



Earnings in Focus as Bear Market Continues

September 20, 2022

Key Takeaways

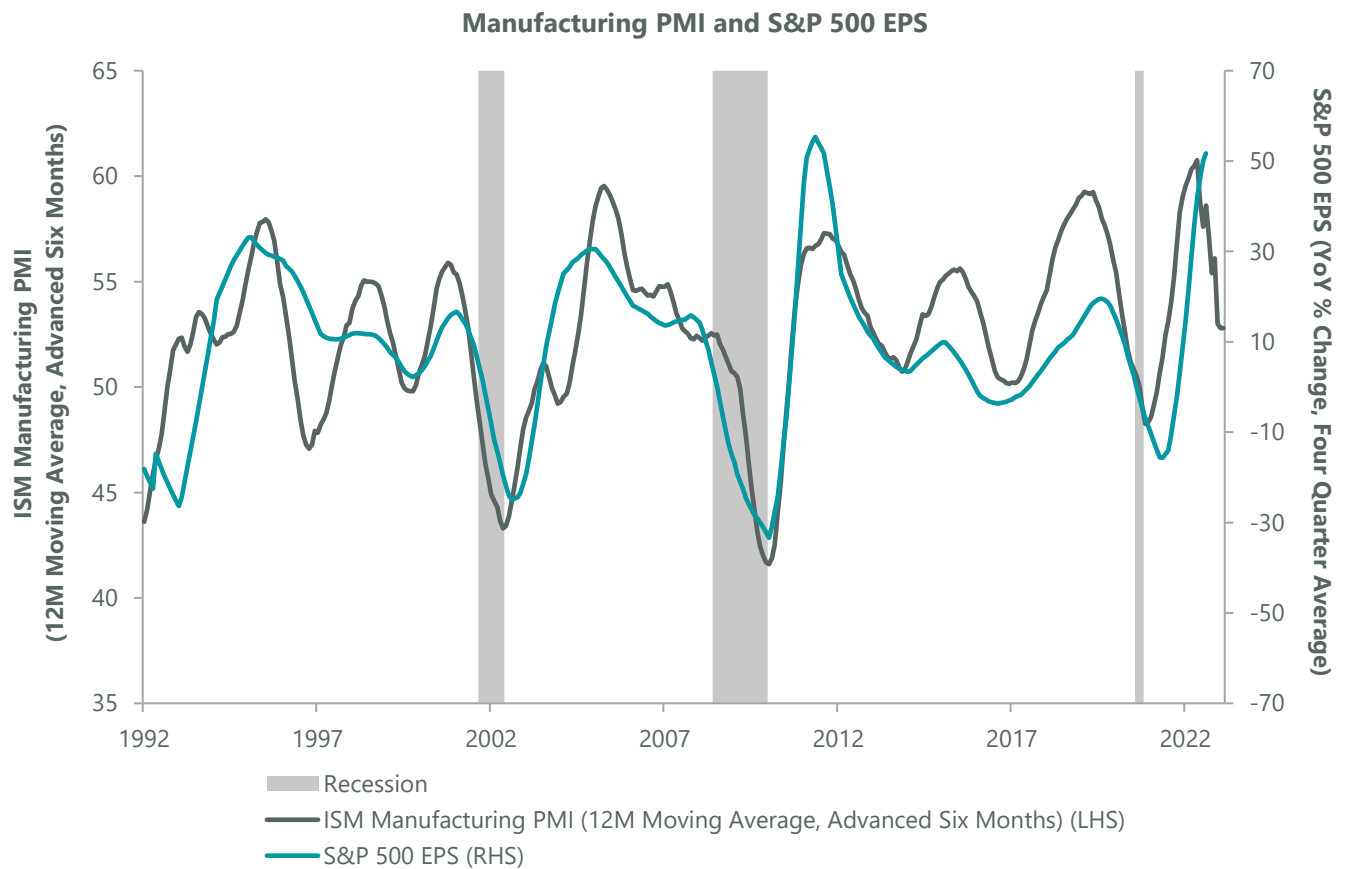
- ▶ Consistent with bear markets in 2008/2009 and 2001/2002, which included at least one period with a significant rally before making a final low, we believe stocks could retest mid-June, or potentially lower levels before a durable bottom is established.
- ▶ While the tightening liquidity environment caused valuation multiples to contract during the initial selloff, the next stage of the downturn is likely to be driven by falling corporate profits, which are expected to turn negative over the next six months.
- ▶ We continue to favor more defensive industries like pharmaceuticals and insurance and believe much of the damage from the bear market is already reflected in valuations in the technology sector. From a bottom-up perspective, our focus is on stocks where dominant market positions, "self-help" initiatives or meaningful capital return programs can support earnings growth and share prices.

