



U.S. Equity Outlook: Patiently Waiting for a Durable Bottom

12 December 2022

Key Takeaways

- ▶ The economic repercussions of the change in liquidity from easy to tight will likely determine when, and at what level, equity markets find a durable bottom.
- ▶ The second leg of this bear market will likely be driven by negative revisions to earnings. While 2023 earnings expectations have started to decline, we believe estimates have at least a 10% downside and expect steady erosion throughout the year.
- ▶ We see 2023 shaping up to be a tale of two halves. Heading into the new year, we continue to favor value stocks with defensive characteristics. However, as market participants become convinced the bear market is over, leadership should rotate toward small cap and more aggressive, higher risk stocks.

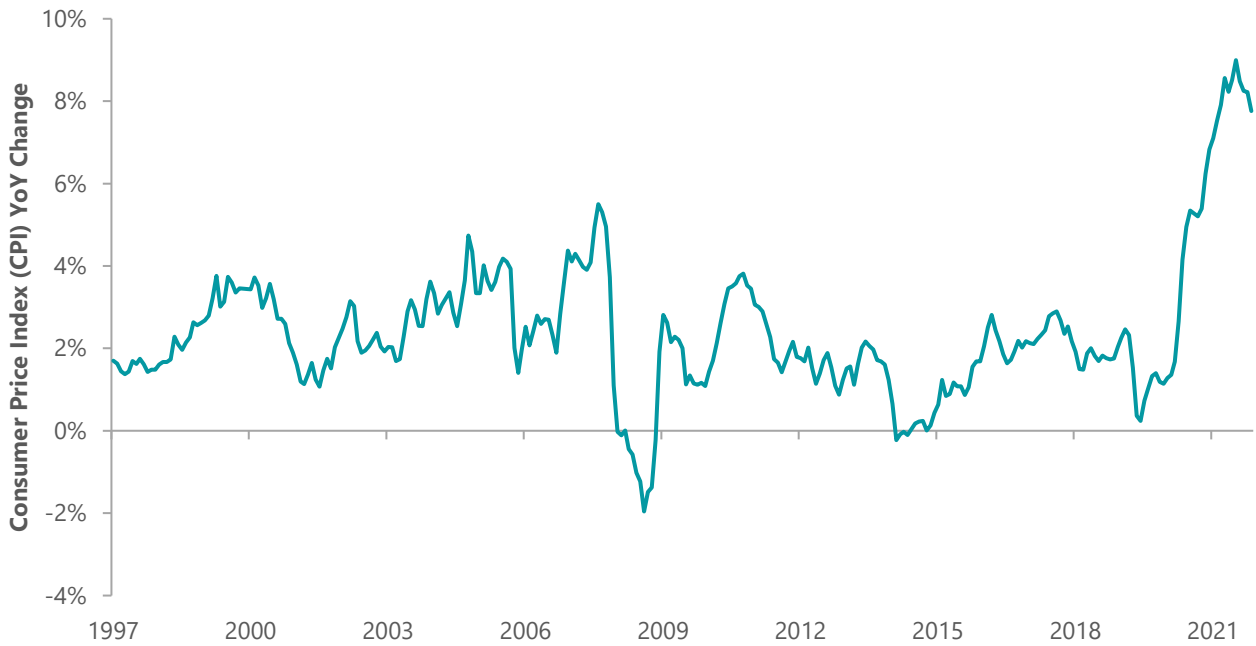
Efforts to Combat Inflation Have Dictated Market Conditions

U.S. equities entered a bear market in 2022 but unlike the short-lived bear market following the initial COVID-19 outbreak in 2020, the current drawdown will take more time to resolve. Several factors have pressured stocks this year, all primarily tied to persistent inflation. To quell sticky inflation, the Federal Reserve has been forced to tighten liquidity – a key factor we monitor to gauge the likely trajectory of risk assets – via higher interest rates and a reduction in the size of the Fed’s nearly \$9 trillion USD balance sheet.

The intended impact of Fed actions is to reduce aggregate demand and weaken the red-hot employment market, thus alleviating supply chain stress and spiraling wages. Given the lagged effect of monetary policy, success on this front will take time while the risk of over-tightening and potentially causing a dreaded “hard landing” lingers. Last year, we asserted the change in liquidity from easy to tight money would create a difficult environment for equities. As we look towards 2023, the economic repercussions of those actions will likely determine when, and at what level, the markets find a durable bottom.

