Consumer Price Index data prompted a 5.5% rally in the S&P 500, the biggest one-day gain since April 2020, and a 25-basis-point decline in 2-year US Treasury yields, the largest daily drop since 2008. (ddp)

Bracing for volatility ahead of bellwether CPI print

13 December 2022, 1:24 pm CET, written by UBS Editorial Team

The S&P 500 rose the most in two weeks on Monday, climbing 1.4% on speculation that a further deceleration in US inflation data later today may spur the Federal Reserve to tone down its aggressive policy stance this week.

However, at the same time, the VIX measure of equity volatility rose above 25 to reach a 1-month high as investors brace for choppy trading conditions. Last month's softer-than-expected Consumer Price Index data prompted a 5.5% rally in the S&P 500, the biggest one-day gain since April 2020, and a 25-basis-point decline in 2-year US Treasury yields, the largest daily drop since 2008.

November headline inflation may decelerate to 7.3% y/y versus 7.7% in October, according to the Reuters consensus forecast. If so, this will mark the fifth consecutive month of a lower CPI after the index hit a four-decade high of 9.1% in June. November core inflation is expected to remain steady at 0.3% m/m, according to the poll. Markets are almost fully priced for the Fed to reduce the size of its rate hike on Wednesday to 50bps after four consecutive increases of 75bps. Markets are still pricing a 9% chance of another 75bps rise.

But while we expect the Fed to hike the fed funds rate by 50bps this week from the current 3.75-4% range, we think it's too early for the Fed to send a clear signal about an end to its tightening cycle. Importantly, we think the US economy has yet to fully reflect the lagged impact of the steep hikes in interest rates this year.

Twin track US economy means scope for disappointment from Fed.

While the housing and the manufacturing sectors are contracting, the labor market data—especially for the services sector—suggests that parts of the US economy are still over-heating. This two-track economy will make it difficult for the Fed to clearly signal an end to the tightening cycle and there is even scope for disappointment. Chair Jerome Powell is likely

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to point out the risks that higher rates will be needed to anchor underlying inflation pressures. Depending on how sticky inflation proves to be, we expect the Fed to conduct its final rate hike in 1Q 2023, and the risks are tilted toward further tightening if labor market data remain tight. Current market pricing projects the fed funds rate to peak at just below 5% in May.

The US economy is starting to hurt from this year's tightening.

While the labor market remains tight, large companies are beginning to lay off workers. Goldman Sachs is the latest big US bank to announce plans for layoffs, joining others like Morgan Stanley, as they brace for an uncertain economy in 2023. This follows announcements of job cuts and hiring freezes in recent months at large tech companies. Higher mortgage rates have already pushed the housing market into a recession.

As the impact of higher rates ripples through the economy, we expect growth and earnings expectations to fall through the first half of the year. Overall, we are looking for a 4% contraction in S&P 500 earnings in 2023 versus market consensus for mid-single-digit growth.

Geopolitical risks add to uncertainty.

The war in Ukraine shows no signs of coming to an end, thus posing energy and security threats to Europe as well as the risk of NATO involvement. US-China tensions are unlikely to lessen, given Beijing's increased focus on self-sufficiency and the Biden administration's moves to restrict trade on security grounds.

So, as we enter the new year, we maintain a defensive stance. We have a least preferred view on US equities and prefer more value-oriented markets, like the UK. Across sectors, we like global energy, healthcare, and consumer staples, and are least preferred on information technology and consumer discretionary. Across styles, we prefer value and quality income to growth.

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Content is a product of the Chief Investment Office (CIO).

Original report - Bracing for volatility ahead of bellwether CPI print, 13 December 2022.

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