CIO have now separated "Artificial intelligence" as a standalone theme and expand the stock list to capture opportunities across the value chain.(UBS)

Tactical US Equity Themes: Breaking out AI

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The equity market continues its momentous climb—with the S&P 500 already notching 22 all-time highs so far this year. The benchmark index has risen 10% year-to-date and is up 27% since late October. Stronger-than expected economic growth, a pickup in global manufacturing activity and less-hawkish central banks have helped support the market, despite the increase in bond yields. Performance leadership has broadened out beyond mega-cap technology stocks to cyclical areas—including the energy, financials and industrials sectors, which are outperforming year-to-date.

While every sector is up on the year, except for real estate, interest-rate sensitive ones have lagged, partly due to the backup in bond yields. The 10-year Treasury yield is up nearly 50bps since the start of the year and hovering at its highest level since late-November—as the market repriced inflation and Fed expectations.

The timing of the first rate cut is an ongoing debate given the strength of the economy and recent hot inflation prints. However, we continue to expect the easing cycle to start in June and look for 75bps of cuts in 2024—a magnitude that is in line with the Fed's forecast. This should support risk assets, in our view, as financial conditions ease further and, at the same time, the US economy is still growing. The Atlanta Fed GDPNow for Q1 is tracking at 2.5%—which could mark the seventh consecutive quarter of above-trend economic growth. The labor market remains robust, with March payrolls at 303k and the unemployment rate ticking down to 3.8%. Moreover, the purchasing managers' index (PMI)—a gauge on business sentiment and a leading indicator—has improved globally, with the US manufacturing PMI finally back in expansion territory after 16 consecutive months of contraction.

We believe this solid macro backdrop bodes well for the upcoming Q1 earnings reporting season, where companies are likely to beat relatively low profit expectations. The early reporters—that is companies with a February quarter-end—are handily beating expectations, and this typically is a good indicator of the earnings season. That said, a lot of good news is already priced into the market, with valuations elevated at 21x on a forward P/E basis.

We remain constructive on equities, but upside from here is likely more limited. However, we expect rotation under the surface to persist and market performance to further broaden out. In such an environment, we believe a balanced approach is warranted. We favor quality stocks, which we view as an anchor given they typically outperform across much of the economic cycle. Within our tactical equity themes, "Time for quality" and "Pricing power standouts" offer this exposure. We would continue to take advantage of laggards ("Investing in self-help"). We also see select opportunities in secular growth trends, including housing, reshoring, infrastructure, energy transition, and healthcare innovation—which can be accessed through our "Diabetes and obesity," "Housing recovery" and "Made in America" themes. From the latter, we now separate "Artificial intelligence" as a standalone theme and expand the stock list to capture opportunities across the value chain.

We close our "Select semis" theme after strong outperformance by the stocks on the list. We launched this list late last year focused on companies that we believed would benefit from the recovery in key ends markets—PCs, servers, and smartphones. Consensus earnings estimates have since been meaningfully revised up and the theme has played out, with several of the stocks now closer to fair value.

More details about all these tactical themes and the full stock lists, **explore the full report**.