The everything rally seems to have made a comeback, but it shouldn't be taken as a given. The Chief Investment Office (CIO) thinks there's reason to act with caution; being selective is key. (UBS)

A check-in on the market vibe

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In case you haven't noticed, the markets have been on the rise over the past few weeks. It has felt a little like a revival of the "everything" rally – which we witnessed in late 2023 – with equities, treasuries, gold, and even crypto currencies being strongly bid. The specific driver of this risk-on mood is somewhat difficult to determine, however. In this note we try to make assessment of what we think could be at play.

The Fed, AI, and the February jobs report

- In our view, as the US treasury market re-priced the Fed's cutting cycle closer to policymakers' forecasts, the market's risk asymmetry seems to have stood in a better place—leaving room for sentiment upside. In this context, Chair Powell's comments last week that the FOMC is "not far" from the confidence level required to start cutting, may have been all that was needed to further push up select financial assets.
- Moreover, idiosyncratic themes have also been gaining ground, keeping the soil fertile for risk on moves. The 2.5% market rally that took place following the Nvidia earnings, serves as a reminder of the power of AI as a new source of wealth creation, and outweighs any discussion regarding monetary policy and/or economic data.
- The payroll figures were another boost to investor appetite, or—at least—fueled increasing conviction that some sort of monetary easing is on the horizon. The February jobs report had a little something for everyone, with non-farm payrolls adding 275,000 jobs (well above consensus expectations of 200,000), downward revisions in the job creation numbers of the past two months, a rise in the unemployment rate (3.9% versus 3.7% previously), and a softening in average hourly earnings.

In the words of our US Economist Brian Rose, "the jobs report was mixed, but the numbers suggest that there's a better balance in the labor market." Thus, by the end of the week, there seemed to be a greater sense of confidence that the American economy is growing (adding jobs), but without wage pressure. Unsurprisingly, front-end US Treasuries rallied last Friday, with the market now pricing in 90bps of cumulative cuts this year, and with a 20% chance that the first 25bps cut takes place in May.

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But, beware of first impressions

The everything rally seems to have made a comeback, but it shouldn't be taken as a given, especially since return dispersion has become more significant over the past few months. For example, the S&P 500 has rallied roughly 25% since last October's low; over that period, nearly 90% of the companies that make up the index gained in value. Year-to-date, however, only 65% of the S&P 500 constituents saw their share price increase. Unless the rally broadens out, we think there's reason to act with caution and be selective in terms of allocation. If you think all stocks are rallying, just look at Tesla—shares are down 20% year-to-date.

How to invest?

In equities

We stand by our preference for quality stocks, as these assets have strong returns on invested capital, resilient operating margins, low debt, and are ultimately favored to generate profits in an environment where economic growth weakens somewhat relative to 2023.

From a size standpoint, we are most preferred small-caps vs. large caps. In our view, small-cap companies' balance sheets, partly due to their high variable interest rate debt burden, should benefit—more than large caps—from the decline in US rates. From a sector standpoint, we remain most preferred on healthcare, industrials, and information technology. Theme-wise, we reiterate how companies with exposure to AI, or involved in new drug therapies in large untapped end-markets, such obesity and Alzheimer's, offer interesting opportunities.

In fixed income

We remain most preferred on IG corporates, TIPS, and Agency MBS. Meanwhile, we are neutral on US government bonds. In US Treasuries, we have a 10Y year-end rate target of 3.5%; thus, we have been highlighting the opportunity to lock in yields when volatility leads rates towards 4.5%.

Something to be looking out for this week

The path toward the first cut by the Fed is unlikely to be a straight line, since many risks can still surface. Be mindful of the February CPI report (out on Tuesday, 12 Mar), where a surprise either to the upside or downside could have significant consequences in terms of market moves.

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For more on this, please see our **US Weekly - The return of the everything rally?**, 10 March, 2024

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