The rally in the S&P 500 on Monday was sent into reverse after top Fed officials reiterated a more hawkish line on the outlook for rates. (ddp)

Fed's dovish pivot remains elusive

10 January 2023, 1:07 pm CET, written by UBS Editorial Team

Equity market sentiment has been positive at the start of the year, with the S&P 500 gaining 1.4% and the Euro Stoxx 50 surging 6.7%. The main impetus—as with several rallies in 2022—has been renewed hopes of a dovish pivot by central banks, especially the Federal Reserve.

Optimism over less aggressive tightening was fueled last week by a steep decline in the ISM services index, which pointed to a contraction in December, and some early signs of moderating wage growth, with the increase in average hourly earnings slowing.

But a rally in the S&P 500 on Monday was sent into reverse after top Fed officials reiterated a more hawkish line on the outlook for rates. We continue to believe that markets have moved too quickly to position for an inflection point in Fed policy, and that conditions are not yet in place for a sustained equity rally.

Fed officials have consistently pushed back against the more dovish policy stance being priced by markets. Futures are now implying that rates will peak around 4.95% in June and that the Fed will bring rates back down to 4.5% by the end of the year. That is at odds with the message from policymakers. Based on the most recent dot plot, most Fed officials expect a peak in rates between 5% and 5.25%, and the minutes of the Fed's December meeting showed no top policymaker backing rate cuts until 2024.

On Monday, Atlanta Fed President Raphael Bostic and San Francisco Fed President Mary Daly reinforced this message. Bostic said rates should stay above 5% for "a long time," adding that he was "not a pivot guy." Daly said she also expected rates to go above 5%, and that how far above 5% would depend on incoming data. In addition, Fed officials have warned that "an unwarranted easing in financial conditions" due to market hopes of a dovish shift in policy would "complicate" efforts to restore price stability—implying this could cause rates to stay higher for longer.

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Evidence that wage growth is slowing remains tentative. While the latest monthly employment report showed the rise in average hourly earnings slowing to 4.6% in December, down from 5.1% in November, this series does not adjust for the changing mix of jobs. As a result, the figure can be suppressed by an increase in the share of lower paid or part-time jobs.

The Fed will be looking at a broader range of employment indicators, and most of these still point to excessive demand for labor. The three-month rolling average of wage growth was at 6.4% for November, based on the Atlanta Fed's Wage Tracker. Importantly, the quit rate remains high, which is associated with strong wage growth. Atlanta Fed's data show that job switchers are achieving wage growth of 8%. In addition, at 3.5% in December, the unemployment rate matched a 50-year low.

Investors should be careful what they wish for on growth. Equities have been helped in recent weeks by any signs of slower growth, including most recently the ISM nonmanufacturing index for December, which pointed to an unexpected contraction last month. While such readings may contribute to less aggressive tightening from the Fed, a weaker economy also erodes the outlook for corporate profits. In an environment of high inflation and less accommodative central banks, equity returns will likely rely more on earnings per share, which now we expect to contract next year by 3% globally, versus a consensus for a 3% increase.

We do expect an inflection in central bank policy later on this year. More risk-tolerant investors can look to anticipate this turn by phasing into markets, seeking early winners from a global improvement in sentiment, and identifying beneficiaries from China's reopening. However, we don't believe we have yet reached the inflection point in policy or economic growth, and as we enter 2023 we continue to favor a defensive tilt when adding exposure in both equity and fixed income markets.

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

Original report - Fed's dovish pivot remains elusive, 10 January 2023.

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