(UBS)

Weak data and tech concerns drive equity selloff

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Equities fell and bonds rallied on Tuesday as a soft ISM manufacturing report and renewed pressure on mega-cap tech stocks prompted a risk-off move. We see the potential for further volatility but recommend remaining invested and using the selloff to build a balanced and diversified portfolio.

What happened?

US equities fell and bonds rallied on Tuesday as the ISM manufacturing index signaled ongoing weakness in the industrial sector, while NVIDIA and other mega-cap stocks came under pressure, contributing to the market's slide.

The S&P 500 fell 2.1%, its steepest decline since 5 August, as markets resumed activity following the Labor Day break. The tech-heavy Nasdaq Composite dropped 3.3%, with mega-cap tech stocks lower across the board, as Apple, Meta, Amazon, Alphabet, and Microsoft all lost ground. NVIDIA led the decline, falling 9.5%. The AI chipmaker's shares have been volatile since the company reported earnings last week.

The ISM manufacturing report added to investor concerns about the health of the US economy. The headline index edged up slightly to 47.2 in August from July's eight-month low of 46.8, but it remained in contractionary territory and missed consensus estimates. The new orders component fell further into contraction, dropping sharply to 44.6 from 47.4 in the previous month, marking its lowest reading since May 2023.

Bonds rallied amid the risk-off sentiment, with yield on 10-year Treasuries dropping by 7 basis points. Futures markets now price that the Fed will cut policy rates by roughly 100 bps in the remainder of this year.

What do we expect?

We expect stocks to trade higher over the coming 6-12 months but would not rule out renewed volatility in stocks in the near term.

September has historically been a poor month for returns, suggesting that some seasonality may be playing a role in negative sentiment. The S&P 500 has declined in September in each of the last four years and seven of the last ten. This historical context may help explain why today's move could be signaling a broader risk-off sentiment as investors brace for potential volatility.

Additionally, uncertainty about the economic growth outlook may affect expectations for companies with cyclical revenue streams, including those at many technology companies. In the lead up to the US presidential election, fears of increased restrictions on technology trade between the US and China could also weigh on the outlook. Additionally, we note that some leveraged and carry-fund positioning has already returned, though it is not at the extreme levels seen in early August.

Attention will now turn to the labor market, and Friday’s nonfarm payrolls report for August. Another disappointing jobs report could heighten recession fears and prompt the Fed to take more aggressive action.

How do we invest?
An uncertain final quarter of the year may augur more equity market turbulence, but we believe investors should keep a long-term perspective, stay the course, and focus on building a balanced and diversified portfolio. We also recommend that investors maintain “shopping” and “disposal” lists to stay disciplined during turbulent times and be prepared to build strategic exposures at more favorable prices as and when volatility arises.

Within technology, we recommend investors examine their AI exposure while keeping a long-term perspective on financial goals. We think current volatility may say more about positioning and expectations than about a new fundamental development for the AI trend. Those with low AI holdings should consider building exposure through structured strategies to navigate potential volatility ahead. For those with higher allocations, capital preservation strategies could serve as a hedge.

Investors also need to continue preparing for lower rates as Fed cuts get under way**.** We expect the Fed to cut interest rates at each of its three remaining meetings in 2024. As returns on cash are eroded, we think investors should consider diversified fixed income and equity income strategies as alternatives to cash.

Finally, investors should maintain diversification across asset classes, regions, and sectors, including in alternative assets like gold. Periods of elevated volatility have historically created favorable conditions for select hedge funds to stabilize portfolios and generate strong returns, especially when other asset classes struggle.

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