

New hiking cycle: Downgrade equities to neutral

17 September 2026

Key Takeaways:

- Downgrade equities from Overweight to Neutral. Earnings remain healthy, but oil, inflation fears, Fed uncertainty and crowded positioning have weakened the near-term risk-reward balance.
- The biggest risk is Fed ambiguity, not the rate hike. An open-ended tightening path leaves markets hostage to every inflation print, oil move and economic release.
- Oil is back in charge. Brent above USD100, depleted US strategic reserves and geopolitical supply risks are reviving inflation concerns and pushing bond yields higher.
- Good earnings are losing their punch. Beat-and-raise results are generating muted share-price reactions, suggesting expectations are already stretched after strong gains and elevated investor exposure.
- We are reducing risk while keeping dry powder ready to redeploy if oil eases, rates stabilise or markets reset.

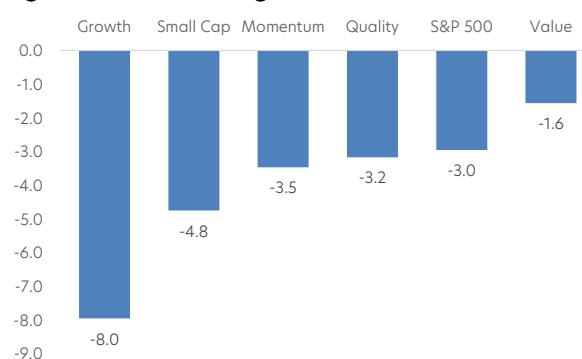
We are moving equities from Overweight to Neutral

After going overweight 1 year ago, we are now downgrading equities from overweight to neutral. Our stance is tactically cautious but still strategically constructive. Our near term caution mainly revolves around interest rate ambiguity by the Fed, near term unpredictable oil prices that feed into inflation fears and a lack of positive share price reaction during the recent solid “beat-and raise” earnings season.

This is not a call that the earnings cycle is ending. It is a judgement that the near-term balance between earnings growth, oil, inflation, interest rates and crowded positioning has become less attractive. The S&P500 is already up a solid 9.6% year to date, returns typically only achieved over a full year. As such, we would rather give up a little upside than discover that strong earnings are no longer enough to cover a hawkish Fed. History (Fig 1) shows that growth and momentum factors could have larger drawdowns.

As a result, we move US and EM Asia equities to neutral, while retaining existing neutral positions in Japan and Europe. AI growth hardware stocks that are strongly represented in Taiwan and South Korea remain vulnerable. China has also not delivered, and patience alone is not an investment thesis. For China, we have moved to a diversified “Tribell” approach (see Fig 7 later) that has weathered volatility well.

Figure 1: 3mth average % when fed starts hiking



Source: Bloomberg, UOB Private Bank. Data since May 1983 fed hike.

Fed's policy message matters more than the hike

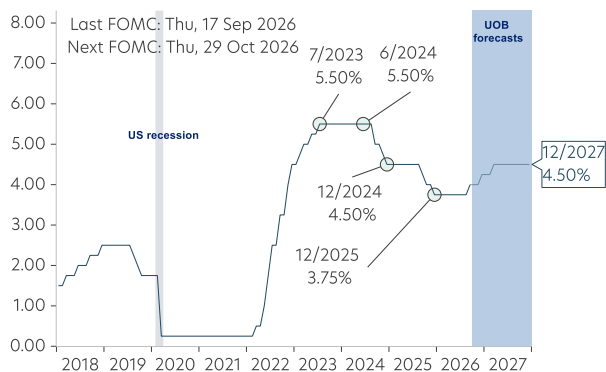
The Federal Reserve has now raised interest rates by 25 basis points. More important than the decision itself was the message that followed.

The Fed stopped short of closing the door on further hikes. Markets could digest “one and done”. They may react rather differently to “one and the door remains open”. A vague reaction function would leave oil, inflation expectations and each data release to rewrite the rate path. That is an efficient recipe for volatility and a poor anchor for long-duration assets.

