



The Federal Reserve signaled an end to rate hikes, with Chair Jerome Powell saying the central bank is willing to cut interest rates even if the US does not enter recession. (UBS)

Investing after the late-2023 rally

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Since we published our Year Ahead outlook in mid-November, global equities and high-quality bonds have rallied. The S&P 500 is now up 14% from its October low, and the 10-year US Treasury yield is about a full percentage point lower than its October highs.

Such market moves are in response to a shifting macro environment where inflation, economic growth data, and rates expectations continue to shape the investment outlook.

Over the past two months, US inflation has been surprisingly soft, with November consumer price index (CPI) data confirming the trend established in October that it is on course to approach central bank targets by the second half of this year. Recent releases also point to resilient growth, with US retail sales beating expectations and a still-robust US labor market.

In addition, the Federal Reserve signaled an end to rate hikes, with Chair Jerome Powell saying the central bank is willing to cut interest rates even if the US does not enter recession.

We have therefore revised our potential scenarios for the Year Ahead, and discuss how investors can position from here.

Base case: Soft landing (60%). Our base case scenario is for a soft landing, in which growth slows to just below trend, a US recession is avoided, inflation falls toward central bank targets by the second half of the year, and the Fed cuts interest rates by 100 basis points. We think growth headwinds in the US are unlikely to lead to higher precautionary savings, and that inflation should fall at a more gradual pace. Though markets are now pricing steeper rate cuts than our forecast, we think the Fed is trying to balance its desire to help the economy avoid recession with labor market and core inflation data that still suggest a need for somewhat restrictive monetary policy.

In this scenario, we would expect moderate further falls for medium- and longer-term bond yields, and further modest gains for global equity indexes over the course of the year. We have raised our end-2024 target for S&P 500 to 5,000, and kept the US 10-year yield one at 3.5%.

Upside scenario: Goldilocks (20%). This scenario would see no material slowdown in growth, which would remain at or above trend. In addition, the Fed may cut interest rates preemptively to potentially avoid starting a rate-cutting cycle too close to November's presidential election, with six rate cuts in 2024 starting as early as March. Inflation also falls more quickly and consistently in this case, supplying the Fed further justification to cut rates sooner, and by more than in our soft landing scenario. In these circumstances, the S&P 500 could reach 5,300 by the end of 2024, with the 10-year US yield at 4%.

Downside scenario: Hard landing (20%). Here, a slowdown in growth would result in a moderate US recession. The potential severity of this scenario, however, would be mitigated by the easing in financial conditions so far and likely sharp interest rate cuts by the Fed in response. In this scenario, we would expect equities to deliver sharply negative returns, and bonds strongly positive returns as safe-haven assets attract inflows. While this scenario remains plausible, every month that passes with incoming data continuing to demonstrate a healthy US economy reduces the chance of a rate-hike-induced recession.

Alternative scenarios. We remain watchful of the risk that a period of higher-than-expected inflation or excess US Treasury supply could lead to an increase in interest rate expectations or push the 10-year US yield back to around 5% again. Such a scenario would be negative for both bond and equity markets, although the recent decline in inflation and Fed rate expectations make it less likely than it appeared late last year.

So, we reiterate the need for investors to manage liquidity—limiting cash balances and locking in yields. While yield volatility is likely to remain high in the near term, we expect positive returns for quality bonds across a range of market scenarios this year. We also maintain our preference for quality in our equity strategies.

We believe investors should complement core quality stock holdings with tactical exposure to US small caps. US small caps (Russell 2000 Index) trade at relative valuations 10–15% lower than they were prior to the regional banking crisis in March, with the segment suffering from fears that the Fed could hold rates at elevated levels for a prolonged period to bring inflation lower. With around 50% of small-cap debt floating rate (versus 10% for large caps), the segment is highly sensitive to interest rates, and so would be a particular beneficiary of faster Fed rate cuts.

Finally, we think a balanced portfolio of equities, bonds, and alternatives is the best way for investors to preserve and grow wealth over time, as it can offer durable and strong returns, diversification benefits, and dependable growth. For more details, see [Year Ahead 2024: Scenario update](#).

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Read the original report : [Investing after the late-2023 rally, 8 January 2024](#).

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