CIO Daily Updates

Dailyvideo ? Volatility on energy and tax cuts (4:26)

OPEC+ looks set to deliver a major output cut this week, while the UK government drops one of its more significant tax cut pledges.

Thought of the day

What happened?

The S&P 500 rebounded 2.6% on Monday after falling to a year-to-date low at the end of last week. Energy stocks led the advance, rising 5.8%, supported by a rise in oil prices amid reports that OPEC+ is set to announce a production cut this week. Brent crude rose 4.4% to USD 88.86/bbl. S&P 500 futures pointed to another positive trading day, with a rise of 1.4%. The Euro Stoxx 500 index was up 2.6%.

Bonds rallied along with equities on Monday, with the 10-year Treasury yield falling 19 basis points to 3.64%. On Tuesday, the 10-year yield fell further to 3.58%. UK gilts, which were at the center of last week?s bond market turbulence, also recovered. The yield on 10-year gilts fell to 3.96%, having risen to 4.58% last week. On Tuesday, the yield stood at 3.86% The DXY Dollar Index fell 0.4%, while sterling advanced. The GBPUSD rose to 1.13, from an intraday low of under 1.04 on 26 September.

The latest US ISM manufacturing PMI survey pointed to a cooling economy, suggesting the Federal Reserve?s aggressive rate hikes are taking effect. The overall index fell to 50.9 in September from 52.8 in August, the lowest since May 2020, while the prices-paid component dropped to its lowest since June 2020.

Global bond yields were driven higher last week, partly by turbulence in the UK gilt market after the government unveiled a new fiscal plan that included GBP 45bn in unfunded tax cuts. On Monday, gilt yields fell as Chancellor Kwasi Kwarteng announced that he was abandoning plans to cut taxes for higher earners, adding: ?We get it, and we have listened.?

What do we expect?

After falling more than 9% in September and extending its year-to-date decline to nearly 25% as of Friday?s close, we think the S&P 500 looked oversold. In addition, some of last week?s selling pressure may have been driven by quarter-end rebalancing, which has now ended.

The American Association of Individual Investors? survey of investor sentiment, for example, has moved to a bearish extreme. The latest reading, from 22 September, showed bearish sentiment reaching a new high of 60.9%, and the balance of bull-bear sentiment was more than 2 standard deviations below its long-term average. As of 26 September, more than 97% of S&P 500 stocks were trading below their 50-day moving average. This measure peaked at 98% at the June lows.

With sentiment toward equities already very weak, periodic rebounds are to be expected. But markets are likely to stay volatile in the near term, driven primarily by expectations around inflation and policy rates.

US economic data supported Monday?s rally. The combination of a weaker, although still expansionary, ISM print and a lower prices-paid component raised hopes that inflation pressure is easing. This led to a fall in Treasury yields and a reduction in markets? pricing of the terminal federal funds rate to 4.45%. In turn, this helped support the equity rebound.

While risk assets rebounded on Monday, we think a more sustained rally in equities is likely to require indications of a clear downtrend in US inflation (i.e., at least three months of core PCE inflation of 0.2% month-over-month or lower), along with signs of a cooling labor market, which could then allow the Fed to pause its rate hiking cycle. This week?s JOLTS job openings data and the September labor report will be key data releases to watch.

Energy markets have moved to price in a sizable production cut from OPEC+ on Wednesday, so anything at or below a 0.5mbpd curb could drive renewed pressure on crude prices in the near term. We retain a positive outlook on crude oil prices in view of low OECD inventories, gas-to-oil switching, the end of strategic petroleum reserve sales, and Russia-linked supply disruptions. This supports our preference for global energy stocks.

The combination of the Bank of England?s intervention in the gilt market and the government?s U-turn has helped stabilize UK assets and sterling. But the reversal of the cut in the highest tax rate represents just part of the unfunded tax cuts that were announced. We expect continued volatility until the government announces how it intends to fund the fiscal expansion. On Tuesday, the UK Chancellor indicated this statement will be brought forward from the currently scheduled date of 23 November.

How do we invest?

With uncertainty elevated, we expect market swings to remain pronounced. This is not an environment to be positioned too heavily for any given short-term scenario, but it is one in which we believe smart reallocations within asset classes can build resilience and improve the risk-return profile of overall portfolios.

Invest in value. The MSCI All Country World Value index outperformed the comparable growth index by 12 percentage points in the first three quarters of the year. With inflation likely to remain above central bank targets for some time, and policy rates rising, we expect value?s outperformance to continue. In addition, we expect energy stocks?a value sector with attractive cash returns?to benefit from higher oil prices in the months ahead. The UK market, which is oriented toward defensive and value sectors, remains among our most preferred. We expect sterling to remain weak in the quarters ahead, which should support FTSE 100 revenues, three-quarters of which are generated overseas.

Add defensive exposure. Central banks have signaled that they will continue to hike policy rates to bring down inflation, even if this causes some economic pain. To build resilience in an environment of slowing economic growth, we recommend tilting exposure toward defensive areas of each asset class. In equities, that includes healthcare and consumer staples, while in fixed income we favor high-quality bonds and resilient credit. The Swiss franc and US dollar?two safe havens exposed to convincing rate-hike cycles?are among our preferred currencies.

Seek uncorrelated hedge fund strategies. It has been difficult for investors to earn positive returns in 2022. But hedge funds have been a bright spot, with some strategies, like discretionary macro, doing well. Global macro funds, which can often thrive amid persistent uncertainty and heightened market volatility, delivered a positive return of 9.3% year-to-date up to the end of August, based on the HFRI Macro (Total) Index. In the current environment, we think ?owning beta? is no longer sufficient to generate attractive risk-adjusted returns.