The danger is therefore not simply the hike. It is the guidance, of which there was none in the style of the new Fed Chair. UOB has today revised its Fed interest rate path to 1 hike in Dec 2026 and 1 in 1Q 2027 (Fig 2).

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Figure 2: Fed rates and future path



Source: Bloomberg, UOB Private Bank

Source: Bloomberg, UOB Private Bank.

The market is revisiting the oil problem

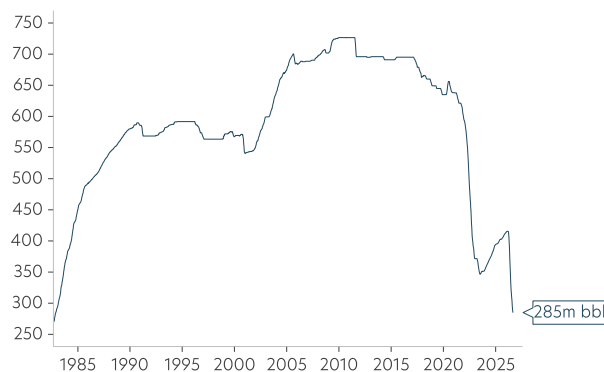
The dominant catalyst is energy, not earnings. Brent crude settled at USD105.83 per barrel on 16 September. It traded near USD110 intraday. The US 10-year Treasury yield briefly touched 5.02% and is now just shy of 5%.

These moves reflect a market linking oil supply risk directly to inflation and tighter monetary policy.

The latest inflation report did little to break that chain. August headline CPI rose 0.4% m/m and 3.4% y/y. Core CPI increased 0.3% m/m and 2.4% y/y. Gasoline rose 3.9% m/m and accounted for more than one-third of the monthly headline increase. Energy prices were 16.3% higher y/y.

Transport may not dominate the inflation basket, but oil rarely stays politely within its assigned weight. It seeps into freight, airfares, chemicals, packaging and corporate margins. The more persistent the shock, the greater the risk of second-round effects.

Figure 3: US SPR levels back to 1982



Source: Bloomberg, UOB Private Bank

Source: Bloomberg, UOB Private Bank.

The US Strategic Petroleum Reserve (SPR) has fallen to 285.4m barrels (**Fig 3**), its lowest level since 1982, leaving Washington with less room to cushion another supply shock. With Middle East infrastructure under threat and replacement barrels potentially slow to arrive, depleted reserves make oil spikes harder to contain and inflation risks greater.

Good news is losing its punch

The bull case has not disappeared. Earnings remain strong, and we continue to expect healthy growth in 3Q and 4Q. Midterm history is also supportive beyond the immediate volatility window. US equities have historically delivered strong returns following midterm elections.

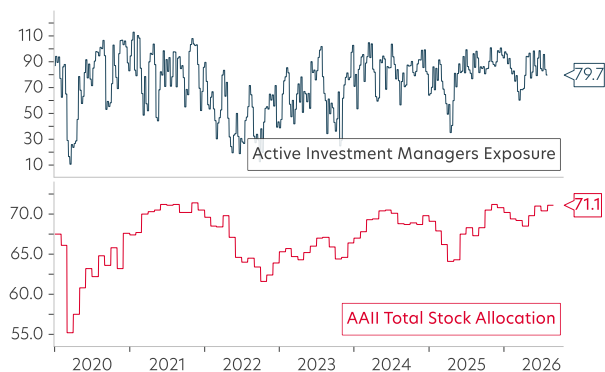
The problem is what investors are already paying for that resilience. As of the 17 September close, the S&P 500 was up 9.6% YTD, while the Nasdaq Composite had gained 11.1%. The Nikkei remained up roughly 26.7% YTD.

Meanwhile, beat-and-raise results are producing less consistent share-price rewards. That is a warning about expectations, not necessarily fundamentals. When excellent news merely keeps a stock standing still, the hurdle for the next quarter has become uncomfortably high.