Recent Equity Rally Giving Way to Next Leg of Downturn

The bear market appears to be following the course that [we were concerned about](#) in May. After the S&P 500 Index's sharp initial selloff (-23% from March 29 to June 16) as the Federal Reserve began its tightening cycle, stocks rallied meaningfully (+18% from June 16 to August 16) through the summer on hopes of an economic soft landing and pivot towards lower interest rates in 2023. However, sentiment soured in mid-August with stocks taking another leg down as the Fed asserted rates will stay high amidst persistent inflationary pressures even if, as Fed Chair Powell said in Jackson Hole, this causes "some pain to households and businesses." This pattern is consistent with the last two significant bear markets (2008/2009 and 2001/2002), as each included at least one period with a significant rally before making a final low. We believe the probabilities favor a return to mid-June, or potentially lower levels before a durable bottom is established.

While the tightening liquidity environment (as measured by rising interest rates, higher commodity prices, a strong dollar, and wider credit spreads) caused valuation multiples to contract during the initial selloff, the next stage of the downturn is likely to be driven by falling profits. From a macro perspective, the Purchasing Managers' Index (PMI) remains the best way to forecast corporate profit trends and, unfortunately, PMIs continue to decline with S&P profits likely to follow and turn negative over the next six months. Ironically, higher prices for goods and services are the very reason that earnings have held up to date, helping cushion margins and profits as companies pushed price to offset cost pressures.

Exhibit 1: ISM Manufacturing PMI a Leading Indicator of Earnings



Data as of August 31, 2022. Source: FactSet, ISM, Standard & Poor's.

We continue to favor more defensive industries like pharmaceuticals and insurance. From a bottom-up perspective, our focus is on stocks where dominant market positions or “self-help” initiatives (such as overhead reduction plans) can support earnings growth despite a more challenging economic backdrop. Additionally, companies with meaningful capital return programs, either through dividends or large share buybacks, are likely to fare better.

While the technology sector and other longer duration growth stocks were the first and hardest hit in this selloff, many of these companies have already absorbed a lot of the pain from multiple compression. The combination of price flexibility, advantageous margin structures and strong secular growth drivers should allow for profit growth to hold up better than their more cyclical peers.

Financials Could Foretell Severity of Slowdown

We are watching the banking sector as a valuable barometer for assessing the depth of an economic slowdown and potential U.S. recession. While the current environment is good for banks given higher interest rates, steady loan demand, and benign credit, future investment performance will be driven by investor perception of the breadth and depth of an impending credit cycle and the magnitude of losses for the industry.

One sector likely to remain under pressure is consumer discretionary. We have witnessed major earnings warnings out of several large retailers and companies supporting e-commerce that have caused their stocks to derate. Many were hit by the double whammy of a consumer pivot toward everyday items (such as grocery and fuel) creating bloated inventory in higher margin products such as electronics. Meanwhile, cost pressures remain unrelenting, and we are seemingly at a point where incremental price increases cause demand destruction.

Market breadth statistics and corporate bond spreads are key indicators that we continue to watch. The recent rally was dominated by defensive sectors. Yes, technology and discretionary stocks outperformed in the June-August rally but so did utilities and real estate. To make a durable bottom, we need to see stock prices decline to a level where investors are willing to add risk and duration to their portfolios and for market breadth to expand to include small and mid-capitalisation companies. Bond spreads are high and trending towards recession, but are not there yet, in our view.

It's important to remember that the market is a discounting mechanism and will make its bottom before earnings and the economy trough. Stocks continue to react aggressively to earnings misses or lowered guidance, indicating that the market is struggling to discount an appropriate level of future profits. Given such volatility, rather than trying to project near-term earnings trends, we believe it's better to look out two to three years and make investment decisions based on the longer term, sustainable growth rates of companies.

About the Author



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- 31 years of investment industry experience
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