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CIO Alert: Stocks fall on hawkish central bank signals

20 December 2022, 03:24 am CET, written by Mark Haefele

Global stocks fell following hawkish signals from top central banks, including the ECB and the SNB. That followed indications from the Fed on Wednesday that further action will be needed to curb inflation. The news underlines our view that markets had moved too fast in anticipating an end to the rate hiking cycle. We recommend a defensive tilt across asset classes.

The S&P 500 fell 2.5%, as top central banks tightened policy and indicated that more needed to be done to bring inflation under control. The European Central Bank, Swiss National Bank, and Bank of England all raised rates by 50 basis points on Thursday, following a similar move by the Federal Reserve on Wednesday. But while the hikes were expected, it was the hawkish accompanying statements by central bankers that unnerved investors.

ECB President Christine Lagarde said that rates will "still have to rise significantly and at a steady pace," adding that further 50bps increases were possible at each of the next three meetings. Futures markets moved to price a peak in rates of just over 3%, up from 2.75% prior to the meeting. In a similar vein, SNB Chair Thomas Jordan said it was too early to "sound the all-clear" on high inflation, and further rate rises "cannot be ruled out." The BoE also warned of the need for higher rates in the coming months.

These comments reinforced the message delivered on Wednesday by Fed Chair Jerome Powell, who said the central bank still had "some ways to go." While the Fed decision produced only a modest market reaction on Wednesday, with a 0.7% fall in the S&P 500, the cumulative impact of various central bank statements took a heavier toll on confidence on Thursday. The Euro Stoxx Index fell 3.5%, Switzerland's SMI declined 2.5%, and even the more defensive UK FTSE 100 index was off 0.9%. The risk-off mood was also underlined by a widening of the yield gap between the safest and riskier sovereign bonds in the Eurozone. The spread between 10-year German and Italian yields increased after the ECB announced plans to stop replacing maturing bonds and so drain liquidity.

US economic data added to investor anxiety. A fall in first-time claims for unemployment benefits in the latest week underlined the Fed's concern that demand for labor remains in excess of supply. Meanwhile, retail sales in November fell 0.6% month-over-month, the largest decline in 11 months, highlighting that while the labor market remains tight, consumer budgets are under pressure.

What do we expect?

We expect inflection points on inflation, monetary policy, and growth in 2023. But in our view, fundamental conditions are not in place for a sustainable rally, and markets got ahead of themselves in pricing in a brighter outlook. The latest statements and forecasts from central banks reinforce this view.

The FOMC on Wednesday provided clear indications that it does not believe it has accomplished its mission to restore price stability. The dot plot pointed to a strong consensus among policymakers for at least a further 50bps of tightening —17 of the 19 policymakers forecast rates peaking above 5%.

While recent inflation readings have been encouraging, including the November consumer price index released earlier this week, the Fed stressed that service prices remained a concern, driven by strong wage growth. Powell said that the US appeared to be experiencing a structural labor shortage, meaning that an increase in workers returning to the market was unlikely to bring wage growth lower. This view has been supported by the labor force participation rate in recent data, which declined for the third consecutive month in November. Average hourly earnings also rose 0.6% in November, following an upwardly revised 0.5% in October.

Thursday's comments from a wider range of top officials indicate that other central bankers also believe that more tightening is needed. The S&P 500 is now around up 8.9% from its 2022 low struck in mid-October. We do not see this as fully reflecting the drag on growth imposed by prior tightening. In our view, this slowdown will take a toll on S&P 500 earnings, which we expect to contract by 4% in 2023. Bottom-up consensus earnings growth expectations are currently 5%, which may be too optimistic.

How do we invest?

The recent rebound in stocks took the S&P 500 as much as 14% higher from its 2022 low in mid-October, and in our view, risks remain for a further retracement. However, we prefer to use options to mitigate this risk, rather than reducing our allocation to equities.

In addition, when adding exposure, we continue to favor a more defensive stance. In equities, we favor healthcare and consumer staples—sectors that are less vulnerable to the economic slowdown. Regionally, we like the cheaper and value-oriented UK and Australian equity markets relative to US equities, which have a higher exposure to technology and growth stocks, and where valuations are higher.

In fixed income, we see high grade and investment grade bonds as offering attractive yields with some protection against recession risks. Moreover, with the Fed being more advanced in its tightening cycle than the ECB—and with quantitative tightening already under way in the US—we expect 10-year US Treasuries to outperform 10-year French OATs.

We also recommend considering exposure to less correlated hedge fund strategies, including macro funds, which can be well-placed to navigate volatile markets.

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