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Figure 4: Investor positioning data



Source: Bloomberg, UOB Private Bank

Source: Bloomberg, UOB Private Bank.

Positioning offers little cushion. The latest AAll survey (Fig 4) showed retail investors holding 71.1% in stocks and stock funds, compared with a historical average of 61.5%. Elevated exposure is not an automatic sell signal, but it increases the potential speed of any unwind.

AI may face an investment slowdown

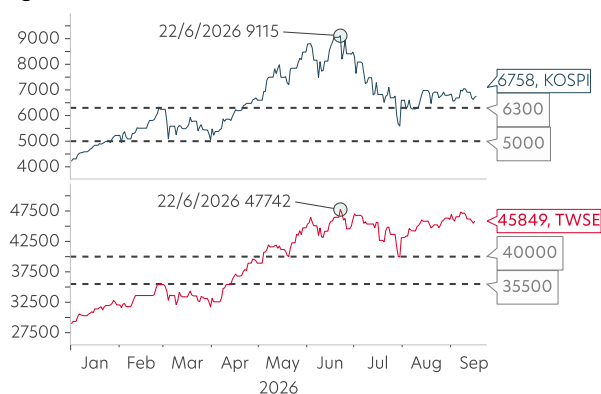
The AI thesis is not broken. Its timetable has become less certain. AI adoption remains intact, but the timing of infrastructure spending may become less predictable due to increasing regulatory, safety and geopolitical considerations.

Senior industry leaders from Open AI, Anthropic and xAI have endorsed slowing frontier-model development and strengthening external safety oversight. The immediate market reaction was concentrated in semiconductors, data centres and power infrastructure.

A slower model race does not automatically mean collapsing AI capital expenditure. It could even improve free cash flow at platform companies. However, it introduces a new risk for the hardware stack. Spending may be deferred, redirected towards safety and software, or forced to clear higher regulatory hurdles.

There is also a strategic contradiction. If the US genuinely believes it is in an AI race with China, it is unlikely to accept a prolonged unilateral slowdown. Safety concerns may delay projects at the margin, but competitive pressure should limit the extent of any retreat.

Figure 5: South Korea and Taiwan



Source: Bloomberg, UOB Private Bank.

That matters for our overweight in Taiwan and South Korea (Fig 5), which are AI infrastructure plays. Post the comments, the KOSPI fell 3.26%, with Samsung Electronics down 4.05% and SK Hynix down 6.35% the next trading day. The move illustrates how quickly AI, oil and rates can converge on a crowded semiconductor trade.

Where should investors rotate to now?

Figure 6: AI beneficiaries vs AI infrastructure



Source: Bloomberg, UOB Private Bank

Source: Bloomberg, UOB Private Bank.

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Finding somewhere to hide is admittedly difficult because AI remains the market's dominant theme. We think investors who want to retain AI exposure may be better served by AI beneficiaries/adopters (**Fig 7**) rather than AI hardware suppliers. Companies using AI to raise productivity and improve margins can participate in the theme without making the same enormous capital commitments.

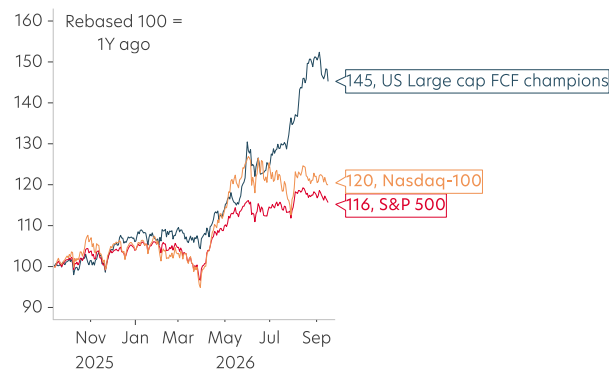
Figure 7: Access China through the "Tribell"



