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With the economic and political backdrop still highly fluid, CIO believes it is important for investors to prepare portfolios for a range of outcomes. (UBS)

The importance of strategies that can perform well in a range of scenarios

05 February 2024, 2:25 pm CET, written by UBS Editorial Team

In January, the US economy posted the highest monthly job creation figures in almost two years, with the January employment report topping even the most upbeat forecasts.

Job growth accelerated to 353,000 last month, versus a consensus projection of 185,000. After upward revisions to prior months, the three-month moving average of job growth sped up to 289,000 from 165,000 at the time of the December release. Average hourly earnings growth also picked up to 0.6%.

The data followed guidance from the Federal Reserve earlier in the week that rate cuts may not come as soon as the market had expected, with Fed Chair Jerome Powell saying that a reduction at the March meeting is “unlikely.” The yield on the 2-year US Treasury, which is sensitive to Fed rate expectations, rose 16 basis points to 4.37% on Friday, the largest daily increase since March. Meanwhile, the S&P 500 climbed 1.1% to a fresh all-time high, helped by optimism over the strength of the US economy and a positive earnings announcement from Meta Platforms, which added USD 197bn to its market capitalization on Friday—the largest one-day increase for any company in US market history. (See below for more) These factors helped offset renewed concern over the health of US regional banks, along with continued concern over risks relating to the conflict in the Middle East.

But despite the upbeat mood among equity investors, the mixed events of the week further highlighted the importance of considering strategies that can perform well in a range of economic scenarios:

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Anticipate a "Goldilocks" scenario. A soft landing for the US economy still looks likely, in our view, with growth slowing to slightly below the long-term trend. But the recent strength of US data has highlighted the possibility of an even brighter outcome. In a "Goldilocks" scenario, US growth would be stronger than expected, inflation would continue to slow smoothly, and the Fed would feel able to cut rates more aggressively through 2024—with perhaps six 25-basis-point cuts.

This would be broadly positive for equities, with the S&P 500 more likely to end the year around 5,300. But certain parts of the market would stand to benefit more than others—and should also fare well in our base case. In particular, US small-caps, which have lagged in recent years, would likely outperform in this more optimistic scenario. That's because nearly half the debt held by Russell 2000 companies is floating rate, versus around a tenth for large-cap companies, so they would likely gain more from a faster easing of Fed policy.

Buy quality. Despite the recent strength of US data, our base case is for a gradual growth slowdown through 2024—still consistent with a soft landing. Headwinds for consumers should continue to mount from a deterioration in housing affordability and the withdrawal of extra government benefits introduced during the pandemic. As growth slows, we expect quality bonds to benefit further. We forecast the yield on the 10-year US Treasury to fall to 3.5% by the end of 2024, versus around 4.1%as of 5 February.

We also expect investment grade corporate bonds to be well-placed to weather a period of more moderate economic growth. Within equities, we favor quality stocks—those issued by companies with strong returns on invested capital, resilient operating margins, and relatively low debt on their balance sheets. These companies should be able to generate profits in an environment of weaker growth.

Hedge market risks. We expect a supportive environment for equities and bonds this year. But investors should also keep an eye on economic and geopolitical risks that could cloud the outlook and add market volatility. This was underlined last week when the US launched airstrikes in Iraq and Syria against targets linked to Iran, in retaliation for a recent attack that killed three US troops. Although our base case is that the war between Hamas and Israel will be contained, the situation is fluid and an escalation that disrupts oil supplies remains possible. On the economic front, disappointment over the pace at which inflation falls, especially given recent strong jobs data, could dampen optimism over the pace of rate cuts from the Fed.

Investors looking to hedge against the risk of equity market losses can make use of structured strategies with capital preservation features. Such strategies are particularly attractive in times of higher bond yields and average or below-average implied equity market volatility. Investors worried about the potential market impact of a further escalation in the Israel-Hamas or Russia-Ukraine wars can consider hedging portfolios through oil market investments or energy stocks.

So, with the economic and political backdrop still highly fluid, we believe it is important for investors to prepare portfolios for a range of outcomes.

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