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Stocks rally despite disappointing earnings

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Stocks rallied on Friday despite slowing earnings momentum and economic data showing US inflation remains elevated. The S&P 500 closed 2.5% higher and the tech-heavy NASDAQ index gained 2.9%.

Sentiment was mixed on Monday, with Japan's Nikkei 225 up 1.8% but the Hang Seng ending 1.2%lower, and US futures pointing to a weaker start for the S&P 500.

After a series of disappointing mega-cap tech results throughout last week, signs of resilience in demand from Apple were sufficient to send its stock 7.6% higher, pulling the index up with it. Markets were also supported by rising optimism about central banks "pivoting" to a slower pace of rate hikes, following the Bank of Canada's smaller-than-expected 50-basis-point hike, comments from European Central Bank President Christine Lagarde that the Eurozone could be headed for recession, and comments from some Fed governors since the last FOMC meeting on the potential for more moderate rate increases.

The yield on the 10-year US Treasury rose 7 basis points on Friday after the core personal consumption expenditures (PCE) price index rose 5.1% year-over-year in September compared with 4.9% y/y in August. But 10-year yields still declined over the week. As well as hopes of a central bank pivot, other data pointed to a slowing in wage pressures, with the employment cost index, the broadest measure of labor costs, increasing by 1.2% in 3Q, after rising 1.3% in 2Q. Within that figure, wages and salaries grew by 5.1% y/y in 3Q, down from 5.3% in 2Q. Private industry wages increased by 5.2% y/y, down from 5.7% in 2Q.

Oil prices fell on Friday after China imposed further COVID-19 restrictions on a number of cities, though crude still finished the week 2.4% higher. The dollar edged up marginally after losing some ground in recent days; the DXY index closed 0.1% firmer on Friday.

What do we expect?

After the 4% gain last week, the S&P 500 is now up 9% from the 12 October low. We attribute most of the move to hopes that the Federal Reserve might begin to dial back the pace of its rate hikes and technical factors related to already cautious investor positioning.

After nine consecutive weeks of outflows from global equity funds, investors put money back into stocks in the week ending 26 October: According to Refinitiv Lipper data, net inflows into global equity funds totaled USD 7.8 billion. Equity volatility also fell over the week, with the VIX index declining from 30 at the start the week to 26 on Friday. This decline may have triggered buying by systematic strategies, and the markets' momentum from the mid-October low has likely reached levels that is triggering CTA purchases.

Yet, while technical factors and shifts in investor sentiment do have the potential to drive periodic market bounces, at this stage we do not think the risk-reward favors a sustainable rally in equities.

The equity rally in the first part of last week was based on hopes of an imminent Fed policy pivot. But Friday's inflation data reinforces the case for the Fed to deliver a fourth consecutive 75-basis-point rate hike at the 2 November FOMC meeting. Despite some Fed officials commenting on the potential for a slower pace of rate hikes, we think it is too early to expect a Fed pivot. Inflation remains too high, we think the Fed sees its own credibility as at stake, and we expect it to keep hiking aggressively until the official data show inflation is receding. Even when the Fed finally does stop raising rates, it's worth remembering that monetary policy is likely to remain at restrictive levels for some time.

Meanwhile, mega-cap tech results have been disappointing overall. There has been a further pullback in digital advertising, cloud spending has downshifted, e-commerce is sluggish, and cost increases are crimping margins for many of these companies. Apple's results were the best of a poor series of mega cap tech announcements, and the stock rallied 7.6%on Friday, accounting for a quarter of the S&P 500's move. But, even here, the company also talked about an uncertain outlook and gave less precise guidance than usual.

Year-over-year 3Q S&P 500 earnings per share (EPS) growth is tracking below our original 3–5% expectation. With 70% of the S&P 500 market cap having reported earnings, it looks likely that growth will be in the 1–3% range. Only 64% of companies are beating estimates—compared to the 75% average over the last five years. The magnitude of earnings beats is also smaller, with aggregate EPS coming in only 1% better than expected, substantially lower than the five-year average of 8%.

Against this backdrop, we believe the pressure on corporate profits will only increase in the coming quarters. As a result, we look for S&P 500 EPS to fall 4% next year to USD 215. In a full-blown recession, EPS could fall to around USD 200. This compares to bottom-up consensus estimates of USD 235.

How do we invest?

As noted above, we do not think the risk-reward currently favors a sustainable rally in equities. In our view, investors will need to see Fed rate cuts or a trough in economic activity on the horizon. Today, these conditions are not in place.

As for valuations, even if we use the (optimistic, in our view) consensus forward EPS expectations, the S&P 500 price/earnings ratio has risen to nearly 17x. We find this valuation unattractive considering that recession risks remain elevated and given the current level of bond yields. The spread between the S&P 500 earnings yield and the US 10-year bond yield is now at its lowest level since the global financial crisis.

In this environment, we retain our focus on mitigating near-term downside risks, while retaining upside exposure for the medium and long term.

Within equities, we like capital protected strategies, value, and quality income. We like global healthcare, consumer staples, and energy, and have a least preferred stance on growth, industrials, and technology. Weak mega-cap tech earnings over the last week support our least preferred view on technology. By region, we like the cheaper and more value-oriented UK and Australian markets, relative to US equities, which have a higher technology and growth exposure and where valuations are more extreme.

In fixed income, we prefer high-quality and investment grade bonds relative to US high yield. And in currencies, the recent pullback in the USD should not be seen as the beginning of a trend reversal. Slowing economic growth globally and

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higher US rates amid more cautious central banks elsewhere still favor the US dollar. The Swiss franc should benefit from its safe-haven status, while exposure to growth-oriented currencies, such as the British pound, the euro or the Chinese yuan, should be hedged.

In commodities, we favor exposure to crude oil on the expectation prices will rise to USD 110/bbl next year.

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