ALTMAN
INVESTMENT MANAGEMENT

BRIEF INSIGHTS

December 13th, 2022

IN BRIEF:

As this last month of the year unfolds, the stock market certainly has the jitters, as investors are equally worried that the economy may be too strong and that it may be too weak at the same time. The S&P 500 has been under some selling pressure since the November's non-manufacturing purchasing managers index revealed stronger than expected numbers. Investors concluded that the economy may be too strong, requiring the Fed to raise interest rates still higher and increase the risk of a recession.

The purchasing managers index was followed by additional investor concerns that a recession is now under way. At the Goldman Sachs banking conference this week, during an interview with CNBC, JPMorgan Chase's CEO Jamie Dimon declared that inflation and its impact on the consumer "may very well derail the economy and cause a mild or hard recession that people worry about." Separately, Morgan Stanley announced that the company will cut 2% of its workforce. Meanwhile, the yield-curve spread between the 10-year and 2-year Treasuries suggests that the Fed's monetary policy tightening cycle is almost over. One could conclude that either a recession is imminent in the U.S. or that inflation is likely to keep falling, and potentially avoid a recession.

The recent CPI report coupled with this week's FOMC meeting will bring more clarity. The lower-than-expected CPI report likely gives another lift to a sustainable year-end rally. Gasoline and used car prices fell in November as durable goods inflation continued to moderate. It's important to note that even rent inflation is plunging, according to newly released data.

While recession fears are now widespread, we are expecting global growth to be soft but still resilient next year, with the U.S. economy holding up better than the G7, the euro area should be perking up after a tough winter, and China eventually resuming more normal economic activity. This should temper corporate credit defaults and prevent a pronounced decline in corporate earnings. We would expect inflation will ease in the coming months helped by more favorable year-over-year comparisons, lower energy prices and lagging indicators to slower growth. However, a resilient global economy implies that inflation will ultimately prove stickier than is discounted later next year and the Fed will have little room to fulfill market expectations of rate cuts. A more positive turn in the liquidity cycle doesn't look like it's on the horizon, and the overarching investment climate could be characterized as late-cycle. Such a scenario is consistent with conditions in capital markets favoring periodic tactical asset allocation shifts rather than a decided pro-growth or defensive investment posture.

Accordingly, we continue to advocate an overweight stance on equity with some cash on the side lines in balanced/multi-asset portfolios. We maintain our portfolio tilt in favor of equities versus bonds, but find that in absolute terms the road to outsized returns on a 6–12-month horizon may be challenging despite the improvement in valuations. We remain underweight commodities with the exception in energy, expecting soft demand conditions to outweigh supply constraints and the U.S. dollar to move lower in the next year.

Markets - Rewards and Risks:

There is ample room for surprises to either the upside or downside in 2023.

On the upside, a quasi-Goldilocks scenario of easing inflation, pausing central banks and a stronger than expected recovery in euro area and Chinese economic growth could enable equities and commodities to outperform our expectations, while catalyzing a pronounced and overdue rotation away from the U.S. stock market.

The current risk-on phase will likely last into the new year, but despite better valuations than a year ago, the 6–12-month investment climate could remain challenging given economic growth and policy uncertainty.

- We believe that inflation will ease and the Fed will pause in the coming months, but markets may be overly optimistic about Fed rate cuts in the second half of 2023, especially given an expected resilient global economy and sticky inflation.
- Balanced/Multi-asset portfolio returns should continue to be volatile next year, with subdued performance most likely over the year as a whole. Accordingly, we remain somewhat cautious on buying the dips indiscriminately in portfolios.
- We would expect lower inflation and a pausing Fed should provide some support for bonds into the first half of 2023, but another leg up in yield is likely thereafter - and we remain underweight duration in a multi-asset portfolio. Bond investing will need to be cognizant of potential credit risk and we remain overweight investment-grade corporates in shorter duration versus the benchmarks within a fixed-income portfolio.
- We also believe there is limited sustainable upside for global equities on a 6–12-month horizon, with earnings expectations destined to get downgraded along with valuations (forward price/earnings ratios), particularly as continental Europe drops into recession. A rotation away from the U.S. could develop over the year with the euro area stocks remaining the favored regional market.
- There is further downside for the U.S. dollar in 2023, but stock selectivity will be key. We remain cautious on commodities until global growth prospects improve.

On the downside**, geopolitics could continue to weigh on economic activity in China and the euro area, adding to growth risks.** U.S. government bonds would fare well in such a scenario, but significant downgrades to corporate earnings could drag down equity and credit prices. Conversely, if bond yields were to climb materially in 2023, then the overleveraged global economic “weak links” could potentially trigger continued economic and financial market headwinds.

We would expect traditional equity-bond portfolio performance should improve in 2023, after this year’s brutal losses (albeit tempered by the recent rally). The fundamental outlook for both stocks and bonds in the next year is muted and returns will likely be subdued by historic standards, accompanied by above-average volatility. Global stock/bond allocations have indeed risen to the upper-end of this year’s range, which has otherwise been choppy. Both global equities and G7 10-year government bonds have posted gains since mid-October, reflecting optimism that the Fed’s hiking cycle is nearing its end as inflation gradually eases. Both stocks and bonds were deeply oversold prior to the bounce, and could continue moving higher through year-end, especially with most balanced portfolios still in negative territory and investors anxious to reduce losses. While both stocks and bonds are still oversold, the economic growth and policy backdrop appears to indicate lingering downside risk to balanced portfolios.

