CIO highlights their highest conviction tactical thematic equity ideas over a six- to 24-month time horizon. (UBS)

Tactical US equity themes: 4 key opportunities

17 February 2023, 4:30 pm CET, written by UBS Editorial Team

This month, the UBS Chief Investment Office (CIO) reiterates their conviction in four key themes: Reopening China, Time for quality, Resilient spending, and Pricing power standouts, and make a few changes to our stock lists. Additionally, they are closing the Security takes center stage theme.

US stocks are off to a good start this year with the S&P 500 up nearly 7% year-to-date, driving the index to a 14% gain from its October low. We attribute the strong performance to the fact that the Fed is in the later stages of its rate hiking program while at the same time US economic growth has been resilient.

Much larger than expected Fed rate hikes in 2022 weighed heavily on equity markets last year. For example, the yield on the 2-year Treasury yield surged from less than 1% at the end of 2021 to as high as 4.75% in November of last year. But since November, 2-year Treasury yields have generally moved sideways, a period that coincides with the latest equity market rally. So unless the Fed further surprises markets by raising interest rates much more than expected (because inflation proves to be sticky), the Fed may not be a source of downside risk for equity markets like it was in 2022.

But this does not mean stocks are out of the woods. There is still a great deal of uncertainty about the lagged effects of Fed rate increases. The housing market is at the epicenter of this. So far, housing-related employment has continued to rise despite the sharp decline in new and existing home sales. Homebuilders and contractors are still burning through large backlogs of activity. But unless housing activity picks up—which seems unlikely due to very poor affordability—we think it is just a matter of time before this backlog is depleted to a level that begins to result in job losses, raising fears of an economic hard landing. Still, we acknowledge that the timing of this potential labor market weakness is uncertain, and it may take some months to materialize.

So what does this all mean for equities? Despite fairly lofty valuations, in the context of year-over-year declines in profits, stocks could continue to move higher until there are signs that the lagged effects of the rate hikes are starting to come through. This suggests a fairly tricky period for equity investors.

Given this backdrop, we suggest investors stay focused on segments of the market that can continue to produce respectable earnings growth, despite the possible twists and turns in the market. In this context, our tactical themes are focused on high quality companies, those that have pricing power, or are leveraged to long-term growth drivers that are more insulated from economic growth. For those investors that are looking to take a bit more risk, we have a list of stocks that are leveraged to China's reopening. As we explain below, this month we are closing our Security takes center stage theme. More details about all of these tactical themes can be found below and in the pages that follow.

1. Reopening China—After years of enforcing a strict COVID-19 containment policy, China is rapidly exiting its zero-COVID measures putting it on track for a full reopening in Q1 2023. Top policymakers have shifted the focus to economic growth and are likely to continue to adopt pro growth initiatives to smooth the path. We identify US companies that we expect to benefit.

2. Time for quality—High quality stocks tend to perform well later in the business cycle or when the economy is in recession. With limited or no slack in the economy, it is clear that the business cycle is somewhat mature. This suggests that investors should focus on high-quality

3. Resilient spending—Businesses that are leveraged to infrastructure, renewables, defense, aerospace aftermarket, energy efficiency, segments of enterprise IT spending, and efforts to expand energy supply should remain relatively well-supported despite a more uncertain macro environment.

4. Pricing power standouts—Still-elevated input costs have created a more challenging backdrop for many businesses. Companies with pricing power should be better able to pass on these costs to consumers and protect profit margins. We identify companies with pricing power as those with historically high and stable gross profit margins and a large market share in their respective industries.

Finally, we are closing the **Security takes center stage** theme. We still believe we are in an era of security that will drive higher spending on defense, food, energy, and technology security. However, the near-term outlook for US defense spending has become more uncertain in the context of the likely contentious battle to raise the US government debt ceiling. During this process there could be calls to reduce military spending. Still, we believe select companies continue to have a favorable outlook in the near-term, and we shift some of those names to other themes in our thematic suite. We still think investors should have some exposure to defense spending, but, in our view, it does not warrant maintaining a stand-alone theme at this time. All previous views and estimates should not be relied upon going forward.

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Reach out to your financial advisor for a copy of the full report "Tactical US Equity Themes: monthly update," a one-stop resource to access CIO's highest conviction thematic equity ideas.

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