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Will earnings resolve the bond-equity split?

Divergence between equities and bonds

Equity markets signal calm, with the S&P500 volatility index (VIX) at around 15 and the S&P 500 near record highs, while the US government bond volatility index (MOVE) has surged to its highest level since March. Bond stress reflects multi-decade-high long yields amid strong economic growth, oil above USD 100/bbl fuelling near-term inflation, fiscal policy uncertainty and crowded short investor positioning, which remains vulnerable to abrupt unwinds.

Taking some chips off the table; locking in gains in semiconductors

Rising bond volatility, weak equity market breadth and approaching US mid-term elections warrant near-term caution. US small-cap equities remain about 9% below August's all-time highs despite large-caps scaling new records. The near-term uncertainty prompts to lock in gains in semiconductor and Taiwan equity opportunistic ideas. Historically, US equities have performed strongly after mid-terms, particularly when the opposition controls both houses - as seems likely next month.

Strong Q3 earnings season likely to overcome near-term challenges

Strong US and Asian corporate earnings are likely to resolve the equity-bond divergence in favour of stocks. The consensus S&P 500 Q3 earnings growth estimate has risen to 30% from 27% at the start of July, while the technology sector growth estimate is tracking 66.5%, driven by the AI infrastructure build-out. Record memory-chip profits and upgrades to long-term targets from AI leaders support staying long technology-led risk assets and using any near-term volatility to scale into preferred sectors.

French uncertainty challenges and near-term EUR view.

The impact of rising French political and fiscal risks has been largely confined within France so far, with France's bond yield spread versus German peers rising to its highest since the 2011-12 Euro area crisis. Nevertheless, EUR/USD has slumped around 4% since mid-August. There is one December ECB rate hike expected, though tighter financial conditions and political uncertainty in France and Spain could prompt a hold. Euro area bank equities remain attractive on robust profitability, capital strength and valuations, subject to sovereign-spread and funding-cost risks.

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