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Yield and Income: Visions of sugarplums

01 December 2022, 5:22 pm CET, written by UBS Editorial Team

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In November, investors continued to pin their hopes to a vision of economic soft-landing wherein inflation continues to fall as growth slows but remains robust with a strong labor market. This would enable the Federal Reserve to end its rate hikes sooner or at a lower level than expected and possibly even begin to lower rates. The 10 November release of inflation data further energized the "Fed pivot" rally that began in October. Inflation for services remains elevated, but the October CPI rose at a slower-than-expected pace as core goods prices fell. This drove a historic stock market surge, with the S&P 500 posting a one-day gain of 5.5%.

Nonetheless, the Fed's inflation fight is far from over. After the 2 November FOMC meeting, Fed Chair Jerome Powell said, "it is very premature to be thinking about pausing" rate hikes. After four consecutive 75-basis-point increases, investors have been encouraged by the notion of smaller rate hikes from here. This possibility was supported by the minutes of the latest Fed meeting, and the market is pricing a 50bps Fed hike on 14 December. But a slower pace of monetary policy tightening is not the same as pausing and could still lead to a higher-than-expected peak rate. In the weeks following the October CPI release, Fed officials continued to stress the need for tighter monetary policy in light of more persistent trends in the labor market and inflation data.

So the Fed remains hawkish and the market has somewhat aligned with Fed guidance of a slower pace of rate hikes toward a higher peak. However, current pricing of risk assets may be inconsistent with this degree of monetary policy restriction. The latest rally appears to reflect a "fear of missing out" (FOMO) on a year-end rally rather than fundamentals. Earnings forecasts appear too high, and the difference between long-term and short-term yields has grown. While the

2-year Treasury yield is 4.4%, the 10-year rate is 3.7% for a difference of 70bps, the widest gap in 40 years. Yet, strong equity market trends and declining rates in November supported broad gains for Yield & Income sectors.

At the UBS Chief Investment Office (CIO), we remain cautious heading into 2023. While overall year-over-year inflation has likely peaked, tight labor markets and higher employment costs may drive persistent price increases particularly in the services sector. Earnings expectations do not fully reflect these and other operating pressures, and earnings risk is likely to pressure stocks. Against this backdrop, the Fed is willing to accept the risk of "overtightening."

In our base case, the US economic expansion continues but at a below-trend pace. A mild recession is possible particularly as it relates to the labor market, where the Fed's own projections are consistent with recession. Given our outlook, the risk-reward proposition over the next three to six months appears unfavorable.

We continue to focus on defensive sectors such as consumer staples and healthcare, as well as value stocks and dividend-paying equities. Weaker growth and inflation should support fixed income, and we favor higher-quality sectors including agency Mortgage-backed securities.

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Reach out to your financial advisor for a copy of the full repot "Yield & Income: Visions of sugarplums," 30 November 2022.

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