UBS

CIO reminds investors that Fed rate cuts in prior non-recession episodes have typically driven strong equity market returns, with the S&P 500 rising by 17% on average after the first Fed rate cut. (UBS)

Risk-reward for stocks getting more appealing

05 August 2024, 2:28 pm CEST, written by UBS Editorial Team

US equities sold off on Friday following a weaker-than-expected July labor market report. The S&P 500 ended the day 1.8% lower, with small caps and cyclical sectors leading on the downside.

The weaker-than-expected report—alongside softer macro data released earlier in the week—raised investor concerns that the economy may be slowing quickly and that the Fed may be behind the rate-cutting curve.

While we acknowledge that the data has been softer, we believe it is primarily due to restrictive interest rates. And Fed Chair Jay Powell made it clear that the Fed has plenty of scope to cut interest rates if economic growth cools too quickly. A faster pace of rate cuts should reinvigorate growth, and we think this is exactly what the Fed will do. CIO now expects 100bps of rate cuts by year-end, up from 50bps. So we believe the US economy is still headed for a soft landing.

Within the details of the labor market report, it was encouraging to see that some of the more cyclical industries—which tend to be leading indicators for overall job growth—are not flashing warning signs. Construction employment continues to grow, and while manufacturing job growth has been somewhat flattish in recent months, there are no pronounced signs of weakness.

Given our base case remains a soft landing, we believe that the risk-reward for US equities looks more appealing and that contrarian bullish signals are starting to emerge. For example, the spike in the VIX index into the mid-20s suggests a favorable outlook for equity market returns. We also remind investors that Fed rate cuts in prior non-recession episodes have typically driven strong equity market returns, with the S&P 500 rising by 17% on average after the first Fed rate cut.

As it relates to the second quarter earnings season, more than 75% of the S&P 500 market cap has now reported. We have seen some softening in the data, but it hasn't been significant enough to change our outlook on earnings. Corporate profits are likely to grow by 10-12% in 2Q on a year-over-year basis, which is in line with our initial estimates. Seventy-five percent of companies are beating EPS estimates and nearly 60% are beating sales estimates, in line with historical averages. Guidance has been fine, with the 3Q EPS estimate being revised lower at a pace that is similar to normal seasonal patterns.

If we look at some of this week's reporters, we received additional commentary that consumer spending appears to be stable, but tsigns of softness on the lower end remain. While results from many of the Magnificent 7 were somewhat mixed, we didn't hear anything that was a significant concern and many of these companies still have compelling growth opportunities ahead of them. We believe concerns about the likely returns on AI investment are premature. Management teams remain enthusiastic about the technology's potential, even if it may take some time for the payoff to become clear. All indications are that demand continues to exceed supply for AI infrastructure, suggesting continued growth in AI-related capex—a trend that was confirmed by all the major cloud service providers.

Following the recent declines in US equities, we believe the risk-reward looks more appealing. The S&P 500 is 6% below its recent peak and this has mostly been driven by weakness within tech and other strong performers year to date. We would advise investors to maintain allocations to US equities given the supportive backdrop that includes: (1) healthy earnings growth, (2) improving inflation, (3) Fed rate cuts, and (4) AI investment. While stocks will likely remain volatile in the near term, our year-end and June 2025 S&P 500 price targets are 5,900 and 6,200, respectively. We expect 11% S&P 500 earnings growth in 2024 (USD 250) and 8% growth in 2025 (USD 270).

Main contributors: David Lefkowitz, Nadia Lovell, and Matthew Tormey

Original report: **Risk-reward for stocks getting more appealing, 5 August 2024.**

Important information
As a firm providing wealth management services to clients, UBS Financial Services, Inc is registered with the U.S. Securities and Exchange Commission (SEC) as an investment adviser and a broker-dealer, offering both investment advisory and brokerage services. Advisory services and brokerage services are separate and distinct, differ in material ways and are governed by different laws and separate contracts. It is important that you carefully read the agreements and disclosures UBS provides to you about the products or services offered. For more information, please visit our website at www.ubs.com/workingwithus.
© UBS 2024. All rights reserved. UBS Financial Services Inc. is a subsidiary of UBS AG. Member FINRA/SIPC.
There are two sources of UBS research. Reports from the first source, UBS CIO Global Wealth Management, are designed for individual investors and are produced by UBS Global Wealth Management (which includes UBS Financial Services Inc. and UBS International Inc.). The second research source is UBS Group Research, whose primary business focus is institutional investors. The two sources operate independently and may therefore have different recommendations. The various research content provided does not take into account the unique investment objectives, financial situation or particular needs of any specific individual investor. If you have any questions, please consult your Financial Advisor. UBS Financial Services Inc. is a subsidiary of UBS AG and an affiliate of UBS International Inc.