Overall resilience in the American economy has underpinned investor optimism and fueled equity performance over the past few weeks. (UBS)

The S&P nears 5,000: Starting the year on the right foot!

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The S&P hit record highs this week, fueled by tech stocks and strong consumer spending. The UBS Chief Investment Office (CIO) believes investors should focus on quality, in both bonds and stocks, in this environment.

The S&P has been trading near the 5,000 level, which would imply a ~5% increase year-to-date, following the robust ~25% rise posted in 2023. Note that the market now sits ~50% higher than where it was before the COVID-19 pandemic hit, with roughly half of the performance attributed to the outstanding value creation of the Magnificent 7 tech companies.

For context, the two companies that have rallied most this year—unsurprisingly—are key firms within the technology space: NVIDIA and Meta. "Demand for AI compute capacity remains very strong, benefiting NVDA," says Kevin Dennean, CIO Equity Strategist, US Technology & Telecom, UBS. "It's also important to note that Meta is not only benefiting from cost discipline, but also a strong digital ad market and good execution enabled by AI. Their use of AI for content recommendations seems to be driving higher engagement, and this engagement is monetized through advertising."

More broadly, overall resilience in the American economy has underpinned investor optimism and fueled equity performance over the past few weeks.

In particular, stronger-than-expected 4Q23 real GDP data, surprisingly hot employment figures for January, along with inflation trending toward 2%, and a good earnings season provides a context that supports bullishness and the increase in valuations.

Moreover, at this point monetary policy appears to be a potential tailwind rather than a headwind, with the Federal Reserve having the room to cut rates if economic data start to display unexpected weakness.

Our take: Our base case remains for a soft landing for the US economy, with the S&P 500 ending the year around current levels. However, recent economic data have highlighted the potential for a period of continued stronger growth, benign inflation, and swifter monetary easing. In this context, we think there is a rising likelihood of our "upside scenario" in which we envisioned a year-end S&P at 5,300. We believe this would be a particularly positive outcome for small-cap stocks, which benefit more from Fed easing given their greater reliance on floating-rate debt.

We expect positive overall returns for both equities and bonds in the year ahead. Within each asset class, we believe investors should focus on quality. In fixed income, quality bonds (including sustainable and MDB bonds) offer attractive yields and should deliver capital appreciation if interest rate expectations decline, as we expect. In equities, quality companies with strong balance sheets and high profitability, including those in the technology sector and within ESG leaders, should be best positioned to outperform.

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For more, see the report **The S&P nears a milestone** 8 February 2024.