CIO continues to see a favorable backdrop for US equities and advises investors to maintain a full allocation to the US market. (UBS)

Stick to long-term plans through periods of volatility to avoid missing out

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US stocks recorded their strongest daily rally since February on the last day of July, with the S&P 500 index climbing 1.6%. A recovery in growth stocks and mounting confidence that Federal Reserve rate cuts are on the way buoyed equities and sentiment.

The tech sector led the rally, with AI chipmaker NVIDIA advancing 13% and Meta shares up 7% in after-hours trading. The rebound follows a period of investor caution over how swiftly leading tech companies would be able to monetize heavy investments into AI—contributing to a near 5% fall in the S&P 500 index from an all-time high in mid-July.

The gain in NVIDIA reflected news of rising capital spending on AI from other mega-cap tech firms. Microsoft announced AI capex had reached USD 19bn in the second quarter, 80% higher than the same period a year ago. Analysts raised capex spending estimates on the heels of the results. Meta's results also boosted investor confidence, following better-than-expected second quarter earnings and revenues (including in advertising) and guiding for third quarter revenues that surpassed prior consensus expectations.

Beyond corporate results, investors were also heartened by a more dovish message from the Federal Reserve's latest policy meeting. Despite keeping rates on hold as expected, Fed Chair Jerome Powell said that “a reduction in our policy rate could be on the table as soon as the next meeting in September.” Recent data had added to “confidence” that inflation is returning sustainably to the central bank’s 2% target, he said. Most notably, Chair Powell and the committee focused comments on the labor market side of their dual mandate, noting in their statement that "job gains had moderated" and becoming more sensitive to risks that the jobs market is cooling excessively rather than overheating.

How do we invest?

The revival in markets highlights our view that investors should stick to their long-term plans through periods of volatility to avoid missing out on rebounds. Market sentiment and positioning had become extended earlier this month—making a pullback more likely. But market fundamentals remain positive, and we continue to expect the S&P 500 to recover and end the year higher at 5,900 versus the current 5,522. Against this backdrop, we advise investors to consider several strategies:

- **Seize the opportunity from AI**. AI's market potential vast, and we expect it to be a key driver of equity market returns over the coming years.
- **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.

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Original report: **Stocks rally on AI and rate cut optimism, 1 August 2024.**

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