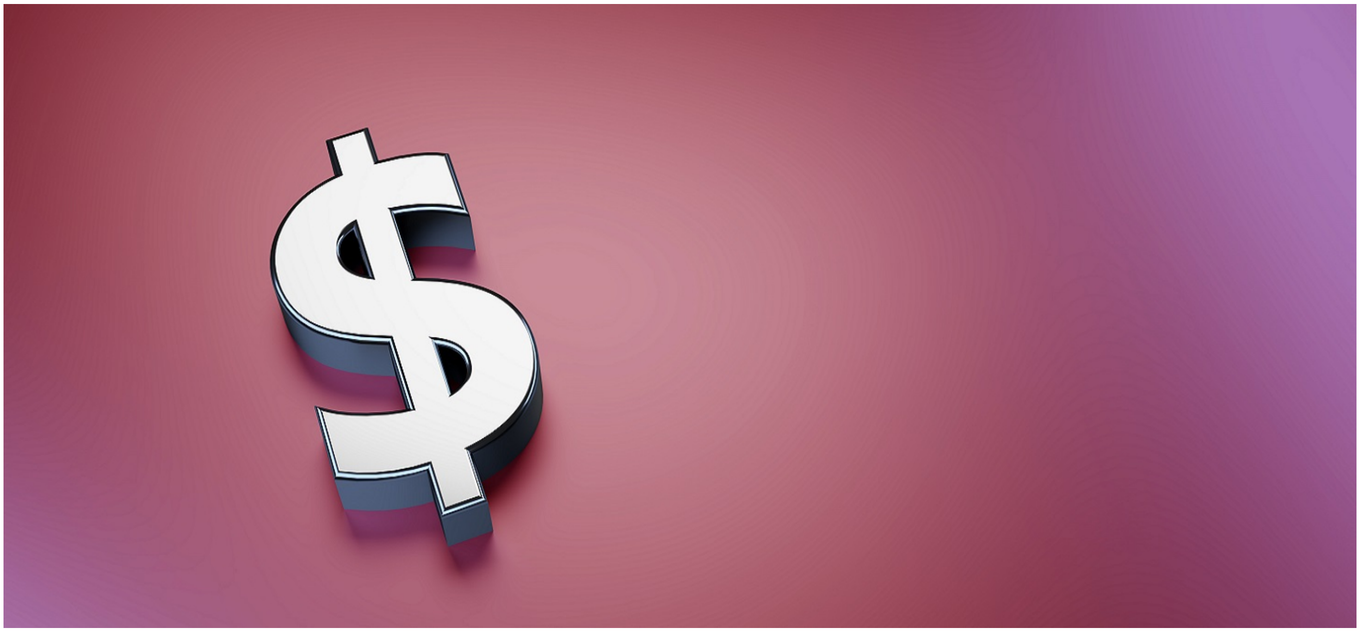

CIO favors tilting exposure toward defensive parts of both the equity and fixed income markets. (ddp)

Risks to markets come back into view

28 November 2022, 2:46 pm CET, written by UBS Editorial Team

Markets started the week in a risk-off mood, with worries over slowing growth overshadowing renewed hopes of a more dovish pivot by the Federal Reserve.

Protests in China over intensified pandemic restrictions underlined the economic headwinds facing the world's second-largest economy. The Hang Seng index ended 1.6% lower, while futures pointed to a 0.8% fall in the S&P 500.

Concerns over weaker energy demand from China, the world's largest oil importer, contributed to a 2.9% fall in the price of Brent crude, which has now fallen more than 17% since its recent peak earlier this month.

The latest market moves support our view that investors should remain cautious over the revival in risk appetite that has occurred over the past few months. Risks to growth remain a factor across asset classes, in our view.

The US dollar should benefit from renewed bouts of risk aversion, along with shifting market views on Fed policy. The DXY dollar index has now dropped around 7.5% from a multidecade peak in late September. Its decline has been fueled by rising hopes over the possibility of a slowing of Fed rate hikes, along with a broader improvement in risk sentiment—and hence a reduction of safe-haven flows into the US currency. During 2023, the US rate hike cycle is likely to end, and the US dollar should weaken when the cycle draws to a close.

However, while the dollar did not benefit from the risk-off mood at the start of this week, a further burst of strength is likely in the coming months, in our view. The decline in US inflation may be less smooth than investors appear to be assuming, and setbacks on inflation could revive concerns over the extent of monetary tightening. Downside risks for the global economy could also cause renewed safe-haven flows into the dollar. We expect the euro to fall back to 0.96 versus the US dollar by March, down from 1.04 at present.

Downward pressure on oil from a weaker global economy should be offset by lower global supplies. Brent has now more than fully reversed the sharp rise following Russia's invasion of Ukraine. At USD 81.2 a barrel, it is trading at the lowest level since early January and is up just 4.2% year-to-date, having traded as high as USD 128 in early March. Pandemic curbs in China look likely to remain a near-term headwind for crude, adding to worries over ebbing demand as the global economy slows.

That said, we remain positive about the outlook, and expect Brent to trade around USD 110 a barrel through next year. Leaders of OPEC+ exporting nations meet on 4 December and will consider steps to address the recent fall in prices. The price of oil should be supported by the European Union's ban on Russian crude imports, which comes into force on 5 December. Meanwhile, the US and other OPEC governments are ending the sale of oil from official stockpiles.

The recent equity rally looks vulnerable, in our view, especially as recession fears mount. The S&P 500 has gained 12.6% from its 2022 low in mid-October. Again, the hopes of a Fed pivot have been the main factor. While data for October showed an encouraging fall in inflation and Fed comments have recently been less aggressive, we believe the market moved too quickly to assume that the central bank has succeeded in ending the threat from inflation.

The path back toward the Fed's 2% inflation target could be bumpy, sparking renewed concerns about how high rates will have to rise. In addition, we believe markets have been downplaying the threat posed by slowing growth to earnings. We expect S&P 500 earnings to fall 4% next year, compared to a consensus for a 5% increase in earnings based on bottom-up forecasts.

So, investors should brace for continued volatility ahead. As a result, we favor tilting exposure toward defensive parts of both the equity and fixed income markets. We also recommend seeking less correlated returns from certain hedge fund strategies.

Main contributors - Mark Haefele, Christopher Swann, Vincent Heaney, Jon Gordon

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

Original report - Risks to markets come back into view, 28 November 2022.