



(UBS)

# Alert: Markets rebound as recession worries ease

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**US equities rallied on Thursday after a drop in jobless claims helped alleviate recession fears. Markets are now eyeing upcoming inflation and retail sales data, which could lead to future volatility. In a period of thin summer liquidity and heightened political risk, we recommend that investors focus on long-term fundamentals and seek quality growth, while positioning for lower rates with quality bonds, and diversifying with alternatives.**

**Video replay:** [CIO Client Livestream – Market swings: What’s next?](#) (28:00)

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## **What happened?**

The S&P 500 rose 2.3% and Treasury yields increased after a fall in jobless claims helped allay fears that the US economy is sliding into a recession.

Initial jobless claims fell by 17,000 to 233,000 for the week ending 3 August, the largest drop in nearly a year. While the series is usually not a major focus for markets, the release comes at a time of heightened concern that the Federal Reserve has put the economy at risk of a contraction by waiting too long to cut rates.

Volatility in the yen, which many commentators have blamed for recent market turbulence, also declined. This eased concerns that over the disruptive impact of the unwinding of yen carry trades, a popular strategy by which investors borrow at near-zero interest rates in the Japanese currency and put the proceeds into higher-return markets.

The VIX index of implied US stock volatility, a gauge of investor uncertainty, also moved down from 28.3 to 23.8—having reached a peak of 65.7 earlier in the week. The yield on 10-year Treasuries climbed by 4 basis points to 3.99%.

### What do we think?

Market volatility could remain elevated for some time. Liquidity is typically thinner over the summer. More yen carry trades could unwind, leading some investors to sell risk assets. Economic uncertainty remains high after the release of weak July jobs data last week. The US election campaign remains fluid. Geopolitical tensions have increased amid concerns that Iran will launch a fresh attack on Israel, and the war between Russia and Ukraine has also intensified after Ukraine launched an attack on Russia's Kursk region.

But much about the backdrop has also remained positive. Although the US economy now looks to be growing at a rate slightly below trend, fears of a recession look premature. Recent consumer spending data points to a normalization from elevated levels rather than a period of weakness. Household finances remain in good shape, and the ISM services survey rebounded in July.

The latest jobless claims data, though not normally a major market event, supports the view that recent pessimism may have been overdone. Unlike survey-based releases, the jobless claims series reflects actual actions by individuals to claim unemployment benefits.

Corporate fundamentals have also been solid. Although we saw negative share price reactions to some earnings results from the tech sector, in our view the market had set an overly high bar. With the second-quarter reporting season nearing its close, the outcome has been consistent with our forecast for 11% earnings-per-share growth for 2024 overall.

Finally, the recent retreat in stocks has made valuations in the US tech sector look less demanding. The sector is now trading on 26.5x 12-month-forward earnings, down from a peak of 32x on 10 July.

The focus of investors is now likely to shift to economic releases next week, including the consumer price index for July and retail sales. Markets will be hoping for evidence of a soft landing—with inflation gradually falling toward the Fed's 2% target and consumer spending moderating without pointing to an economic contraction.

### How do we invest?

The recent risk-off move in markets has reflected some concern over whether the Fed has put the US economy in peril by delaying rate cuts for too long. But moves have also been exacerbated by technical factors, including the unwinding of yen carry trades and overextended positioning. We believe investors shouldn't overreact to swings in market sentiment. With economic and earnings fundamentals still good and the Fed likely to cut interest rates, our base-case scenario is still for the S&P 500 to end the year around 5,900 and 6,200 by June 2025, versus around 5,320 at present.

Against this backdrop, we advise investors to consider several strategies:

**Seek quality growth.** We believe quality growth is an appealing equity strategy and especially in periods of heightened volatility. Recent earnings growth has been largely driven by firms with competitive advantages and exposure to structural drivers that have enabled them to grow and reinvest earnings consistently. We think that trend will continue, and expect quality growth to outperform, particularly if cyclical concerns mount.

**Position for lower rates.** Earlier this week Chicago Fed President Austan Goolsbee adopted a reassuring tone, saying that if the economy deteriorates the central bank will "fix it." We expect other top officials to echo this message. With evidence that inflation is coming under control, the Fed should be freer to focus more on supporting jobs and growth. Our base case is now that the Fed will front-load rate cuts, with 100-basis points of easing in 2024. This is part of a broader global cutting cycle for which we have been advising investors to prepare. As returns on cash are eroded, we think investors should consider investing cash and money market holdings into high-quality corporate and government bonds. These assets have recently shown their value, cushioning volatility in equity markets.

**Diversify with alternatives.** Amid ongoing market fluctuations and the potential for increased volatility from upcoming economic data releases, we view alternatives as a strategic source of diversification and risk-adjusted returns. Hedge funds not only have the potential to help stabilize portfolios during times of stress but also take advantage of dislocations and generate attractive returns when other asset classes may struggle. Investing in alternatives does come with risks, including around illiquidity and a lack of transparency.

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