



(UBS)

Stocks and bonds rally on softer inflation data

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Equities rallied, bond yields fell, and the US dollar depreciated on Tuesday after US CPI data showed cooler headline and core inflation in October. The weaker-than-expected data bolstered hopes that the Fed rate hiking cycle is over and that rates will be cut next year. In this environment, we prefer high-quality bonds and quality equities.

What happened?

US inflation is heading closer toward the Federal Reserve's 2% target. The October Consumer Price Index (CPI) report showed lower energy prices helped headline CPI cool more than expected, while lower prices for lodging away from home (hotels) took core CPI below economists' forecasts. Following the release, equities and fixed income markets rallied as investors anticipate the Fed will continue its rate policy pause until it begins to cut in 2024.

Following today's 1.9% gain in the S&P 500 to 4,496, the index has jumped 9.2% from the 27 October low (just 12 days ago). Gains were broad-based as nearly 93% of the index constituents improved on the day. Stocks that were previously pressured by expectations for higher rates were prominent among the day's gainers.

Meanwhile, the 10-year Treasury yield dipped 17 basis points to 4.45%, while the 2-year yield experienced its largest daily drop since the Silicon Valley Bank crisis in March (down 20bps to 4.83%). The US dollar DXY index declined 1.5% to 104. Fed funds futures markets moved to price in a lower chance of a further hike in December and 100bps of cuts by December 2024.

Within the October CPI report, headline inflation increased 3.2% year over year (versus 3.3% forecast) from 3.7% in September as WTI oil prices declined nearly 10% during the month. On a month-over-month basis, headline CPI was

flat (0%) versus expectations for 0.1%. Additionally, core inflation (ex-food and energy) rose 4% year over year (4.1% forecast) from 4.1% in September. On a monthly basis, it gained 0.2%, below economists' estimates of 0.3%.

Core goods inflation was negative (-0.1% m/m) due to lower used-car prices, meaning services inflation contributed the most to core CPI because of elevated shelter prices. Nonetheless, shelter prices fell more than expected, and core services inflation cooled to 0.3% m/m from the peak of 0.8% in September 2022.

What do we think?

Our base case is that the Fed is likely finished raising rates, and that a combination of lower growth and lower inflation should lead to interest rate cuts in 2024. Although inflation will likely remain above the 2% target through most, or all, of the year ahead, we believe policymakers will be sufficiently confident by midyear that inflation is falling sustainably toward target.

Today's data reinforces that view, and the strong market reaction to the data should serve as a reminder that when the Fed starts cutting, those cuts can be sharp. In the 10 instances of Fed rate-hike cycles since 1970, when the Fed started cutting rates, it cut by an average of 260bps in the first 12 months (excluding 1987 and 2006, when rates rose again after a pause).

Today, markets are pricing around 100bps of easing by the end of next year. Should the inflation data continue to weaken, particularly if accompanied by weaker growth data, markets could quickly move to price additional rate cuts in 2024.

That said, investors shouldn't rush to assume the path to lower inflation and lower rates will be smooth. Progress in reducing underlying inflation may appear to stall in the fourth quarter of 2023, due to seasonal adjustments and specific factors such as the annual medical care insurance cost adjustment. That means a renewed fall in inflation may have to wait until the first quarter of 2024, when ongoing disinflation in the cost of shelter should cause progress to resume.

Surveys of consumer expectations of inflation have also been mixed. The University of Michigan's November survey showed consumers seeing inflation at 3.2% over the next five years, up from 3% in October. Although that contrasted with a survey from the New York Fed, and consumers have historically been poor at forecasting future inflation trends, Fed officials and investors would likely feel more reassured by a more consistent downward move in consumer expectations.

Recent signals from the central bank have been ambiguous as policymakers keep their options open, and Fed Chair Jerome Powell has warned against inflation "head fakes"—the potential that the falling trend could go into reverse.

Overall, our base case is for the Fed to cut two or three times in 2024. Inflation crosswinds over the next couple of months could contribute to market turbulence in the near term, but our view remains that by spring or summer, inflation will have fallen far enough for the Fed to consider a first rate cut—a supportive move for both bonds and stocks. This supports our expectations for positive returns for both quality fixed income and equities over the next six to 12 months, making it a good time to add to diversified balanced portfolios.

How do we invest?

We recommend investors look for quality across asset classes since we expect volatility in markets as economic growth slows and inflation cools further. Today's sharp move lower in Treasury yields should also serve as a reminder of the importance of managing liquidity and minimizing reinvestment risk in the event rates move lower in the months ahead.

Fixed income remains our preferred asset class as we expect bonds to rally in 2024. Our base case target for the 10-year US Treasury yield is 3.5% by the end of 2024. We like high-quality bonds, particularly the 5-year segment.

We expect a moderate rally in global equity indexes in 2024 as central banks cut rates, yields fall, and quality companies continue to grow earnings. For the S&P 500, we see potential for 9% earnings growth in 2024 despite slowing GDP growth. With 5% upside from current index levels to our 2024 target of 4,700, the current risk-reward is balanced, in our view.

Against this backdrop, investors will need to be more discerning in their equity selection. We think quality companies—those with a high return on invested capital, strong balance sheets, and reliable income streams—will still grow earnings despite a tougher operating backdrop. Many of the companies with the highest returns and the strongest balance sheets are in the IT sector, and we recently upgraded the US IT sector to most preferred.

Meanwhile, as 2024 progresses, USD weakness may emerge as US economic growth eases relative to other economies, thereby making selling USD upside for a yield pickup attractive.



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