

CIO Daily Updates

Monthly video ? Picking the bottom (2:51)

CIO Mark Haefele explains our risk positioning and portfolio strategy

Thought of the day

The S&P 500 climbed 2.4% on Friday and 4.7% for the week as a whole, its best week since June, as top Federal Reserve officials indicated they had started to discuss pausing rate rises. While the Fed is expected to deliver its fourth consecutive 75-basis point rate hike at its 2 November meeting, policymakers started to warn last week of the dangers of inflicting excessive economic pain by hiking too far, too fast.

Chicago Fed President Charles Evans warned of ?nonlinear? risks to the economy if the federal funds rate moves beyond 4.6%, versus a current range of 3% to 3.25%, saying ?it really does begin to weigh on the economy.? San Francisco Fed President Mary Daly said that while high inflation made considering a pause in rate hikes ?really challenging?, it is now ?time to start planning for stepping down.? She added that the central bank should seek to avoid pushing the economy into an ?unforced downturn.?

The comments caused markets to scale back expectations for the peak in rates to around 4.9% by May 2023, down from over 5% for the first time earlier last week. The yield on the 2-year US Treasury fell back from an intra-day high on Friday of 4.63%, close to the highest level since the global financial crisis, to end the day at 4.49%. The yield on the 10-year US Treasury also fell from an intraday peak, but remains close to levels last seen in 2008, ending the day at 4.21%, from 1.63% at the start of the year.

The start to the third quarter US earnings season, though mixed, has so far not undermined the nascent rally, with results in line with the market?s relatively cautious expectations. The banking sector was a highlight; Results from America?s banks benefited from higher net interest margins, with higher interest rates proving a tailwind.

What do we expect?

The latest rally underlines our view that markets will remain volatile, and investors should prepare for large moves in both directions. Incremental improvements in inflation or labor market data, indications of economic resilience or any softening of language from the Fed has the potential to drive a market bounce, as we have seen in recent days

But while it is encouraging that Fed officials have started to point to an end in sight for rate rises, such a pause will remain conditional on fading inflation and a cooling labor market. This has yet to be seen in the data. The Consumer Price Index measure of inflation for September came as an unpleasant surprise to investors, with the core month-on-month measure rising by 0.6% for the second consecutive month, well above levels consistent with the Fed?s inflation goal. The Personal Consumption Expenditure inflation gauge, traditionally the Fed?s favorite measure of price inflation, is released on Friday. Meanwhile, jobs data showed unemployment for September falling back to a 50-year low of 3.5%.

Earnings may pose an additional impediment. We believe the full effects of restrictive monetary policy for the economy and corporate profits are not yet well reflected in consensus forecasts?leading to potential disappointments ahead. Companies face the challenging combination of weakening demand, rising labor costs, and unfavorable comparisons with 2021?22 earnings growth. We now expect global earnings per share to fall by 3% in 2023, versus the bottom-up consensus for 5% growth. The latest rally will face a test this week when the four largest US companies by capitalization report?Apple, Microsoft, Alphabet and Amazon?representing a fifth of the S&P 500?s value.

How to invest?

Given a challenging backdrop but with the potential for bounces and volatility, we favor strategies that add downside protection, while retaining upside exposure. For investors whose exposure to equities is already close to long-term target levels, we recommend using options or structured solutions to hedge against further near-term downside without risking missing out on market rallies. However, we have become incrementally defensive in our positioning over the past year, and we do not currently see sufficient justification to shift course.

Some of our other preferred strategies include:

Focus on defensive parts of equity and fixed income markets. Within equities we like capital protected strategies, value, and quality income. Globally, we like healthcare, consumer staples, and energy, with a least preferred stance on growth, technology, and industrials. By region, we like UK and Australian equities relative to US equities.

Within fixed income, our defensive posture is also reflected by a preference for higher quality segments such as high-quality bonds and investment grade versus lower quality segments such as high yield and loans. We also like relative value opportunities in rates such as long US 10-year US Treasuries against French 10 year OATs, which should benefit as global market liquidity conditions tighten.

Diversify with hedge funds. Hedge funds have been a rare bright spot for investors in 2022, with some strategies, like macro, doing particularly well. With inflation data and central bank policy likely to continue driving a high correlation between equities and bonds in the near term, we recommend investors diversify into less correlated hedge fund strategies to navigate market uncertainty.

Consider safe-haven currencies. We maintain our preference for the ?safe haven? US dollar and Swiss franc, relative to the British pound and euro. The Fed?s rate hiking cycle remains the most aggressive of any major central bank globally, and we believe both the dollar and Swiss franc should continue to attract inflows in a risk-averse environment. Meanwhile, although the pound and euro are relatively cheap, downside risks remain while energy supplies stay tight.