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Stocks and bonds fall on upbeat US services data

06 December 2022, 1:53 pm CET, written by UBS Editorial Team

US equities fell and Treasury yields rose on Monday as strong US service sector data raised concerns that the Federal Reserve may have to raise rates by more than expected.

The S&P 500 closed 1.8% down in a broad-based decline, with all sectors finishing lower on the day. The tech-heavy Nasdaq fell 2.1%. Yields on 2-year and 10-year US Treasuries increased 13 and 11 basis points, respectively. Expectations for the terminal Federal Reserve policy rate also edged 9bps higher, with the May 2023 federal funds futures implying a peak at a fraction above 5%. The US dollar rallied, recouping a small part of its recent losses, with the DXY index gaining 0.7%.

The ISM nonmanufacturing purchasing managers' index rose unexpectedly to 56.5 in November from 54.4 in October, beating expectations for a decline to 53.1. The business activity reading jumped to 64.7 (vs. 55.7 in October) and the employment measure rose to 51.5 (vs. 49.1). The ISM attributed these increases in part to the start of the holiday season. The gauge of new orders fell slightly, and the prices paid measure declined to 70 (vs. 70.7). The ISM manufacturing PMI for November released last week fell into contraction territory at 49, the lowest reading since May 2020.

What do we expect?

The latest ISM data underline the divergences evident in the US economy as spending continues to shift from goods to services: The weakening manufacturing sector contrasts with robust services activity.

The prices paid component in the nonmanufacturing PMI declined, but only modestly. While inflation has likely peaked, price pressures in the services sector are proving slow to abate—as Fed Chair Jerome Powell highlighted in his speech at the Brookings Institution last week.

Powell also noted that wage growth remains "well above the levels that would be consistent with 2% inflation over time." His view was borne out by a surprise increase in average hourly earnings in last Friday's nonfarm payroll report. Earnings increased by 0.6% month-over-month in November, after rising 0.5% in October and 0.4% in September.

Bringing inflation down from 40-year highs toward the Fed's 2% target is unlikely to be a smooth process. We appear to be heading for a situation where inflation is slowing from its peak but is not on track to hit the 2 target because of rapid wage growth. We think this could eventually end up forcing the Fed to raise rates beyond the 5% terminal rate currently priced into markets. However, we still expect the Fed to moderate the pace of hikes to 50bps at the FOMC meeting on 14 December.

Recent market reaction to good economic news has been to interpret it as bad news for equities and bonds, as the Fed is less likely to be able to pivot to a more accommodative stance in the near term. However, despite resilience in the service sectors of the economy, we think GDP growth is likely to slow further next year as the cumulative impact of Fed rate hikes weighs on activity. In turn, this is likely to take a toll on corporate earnings. We expect 2023 S&P 500 EPS to contract 4% and believe bottom-up consensus expectations for 5% growth may be too optimistic.

How do we invest?

We do not think the economic conditions for a sustained upturn are yet in place. But given the prospect of periodic rallies, we prefer strategies that add downside protection while retaining upside exposure. Growth is slowing and central banks are still raising rates. We think the inflection point will be reached when a trough in economic activity is in sight and investors can confidently expect rate cuts, rather than a slower pace of hikes.
We prefer the more defensive areas of the equity market—including consumer staples, healthcare, and quality-income stocks—which should be relatively resilient as economic growth deteriorates.

We also favor value stocks, which have outperformed growth stocks by 19 percentage points in the first 11 months of 2022, based on MSCI indexes. While peak inflation has likely passed in the US, inflation above 3% has historically favored value stocks relative to growth, and we only expect inflation to fall below 3% toward the end of 2023.

While we expect global growth to slow, we think the oil market is sufficiently tight to support higher prices, and we continue to prefer the energy sector, which trades at a close to 50% discount to its 10-year average forward price-to-earnings ratio.

In fixed income, in an environment where we expect defaults to rise, we prefer higher-quality and investment grade bonds versus high yield.

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

Original report - Stocks and bonds fall on upbeat US services data, 6 December 2022.

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