Source: Bloomberg, UOB Private Bank. UOB China "Tribell": 50% dividend stocks (3110), 30% Chinext (3147), 20% CSI300 (2846)

China has tested investors' patience. We believed investors should align with national priorities, particularly technological self-sufficiency, which led us to favour the ChiNext segment. The thesis was right, but the volatility was difficult to stomach (**Fig 7**). We therefore designed a "Tribell" portfolio that blends reliable dividend income with exposure to both the broad onshore market and the innovation-driven ChiNext segment. The combination has delivered returns of 7%, 48% and 132% over one, three and five years respectively. More importantly, it has broken above the market highs that existed before Beijing's 2021 regulatory crackdown, demonstrating the benefits of a more balanced approach.

Figure 8: Free cash flow companies do well

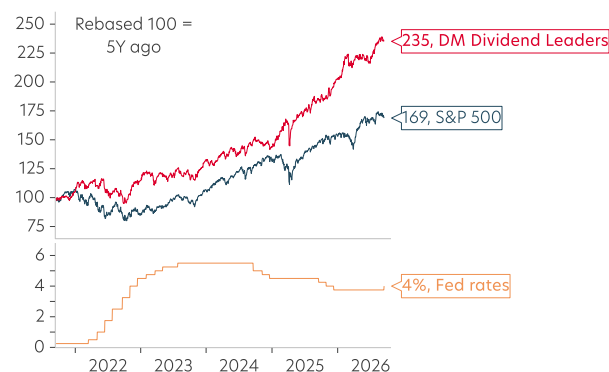


Source: Bloomberg, UOB Private Bank. Equivalent FCF ETF is VFLO.

Source: Bloomberg, UOB Private Bank.

Cash flow will matter more from here. Investors have happily tolerated mega-cap technology's spending boom because these companies continued producing substantial free cash flow (**Fig 8**). If that free cash flow turns negative, the market may become less patient. Profitable companies generating cash today would then look considerably more interesting than businesses promising cash tomorrow.

Figure 9: Dividend stocks performance



Source: Bloomberg, UOB Private Bank

Source: Bloomberg, UOB Private Bank.

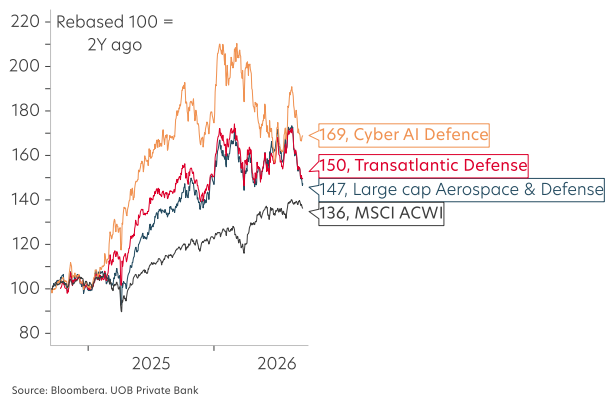
Dividend stocks could initially struggle if bond yields rise further. However, we remain unconvinced that this is the start of a prolonged hiking cycle. Any near-term yield-driven weakness in quality dividend equities may create a more attractive entry point for long-term income-oriented investors, provided earnings expectations remain stable (**Fig 9**). Banks may also be well placed: higher rates typically

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support income (barring recessions), while healthy capital levels leave room for dividends and share buybacks.

Figure 10: Defence sector performance



Source: Bloomberg, UOB Private Bank.

Defence remains a long-burn theme and the recent correction could serve as entry points (Fig 10). Governments increasingly recognise that they may have to look after themselves rather than rely as heavily on the US safety umbrella. Healthcare also deserves attention. Its earnings are less tied to the technology cycle, making it a natural destination when investors discover that too many portfolios own variations of the same AI trade.

