(UBS)

CIO Alert: Stocks retreat as earnings fail to inspire.

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The S&P 500 fell by 2.3% after earnings announcements from several top tech and growth stocks failed to impress investors. We still see better risk reward in quality bonds and remain neutral on global equities. However, with earnings per share still on track to rise at their fastest pace in more than two years, and rate cuts on the way, we see the S&P 500 climbing into year-end.

What happened?

The S&P 500 fell 2.3% today, as earnings announcements from several prominent US companies failed to impress. Alphabet, the parent company of Google, fell 5%, as investor concerns over rising AI-related capital spending outweighed better-than-expected second-quarter earnings. The response to a strong report underlined that optimism in markets over the outlook for tech has created a high hurdle for companies to clear. Electric carmaker Tesla lost even more ground after reporting its lowest profit margin in more than five years owing to weaker demand and rising incentives for consumers. Finally, Visa suggested a continued modest deceleration in consumer spending, primarily driven by lower-end consumers.

The retreat in the index was led by leading tech and growth companies. The FANG+, which tracks the top 10 most traded tech firms, fell 5.5%. The tech-heavy Nasdaq Composite was down 3.6%. However, it is worth noting that the performance of the equal-weighted S&P 500 was down only 1.2%. This indicates that the losses were not as widespread as they may appear by looking at the market-cap weighted SPX.

Political uncertainty also remains elevated, as Vice President Kamala Harris launched her campaign for the White House in earnest after Joe Biden withdrew his bid over the weekend. The decline in the S&P 500 followed a 2% retreat last week, its worst performance since April.

What do we think?

After a roughly 20% rally since the start of the year, a pullback at some point was always a possibility. The recent smooth ascent of the S&P 500 has been unusual. The index had gone more than 350 trading sessions without a drop of more than 2%—its best run in 17 years. Prior to last week, the market had also risen in 28 of the past 37 weeks, rising 75% of the time. That was the longest winning streak in 35 years. And market dips are not uncommon. Losses of 1-2% make up about 8% of all daily returns, based on data going back to 1927.

In addition, investors have already priced in plenty of positive news on the commercialization of AI, raising the bar for tech companies. The world's largest contract chip manufacturer recently indicated that it expected AI chip demand to exceed supply until 2026, from 2025 previously, while one of the world's largest semi equipment companies indicated strong demand into 2025.

Despite the recent market setback, we believe the earnings season—which is still at a relatively early stage—is likely to support confidence. While we expect further signs that there is some softening in profit momentum, results so far remain consistent with our forecast for 10-12% S&P 500 earnings per share growth, which would be the best outcome in more than two years.

We also expect a broadening of earnings growth beyond the Magnificent 7, the top growth and tech stocks that have led the recent rally. The current earnings season is likely to show the first growth in earnings per share for the S&P 493 since 2022. In our view, this broadening of earnings growth makes the recent rally more sustainable. We also expect markets to be supported by easier monetary policy, with slowing inflation allowing the Federal Reserve to cut rates at its September policy meeting. Investors will look for further confirmation later this week that inflation is headed back to the Federal Reserve's 2% target.

How do we invest?

Investors should be prepared for periodic market dips. The equity market has come a long way, and both positioning and sentiment had become extended, in our view. However, we continue to expect the S&P 500 to recover and end the year higher at 5,900 versus the current 5,427. Easing monetary policy along with further buildout of AI infrastructure and applications should be supportive. Against this backdrop, we advise investors to consider several strategies:

Seize the opportunity from AI. The market potential of AI is vast, and we expect it to be a key driver of equity market returns over the coming years. We think it is important that investors hold sufficient long-term exposure to AI. For now, we see the best opportunities in the enabling layer of the AI value chain—which is benefiting from significant investment in AI capabilities—and in vertically integrated mega-caps, which are well-positioned across the value chain. We also think investors should look beyond the US for ways to capture AI growth, including in China's tech monoliths.

Seek quality growth. We believe seeking quality growth should apply broadly to investors' equity holdings. 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 investors should tilt toward quality growth to benefit.

Position for lower rates. With economic growth and inflation slowing, and central banks starting to cut interest rates, we see significant opportunities in the fixed income market. We believe investors should invest cash and money market holdings into high-quality corporate and government bonds, where we expect price appreciation as markets start to anticipate a deeper rate-cutting cycle. We also expect broadly diversified fixed income strategies to perform well in the months ahead. In addition, we have identified select ideas within Europe that can benefit from lower rates.

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