

“The trick is not to learn to trust your gut feelings, but rather to discipline yourself to ignore them. Stand by your stocks as long as the fundamental story of the company has not changed.”

Peter Lynch

IN FOCUS:

For the most part, U.S. equity prices remain on an upward trajectory, supported by improving economic prospects and rising earnings. First-quarter earnings reports have been overwhelmingly positive, with most companies beating consensus top- and bottom-line forecasts by large margins, and in some cases, also raising guidance. Share price reactions to the earnings beats and guidance raises have been somewhat muted, underscoring that the equity market has discounted a lot of good news, and the easy gains are likely behind us.

While inflation fears have put pressure on stock prices over the more recent days, in our estimation the downside should be limited - eliminating some of the valuation froth, as share prices are supported by the expectation of earnings growth through next year. Analysts are forecasting a healthy 12.0% jump in S&P 500 earnings in 2022, which follows the 32% increase forecast for this year.

As you may be aware, April’s Consumer Price Index (CPI) was up 4.2% y/y, which was more than expected, causing prices of stocks with high valuation multiples to drop. Much of the jump was attributable to the base effect on various components of the CPI that were depressed a year ago by the pandemic-related lockdowns. The base effect should diminish over the next few months providing a better handle on the underlying trend in consumer price inflation. We believe that the headline CPI inflation rate will range between 3%-4% through the summer and then settle down to 2.0%-2.5% later this year. Fed officials are likely to say that the rebound in inflation is what they expected and that it should be transitory. They are likely to reiterate that their monetary policy course remain unchanged.

The positive economic and earnings outlook should continue to provide tailwinds for equities in the year ahead. However, elevated valuations could limit returns and leave the market vulnerable to periodic bouts of volatility as bond yields climb in response to stronger economic growth and higher inflation readings. Moreover, technical conditions appear overbought, implying that a pullback or consolidation phase is likely in the near term.

We are neutral on sectors with large exposures to growth or long-duration equities (i.e., Technology, Communication Services, and Consumer Discretionary), and underweight fixed-income proxies such as Consumer Staples, Utilities, and Real Estate, given the upside risks to bond yields on a 6–12-month horizon.

CLOSE-UP: The Economic Landscape as the Second Quarter Unfolds

Will peak earnings growth doom cyclical leadership? The positive earnings picture remains a key support for the equity market and the relative performance of cyclical sectors. The profit cycle, which we define as the year-over-year (YoY) percent change in the 12-month forward earnings of the broad equity market, began moving higher in mid-2020. Overall, we believe earnings growth will accelerate significantly in the next few months as weak earnings from last year are lapped.

As we have previously highlighted, the profit cycle can be a useful tool for cutting through macro noise and provides a good crosscheck on how to position equity portfolios. History shows that accelerations in the profit cycle generally favor the outperformance of cyclical stocks, while decelerations in overall earnings growth have supported defensive leadership.

This relationship can be proxied by comparing the performance of Industrials relative to Consumer Staples stocks with the YoY percent change in the broad equity market's forward earnings. The positive correlation between the profit cycle and the relative performance of cyclical stocks makes intuitive sense, since cyclical companies drive overall earnings growth.

Accelerating corporate profit growth suggests that cyclical stocks have further room to run relative to their defensive counterparts. That said, overall profit growth should peak later this year, and with cyclicals already having significantly outperformed defensives, it is reasonable to question whether cyclical leadership will begin to fade in anticipation of a peak in overall earnings growth momentum. We believe it is premature to begin paring back exposure to cyclicals. Many of the macro conditions that have supported the outperformance of cyclical stocks are expected to remain in place. These include hyper-accommodative monetary policy, fiscal stimulus, and improving global trade. Thus, overall earnings growth, while decelerating, will remain strong through the balance of the year and into 2022. Moreover, we expect inflation to pick up and bond yields to climb further once oversold conditions in the government bond market unwind, both of which should provide tailwinds to the relative performance of cyclicals.

Corporate taxes will be a key consideration for the 2–3-year earnings growth outlook. If President Biden's proposed corporate taxes hikes are passed, they could lead to a more pronounced deceleration of overall earnings growth in 2022 and beyond. However, at this time, there are significant uncertainties about the magnitude and timing of the tax increases, and the extent to which they will be packaged with other fiscal measures such as increased infrastructure spending. Until such details are known, it is difficult to assess how the proposals will impact earnings in the next 2-3 years.

While it is premature to rotate out of cyclicals, a prospective peak in the profit cycle reinforces that investors will need to be more selective in allocating to pro-growth sectors. Despite significant year-to-date outperformance, we expect further relative upside for the Financial and Energy sectors on a 6–12-month horizon. Relative forward earnings for Financials will continue to benefit, as the economic recovery improves credit quality and bolsters the outlook for loan growth and bank net interest income. Although we expect oil prices to be range-bound in the year ahead, Energy stocks should still see a significant recovery in their underlying relative forward earnings. Valuations for both sectors remain reasonable versus their history, implying that there is ample room for them to further re-rate. We would use near-term weakness to add to positions in the banks and consumer finance groups, and continue holding our oil and gas positions.

A prospective peak in the profit cycle also underscores that some defensive exposure is warranted, especially given the risk of a near-term pullback or consolidation phase in the equity market. We favor Healthcare stocks for this purpose. The sector is currently unloved, but it retains significant re-rating potential given its solid earnings growth prospects, historically low valuations, and diminished policy risks. Declines in medical visits and elective procedures have weighed on the earnings of some drug and medical equipment companies, but this headwind should reverse as the vaccines enable a recovery in patient visits.

CONCLUSIONS – And What This Means for The Markets:

The profit growth cycle is poised to peak later this year. However, this does not signal an imminent end to cyclical leadership. The macro conditions that have been supporting the outperformance of cyclical stocks are likely to remain in place in the year ahead. Nevertheless, we believe one should be more selective in allocating to cyclicals and have some exposure to defensive equities given demanding valuations in some pro-growth sectors and the risk of a near-term pullback or consolidation phase in the equity market.

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