MARKET PERSPECTIVE

FEBRUARY, 2023

IN FOCUS:

From 30,000 feet high, the investment landscape remains attractive. The global economy is proving resilient, inflation is poised to continue to ease (albeit at a slower pace) in the coming months, and major central banks are likely to pause their hiking cycles by or before mid-year. After last year's bloodbath, stocks, bonds, commodities and even cryptocurrencies have rebounded significantly in the past quarter, with price trends for many assets now tilting in a decidedly positive direction. We have been and remain comparatively constructive about the economic outlook, although the consensus is catching up to our view. As we outlined in our January *Equity Strategy Focus,* we expect the U.S. to avoid a recession, while economic momentum in China and the euro area appears to have improved markedly since year end.

The stock market correction in 2022 was largely driven by multiple compression (a drop in the market's valuation multiple). Studies have shown that valuation multiples tend to be inversely correlated with interest rates. These valuation levels approached the high end of their historical ranges, following the stimulus-induced, speculative stock market rally that trailed the pandemic. At the end of 2022, the consensus estimate by Wall Street analysts for 2023 S&P 500 Index earnings growth was close to 5%. According to Ned Davis Research, since World War II, the average earnings decline during recessions has been approximately -25%.

We believe corporate earnings growth in 2023 could disappoint and come in closer to 3%, according to Yardeni Research. As intended, the Fed's deliberate moves to slow the economy and bring inflation under control will likely weaken aggregate demand.

The economic impact of Fed interest rate increases tend to work with a lag, and could result in continued pressure on corporate earnings in 2023 - and run into 2024. In this environment, we remain focused on mitigating downside exposure, while staying attuned to investment opportunities that ongoing market volatility may create.

Stock/Bond Allocation and Investment Strategy Outlook:

The recent risk-on climate has driven the global stock/bond total return mix to an all-time high. This blended ratio has begun to re-establish an uptrend after spending most of last year in a sideways trading range. More specifically, the global 60/40% portfolio of equities and 10-year government bonds has recouped about 40% of the peak-to-trough losses last year, although it is still down approximately 10% from its early-2022 peak, according to MRB Research. The rally in global equities has been even more impressive with the indices some 17% above their 2022 lows - while global (G7) 10-year government bond total returns have increased approximately 7% from last year's low. There remains considerable uncertainty and debate about the economic outlook, but our more constructive view relies on:

- The U.S. economy is likely to slow further in the coming months, but a recession is still unlikely in our view given moderating inflation and the underlying financial strength of the household and corporate sectors.

- China will be a net positive for global growth this year. Chinese consumers' savings accumulated during the lockdowns should help drive an economic rebound, which was imminent as mobility improves (evident in the surge in last month's services PMI).

- The euro area will be another positive surprise for the global economy. Sentiment is improving across most sectors and countries, as the energy shock fades. Barring any fresh shocks, lingering pent-up demand from the pandemic should ensure that the region's growth momentum continues to gather speed. There are tentative signs that global manufacturing activity is bottoming as well, which typically is followed by a pick-up in economic momentum.

Historically, continued economic expansion points to further upside for an equity bias in balanced portfolios (Stock/Bond ratio). However, because of the unique nature of the current cycle and last year's bond market losses, an overall elevated equity exposure ratio may be ahead of an expected firming of global growth momentum. This implies a more muted upside at this juncture compared with past expansion phases. Moreover, past economic expansions and strong rises in the stock bond mix coincided with sharp declines in the global (G7) unemployment rate from elevated levels and pronounced increases in corporate ROE from generally depressed levels, neither of which are now present. The current unemployment rates and ROE may be more consistent with late-cycle investment conditions. These underlying constraints aside, according to our internal research both global equities and global 10-year government bonds remain oversold, based on many cyclical indicators.

A Closer Look at how the U.S. Debt-Ceiling Crisis Unfolds:

The political battle over raising the U.S. debt ceiling is now ramping up in Washington, with federal debt surpassing the statutory limit last month. Treasury Secretary Yellen has already proposed/undertaken measures that should enable the government to service its debt until June, but ultimately only the Congress can authorize a formal increase in the debt ceiling. The issue is now front and center for the new Congress and political posturing on both sides is heating up. How things will play out remains to be seen, but our expectations are that an agreement will be reached by early June to avoid a formal default. However, it may very well be pushed to the final hour. We suspect that Treasury Secretary Yellen's June date likely has some additional financing flexibility that she has yet to acknowledge. While the Biden Administration has indicated it is unwilling to negotiate on the ceiling, we suspect it inevitably will do so to avert disaster. But, like Yellen, it will delay engaging in serious negotiations hoping that political pressure on the Republicans will force a capitulation as the June deadline approaches. Various hardline elements in the Republican Party in both the Senate and House have advocated demanding aggressive spending cuts to raise the debt ceiling, but the specific proposals have yet to be outlined.

