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The unexpected strength in payrolls comes at a time when other economic indicators suggest a slowing US economy. (UBS)

How to invest in a slowing US economy

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The US economy generated 272,000 jobs in May, according to data released on Friday, significantly exceeding the consensus estimate of 185,000.

The unexpected strength in payrolls comes at a time when other economic indicators suggest a slowing US economy. Recent data, including the job openings and labor turnover survey (JOLTS), initial jobless claims, the ISM manufacturing index, housing data, credit card spending, and the trade balance, all point to a moderation in economic activity in the US. This mixed picture complicates the Federal Reserve's task of setting monetary policy.

It's also worth noting that, despite the strong payroll number, the unemployment rate edged up slightly, to 4.0% from 3.9%. This discrepancy is likely down to differences between the establishment survey (which measures payrolls based on responses from businesses) and the household survey (which measures the unemployment rate). One contributing factor to this anomaly is the double-counting of part-time jobs in the establishment survey. In short, the labor market may not be as strong as May’s payroll data suggests.

Overall, we keep our view that the US economy is slowing.

What does it mean for rates?

The past week saw the Bank of Canada and the European Central Bank cutting interest rates for the first time in this cycle. But the Fed is lagging, and almost nobody expects the US central bank to ease policy at this week's meeting. We think the strong nonfarm payroll data have also effectively ruled out a surprise cut in July.

At its July meeting, we would expect the Fed's to maintain a patient approach and for Fed Chair Jerome Powell's message to remain unchanged: Rate cuts are delayed relative to previous expectations, but further hikes are unlikely.

We believe the Fed will ease interest rates twice this year, starting in September. The market is pricing in 39 basis points of cuts in 2024, starting in November, with a terminal rate of 3.8%. We would expect the Fed's Summary of Economic Projections ("the dot plot") to align with this outlook, indicating one or two cuts, consistent with current market pricing.

How to invest

Given the current US economic landscape and the Fed's likely stance, we recommend the following investment strategies:

Buy quality bonds: The bond market's reaction to the payroll report appears overdone in our view. We continue to see growth moderating due to high rates and the fading impact of previous fiscal stimulus. Investors should consider maintaining exposure to high-quality bonds, as we still anticipate Fed rate cuts beginning in September, followed by one cut per quarter. This outlook supports a gradual decline in yields, benefiting fixed income portfolios. We forecast the 10-year US Treasury yield will end 2024 at 3.85%.

Optimize tech exposure and find opportunities beyond tech: Our overall US equity market view remains unchanged. The S&P 500 has shown resilience, up 13% year-to-date, even as the market's expectations for rate cuts have diminished from six at the beginning of the year to approximately 1.5 now.

If the Fed were to raise rates, it would pose a greater challenge for US equities. However, with rate hikes unlikely, we continue to see opportunities. Our year-end S&P 500 forecast is 5,500, 3% higher than today's levels. We keep a positive stance on technology, with a particular focus on semiconductors, which are benefiting from AI investment demand, and the monoliths, which are well positioned to monetize future AI applications. We see also see select opportunities in UK, US, and European small-caps, and in China internet companies.

Diversify with alternatives: In an environment of economic moderation and potential market volatility, we believe investors should consider an allocation to alternative investments within portfolios. Including an allocation to hedge funds can mitigate portfolio volatility at times when equity and bond markets may move together. Private markets can provide an alternative source of return to further diversify portfolios. Investors should be aware of the inherent risks in this type of investment, including illiquidity and the complexity of such strategies.

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Original report - **Upward surprise in US nonfarm payrolls, 10 June 2024.**

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