CIO expects the Federal Reserve to cut rates by 100 basis points in the remainder of this year, double the prior forecast, as it seeks to protect the labor market. (UBS)

Quality growth is an appealing equity strategy during heightened volatility

12 August 2024, 2:51 pm CEST, written by UBS Editorial Team

Markets have given investors a rollercoaster ride over the past week. A risk-off move in markets gathered pace at the start of last week as an unwinding of yen carry trades caused some to sell risk assets.

Strains were intensified by growing fears of a US recession. Sentiment appeared to improve later in the week after reassuring US jobs data eased concerns that the US economy is headed for a contraction.

The calmer end to last week has carried through to early Monday, with Asian markets and US futures both modestly higher. But volatility could return this week, especially following the release of US inflation data for July. If inflation is too low, this may heighten concerns that the US may be heading for a recession. If inflation is too high, it could encourage fears that the Federal Reserve may be unable to cut rates quickly enough to protect the economy. Geopolitical risks also remain elevated.

But after large swings last week, it is a good time for investors to take stock of how far key markets have moved.

Japanese markets, a key source of global volatility, should subside. The yen has strengthened significantly following the Bank of Japan's decision on 31 July to raise interest rates by 15 basis points to 0.25%. That pushed the yen from around 153 against the US dollar to an intraday level of 141.7 on 5 August—having reached a multi decade weak point of USD 161 earlier in July. Concern that Japanese rates were headed higher, leading to further yen appreciation, led many investors to exit the popular yen carry trade—which involves borrowing at ultra-low rates in the Japanese currency to invest

in higher-yielding currencies or riskier assets such as US tech stocks. This contributed to a 12.4% fall in the Nikkei 225 index on 5 August, its largest one-day decline since 1987, and seems to have contributed to weakness in global stocks.

But both the yen and Japanese equities regained some stability over the course of last week. The yen ended almost flat against the US dollar and the Nikkei ended last week just 2.5% lower. In our view, the bulk of yen carry trades have already been unwound, and remaining positions are likely to be unwound gradually. The International Monetary Market (IMM) exchange through 6 August shows net short yen contracts have fallen to -11,354, well below the 2 July high-water mark of around -184,000. We believe further risks from the yen carry trade are likely to remain contained. On Monday, the Nikkei 225 rose 0.6% and the USD was trading at 147 versus the yen.

A swift fall in US stocks early last week was largely recovered. The S&P 500 started last week with a 3% fall, its largest one-day decline since September 2022. That built on declines late in the prior week amid concerns that the US economy could be at risk of recession, especially after disappointing July employment data. The FANG+ index, which tracks the top 10 most traded tech stocks, fell 4%. The unwinding of yen carry trades, some funds of which may have been invested in US stocks, may also have contributed.

Sentiment improved later in the week, after more positive jobs data came from the US. The S&P 500 ended last week flat while the FANG+ was up 0.5%. Our view is that the outlook for stocks remains positive, with earnings per share for S&P 500 companies on track to grow 11% in 2024. Meanwhile, the recent retreat in stocks has made valuations in the US tech sector look less demanding. The sector is now trading on 27.4x 12-month-forward earnings, down from a peak of 32x on 10 July.

The fall in US Treasury yields has been partly reversed as recession fears have abated. The yield on the 10-year US Treasury fell below 4% at the start of August for the first time since February. A combination of technical factors and economic pessimism contributed to a slide to an intraday low of 3.66% on 5 August. However, over the course of the week, the yield rose from 3.79% to 3.93% as better-than-expected initial jobless claims eased fears of a slowdown. At the time of writing, the yield is 3.95%.

An economic hard landing in the US remains a risk. We expect the Federal Reserve to cut rates by 100 basis points in the remainder of this year, double our prior forecast, as it seeks to protect the labor market. However, recession risks look overstated, in our view, given that household finances remain solid. So, we advise investors to avoid overreacting to bursts of volatility during periods of thin liquidity. With economic and earnings fundamentals still good and the Fed likely to cut interest rates, our base-case scenario is for the S&P 500 to end the year around 5,900 and reach 6,200 by June 2025, versus 5,344 at present. We believe quality growth is an appealing equity strategy, especially in periods of heightened volatility.

Main contributors - Solita Marcelli, Mark Haefele, Christopher Swann, David Lefkowitz, Brian Rose, Jon Gordon, Daisy Tseng

Original report - **Taking stock after a surge in volatility, 12 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.