High-quality fixed income at present offers both attractive yields and the potential for capital appreciation if growth risks should mount. (UBS)

Bonds look better placed than stocks

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Equity and bond markets seem at odds over the economic outlook. The bond market looks braced for a further slowdown in growth.

The 2-year US Treasury was on Monday yielding 103 basis points more than the 10-year bond, the largest inversion since the collapse of Silicon Valley Bank in early March. An inversion is considered a popular early warning signal of recession.

By contrast, even after a recent bout of weakness, equity markets appear to be pointing to a solid economic outcome, with the MSCI All Country World Index still up 10.4% so far in 2023 and the S&P 500 up 12.7%.

But while global economic prospects appear finely balanced, we see greater upside in bonds at present.

Government bonds appear well-placed to do well in either a recessionary or a soft-landing scenario. Government bonds would gain if inflation declines more rapidly than expected, allowing an earlier end to central bank tightening and yields fall across the yield spectrum.

However, if inflation remains stubbornly high and central banks continue to tighten, rising recession risks would typically boost demand for medium- to longer-duration government bonds. In either scenario, we think current yields are at attractive levels for investors to lock in before markets start to price lower rates in the future. We prefer maturities of five to 10 years.

A further rise in equity markets would likely require a near-perfect economic outcome. This year's rally has taken the US equity market, based on the MSCI US index, to around 19.4 times 12-month forward earnings—a roughly 16% premium to its average over the past 15 years. Such valuations would be more consistent with an expeditious fall in inflation that allows the Federal Reserve to end rate rises soon, accompanied by resilient economic growth. In addition, as the rally has been driven largely by a small coterie of mega-cap tech firms—especially due to investor enthusiasm over the promise of artificial intelligence—it is also crucial that this fervor does not evaporate too quickly. The bottom line is that a lot needs to go right for equities to rally further.

Bonds offer a better risk-reward tradeoff than equities. The equity risk premium—which measures how well investors are compensated for the extra risk of stocks compared to safe government bonds—suggests global stocks are at their least attractive since prior to the global financial crisis. This is based on the earnings yield of the MSCI All Country World stock index minus the 10-year US Treasury yield.

So, we remain least preferred on equities relative to bonds. High-quality fixed income at present offers both attractive yields and the potential for capital appreciation if growth risks should mount. Among riskier parts of the fixed income market, we continue to prefer emerging market bonds. Despite our least preferred stance on stocks, there are areas of opportunity. We think investors should look to rebalance US equity exposure toward these more attractively valued areas, either by using equal-weighted indexes or tilting away from technology and toward lagging sectors such as consumer staples and industrials.

Main contributors - Solita Marcelli, Mark Haefele, Vincent Heaney, Christopher Swann, Jon Gordon

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