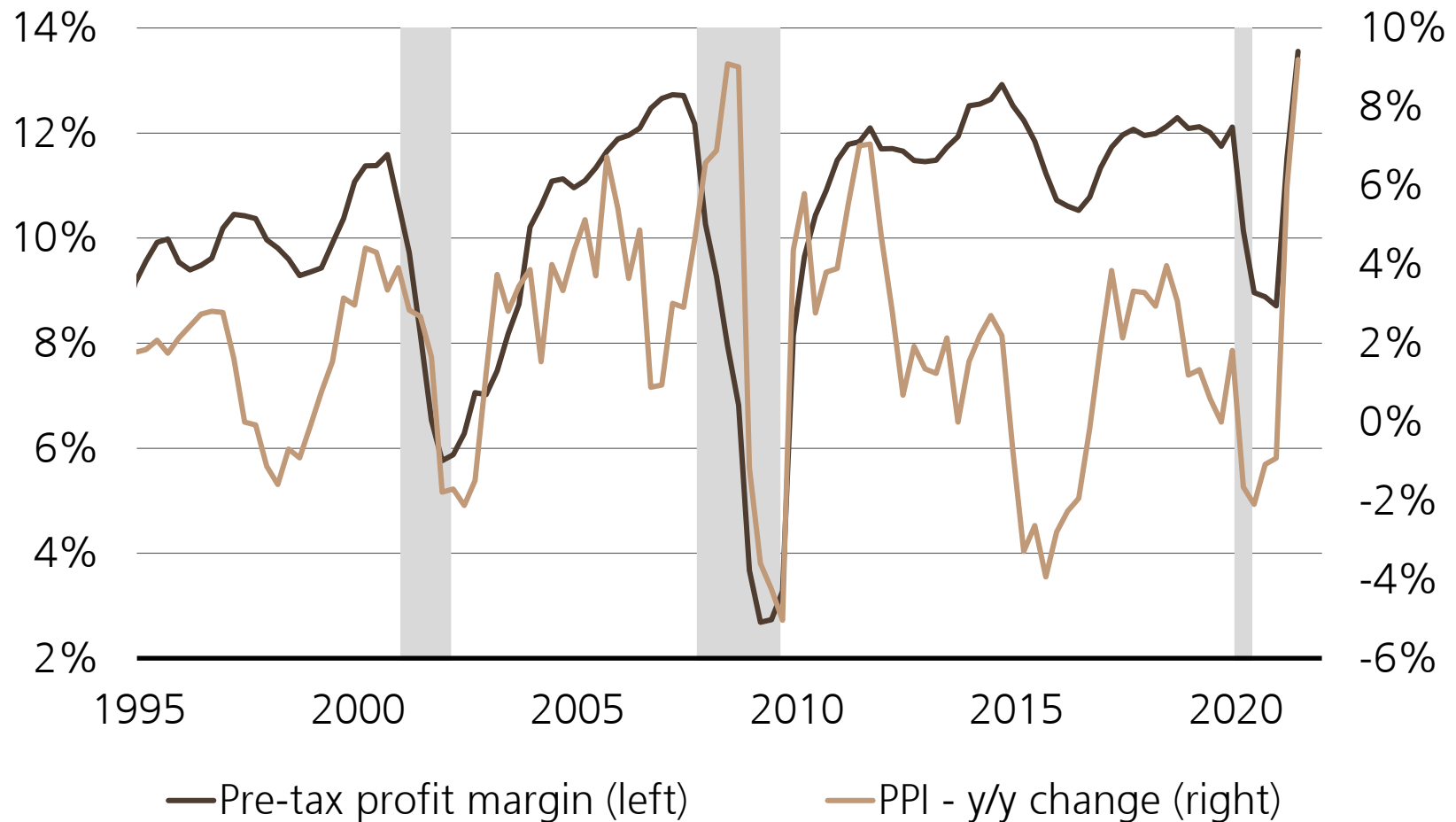


Source: Bloomberg, UBS, as of 30 June 2021

Source: OMB, Bloomberg, UBS, as of 30 June 2021

# Margins typically remain healthy when inflation rises

S&P 500 pre-tax margin vs. PPI



Source: FactSet, UBS, as of 21 September 2021

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# Appendix

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## Statement of risk

1. Equity markets are difficult to forecast because of fluctuations in the economy, investor psychology, geopolitical conditions, and other important variables.
2. Bond market returns are difficult to forecast because of fluctuations in the economy, investor psychology, geopolitical conditions and other important variables. Corporate bonds are subject to a number of risks, including credit risk, interest rate risk, liquidity risk, and event risk. Though historical default rates are low on investment grade corporate bonds, perceived adverse changes in the credit quality of an issuer may negatively affect the market value of securities. As interest rates rise, the value of a fixed coupon security will likely decline. Bonds are subject to market value fluctuations, given changes in the level of risk-free interest rates. Not all bonds can be sold quickly or easily on the open market. Prospective investors should consult their tax advisors concerning the federal, state, local, and non-U.S. tax consequences of owning any securities referenced in this report.
3. Prospective investors should consult their tax advisors concerning the federal, state, local, and non-U.S. tax consequences of owning preferred stocks. Preferred stocks are subject to market value fluctuations, given changes in the level of interest rates. For example, if interest rates rise, the value of these securities could decline. If preferred stocks are sold prior to maturity, price and yield may vary. Adverse changes in the credit quality of the issuer may negatively affect the market value of the securities. Most preferred securities may be redeemed at par after five years. If this occurs, holders of the securities may be faced with a reinvestment decision at lower future rates. Preferred stocks are also subject to other risks, including illiquidity and certain special redemption provisions.
4. Although historical default rates are very low, all municipal bonds carry credit risk, with the degree of risk largely following the particular bond's sector. Additionally, all municipal bonds feature valuation, return, and liquidity risk. Valuation tends to follow internal and external factors, including the level of interest rates, bond ratings, supply factors, and media reporting. These can be difficult or impossible to project accurately. Also, most municipal bonds are callable and/or subject to earlier than expected redemption, which can reduce an investor's total return. Because of the large number of municipal issuers and credit structures, not all bonds can be easily or quickly sold on the open market.

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Version C/2020. CIO82652744

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