Investors can mitigate the volatility and keep their portfolios on track by diversifying and balancing across asset classes. (UBS)

Asset class volatility could remain elevated

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US equities extended their gains amid renewed confidence of Federal Reserve rate cuts, with the S&P 500 recording the best three-day rally since November.

Richmond Fed President Thomas Barkin indicated rates are restrictive enough to "take the edge off demand," and "the full impact of higher rates is yet to come." New York Fed President John Williams also noted his expectations for rate cuts as the US economy was overall moving back into better balance. The yield on 10-year US Treasuries fell below 4.5% for the first time in three weeks.

However, while we continue to see a constructive macro backdrop for risk assets, investors should stay vigilant on a range of economic and geopolitical risks that could send market volatility back up again.

A ceasefire deal in Gaza remains uncertain. Brent crude oil has retreated to below USD 84/bbl, from a recent peak in April above USD 91/bbl, amid some easing of investor anxiety in recent weeks over the threat of a further escalation of the Middle East conflict. However, no ceasefire is in immediate sight, either. While Hamas on Monday agreed to a truce proposal from mediators, Israel said the terms of the latest peace talks did not meet its demands and that it would continue strikes on the Gazan city of Rafah. Further negotiations are expected to resume in Cairo this week. Our base case is for the conflict to continue alongside sporadic attacks in the region without snowballing into a war between Israel and Iran. But the risk remains for oil prices to rise beyond USD 100/bbl if the flows through the Strait of Hormuz are disrupted or if major oil production facilities are attacked.

The disinflation trend could be vulnerable. A renewed spike in oil prices, so soon after the recent string of disappointing US inflation readings, could increase investor concerns that consumer and business inflation expectations may get destabilized and require higher interest rates in response. In addition, if US growth remains too strong, investors

could further scale back expectations over the timing and pace of Fed rate cuts. This is not our base case, as we continue to see signs that point to a renewed fall in inflation, but investors are likely to look for further confirmation that disinflation has resumed.

The US presidential election adds to uncertainty. With the US presidential election just six months away, headlines around the campaigns have the potential to create swings in market sentiment. While data going back to 1928 suggest that markets don't tend to do better or worse during election years than on average, the candidates' policy and trade stances could affect the performance of specific sectors in the short run. A growing federal deficit is also likely to come under the spotlight, with the Congressional Budget Office recently projecting that interest costs on US debt are set to exceed defense spending this year.

So, with markets oscillating between pricing different scenarios, asset class volatility could remain elevated. Investors can mitigate such volatility and keep their portfolios on track by diversifying and balancing across asset classes. We see significant value in quality bonds in a portfolio context, given their potential for outsized returns if there is a growth misstep, or heightened fears about geopolitical uncertainty. We also like both oil and gold for portfolio hedges, while an allocation to hedge funds can help diversify and manage risks across scenarios for investors willing and able to bear the asset class's inherent risks like illiquidity.

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Original report - **Market risks linger despite improved sentiment, 7 May 2024.**

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