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CIO sees the risk-reward outlook for equity markets in the next three to six months as unfavorable. (Shutterstock)

Ask CIO – Equities, bonds, and energy

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US equities have rallied more than 10% from their October low. But is the rebound sustainable, or has the revival of risk appetite gone too far, too fast? For answers to this and other key questions, see our "Ask CIO" segment below.

Is the equity rally sustainable?
The S&P 500 has experienced several periodic rallies this year, though the index is still down more than 16% year-to-date. The latest rebound has lifted the index by more than 10% since its October low, as hopes have resurfaced that the Federal Reserve will pivot to a more dovish stance. But none of these bounces have lasted, and we do not think the current macro environment is conducive to a sustained rally. With inflation still high, interest rate cuts remain a distant prospect, in our view. Aggressive tightening will likely lead to further economic weakness and a contraction of US earnings in 2023.

As a result, we see the risk-reward outlook for equity markets in the next three to six months as unfavorable. In this environment, we recommend considering capital protection strategies, and prefer more defensive and value-oriented areas of the equity market. These include the consumer staples, healthcare, and energy sectors, along with quality-income stocks. Watch a short video on defensives and value.

Should I lock in improved yields?
Fixed income markets have come under pressure amid elevated inflation and aggressive central bank tightening. The Bloomberg Global Aggregate Bond index has fallen more than 20% since its peak in 2021. But after the sell-off, yields are now closer to fair value, in our view, and we see opportunities—especially in more defensive parts of the fixed income space.

We favor higher-quality segments such as high grade and investment grade bonds versus lower-quality segments such as high yield and loans.

Can energy still outperform?
After surging in early 2022, commodity prices have eased back to a roughly 15% year-to-date gain amid concerns over slowing global economic growth. The Brent crude price fell below USD 85/bbl in recent days.

We rate commodities as neutral. But there are still pockets of opportunity in the asset class, in our view, notably in energy. We maintain a preference for both energy equities and crude oil itself, both of which should benefit from tightening crude supply dynamics in early 2023. The European ban on importing Russian oil, the end of strategic sales of oil inventories in OECD countries, and gas-to-oil switching should be price-supportive factors. Our forecast is for Brent crude to rise to USD 110/bbl next year.

Read more in the latest UBS House View Briefcases: Top 10 questions answered.

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