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Investors may question whether the market's recent turmoil has run its course

07 August 2024, 2:21 pm CEST, written by UBS Editorial Team

Markets have remained volatile over the past 24 hours. The S&P 500 and the tech-heavy Nasdaq index both closed 1% higher on Tuesday. The move followed a 3% drop in the S&P 500 on Monday, driven by concerns over slowing economic growth and the unwinding of Japanese carry trades. Meanwhile, the VIX implied volatility index has dropped to around 25 after spiking above 60 intraday on Monday.

Investors may now question whether the market's recent turmoil has run its course. Amid the volatility, we summarize what has changed, and what remains the same as prior to the sell-off.

What's different now?

The Fed is likely to cut rates faster than previously expected

Market expectations for the pace of Fed rate cuts have shifted significantly in recent weeks. Fed funds futures markets are now pricing in 105bps of cuts in 2024 and roughly a further 100bps in 2025. As recently as 22 July, markets expected just 66bps this year, and at the start of July, the figure was only 36bps. With rates at 5.25-5.50%, the Fed has the capacity to bolster the economy and markets. Recent data should have improved the Fed's confidence that inflation is on a sustainable path back to the 2.0% target.

We now anticipate that the Fed will make a 50bps cut at its September meeting, followed by an additional 50bps of easing throughout the rest of 2024, with further cuts expected in 2025.

Market sentiment has deteriorated (i.e., volatility will likely be higher for a while)

Recent movements in equities, bonds, and currencies have in part been attributed to the unwinding of widely held positions, including long positions in mega-cap US tech stocks and short positions in the Japanese yen.

The yen's rapid appreciation from the early July high of 162 USDJPY to an intra-day low of 141.66 on Monday may well have forced investors to sell assets bought with borrowed yen. We also note that Apple's shares fell after news that Warren Buffett's Berkshire Hathaway had halved its holding during the second quarter.

While the extent of the impact of position squaring in recent market volatility is difficult to gauge, sentiment has become more circumspect about risky assets.

What hasn't changed?

The US economy still appears on track for a soft landing

In our view, despite last Friday's weaker payroll data, recession risks are low. Our base case is for a soft landing for the US economy, with growth bottoming slightly below the 2% trend and inflation moderating further.

Corporate profit margins remain solid, suggesting that companies have little reason to commence job cuts. June retail sales and personal consumption expenditure data suggest consumer spending is normalizing from an elevated level, not deteriorating. Households are in good financial shape overall, with positive real income growth and average debt servicing costs that remain low relative to historical averages. And services sector sentiment is positive: the Institute for Supply Management (ISM) reported that its non-manufacturing purchasing managers' index (PMI) rebounded in July to 51.4.

S&P 500 earnings are still likely to grow by a double-digit percentage this year

More than 80% of the S&P 500 market cap has now reported 2Q earnings. While we have seen some softening in earnings data, it is not so great as to change our profit growth outlook. We believe corporate profits are likely to grow by 11-12% in 2Q on a year-over-year basis, at the higher end of our initial estimate. While the breadth of earnings beats is in line with historical averages, the magnitude of the beats is a bit below normal.

Our base-case year-end and June 2025 S&P 500 price targets remain 5,900 and 6,200, respectively. We expect 11% S&P 500 earnings growth in 2024 (USD 250) and 8% growth in 2025 (USD 270).

Diversification remains crucial

While market moves in recent days have been dramatic and have illustrated the risks of highly concentrated equity portfolios, the recent strong performance by high-quality bonds should have somewhat cushioned portfolios that are diversified across asset classes.

In addition, we believe that other assets that are considered relative safe havens, including gold and the Swiss franc, can also provide hedging benefits, particularly in an environment of elevated geopolitical risk.

How do we invest?

Throughout 2024, we have reiterated the theme of "quality" in both bonds and equities. With recession fears rising, "quality" remains a key theme, and we have not changed our recommendation.

In fixed income, we expect quality bonds to deliver positive total returns in our base case, and they could rally even further if recessionary fears continue to mount.

In equities, "quality" is an investment style that has historically outperformed as a whole and with the highest relative returns during recessions.

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Original report: **What has the past week changed?, 7 August 2024.**

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