CIO sees upside for high-quality government bonds where there is scope for capital gains in the event of an economic downturn. (ddp)

Equities still vulnerable despite lift from inflation data

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US stocks got an initial boost after inflation data from the US added to hopes that an end to rate hikes is in sight. The Consumer Price Index rose 4.9% in the year to April, below the consensus forecast of economists for 5%.

Annual inflation is down from a peak of 9.1% last June, which was the fastest increase in four decades. Core inflation, excluding volatile food and energy prices also moderated, slowing to 5.5% on an annual basis from 5.6% in March.

The data caused markets to revise up the probability that the Federal Reserve will keep rates on hold at its June meeting, ending a series of 10 consecutive hikes that have taken the fed funds rates 500 basis points higher. Futures markets are now implying the possibility that rates could start coming down as soon as July.

But while inflation is trending in the right direction, we still see potential for disappointment among equity investors on the pace of Fed easing in the remainder of this year.

Inflation is still well above the Fed's comfort zone. It is worth noting that inflation undershot the consensus expectation by just 0.1 percentage points on a headline basis in April. The m/m inflation measures could also make it hard for the Fed to justify rate cuts anytime soon. On a core basis, CPI increased 0.4% for April, showing no deceleration over March. Finally, at 5.5% annually, the core rate of CPI inflation, excluding food and energy, remains far higher than the level that would be consistent with the Fed hitting its 2% target, based on the personal consumption expenditure index —an alternate but related measure of prices.

The most recent labor market data looks too hot to justify a further dovish shift in Fed policy. Officials at the May Federal Open Market Committee (FOMC) meeting indicated that rate rises going forward would be data-dependent, with the employment figures a key variable. We believe several elements of the April employment data are likely to concern policymakers. The jobless rate moved back down from 3.5% in March to 3.4% in April, matching a 69-year low. Wage

growth accelerated to 0.48%m/m, the highest since March 2022. And while employment growth was revised down for the prior two months, it surprised to the upside for the thirteenth month in a row, rising 253,000 in April. This is well in excess of the growth rate of the working age population.

Equity markets are pricing in an overly rosy outcome for the economy, in our view. The S&P 500 is trading at roughly 18.3 times forward earnings over the coming 12 months, a 13% premium to the 10-year average, as of 8 May. Historically, when the S&P 500 has traded above 18x, consensus earnings growth expectations are robust (14% on average), or the 10-year Treasury yield is less than 2%. At present, we expect S&P 500 earnings to contract 5% in 2023, and the 10-year Treasury yield is 3.43%. As a result, we believe US equities are pricing a high probability of a near-perfect outcome for the US economy. Yet tighter financial conditions, declining corporate earnings, and relatively high valuations all present risks, in our view.

So, against this backdrop, we remain least preferred on equities relative to fixed income. In particular, we see upside for high-quality government bonds where there is scope for capital gains in the event of an economic downturn.

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