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Leading indicators of profit growth continue to suggest that caution in US equity positioning is warranted.(UBS)

Equity backdrop remains challenging despite solid earnings

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Earnings estimates for S&P 500 companies for the next 12 months have started to stabilize and move higher, reversing the weakness since June last year. This follows a better-than-expected first-quarter earnings season, which is now drawing to a close.

The improvement has been fairly broad-based, with the median estimate up by 1.2% over the last two months. The weaker dollar, cost-cutting initiatives, stabilization in some end-markets such as housing, cloud computing, and digital advertising, as well as stronger growth in Europe and China have all played a role.

However, leading indicators of profit growth continue to suggest that caution in US equity positioning is warranted.

Tighter credit conditions are likely to weigh on growth. The Federal Reserve's Senior Loan Officer Opinion Survey is one of the best leading indicators, and it is clearly pointing to weaker growth. The latest results of the quarterly survey showed that a net 46% of banks are making lending standards stricter for medium and large businesses, and nearly 47% of them said credit terms were stiffer for small businesses. These compare with 44.8%and 43.8%, respectively, in the January survey. Banks added that firms of all sizes were showing less demand for credit than three months earlier.

The Fed is unlikely to pivot toward the dovish side. While the US headline consumer price index continues to ease, it is worth noting that inflation in April undershot the consensus expectation by just 0.1 percentage points. The core rate of CPI inflation remains far higher than the level that would be consistent with the Fed hitting its 2% target, and the most recent labor market data are likely to concern policymakers, with the jobless rate moving back to a 69-year low. We think the US central bank will refrain from hiking rates at its next meeting in June, but a rate cut remains further down the road.

The US economy remains on a slowing path. US GDP growth for the first quarter slowed more than expected to an annualized pace of 1.1%, while the ISM Manufacturing Purchasing Managers' Index in April remained in contraction territory (below 50) for the sixth consecutive month. Last Friday, the University of Michigan consumer sentiment index fell sharply to a six-month low of 57.7 in May, suggesting weakening consumption.

So, we see the risk-reward tradeoff for US equities as unattractive. In a soft landing scenario, we think the S&P 500 could rise to 4,400 by year-end (7%upside), but if the economy slips into a recession, we believe the market could fall to 3,300 (20% downside). Given this asymmetric skew, we have a least preferred rating on equities relative to bonds, especially in an environment where high-quality fixed income offers competitive returns.

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