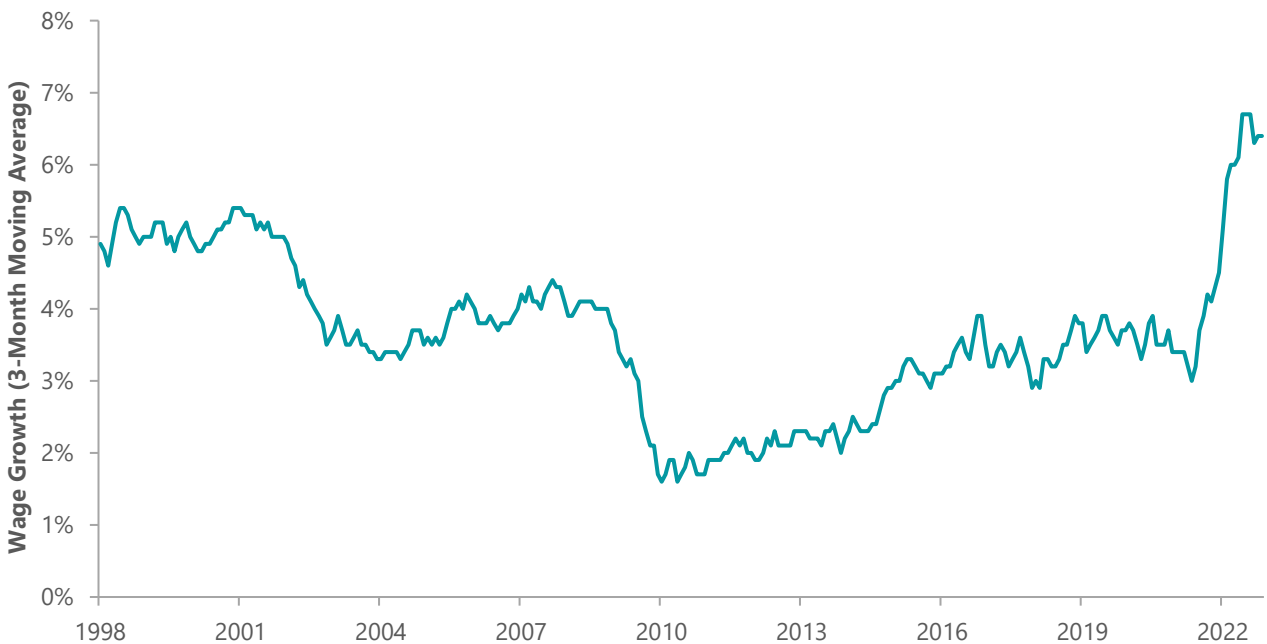
OUTLOOK

Exhibit 1: Inflation More Permanent than Expected



Data as at 31 October 2022. Source: Bureau of Labor Statistics (BLS).

Exhibit 2: Cooling Wage Growth Key to Quelling Inflation



Data as at 1 November 2022. Source: Atlanta Fed.

