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CIO still expects US inflation to trend lower over time as they think the current level of interest rates is high enough to push US economic growth below trend and inflation lower. (UBS)

Risks resurface - What do we expect next?

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Markets took a risk-off turn last week amid investor concerns over hotter-than-expected US inflation data, a mixed start to the US earnings season, and fears of an escalation of the conflict in the Middle East.

Over the weekend, some of those geopolitical fears were realized as Iran launched more than 300 drones and missiles at Israel. The vast majority appear to have been intercepted.

Last week's 1.6% decline for the S&P 500 index represented its worst week since October; on Friday, gold hit a new intraday record high of USD 2,431/oz, and Brent crude rose above USD 92 a barrel for the first time this year. Meanwhile, markets were implying only 48 basis points of Federal Reserve policy easing in 2024, down from around 150 basis points in January.

What do we expect next?

Geopolitics

Iran’s mission to the UN has reportedly stated that the attack on Israel “can be deemed concluded,” suggesting that additional strikes are not imminent. And while markets may be volatile in the days ahead, historically, the market impact of most geopolitical events has tended to be fleeting. For example, the MSCI All Country World Index is up by roughly 17% since Hamas’ attack on Israel on 7 October 2023, and by 10% since Russia’s invasion of Ukraine on 24 February 2022, despite the fact that this also coincided with the start of the Federal Reserve’s rate-hiking cycle.

What could lead to a more long-lasting global market impact? We will be watching for the risk of a significant further increase in commodity prices, particularly given existing fears about sticky inflation and interest rates. With this in mind, markets will be watching for the nature of any potential retaliation from Israel, or an escalation by Iran's proxies in the region.

Iran's UN envoy has reportedly stated that "should the Israeli regime make another mistake, Iran's response will be considerably more severe." Meanwhile, Axios has reported that US President Joe Biden has told Israeli Prime Minister Benjamin Netanyahu that the US won't support any Israeli counterattack against Iran, citing a senior White House official. Yoav Gallant, Israel's defense minister, reportedly said that while the attacks from Iran had caused "very little damage," the "campaign is not over yet."

Interest rates and earnings

Following last week's US inflation data, we now only expect two 25-basis-point rate cuts by the Federal Reserve this year, starting in September. Interest rates staying higher for longer do represent a potential headwind for markets. But this does not change the larger picture, in our view. We still expect US inflation to trend lower over time as we think the current level of interest rates is high enough to push US economic growth below trend and inflation lower. We therefore see rate cuts as delayed, rather than canceled.

And, despite the tepid start to the earnings season (both JPMorgan Chase and Wells Fargo both unveiled lower-than-forecast net interest income), we expect overall year-over-year earnings per share for the quarter to be up by between 7% and 9%, with growth broadening out beyond the Magnificent 7—which accounted for all the profit expansion over the past four quarters. This view partly reflects a positive economic backdrop, and banks easing lending standards—both of which have a good correlation to S&P 500 profits. Furthermore, the surge in AI investment continues to have strong momentum. We expect 9% S&P 500 earnings growth for 2024 as a whole.

How do we invest?

Recent months had seen market volatility settle to the lowest levels since the onset of the COVID-19 pandemic in 2020. A combination of geopolitical risk, inflation uncertainty, and concerns about market valuations look set to test that lull. To improve portfolio robustness against a potential rise in volatility, we believe investors should focus on the principles of diversification, quality, and hedging.

Diversification—by geography, asset class, sector, and security—is a core principle. The UBS Global Investment Returns Yearbook, which analyzes financial markets going back to 1900, shows that a portfolio diversified across 21 countries would have experienced 40% less volatility over the period than an average single-country investment. And a portfolio with a 60/40 split across equities and bonds has only delivered a negative return over a five-year horizon on 5% of occasions, and never over a 10-year horizon (compared with 12% and 5%, respectively, of the time for equity-only portfolios).

We believe that quality will deliver outperformance in the months ahead. Quality bond yields are elevated, providing a strong basis for returns. And the market's longer-term policy rate expectations currently have the Fed ending the rate-cutting cycle at just under 4%, a high level by historical standards. In the event of a sharper economic slowdown, we would expect this market implied equilibrium rate to reprice lower, potentially generating significant capital gains for investors with exposure today. We also see quality equities, including regional champions like Europe's Magnificent 7 and Asia's Super 8, as well positioned to continue to grow earnings even if the economic backdrop becomes more challenging.

Meanwhile, there are additional options for investors looking to further hedge portfolios against geopolitical risks. Gold and oil have performed well in recent weeks, and we would expect prices to continue rising if geopolitical risks carry on escalating. Investors seeking to smooth returns can also consider structured solutions, which could enable investors to retain exposure to further upside in stocks while reducing sensitivity to a correction. We also like macro hedge funds, which should be well-positioned to capitalize on a turn in the interest rate cycle and help investors navigate geopolitical shifts. Finally, systematic allocation strategies can provide an additional risk management element, by significantly adjusting a portfolio equity allocation in response to changing economic and market trends. However, investors must be mindful of the associated risks of investing in alternatives, which include but are not limited to illiquidity.

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