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CIO remains most preferred on quality bonds, although the rally going forward is likely to be bumpier. (UBS)

Focus on quality as US heads for a softish landing

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The yield on the 10-year US Treasury fell a further 10 basis points on Tuesday to below 4.2%, building on the best performance for US bonds since 1985 in November.

The latest decline left the yield around 85 basis points below an intraday high of 5.02% in late October, which now looks likely to have marked the peak for the cycle. Meanwhile, the S&P 500 was close to flat, holding close to the highest levels for 2023 and up 19% year-to-date.

The combined rally in equities and bonds has been supported by evidence that a soft landing will allow the Federal Reserve to cut rates in 2024, while growth remains positive.

The long-awaited cooling of the jobs market, which has been a major priority for the Fed, appears to be occurring. Job openings for October declined to the lowest level in over two years, falling to 8.73 million for a monthly decline of 617,000 or 6.6%. Vacancies were also revised lower for September. With unemployment rising recently, this means there are now 1.3 openings for each American without work, down from a peak above 2. This indicates a better balance between supply and demand for labor. This ratio is a key indicator for the Fed, which is hoping softer labor market conditions will help bring inflation down toward its 2% target.

The next focus of investor attention will be the employment report for November. This is expected to show moderate job creation of 180,000, with unemployment holding steady at 3.9%, up from a multi-decade low of 3.4%as recently as April (based on Refinitiv consensus data).

Business survey data continues to suggest that the key services sector is growing at a moderate pace. The ISM survey of purchasing managers in the services sector rose to 52.7 in for November, from 51.8 the prior month. This

is above the 50 level that separates expansion from contraction, yet not so strong as to raise concerns of overheating. Comments from survey respondents were equally balanced, pointing to some signs of softer demand while being broadly positive. As with recent labor market data, the ISM survey is consistent with a softish landing.

Economic growth is slowing after an exceptionally rapid expansion in the third quarter. The US economy expanded at an annualized 5.2%for July to September, the fastest pace in almost two years. Such a pace of growth would be inconsistent with a sustained decline in inflation to the Fed's goal. Fortunately, the latest GDPNow reading from the Atlanta Fed, a running estimate of growth based on that latest data, points to annualized expansion of 1.2% for the fourth quarter. Again, this is consistent with the gentle deceleration in growth that the Fed has been aiming for.

But while we also expect a softish landing, the pace of the recent rally in stocks and bonds looks unlikely to be sustained. Equity markets are already pricing in plenty of good news, with the MSCI US trading at a 17%premium to its 15-year average, on a 12-month forward price-to-earnings basis. Implied equity volatility is also at the lowest level relative to implied bond volatility since 1995, pointing to an unrealistic level of confidence from stock investors, in our view.

In addition, fixed income investors also appear to have become too optimistic about the timing and pace of easing from the Fed. Markets are now even showing a roughly 13% chance of a rate cut as early as January, and a roughly 60% chance of an initial easing by the March policy meeting. This looks too optimistic to us. As a result, we believe the upside for the S&P 500 is now relatively limited, with the index likely to end the year around 4,700 versus 4,567 at present. As growth slows, we believe investors should consider focusing on high-quality stocks from companies with strong returns on invested capital, resilient operating margins, and relatively low debt on their balance sheets. In addition, yields look set to decline further in 2024, with the 10-year ending at 3.5%, in our view. We remain most preferred on quality bonds, although the rally going forward is likely to be bumpier.

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