While further volatility is possible in the near term, investors should stay invested and consider measures to manage market swings. (UBS)

Market outlook remains favorable despite heightened geopolitical risks

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While markets remained concerned about the potential for further escalation of the conflict in the Middle East, we advise investors against exiting risk assets, and continue to see an overall supportive backdrop for equities.

Fighting between Israel and Hezbollah in Lebanon has intensified in recent days as the Middle East conflict reached its one-year mark this week. Israel's defense minister has declared all options were open for retaliation against Iran, following the latter's missile attacks last week.

In addition, Israel's military said on Tuesday it had launched ground operations in southwest Lebanon, expanding its military operations in its northern neighbor. The US has warned that while military pressure can enable diplomacy, it can also lead to miscalculations.

Markets remained concerned about the potential for further escalation of the conflict with no clear end. While oil prices dipped on Tuesday morning, Brent crude remains around USD 80/bbl after last week's rally. Gold is trading less than 2% below its all-time high struck at the end of September.

But while investor sentiment is still fragile amid escalating tensions in the Middle East, we advise investors against exiting risk assets. We continue to see an overall supportive backdrop for equities.

The market impacts from war and geopolitical crises have historically been temporary. Over the past year, the S&P 500 has risen by 32%. Data over the past eight decades also shows that the effects of international conflicts on financial markets tend to be short-lived. Since 1941, the S&P 500 has been higher two thirds of the time in the 12 months after the start of a geopolitical crisis; half of the time, it has only taken markets a month to recover. Selling in response to immediate uncertainty locks in otherwise temporary losses and hampers investors' ability to participate in the next market recovery.

Recent data underscore a resilient, albeit slowing, US economy. Stronger-than-expected labor data at the end of last week alleviated US recession fears, as the economy in September generated the most jobs since January, with higher hourly earnings growth and a lower unemployment rate. With market focus now turning to inflation data due later this week, we expect the Federal Reserve to reduce interest rates by another 50 basis points by the end of this year, supporting a soft landing for the economy.

Third-quarter earnings should highlight healthy corporate fundamentals. Major US banks and several prominent consumer names will start the third-quarter reporting season this week, and we continue to expect S&P 500 earnings per share to grow 11% this year. The structural growth story of artificial intelligence (AI) also remains supportive, with demand continuing to exceed supply for AI infrastructure. Overall, we expect the S&P 500 to rise to 6,200 by June 2025, compared to 5,695 as of Monday's close.

So, while further volatility is possible in the near term, investors should stay invested and consider measures to manage market swings. We continue to like AI beneficiaries, including semi names and megacaps, as well as a broad suite of quality companies. We also recommend utilizing capital preservation strategies, hedge funds, and exposure to gold and oil to improve the resilience of portfolios (albeit mindful of the unique risks of investing in alternative investments, such as illiquidity).

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