CIO thinks investors should complement core holdings with tactical exposure to US small caps, which trade at attractive relative valuations and would benefit more from faster Fed rate cuts. (UBS)

Stocks rebound amid supportive sentiment

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US equities rebounded on Monday amid a rally in big tech and dovish comments from Fed officials. Both the S&P 500 and Nasdaq Composite rose the most since mid-November, by 1.4% and 2.2%, respectively.

While one day's performance can hardly prove any trend, we continue to see evidence that our "soft landing" base case scenario is the highest probability outcome for markets this year.

Fed sends more dovish signals. Federal Reserve Governor Michelle Bowman on Monday retreated from her usually hawkish view, saying she now sees US monetary policy as "sufficiently restrictive" and that she would support eventual interest rate cuts as inflation eases. Separately, Atlanta Fed President Raphael Bostic said inflation has come down more than he expected and is on a path to reaching the central bank's 2% goal, although he repeated his expectation for a first cut to be in the third quarter of this year. In another dovish message, Dallas Fed President Lorie Logan said the Fed should slow the pace of its balance-sheet reduction and gradually end the program. While no date has been set, it was the first sign that the Fed is mulling an end to quantitative tightening.

Inflation expectations fall further. US consumers' one-year inflation expectations in December fell to the lowest level since January 2021, according to the latest survey by the Federal Reserve Bank of New York. At 3%, last month's figure was below November's 3.4% and the 5% print of a year ago. The survey also reported that consumers anticipate inflation to decline over the course of the next three and five years. US inflation data for December will be released on Thursday, with markets expecting a decline in the core Consumer Price Index.

Growth remains healthy. In the same Fed survey, more participants expected their household financial situation to improve in the coming year, while available data so far suggest US holiday spending remained solid in the final two months of 2023. Mastercard estimates US retail sales rose 3.1%between 1 November and 24 December, in line with historical averages, while several retailers have also put out constructive holiday updates. This points to relatively strong household balance sheets, in our view, consistent with our expectation of growth slowing to just below trend.

So, we expect modest upside for global equity indexes and see quality stocks as a core holding for investors. History shows they tend to outperform in periods of slow economic growth, as we expect in our base case. We keep a most preferred stance on the IT sector within US equities, as it is home to many quality stocks. We also think investors should complement core holdings with tactical exposure to US small caps, which trade at attractive relative valuations and would benefit more from faster Fed rate cuts.

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