CIO thinks it is key for investors to hold a healthy strategic allocation to tech stocks, but also advocate diversified exposure across regions and sectors. (UBS)

Stocks to stay supported despite volatility

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Technology stocks led the rebound in US equities last week after mega-cap names provided a positive outlook for generative artificial intelligence.

The VIX index of implied stock volatility has also retreated to 15, down from above 19 earlier in the month when investor sentiment was knocked by escalating geopolitical tensions in the Middle East and the potential of higher-for-longer interest rates in the US.

Markets could remain volatile this week as investors react to the Federal Reserve's policy meeting, US jobs data, and earnings reports from companies that represent 30% of the S&P 500's market capitalization, including several key tech businesses.

However, we continue to see the current environment as supportive for US equities, driven by solid earnings growth, a potential Fed pivot later this year, and accelerating AI investment.

Corporate fundamentals remain largely solid and intact. About half of the S&P 500 companies have reported so far, and nearly 60% of them are beating sales estimates. In addition, around three quarters of the companies are beating earnings estimates, with an aggregate beat rate above our initial expectations. Forward guidance continues to be encouraging, with the second-quarter earnings per share (EPS) estimate being revised up. Outside of tech, defense company results were better across the board, and US non-residential construction has shown healthy trends. Consumer spending continues to be robust on services and certain experiences, while management commentary from capital-markets-focused companies has been positive on the outlook. Overall, we maintain our 9% earnings growth forecast for the S&P 500 this year.

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Slowing in inflation should resume, leading to a pivot in the Fed's policy later this year. Last week's release of the core personal consumption expenditures index may have further eroded hopes of an imminent rate cut from the Fed, but in our base case scenario, we expect disinflation to resume in the months ahead. We are confident that shelter inflation (the biggest component of the consumer price index) will fall based on data on new leases, and the current strong consumption is unlikely to continue indefinitely with a historically low savings rate. Wage growth also shows signs of slowing, with the three-month moving average of wage growth down to 4.7% in March from 5% in February, based on the latest reading of the Atlanta Fed Wage Tracker. We maintain the view that US rate cuts are likely just pushed back, not canceled. We see two 25-basis-point cuts this year, most likely starting in September.

Strong AI investments should keep stocks supported overall. Meta, Alphabet, and Microsoft all painted a positive outlook for AI last week and raised capital expenditure guidance as a result. Capital spending by these three firms now looks likely to reach USD 140bn this year, up by USD 16bn on the prior estimate. Without taking any single-stock view, we remain positive on the tech sector overall on room for even greater AI monetization and given reasonable valuations. These developments should underpin US equities.

So, we remain constructive on US equities, and expect AI-related companies to drive strong earnings growth in the years ahead. We think it is key for investors to hold a healthy strategic allocation to tech stocks, but also advocate diversified exposure across regions and sectors.

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