The rebound in markets underlines our view that investors should avoid overreacting to bouts of volatility, especially in periods of thin summer trading. (UBS)

US Economy: Not too hot, nor too cold

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US stocks extended their recent rally as new economic data further allayed concerns over the risk of a US recession. Retail sales rose 1% in July, the largest monthly gain since January 2023, adding to evidence that consumers remain resilient.

However, the risk of a more abrupt slowdown in the US, fueled by the weakness of the July jobs data, has not gone away. Investors will likely have to wait until the release on 6 September of the August employment report for clarification of whether the weakening of the labor market seen in July was due mostly to disruptions related to Hurricane Beryl, or whether it reflected an underlying deterioration.

But overall, data released over the past week has struck the right balance, being not too hot, nor too cold. This should help ease both concerns of a looming recession or that sticky inflation will hamper the Federal Reserve if swift rate cuts are needed to defend growth. The data have been encouraging in several ways.

First, the consumer price index has shown inflation trending back toward the Fed's 2% target. Headline inflation in July slowed to 2.9% y/y, down from 3% in June, hitting its lowest level since March 2021. On a three-month moving average basis, the annualized rate of core inflation fell to 1.6%, down from 2.3% in June and 4.5% as recently as March. Producer price data, which feeds into the Fed's favorite measure of inflation, the personal consumption expenditures index, was also benign. The bottom line is that we see no impediment to rate cuts.

Second, the resilience of US consumers should likely be crucial in preventing a slowdown from becoming a recession; the evidence that retail sales are holding up was helpful. Aside from the headline monthly increase, investors may be encouraged by the retail control measure, which feeds into GDP growth. This rose by 0.3% on the month, better than the

0.1% economists had been expecting, and especially impressive following a 0.9% gain in June. Confidence over the state of US consumers was also increased by strong results from retailer Walmart, which raised its sales forecasts for the year.

Finally, the fall in initial claims for unemployment benefits, which had been expected to rise, adds to hopes that the July jobs data exaggerated the weakness of the labor market. In our view, the unemployment rate is unlikely to continue rising rapidly if consumer spending holds up. Of course, we will carefully monitor upcoming data to see if it continues to support this view.

How do we invest?

The rebound in markets underlines our view that investors should avoid overreacting to bouts of volatility, especially in periods of thin summer trading. Our base case remains for an economic soft landing in the US, with the Federal Reserve starting to ease policy at its September meeting. We also see a strong outlook for corporate earnings.

Against this backdrop, we advise investors to:

Position for lower rates. Steadying US inflation and lingering uncertainty about the state of US activity give the Fed more room to shift its focus toward supporting growth. Our base case is now that the Fed will frontload rate cuts, with 100 basis points of easing in 2024. This is part of a broader global rate-cutting cycle for which we have been advising investors to prepare. As returns on cash are eroded, we think investors should consider investing cash and money market holdings into high-quality corporate and government bonds as well as diversified fixed income portfolios. These assets have recently shown their value, cushioning volatility in equity markets.

Seek quality growth. With stronger-than-expected retail sales and a resilient labor market, quality growth stocks are well-positioned, in our view. Recent earnings growth has been largely driven by firms with competitive advantages and exposure to structural drivers that have enabled them to grow and reinvest earnings consistently. We think that trend will continue, and we expect quality growth to outperform, particularly if cyclical concerns mount.

Diversify with alternatives. While Thursday's economic data beat expectations, the potential for increased market volatility remains. Alternatives, particularly hedge funds, not only have the potential to help stabilize portfolios during times of stress but can also generally take advantage of dislocations and generate potentially attractive returns when other asset classes may struggle. That said, investing in alternatives does come with risks, including around illiquidity and a lack of transparency.

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Original report - **US recession fears recede, 16 August 2024.**

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