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At CIO, we see more upside this year for both equity and bond markets. However, we maintain a preference for bonds over stocks. (UBS)

Yield & Income: The road to redemption

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The UBS Chief Investment Office believes the Fed will guide the US toward a soft landing in 2024. The economy's resilience has continued driving equities, and the S&P 500 reached several new highs in January. Yield and income sectors have responded accordingly. In light of this, we share our base case and sector preferences.

In mid-2021, investors were still subscribed to the belief that inflation would prove to be transitory. This notion was supported by Federal Reserve officials. On 28 July, during the Fed's post-meeting press conference, Chair Jerome Powell explained that transitory inflation meant, "increases in prices will happen, so there will be inflation but that the process of inflation will stop." With that in mind, Powell said in response to an earlier question, "We're clearly a ways away from considering raising interest rates."

The S&P 500 went on to post its sixth straight monthly gain in July 2021, before finishing the year with a nearly 29% return. This despite the fact that the Fed was arguably committing its largest policy error in decades. The need to subsequently take more excessively restrictive monetary policy measures—11 rate hikes totaling 525bps over the course of 12 meetings —raised the risk of a policy overcorrection and recession. But at CIO, we believe that the Fed will guide the US economy toward a soft landing in 2024.

The economy has slowed to a more reasonable pace while inflation has fallen. US GDP grew 3.3% in the fourth quarter (2.5% for all of 2023). The Fed's favored inflation measure, core PCE, increased 2%, which was steady with the prior quarter's trend and in line with the Fed's target. Hints of these positive trends were first detected in early November and touched off a rally in stocks and bonds. The S&P 500 gained 9% in November and 4.5% in December. Meanwhile, the yield on the 10-year Treasury topped out at 5% in mid-October before dropping more than 100bps by year-end. Overall, the 10-year Treasury yield took a round trip in 2023, ending exactly where it began, at 3.88%.

The resilience of economic growth suggests there's little urgency for the Fed to begin easing monetary policy. However, market-implied rate cut forecasts appear too aggressive in our view. In our CIO base case, we expect 100bps of rate cuts from the Fed this year, beginning in May, as the economy continues to slow in the months ahead and to keep real rates from becoming restrictive. Still, the recalibration process—aligning market expectations with Fed plans—may cause rate volatility. This tension was most recently on display in the aftermath of the Fed's 31 Jan meeting. The 10-year Treasury yield has drifted higher this year, and while we expect rates to trend lower overall, they will travel a bumpy road.

Nonetheless, the economy's resilience has continued driving equities, and the S&P 500 reached several new highs in January. Yield & Income sectors have responded accordingly, with MLPs and large-cap growth outperforming rate-sensitive groups like REITs and emerging markets. At CIO, we see more upside this year for both equity and bond markets. However, we maintain a preference for bonds over stocks. Valuations suggest more muted US equity returns in 2024. We favor small-cap stocks over largecaps. In fixed income, we like quality bonds including investment grade corporates and agency MBS. As rates decline, cash-heavy investors face reinvestment risk. Now is the chance to reallocate.

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For more, read the full report **Yield & Income: The road to redemption** 31 January 2024.

Also see the **Monthly Letter: Key questions for 2024** 18 January 2024.

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