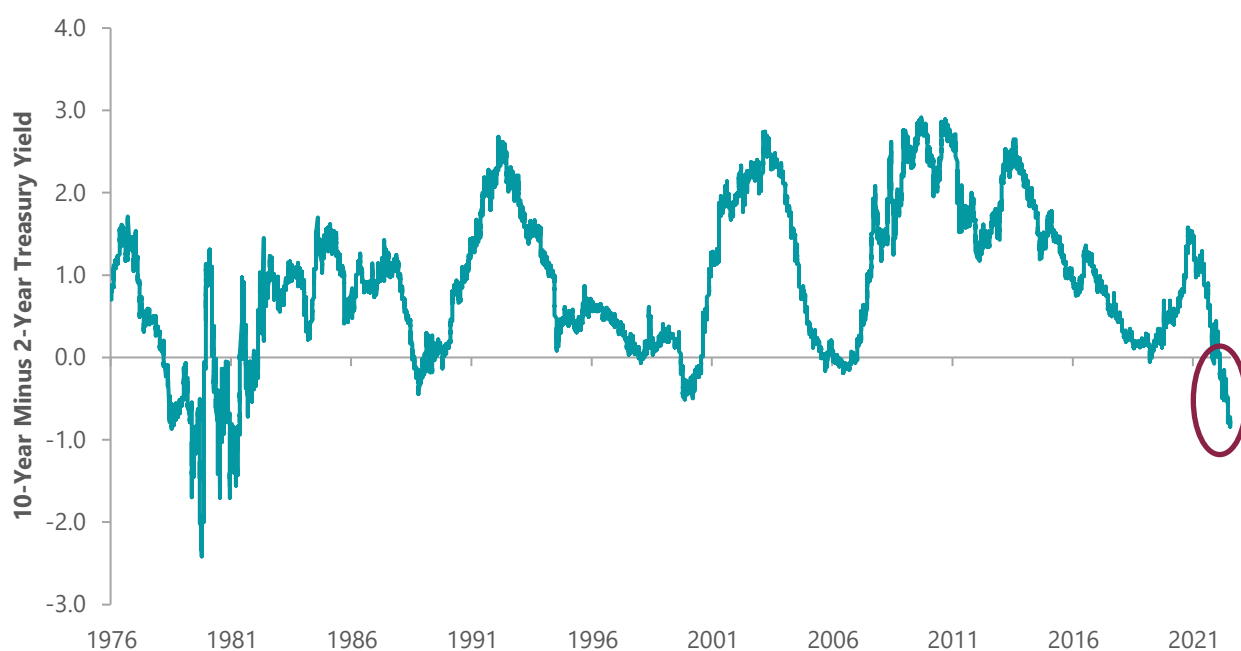
The first leg of 2022's bear market was driven by multiple compression sparked by a significant increase in the discount rate, which reduced the value of future cash flows. At this point, we estimate 75% of that multiple compression is already reflected in stock prices. The remaining 25% may be a function of how long the Fed keeps rates elevated to counter base inflation. Market consensus expects the Fed to transition to a more dovish stance and perhaps cut rates as soon as the second half of 2023. Unfortunately, we believe that assumption is too hopeful and believe the central bank will be on hold longer as both service and wage disinflation occur more slowly than investors expect. Current stock multiples remain higher than the trough levels witnessed during the last three bear markets, creating some future risk.

OUTLOOK

The second leg of this bear market is likely to be driven by negative revisions to earnings. While 2023 S&P 500 Index earnings expectations have started to decline, we believe that estimates probably have at least a 10% downside and expect steady erosion throughout the year. The Purchasing Managers Index (PMI), which measures both manufacturing and services activity, is a good forward-looking indicator of future profits. PMIs are expected to bottom around the second to third quarter of 2023, which suggests corporate earnings will hit a trough around the same time.

That said, there remains reasonable debate about the depth of a future recession. The unique circumstances surrounding COVID-19 (as well as further implications from the Russia-Ukraine war) and its global effect on inflation, labor, supply chains and supply vs. demand make forecasting a challenge. The yield curve, which has an excellent track record, hasn't been this inverted since Paul Volcker was Fed chair and is clearly forecasting a recession. Yet credit spreads, which have widened notably, are not yet at recessionary levels.

Exhibit 3: While Yield Curve Sending Recessionary Signals...



Data as at 12 December 2022. Source: Bloomberg.

OUTLOOK

Exhibit 4: ...Credit Spreads Not Yet at Crisis Levels



Data as at 9 December 2022. Source: Bloomberg.

Clearly, the market has begun to price in a more subdued outlook and certain companies are beginning to discount earnings growth. Anecdotally, companies that missed second-quarter earnings almost uniformly saw sharp stock price declines, while third-quarter misses resulted in a more mixed reaction. While we do expect a recession in 2023, we are not ready to opine on its severity. We believe a more modest decline would likely keep the bear market within the scope of the prior lows while a more severe outcome would push stocks to fresh lows.

We see market performance in 2023 shaping up to be a tale of two halves. At 2023's outset, we continue to lean defensively and favor companies with solid balance sheets, durable cash flows and dividends. Many of these companies reside in traditional value-oriented sectors. However, when market participants become convinced the bear market is over, market leadership will rotate toward small cap and more aggressive, higher risk stocks.

As active managers and fundamental stock pickers, we embrace 2022's elevated volatility as an opportunity to differentiate while the bear market grinds toward a durable bottom. The timing of a market bottom and absolute depth of the market decline will be a function of how quickly the Fed gets inflation under control and the depth of a likely recession. In the meantime, we are building lists of stocks to own for the long term and stand ready to take advantage of the temporary price dislocations that volatility and bear markets create.

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