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Ask CIO – Stocks, cash, and SI

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Equity markets have rebounded quickly from their early-March pullback, and volatility has fallen. But is the rally likely to be sustainable? Read our "Ask CIO" for our thoughts on this and other key questions.

Is the equity rally sustainable?
The S&P 500 rebounded quickly following the March banking turmoil, and volatility has fallen. But we do not think the likelihood of tighter credit conditions and lower growth is adequately reflected in US equity market pricing today. The Federal Reserve's Senior Loan Officer Opinion Survey in April confirmed tighter lending standards across business and household lending, as well as weaker credit demand.

The S&P 500 is currently trading at 18 times 12-month forward earnings. Historically, when the S&P 500 traded above 18x, consensus earnings growth expectations were robust (14% on average) or the 10-year US Treasury yield was less than 2%. We expect S&P 500 earnings to contract in 2023, and the 10-year Treasury yield is around 3.5%.

Given current valuations and the potential macro scenarios from here, we see better risk-reward in high-quality bonds than in broad US equity indexes. Within equities, we prefer more defensive sectors like consumer staples and utilities. We also recommend diversifying beyond the US market, including into emerging markets and select European themes (e.g., German equities and European consumer stocks).

What should I do with my cash holdings?
The Federal Reserve raised policy rates last week, taking the federal funds target range to 5–5.25%, but left the door open to pausing the hiking cycle at its June meeting. For many investors, rising interest rates and uncertainty over the economic outlook have increased the appeal of cash deposits. But we think this appeal is superficial. Inflation has reliably eroded the real value of cash deposits over time, with a decline in purchasing power of 21% for euros, 23% for US dollars, and 25% for sterling since 2007. Deposit rates also have the potential to fall fast as the rate-hiking cycle turns.

We believe the current market environment provides an opportunity for investors to reevaluate their liquidity holdings, and ensure they are sufficiently invested and diversified. We recommend locking in attractive yields in high-quality bonds

—for example, high grade (government) or investment grade—which also offer the potential for capital gains in the event of an economic downturn. Investors holding too much cash overall may consider averaging into diversified portfolios.

Read more in "10 reasons to put cash to work" (published 5 May 2023).

What are the key opportunities in sustainable investing?

Green investment is stepping up around the world in response to the US Inflation Reduction Act. The European Commission has responded with the EU Green Deal Industrial Plan for the Net-Zero Age. These commitments should particularly benefit innovative companies focused on improving resource efficiency, including energy (e.g., renewables, or clean air and carbon reduction solutions) and water. Read more in our recent report, "European greentech leaders: The next step up" (20 March 2023) or in "Sustainable Investing Perspectives" (8 May 2023).

We also like sustainable bonds (including green and multilateral development bonds), and see a growing opportunity to implement hedge funds and private markets within sustainable investment strategies, for example in the areas of education and health. Investors considering alternative investments like hedge funds and private markets need to be aware of risks like reduced liquidity, higher costs, and complexities.

For more topics, see Top 10 questions answered.

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Non-Traditional Assets

Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, "junk bonds," derivatives, distressed securities, non-U.S. securities and illiquid investments.
- Managed Futures: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- Real Estate: There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- Private Equity: There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- Foreign Exchange/Currency Risk: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer's "home" currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a U.S. investor.