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As markets continue to react to incoming data and headlines, CIO maintains the view that investors should ensure their portfolios are well diversified and balanced across asset classes. (UBS)

Signs of a soft landing boost market sentiment

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Coming in at the lower end of consensus forecasts, both headline and core CPI for April rose 0.3% month-over-month. Compared with a year ago, core CPI at 3.6% marked the slowest pace of inflation since April 2021. US retail sales for April also came in weaker than expected, with no growth from the previous month, after a downward revision to data in the prior months.

This set of economic data is the latest that supports our view of a soft landing in the US economy. Earlier this month, the labor report for April showed a smaller-than-expected increase in employment growth, a higher unemployment rate, and wage growth that is at its lowest level since June 2021. The fall in April's ISM services PMI into contraction territory for the first time since December 2022 also indicated softness in broader economic activity.

Looking ahead, we expect core personal consumption expenditures (PCE), which is the Federal Reserve's preferred inflation measure and will be released at the end of this month, to post the smallest increase so far this year. While this may not be enough to support an imminent rate cut from the US central bank, the reestablishment of a disinflation trend in the coming months should allow the Fed to start easing policy in September. We continue to expect US rate cuts of 50 basis points in total this year, and see several implications for investors.

Quality bonds are our preferred asset class. We expect the yield on the 10-year US Treasury to fall to 3.85% by year-end, providing investors with capital gains in addition to current attractive initial yields. In addition, a renewed fall in inflation and slower economic growth should lead markets to price a more meaningful rate-cutting cycle in 2025 and 2026. We also like quality bonds' value in a portfolio context, given their potential for outsized returns if there is a growth misstep, or heightened fears about geopolitical uncertainty. Investors should consider an active and diversified approach to their fixed income exposure.

The macro backdrop is supportive for equities. While US equity valuations are elevated, we believe AI-related companies should continue to report strong earnings growth in the years ahead, given better-than-expected AI capex and monetization trends. Healthy and broadening profit growth seen in first-quarter US corporate results also give us greater conviction in our forecast of 9% earnings growth for the S&P 500 this year. In the near term, changes in interest rate expectations will likely be a key driver of equity market moves, and we think small-cap stocks could catch up amid attractive valuations.

The US dollar should weaken further over the medium term. The DXY dollar index has fallen to its lowest level in over a month. While the US dollar may be supported in the near term as the European Central Bank and the Bank of England are likely to start lowering rates ahead of the Fed, we expect modest USD depreciation as growth outside the US improves. We keep a most preferred view on the Australian dollar, as the Reserve Bank of Australia should be the last among major central banks to begin easing policy amid sticky inflation and solid wage growth. We advocate selling AUDUSD downside price risks on the back of our year-end forecast of 0.68.

As markets continue to react to incoming data and headlines, we maintain the view that investors should ensure their portfolios are well diversified and balanced across asset classes. This should include an allocation to alternative assets for those who are willing and able to manage associated risks, such as illiquidity.

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