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Chief Investment Office GWM
Investment Research

Equity sell-off continues

UBS House View - Daily Europe

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New video – Inside Take: Rate hikes and geopolitics (4:25)
Rate hikes and geopolitics collide, plus our views on the CNY and Japan equities.

What happened?

Global stocks fell over the past 24 hours amid worries that central bank tightening may tip economies into recession. The S&P 500 lost 3.2% after last week's 0.2% decline, which marked the fifth consecutive weekly decline for the index—the longest run since 2011. The index is now down close to 16% since hitting a record high in early January.

Losses were even greater in the technology sector, with the Nasdaq down 4.3%. The sector is sensitive to rising government bond yields, which reduce the current value of future profits. The Euro Stoxx 50 ended 2.8% lower. Bitcoin declined 9.5%, and has now retreated more than 50% from an all-time high in November.

The 10-year US Treasury yield briefly hit 3.2% in intraday trading before retreating to 3.04% at present. Still, this marks a rapid rise from around 2.4% at the start of the quarter. The 5-year yield hit its highest level since 2008, climbing above levels last seen in late 2018, a period also accompanied by an equity sell-off and worries over Fed tightening.

On Tuesday, Hong Kong returned from a public holiday to a 3% decline, with the Hang Seng tech and mainland property indices down 4.5% and 5%, respectively. Alongside market concerns over China's stringent mobility curbs and the resulting impact on global supply chains, tech names were pressured by incremental weekend regulatory action targeting live-streaming platforms. Through the rest of the Asia session, pressure was more, with the MSCI AxJ declining 1.3%, and Nasdaq futures erasing early-session declines to rise 0.8% at print.

These market moves suggest investors are continuing to digest higher yields, the Federal Reserve's decision to raise rates by 50 basis points last week, and Friday's data indicating that the stream of workers returning to the labor market after the pandemic might be slowing. Friday's nonfarm payroll release showed the labor force participation rate falling to 62.2% in April from 62.4% in March. A sustained drop in this metric would be unwelcome

Market update

Hang Seng –2.8%, Hong Kong-listed equities reopen to sharp declines.
S&P 500 futures +0.55%, turning positive in Asia trade.
UST 10Y yields to 3.04%, retreating from Monday's peaks.
Brent crude oil –1.2%, near USD 104.6 a barrel.

What to watch: 10 May 2022

- US April NFIB small business optimism
- Germany, Eurozone May ZEW economic expectations
- Fed's Williams, Barkin, Waller, Kashkari, and Mester speak

news, increasing upward pressure on wages and making it harder for the Fed to achieve an economic soft landing.

Finally, the global political and economic backdrop added to growth and inflation fears. Russian President Vladimir Putin used his Victory Day speech to compare the war in Ukraine to fighting Nazis, while US Democrats proposed allocating near USD 40bn in additional aid to Ukraine. Energy prices have remained volatile as discussions continued over an EU-wide ban on Russian oil, which has been held up by opposition, notably from Hungary. The latest proposed deal is also reported to include extensions for several countries in Central and Eastern Europe. Even so, these extensions would only affect modest volumes of Russian imports. Further disruption to Russian energy supplies remains a risk for markets.

What do we expect?

Our central scenario remains for growth to stay positive in the next 12 months and for inflation to moderate.

The US consumer price index for April is due on Wednesday, and the consensus among economists is for the first signs of slowing inflation since September last year. A Reuters poll has the annual rate falling from 8.5% to 8.1%, and the monthly rate declining from 1.2% to 0.2%. The surge in demand for goods caused by the pandemic—which was the largest since the end of rationing after the end of World War II—has been tailing off, with the balance between the consumption of services and goods starting to return to normal. While no one data point proves or disproves the inflation case, we expect base effects to start to bring inflation lower, as the data no longer compares a normal economy to one suppressed by the pandemic.

Falling inflation over the coming months has the potential to moderate concerns about the pace of Fed tightening, in our view. Markets have already moved swiftly to price in a rapid pace of Fed rate hikes, with futures currently implying around 270 basis points of tightening overall this year.

Meanwhile, the outlook for consumer demand remains positive. The US added 428,000 net new jobs in April, a healthy rate, and the unemployment rate remained low at 3.6%. While a 5.5% increase in average hourly earnings is not keeping pace with inflation—a potential negative for demand—job security is high. There is also little evidence of firms looking to fire workers. Consumers are thus less likely to cut spending to increase precautionary savings.

Finally, the first-quarter US earnings season has pointed to overall resilience in earnings despite some high-profile disappointments. With close to 90% of S&P 500 companies reporting, 78% have beaten earnings forecasts, slightly above the five-year average of 75%. Weakness has mostly been concentrated in areas that face supply chain challenges (Apple, semiconductor stocks), shifts in spending away from pandemic winners (Netflix, Amazon), and stiffer competition (Netflix, Google, Meta). Although we remain watchful for signs of margin erosion and slowing demand, we retain our forecasts for 10% EPS growth in 2022.

How do we invest?

Despite our expectation of falling inflation and sustained growth, we believe investors should brace for further equity volatility ahead amid significant moves in key economic variables and bond markets. We continue to favor areas of the market that should outperform in an environment of high inflation:

Invest in value. Stocks with relatively low valuations (value) tend to benefit from rising real rates. We note that since 1975, value has outperformed growth across the cycle in periods when inflation is 3% or more. On Monday, for example, US value stocks outperformed US growth stocks by roughly 1.3%. We advise investors who have been under-allocated to value after a long period of underperformance to add to long-term positions in value stocks or value-oriented sectors and markets, including global energy and the UK. While energy stocks tracked oil lower on Monday, the MSCI World Energy Index is up 35% year-to-date, versus a 14.5% fall in the broader index. The UK's FTSE 100 has also outperformed with a decline of 2.3% so far this year.

Build up portfolio hedges. Broad commodities have performed well historically during inflation regimes, and we think they represent an effective geopolitical hedge today given the risk of supply disruptions. Commodities (and energy equities) have been among the few assets to deliver positive performance so far in 2022.

We also believe the US dollar can continue to act as a good portfolio hedge in the near term. It is likely to continue to benefit from safe-haven flows, rising US real interest rates, and the US's position as a net energy exporter. The DXY index is up 8% so far this year, and 5.5% since the start of the quarter in April.

Adding exposure to defensive equity sectors like healthcare can also help reduce overall portfolio volatility. The pharmaceutical segment is traditionally relatively resilient during risk-off moves, and valuations currently look undemanding, in our view.

Manage high inflation and rising rates. In fixed income, areas of value have emerged following the rise in yields in recent weeks. We see an opportunity in environmental, social, and governance (ESG) engagement high yield bonds. We retain a preference for areas of private credit, such as first lien loans to middle-market companies.

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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:

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- 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.

Appendix

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