We are tactically cautious not strategically negative

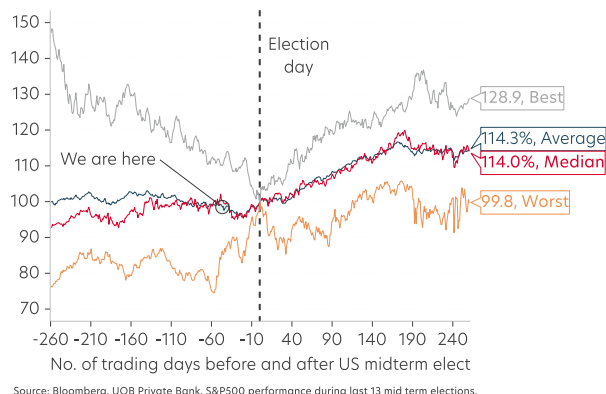
Figure 11: S&P500 earnings to grow 35.5%



Source: Bloomberg, UOB Private Bank.

First, earnings are still growing. We are not forecasting an earnings recession. S&P500 over next 12 months is expected to grow earnings 35.5%, but admittedly front end loaded in 3Q and 4Q 2026.

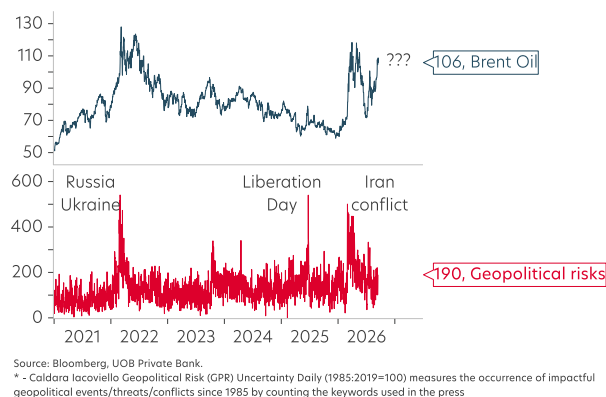
Figure 12: US Midterm historical trend



Source: Bloomberg, UOB Private Bank.

Second, midterm volatility has historically created buying opportunities (Fig 12). The post-election tendency remains constructive, although it is not a timing guarantee. In the last 13 midterm elections we analysed, the S&P 500 was a median 14% higher eight months after the event.

Figure 13: Oil price uncertainty



Source: Bloomberg, UOB Private Bank.

Third, the oil shock may eventually reverse. Historically, oil prices have tended to decline materially in the 12 to 18 months following major geopolitical shocks (Fig 13). However, the present conflict began on 28 February, leaving us only six

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months into the episode. The supply outlook remains too uncertain to trade solely on historical mean reversion.

The policy outcome of the US midterms should not be the core investment thesis. A Democratic sweep would probably be viewed initially through a negative lens, particularly regarding taxes and regulation. However, any policy changes would require legislation and time. Earnings, oil and bond yields are the faster transmission mechanisms.

What Would Bring Us Back to Overweight?

Turning neutral does not mean waiting indefinitely on the sidelines. We see three conditions that could improve the risk-reward balance and justify rebuilding the equity overweight.

First, the oil risk premium needs to ease. A sustained decline in Brent below USD90 per barrel would be encouraging, provided it reflects restored supply or credible geopolitical de-escalation rather than collapsing global demand. That distinction is important. Cheaper oil driven by better supply conditions would relieve inflation pressure, support corporate margins and reduce the need for further rate hikes. Cheaper oil caused by recession would offer considerably less comfort.

Second, the interest-rate path needs firmer boundaries. The Federal Reserve does not have to promise that its next hike will be the last, but it must explain what would justify further tightening and what would allow it to stop. A sustained decline (barring recession) in the US 10-year Treasury yield below 4.75%, alongside softer inflation and inflation expectations, would suggest that the bond market has regained an anchor. Equities can live with relatively high interest rates. What they dislike is having the discount rate goal post shifting with every oil headline.

Figure 14: Where are important S&P500 levels?



