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CIO favors quality stocks, which tend to outperform across much of the economic cycle. (UBS)

Tactical US equity themes: New year-to-date market high

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This month the UBS Chief Investment Office (CIO) reiterates their conviction in key themes—"Diabetes and obesity," "Investing in self-help," "Made in America," "Pricing power standouts,""Select semis," and "Time for quality"—and makes a few changes to their stock lists.

Stocks continue to rally, with the S&P 500 up 12% off the October low and touching a new year-to-date high. Encouraging macro data including lower inflation, a strong labor market, and resilient economic growth, have helped to fuel the rally. While the technology sector continues to outperform, gains have broadened out to some year-to-date laggards. The rapid fall in bond yields—with the 10-year Treasury down 70bps in two months—helped interest-rate-sensitive areas of the market, like real estate and financials, to rebound and outperform. Since late October, the return of the equal-weight S&P 500 index is roughly on par with that of the market-weight index, bucking the earlier-in-the-year trend. While we look for more modest upside for the market from here, we expect breadth to further improve as the soft-landing narrative solidifies. Our year-end 2024 S&P 500 price target is 4,700. However, our upside scenario calls for 5,100—assuming economic growth remains resilient and tracks closer to trend (i.e., ~2%) and the Federal Reserve cuts interest rates sooner than expected due to faster non-recessionary disinflation. Our downside scenario is 3,500 and assumes a hard landing of the economy.

In line with our core view, the economy appears to be on track for a soft landing, with growth slowing to below trend. While some consumer cohorts appear stretched due to inflationary and higher rate pressures of the last year, collectively the consumer remains healthy. Spending on Black Friday and Cyber Monday both reached record levels. The labor market is softening but remains strong, with the demand for labor still exceeding supply. The ratio of the number of job openings to the unemployed is 1.3—still above the pre-pandemic level—and the unemployment rate is relatively low at 3.7%. This should continue to support consumer spending and aid corporate profits. We expect the profits recovery that began in Q3 2023, with S&P 500 earnings inflecting to 6% y/y growth, to accelerate in 2024 to high-single digits.

Valuation multiples have jumped back toward 19x on a forward P/E basis with the recent rally. But that has come alongside rapidly falling bond yields as monetary policy expectations repriced. We expect yields to fall further towards 3.75% on the 10-year Treasury by June (versus ~4.25% today), as economic growth cools. However, we believe the fed funds futures market's pricing of over 100bps of rate cuts in 2024 starting in the spring is aggressive and seems too optimistic. We continue to believe the Fed will remain patient and wait for firmer confirmation in the disinflation trend, before pivoting to more measured cuts starting around mid-year.

The S&P 500 is now less than 5% from its all-time high in January 2022. And while we remain positive on equities, we continue to believe a balanced approach is appropriate. We favor quality stocks, which tend to outperform across much of the economic cycle. Within our tactical equity themes "Time for quality" and "Pricing power standouts" offer exposure. We would continue to take advantage of recent laggards ("Investing in self-help"), as well as segments of the market where weak demand has bottomed, and earnings are set to inflect higher ("Select semis"). We also see select opportunities in secular growth trends, including artificial intelligence, reshoring, infrastructure, energy transition, and healthcare innovation—which can be accessed through our "Made in America" and "Diabetes and obesity" themes.

More details about all these tactical themes can be found below and in the pages that follow.

1. Select semis—We believe a bruising downturn in the key end markets (PCs, servers, and smartphones) is near an end, setting up a better backdrop for select semi conductor suppliers. We focus on companies that we believe will benefit from the recovery in key end markets and where consensus earnings estimates, which have moved off the lows, still do not capture the potential upside of improved end markets and restocking.

2. Diabetes and obesity—Diabetes and obesity are prevalent diseases with high unmet needs, but recent treatment innovations appear promising. We focus on the market leaders across treatment categories, where we believe there is upside to profit estimates driven by new product cycles and increased penetration in growing addressable markets.

3. Investing in self-help—In a slowing economic growth environment, we believe companies with self-help measures to enhance profitability are likely to be better positioned and rewarded by investors. We identify companies that have clear and measurable initiatives—with emphasis on restructuring and product portfolio and capital use optimization—and are likely to increase margins and cash flows regardless of an uncertain\ macro backdrop.

4. Made in America—Over the last two years, the US Congress has passed three acts aiming to upgrade US infrastructure and boost domestic manufacturing of critical resources. Together, these pieces of legislation set the nation up to embark on one of the most significant government investment spending plans we have seen in years.

5. Pricing power standouts—Still-elevated input costs have created a more challenging backdrop for many businesses. Companies with pricing power should be better able to pass on these costs to consumers and protect profit margins. We identify companies with pricing power as those with historically high and stable gross profit margins and a large market share in their respective industries.

6. Time for quality—High-quality stocks tend to perform well later in the business cycle or when the economy is in recession. With limited or no slack in the economy, it is clear that the business cycle is somewhat mature. This suggests that investors should focus on high-quality companies, which we define as those with a high return on invested capital (ROIC) and stable profit margins.

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Reach out to your financial advisor for a copy of the full report "Tactical US Equity Themes: Monthly update," a one-stop resource to access CIO's highest conviction thematic equity ideas.

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