In equities, quality companies with strong balance sheets and high profitability, including those in the technology sector, should be best positioned to generate earnings in an environment of weaker growth. (UBS)

Turn to quality amid shifting US rate expectations

29 November 2023, 2:32 pm CET, written by UBS Editorial Team

The outlook for US interest rates in 2024 remains a crucial driver of asset markets into the end of the year. Dovish comments from a usually hawkish Federal Reserve governor on 28 November (as well as more explicit commentary on when US rate cuts may start) drove down 2-year US Treasury yields to a four-month low, while markets near doubled their estimates for a Fed rate cut as soon as next March.

Fed Governor Christopher Waller, until recently one of the most hawkish members of the US interest rate setting committee, described himself as "…increasingly confident that policy is currently well positioned to slow the economy and get inflation back to 2%." Governor Waller's view that the Fed can engineer a "soft landing" without sharp rises in the US jobless rate came alongside suggestions that Fed rate cuts could follow if inflation were to continue its decline over the coming 3–5 months.

Growing market confidence that the Fed has tamed inflation and will be able to cut US borrowing costs sooner than expected in 2024 pushed down 2-year US Treasury yield to 4.69%, down around 30 basis points in just two weeks and back to levels last seen in mid-July. Gold rallied in response to both lower yields and a weaker US dollar, trading at around USD 2,040 per troy ounce at the time of writing and a six-month high, while the US S&P 500 Index closed just 1% below its year-to-date high.

But we think that investors should not expect the US economic and rate path to be a wholly smooth one next year:

Other Fed speakers struck different tones. While markets chose to focus most on Fed Governor Waller (perhaps because of the perceived change in his view), other influential Fed voices suggested a Fed "pivot" was less unanimous. Fed Governor Michelle Bowman said she "continues to expect that we will need to increase the federal funds rate further to

UBS

keep policy sufficiently restrictive to bring inflation down to our 2% target in a timely way." New York Fed President John Williams described both the deceleration in US inflation and the stability of US inflation expectations as encouraging, but held back on making forward-looking comments about the path for US rates. Beyond the Fed's next rate-setting meeting on 12–13 December, we caution that data dependency and diversity of opinion may mean further repricing of US rate expectations, and potential volatility, before the year-end.

US activity data is still sending mixed messages. While our base case is for the US economy to experience a "soft-ish" landing of decelerating growth and inflation next year, recent data releases remain ambiguous. In particular, policymakers will want to watch for the interaction between signs of a weaker US labor market and the impact on US consumption, the chief driver of US activity this year. The Conference Board's consumer confidence indicator rose in November after three straight months of decline—yet the share of respondents saying jobs were hard to find rose to its highest level since March 2021.

US interest rate pricing is prone to overshooting. Governor Waller's comments marked the first time that Fed speakers had nodded to the timing of US rate cuts since last July. However, subsequently strong activity and price data saw a sharp repricing in market rate expectations, as well as a rebound in the US dollar. We cannot rule out the risk of a repeat experience. The market-implied probability of a March Fed rate cut stands at 42% (from 22% a day earlier), while traders are pricing for 100–125 basis points of rate cuts by the year-end. This looks too early and too sharp a rate cut profile, in our view. We expect a first Fed rate cut in spring or summer depending on the data—most likely in July—and we see the potential for two or three cuts for the whole of next year. We forecast 2- and 10-year US Treasury yields to end next year at 3.25% and 3.5%, respectively.

So, we agree with the market's assessment that US growth, inflation, and rates will all head lower next year—but our view on the timing and size of US rate cuts differs to the market, with potential for uncertainty and market volatility. So, we believe investors should focus on quality. In fixed income, quality 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, should be best positioned to generate earnings in an environment of weaker growth.

For more details on these ideas and more, click here for our **Year Ahead 2024: A new world.**

Main contributors - Solita Marcelli, Mark Haefele, Matthew Carter, Vincent Heaney, Jennifer Stahmer

Read the original report : **Turn to quality amid shifting US rate expectations, 29 November 2023.**

Important information
As a firm providing wealth management services to clients, UBS Financial Services, Inc is registered with the U.S. Securities and Exchange Commission (SEC) as an investment adviser and a broker-dealer, offering both investment advisory and brokerage services. Advisory services and brokerage services are separate and distinct, differ in material ways and are governed by different laws and separate contracts. It is important that you carefully read the agreements and disclosures UBS provides to you about the products or services offered. For more information, please visit our website at www.ubs.com/workingwithus.
© UBS 2023. All rights reserved. UBS Financial Services Inc. is a subsidiary of UBS AG. Member FINRA/SIPC.
There are two sources of UBS research. Reports from the first source, UBS CIO Global Wealth Management, are designed for individual investors and are produced by UBS Global Wealth Management (which includes UBS Financial Services Inc. and UBS International Inc.). The second research source is UBS Group Research, whose primary business focus is institutional investors. The two sources operate independently and may therefore have different recommendations. The various research content provided does not take into account the unique investment objectives, financial situation or particular needs of any specific individual investor. If you have any questions, please consult your Financial Advisor. UBS Financial Services Inc. is a subsidiary of UBS AG and an affiliate of UBS International Inc.