Source: Bloomberg, UOB Private Bank

Third, we would welcome a market reset that leaves the earnings outlook intact. A high-single-digit correction in the broader market, or a deeper shakeout across the AI infrastructure complex, could create a more attractive entry point if earnings estimates remain stable and revisions stay positive. That would represent expectation reset rather than the beginning of an earnings downturn. We want to buy good businesses at better prices, not cheaper markets with deteriorating fundamentals.

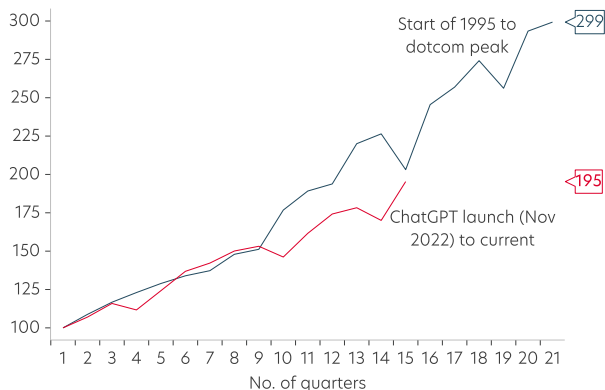
The Uncomfortable Bull Case

Of course, our caution may prove premature. Oil could fall sharply following a diplomatic breakthrough or restoration of disrupted supply. The Federal Reserve could subsequently reverse course allowing bond yields to settle. Strong earnings might once again overpower AI froth concerns, while AI safety measures could redirect spending rather than reduce it.

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Figure 15: S&P500 today vs dotcom

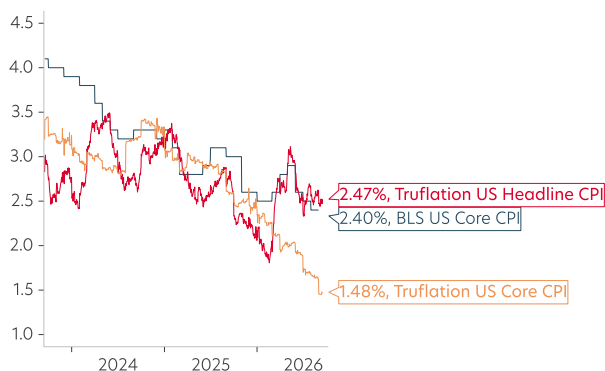


Source: Bloomberg, UOB Private Bank.

There is also the possibility that crowded positioning simply becomes more crowded. Major bull markets can remain expensive and overextended for longer than cautious investors expect, particularly when earnings are still growing. The frequent comparison is with the dotcom period where its final fifth year of returns for the S&P500 was an outsized 37%. That is why we are moving to neutral rather than underweight. We are reducing risk, not abandoning the market.

We remain strategically constructive, but the market is being asked to absorb USD100-plus oil, a 5% US 10-year Treasury yield and renewed tightening risk while expectations remain demanding. That is too much optimism resting on too little room for error.

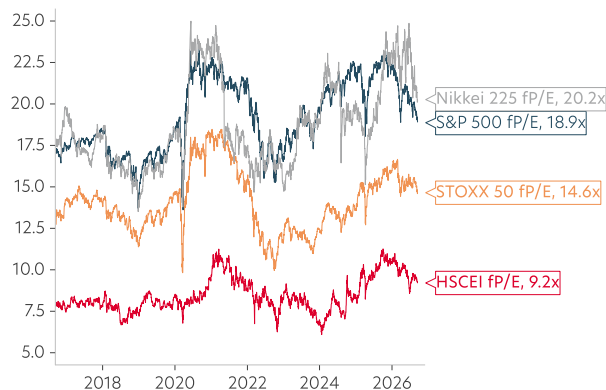
Figure 16: Inflation moving directionally lower



Source: Bloomberg, UOB Private Bank. Note: Truflation used as complementary not replacement

Source: Bloomberg, UOB Private Bank

Figure 17: Valuation of key markets



Source: Bloomberg, UOB Private Bank

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