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CIO continues to favor quality stocks as well as AI beneficiaries, with potential to use structured strategies for exposure to potential gains while limiting losses in the event of further consolidation. (UBS)

Swing to market pessimism looks overdone

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Markets have encountered headwinds at the start of the US earnings season amid heightened geopolitical risks, higher US bond yields, and worries about the outlook for chipmakers. The S&P 500 Index fell 3.1% last week, its worst performance since March last year.

But, without taking single-stock views and looking more generally at global equities, we think investor pessimism may be both premature and overdone:

Early results remain consistent with our expectations for healthy US earnings growth of 7–9% for the quarter. While only 15% of the S&P 500 market capitalization has reported so far, nearly 60% of companies are beating sales estimates and 75% are beating earnings estimates. In aggregate, earnings are beating by roughly 9%, better than our expectations for a beat rate of between 4 and 6%. Guidance has also been encouraging. The second-quarter earnings per share estimates (EPS) for the companies that have reported are holding up better than normal. And we see signs that this earnings growth is likely to expand beyond the largest technology companies, auguring well for a broadening in better corporate fundamentals and potentially elevating some investor concerns about concentration risks.

A market retreat was not unexpected, given the extended nature of market positioning and bullish sentiment coming into the second quarter. At the end of March, the S&P 500 recorded an all-time high, which capped off a six-month return that was among the highest in the past eight decades. This lifted valuation, sentiment, and positioning indicators to elevated levels, in our estimation. Since then, a strong March jobs report and hotter-than-expected US inflation prints have pushed out Federal Reserve rate-cut expectations and driven a more than 40-basis-point increase in the 10-year US Treasury yield in a matter of weeks. History shows that rapid increases in interest rates over short periods of time

typically weigh on stocks. Yet, our view remains that the slowing of US inflation will resume, allowing markets to focus on a likely pair of US rate cuts in 2024, with the first most probable in September.

So, while further volatility can be expected, especially with ongoing attacks in the Middle East, we think a gradually improving risk-reward outlook for US stocks continues to support our focuses on finding opportunities within and beyond technology. Ahead of another busy reporting schedule this week, we maintain our year-end S&P 500 price target of 5,200, underpinned by a solid estimated 9% earnings growth, still-cooling inflation, two expected Fed rate cuts, and continued robust corporate investment in AI.

We continue to favor quality stocks as well as AI beneficiaries, with potential to use structured strategies for exposure to potential gains while limiting losses in the event of further consolidation. We also see ways investors can diversify their stock exposure beyond tech, including in US small-cap stocks that should benefit from the broadening earnings trend identified above and still-compelling relative valuations versus US large-cap stocks.

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