The returns of balanced accounts typically weaken during periods of slowing growth, and generally reflect decelerating corporate earnings growth. The latter has fallen just below the 50 boom/bust level, and there is no evident catalyst for an imminent upturn. The prospect of easing inflation in first half of 2023 opens up the possibility for both stocks and bonds to rise further in the near term - although if global growth momentum remains weak the impact on stocks and bonds would be unclear. In the months ahead, we will remain vigilant in watching broad financial conditions to provide a perspective for assessing the investment climate. Following the Fed's aggressive rate hikes and the fallout in asset prices, U.S. financial conditions have swung dramatically from wildly easy to broadly neutral.

A Note on the Fed:

Even assuming inflation is poised to decline steadily, it seems unlikely that the Fed would be comfortable at this juncture with a significant easing of financial conditions, i.e., a meaningful rise in stock prices and decline in bond yields. Indeed, the Fed has repeatedly indicated it wants tighter financial conditions to help wring out inflation. This argues against a sustained advance in equity prices. Meanwhile the Treasury curve is deeply inverted, with the 2-year yield approximately 100 bps above the 10-year yield. Some are interpreting the inverted yield curve as signaling an imminent recession, but in fact, yields at the long-end have a bigger impact on the economy and are consistent with easy rather than tight monetary conditions. The level of interest rates is far more important than the slope of the yield curve. A negative yield curve could be signaling that monetary conditions ultimately may have to tighten further if the Fed is to sustainably suppress inflation, capping any upside for both stock and bond prices. An extreme inversion of the yield curve also implies that U.S. Treasury market volatility will likely stay high over the next year, which is an impediment to stable broader capital markets.

U.S. equities initially responded exuberantly to Fed Chair Powell's recent comments when he noted that a slower pace of rate hikes looms, building on the bounce that began in mid-October. Global equities still have room to bounce based on the MRB Cyclical Momentum Indicator, and they have at least tentatively broken out of the downward trend that had prevailed since the beginning of the year. Powell's statement came as no surprise, but underscored that investors welcome the absence of bad news after a very difficult year.

A Perspective on Valuations:

While equity investors' focus has been on central bank policy rates, the outlook for equities in the year ahead primarily hinges on how earnings fare. The global 12-month forward price/earnings ratio is relatively low at 15X. However, the ratio is poised to get downgraded in the months ahead. The initially-appealing P/E ratio also masks a large gap between the U.S. and global markets. The 12-month forward P/E ratio on consensus earnings is at 18X in the U.S. versus a much more appealing than 15X for the global benchmarks. Both the U.S. and global forward earnings estimates are falling as 2023 expectations get trimmed, although the latter has been partly exacerbated by the strength of the U.S. dollar. We do not expect a major downgrade cycle for the global benchmarks. Any improvements in non-U.S. earnings expectations likely awaits clear evidence that the euro area and China economies are back on better growth paths. This conclusion may not get reflected in consensus earnings forecasts until the back half of 2023. However, earnings are less elevated than those of the U.S. and should get support from an expected depreciation of the U.S. dollar.

There is greater uncertainty and potential risk for U.S. earnings, although again, a major earnings recession is not in the cards. But as we have stressed, U.S. earnings performance since early-2020 has been extraordinary by any measure and earnings for several major sectors were brought forward and at least a partial reversion to the mean is likely. U.S. 12-month forward earnings are approximately 30% above their immediate pre-pandemic peak less than three years ago. The rebound in the year to mid-2021 was both the strongest and quickest on record and has been further bolstered in the past year by the surge in inflation (earnings estimates are in nominal dollars). Given the inevitable deceleration in U.S. corporate revenue growth in the year ahead, and the fact that margins and return on equity remain historically high, we expect 2023 earnings to be in single digits, implying earnings downgrades in the months ahead. On that basis, the 12-month forward P/E ratio on the U.S. market is closer to the higher end of the range (historically the 30-year average is 16.5X). We have yet to build in any adjustment to U.S. forward P/E valuations even if earnings expectations remain firmer than we expect. The implication is that the U.S. market will struggle to generate sustained double-digit gains over the next year from current levels. With the U.S. representing 60% of global market capitalization, a rebound in non-U.S. markets should provide a modest boost to global equities. Investors should expect global equities to generate improved overall returns in 2023, with a potential for temporary drawdowns during the year.

A key theme for 2023 will be a rotation away from U.S. market leadership, although it will likely be bumpy and may be limited to select non-U.S. markets. Moreover, such a rotation hinges on the expected improvement in the economic outlook in the euro area and China, which we expect to become apparent over the next several months.

The U.S. economy is proving more resilient than pessimists expected, with the energy crisis less intense than feared a few months ago, and strong underlying fundamentals remain in place. Relative forward earnings for overseas benchmarks have also had a major upward revision, although that has been coincident with a jump in the euro versus the dollar over the past month. Regional relative earnings have been highly resilient over the past three years but still have considerable upside to return to pre-pandemic levels.

While we expect a gradual re-opening of China in the coming months, it will take time for that to be reflected in an upturn in its absolute and relative earnings. We expect Emerging Markets (EM) tech sector earnings will likely remain under pressure in the near term. Technology stocks represent approximately 20% of total EM market cap and will therefore act as a significant constraint on overall performance. We continue to advocate a value bias in sector exposure favoring financials and health care. The former is leveraged to rising short-term interest rates that boost net interest income, while the latter provides defensive posture in what we expect will be a choppy equity climate.

We also continue to emphasize value stocks over growth stocks. While earnings growth will be scarce in the year ahead (which normally favors growth stocks), there is still greater downside earnings risk for mega-caps in the tech and tech-related sectors, while the earnings outlook remains favorable for financials, which is the largest component of the global value index.

In Summary:

The economic and policy outlook points to continued choppiness of the global stock and bond markets - and doesn't suggest a major breakout in either direction. Nonetheless, a Fed pause and an eventual pick-up in growth in the euro area and China justifies maintaining a modest tilt in favor of equities versus bonds on a 12-month horizon.
