CIO thinks equities are responding not to earnings but to improvements in other areas. (ddp)

New year, new market

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US equity markets are off to a strong start this year, with the S&P 500 up nearly 8% and the NASDAQ surging nearly 15%. While we are in the middle of the US earnings season, we wouldn't attribute these gains to the 4Q results, which have been somewhat lackluster.

Similar to recent quarters, we are seeing weakness in the areas that benefited in the early stages of the pandemic recovery—housing, goods, PCs, digital advertising, and cloud spending—largely due to a normalization in activity from elevated levels. Results from mega-cap tech earnings last week affirmed this view. On a more positive note, consumer spending remains resilient driven by excess savings and the strong labor market. Last week's employment report, initial jobless claims, and JOLTS survey data all reaffirmed this backdrop.

As of the end of last week, nearly 70% of the S&P 500 market cap had reported quarterly results, with 68% of companies beating earnings estimates and 63% beating sales estimates—both lower than average. In aggregate, earnings are missing by almost 1% but this is somewhat skewed by poor results from the largest companies. The median company is beating profit estimates by about 3%. S&P 500 profits are on pace to decline about 3% versus the year-ago period. So, the earnings recession has already started and—based on management team guidance—earnings look poised to modestly contract again in the first quarter. This is consistent with our view for S&P 500 EPS to decline 3–4% to USD 215 in 2023. Tighter financial conditions and the lagged effects of the Fed's rate hikes will likely keep earnings under pressure.

Better growth, inflation, and the Fed

We think equities are responding not to earnings but to improvements in other areas. First, the outlook for global economic growth has improved. The decline in natural gas prices in Europe—largely due to the mild winter—and the lifting of COVID-19 restrictions in China should both lead to a better tone to global economic growth. In addition, the US job market looks stronger than many would have expected in the face of headline-grabbing news about layoffs in some segments of the economy—especially tech. On Friday, the government reported that the US economy added 517,000 jobs in January, much better than consensus expectations for a gain of about 200,000.

Second, recent inflation readings have been a bit more benign. Despite still very healthy levels of job gains, wage pressures continue to moderate. And recent inflation reports indicate that inflationary pressures are easing, especially for energy

and goods. House prices feed into the inflation data with a lag but recent home price reductions suggest that shelter costs will also be a source of disinflation in the government statistics later this year.

Finally, while the Federal Reserve raised interest rates by 0.25% last week and will likely continue to hike rates a bit more, Chair Jerome Powell shifted his tone at the post-meeting press conference. He acknowledged that disinflation forces are gaining momentum, and he did not push back against the recent easing of financial conditions (financial conditions ease when stocks rise, interest rates fall, and companies have an easier time raising new capital). Both of these were significant changes relative to his comments over the course of 2022.

Lagged effects of rate hikes remain a risk

So, based on the improvement in GDP growth, inflation, and Fed policy, equity markets seem to be pricing in higher odds that the US economy can avoid a recession. While we admit there have been improvements in the outlook, we don't think stocks are in the clear. Even though Fed rate hikes may be entering the endgame, bear in mind that monetary policy works with long and variable lags. So, it's possible we have not yet seen the full effect of last year's rate hikes. For example, despite the slowdown in housing activity, residential construction employment continues to rise. It seems likely that employment in this segment could come under pressure in the months ahead.

Second, we would attribute a meaningful portion of the move higher in equities this year to lopsided positioning. Many investors had been positioned fairly cautiously, and the moves in equities may have been exaggerated by the unwinding of some of these positions. Lastly, valuations appear full. The S&P 500 P/E multiple is now over 18x. We could justify this somewhat elevated multiple if earnings were below trend (they are more than 10% above trend), earnings growth look poised to accelerate rapidly, or if interest rates were at rock bottom levels like they were in 2020/21. But none of those conditions appear to exist today.

So, in our view, the risk-reward tradeoff for equities does not look appealing. We continue to recommend that equity investors position defensively and be prepared for additional volatility ahead. Our S&P 500 year-end price target is 4,000. But, as always, we keep an open mind about potential changes in the outlook.

Main contributors: Solita Marcelli, David Lefkowitz

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