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Rally on soft inflation runs out of steam

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

The S&P 500 initially climbed as much as 2.5% on Tuesday, after muted inflation data added to hopes that an end to Federal Reserve rate hikes is in sight. But the rally ran out of momentum, leaving the index 0.7% higher by the end of trading. The positive tone carried through to Asia markets on Wednesday, with most equity indexes advancing.

The US core consumer price index (CPI), which excludes food and energy, rose 0.2% month-over-month in November, the slowest pace in over a year. The headline rate of inflation climbed 0.1% versus a consensus forecast of 0.3%. That took the year-over-year rate down to 7.1%, the lowest since December 2021 and well below a high of 9.1% in June.

The data reinforce market expectations that the Fed will raise rates by just 50 basis points at its policy meeting on Wednesday, after four consecutive meetings at which it hiked by 75bps. However, after a risk-on response to the immediate release of the data, investors will now be looking to see if the rhetoric from monetary policymakers contains any hawkish surprises.

Despite the later reversal in stocks, the federal funds futures market moved to price in less aggressive policy from the Fed, bringing the peak in rates to around 4.85% by May, down around 14bps over the course of the day. The 2-year US Treasury yield, which is sensitive to Fed policy expectations, fell 16bps to 4.22%. The 10-year yield also fell sharply, down 11bps to 3.5%. The DXY dollar index, which has benefited for much of 2022 from safe haven flows and expectations of aggressive Fed rate rises, fell to its lowest level since June and is now down around 9% from a multi-decade peak hit in August.

Last month’s softer-than-expected inflation data prompted a 5.5% rally in the S&P 500, the biggest one-day gain since April 2020, and a 25bps decline in 2-year Treasury yields, the largest daily drop since 2008.

What do we expect?

The November inflation data supports our view that inflation has passed its peak. Core goods prices fell 0.5%, the second consecutive monthly decline, adding to evidence that the distortions caused by the COVID-19 pandemic—including supply chain disruptions and excessive demand for goods—are unwinding. Notably, the price of used cars and trucks fell 2.9% month-over-month, and new vehicle prices were flat. Apparel prices rose 0.2% following two consecutive months of declines. Services inflation moderated to 0.4%, down from 0.5% in October and half the rate of September. Shelter costs, which account for about a third of CPI, continued to rise strongly, up 0.6% month-over-month. But this partly reflects a stronger market earlier in the year. As rental agreements end and are renegotiated, shelter inflation should abate, in our view.

But while inflation is moving in the right direction, investors should continue to brace for challenges. In addition to further muted inflation releases, the Fed will also need to see a cooling of the labor market. Median wages were still rising by 6.4% in November, based on the Atlanta Fed's three-month moving average. In a speech on 30 November, Fed Chair Jerome Powell stressed that the US labor market shows "only tentative signs of rebalancing," and wage growth remains "well above the levels that would be consistent with 2% inflation over time."

With demand for labor still robust, the market may have moved too far in pricing in an end to rate rises, in our view. While we expect the Fed to slow the pace of rate rises at its Wednesday meeting, policymakers are likely to stress that the job of curbing inflation is not yet over. A slowing of job creation and wage growth will be needed before the Fed can stop hiking.

In addition, markets are not fully reflecting the drag on growth imposed by prior tightening. In our view, this slowdown will take a toll on S&P 500 earnings, which we expect to contract by 4% in 2023. Bottom-up consensus earnings growth expectations are currently 5%, which may be too optimistic.

How do we invest?

In our view, the rally in the S&P 500 since mid-October has moved too quickly to price in good news. We have preferred to hedge downside risk, rather than reducing our allocation to equities. We continue to favor a more defensive stance when adding exposure. In equities, we favor healthcare and consumer staples—sectors that are less vulnerable to the economic slowdown. Regionally, we like the cheaper and value-oriented UK and Australian equity markets relative to US equities, which have a greater exposure to technology and growth stocks, and where valuations are higher. In fixed income, we see high grade and investment grade bonds as offering attractive yields with some protection against recession risks.

We also recommend seeking returns in less correlated hedge fund strategies. Overall, hedge funds have outperformed in 2022. In the first 11 months of the year, the HFRI Fund Weighted Composite Index posted a negative return of 4.1% compared to a 16% decline in the MSCI All Country World Index and a 15% loss for the Bloomberg Global Aggregate Total Return Index. But certain strategies have produced positive returns; the HFRI Macro (Total) Index, for example, was up 8.2% in the first 11 months of the year, with all sub-strategies producing positive returns year-to-date.

Adding private market exposure can also help investors smooth returns and focus on long-term value creation. Between 2001 and 2021, global private equity (CAPE Global Private Equity Index) returned 13.8% annually, compared to 7.1% for publicly traded global equities (MSCI ACWI). While we expect additional valuation markdowns into the year-end as public markets fall further, it is unlikely that private investments will be marked down to the same extent as public markets. Looking at the past three recessions, US private equity markdowns on average only reflected 55% of the S&P 500 drawdown, as measured by Cambridge Associates US Buyout. Investors should bear in mind that both hedge funds and private markets come with certain drawbacks, including the risk of illiquidity. Investors need to be willing and able to lock up capital for longer.

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

Original report - [Rally on soft inflation runs out of steam, 14 December 2022.]

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