As of the state of the Union speech on Tuesday night, there appears to be little appetite for cuts to Social Security or Medicare, and likely defense that would fulfil hardliners demands, which combined with net interest account for more than 60% of total spending. Republicans are certainly not willing to entertain tax increases so there is little room for reaching agreement on a budget before the debt ceiling deadline. Party leadership will make this clear as the discussions progress. Senior Republicans feel the party suffered reputational damage from the 2011 crisis and will want to avoid a replay now as the party begins preparing at yearend for next year's crucial presidential election campaign.

Although we expect that an agreement to raise the debt ceiling will ultimately be passed, we do not rule out that markets may get spooked about a default as the deadline approaches. It is worth noting, however, that during the 2011 debt ceiling crisis, 10-year Treasury yields declined despite an S&P credit downgrade of U.S. government debt. Shorter-term interest rates such as the 1-month Treasury bill briefly spiked, with investors uncertain what might happen when the bills matured. In essence, markets did not lose faith in the underlying credit worthiness of the government, only that there could be some delays to the repayment of short-term obligations.

Global Markets Revisited:

Keep in mind that the European sovereign debt crisis also escalated in mid-2011, which supported the U.S. dollar and longer-dated Treasuries, as investors reduced exposure to European bonds and euro-denominated assets. The implication is that the global landscape may be less supportive of U.S. Treasuries than was the case during the last debt-ceiling crisis. That all said, it is very early days in the new Congress to understand when/how the hardliners might react. How the market might react will also depend on pricing and economic conditions at the time, which are yet to be determined. Ultimately, it will most likely be a bump in the road, but that does not preclude markets from veering off track for a while. At this point, the threat is not having a material impact on our investment outlook or asset allocation.

Financials and industrials, two heavyweight cyclical sectors, have developed positive trends that also augur favorably for broader stock market participation if they persist. Financials, normally an early-cycle play, have benefitted from the rise in interest rates over the past year and look poised to challenge their January 2022 highs in absolute terms, absent any deterioration in global growth conditions. Industrials, normally a mid-to-later-cycle sector, do not have the same steam as financials, but appear in an uptrend that was established in the start of Q4. It's noteworthy that the rebound in global equities since October reflects a re-rating (i.e. a higher 12-month forward P/E ratio), consistent with a more upbeat investor outlook for the global economy and the modest decline in U.S. bond yields. The global 12-month forward P/E ratio for global equities is now back to its 1990's median trendline, according to MRB Research, signaling that global equities have driven more positive shifts away from U.S. exposure.

While global and U.S. earnings revisions continue to be quite depressed, risks could still remain to the downside in the near term, especially in the U.S. The 12-month forward P/E ratios and earnings are also distorted by the pronounced divergence between those of the U.S. and global ex-U.S. benchmarks. The U.S. market trades at a pricey 18 times 12-month forward earnings compared with a lower ratio of 12 times for the global ex-U.S. benchmark. Similarly, the U.S. return on equity is historically elevated at 20% and could be vulnerable versus the more moderate 12% for the global ex-U.S. benchmark.

The sharp divergences between U.S. and global ex-U.S. equities, aggregate earnings and valuation metrics don't provide the only rationale for increasing global stock exposure in portfolios in the year ahead. We believe it is more useful to examine the specific performance outlooks for the U.S. and global equity markets in the context of the dominant sectors in each of the indexes, as well as the U.S. Dollar exposure.

We continue to favor value stocks over their growth counterparts - with the former benefitting from the anticipated better than-expected global economic upturn, while the latter still vulnerable to earnings downgrades after over-earning during the pandemic. On the surface, the macro climate should eventually favor small caps over large caps, but interest rate headwinds present a challenge in the near term. An improving macro climate in the year ahead should provide support for equities, but upside will likely be capped by a richly priced U.S. market with already elevated earnings. Performance of global markets has exceeded the U.S. as the first quarter got underway. However, we believe this trend may have already run its course.

Is the Fed Pivoting Yet Again?

The Fed issued a smaller rate hike at the last FOMC meeting, setting the tone for terminating the ongoing phase of policy tightening in a few months. Bond investors are anticipating a quicker end to policy tightening than the Fed has signaled, and forward markets started pricing in policy rate cuts later this year, a move which, in our view is unlikely. In fact, recent financial market action and perceptions of a dovish Fed ahead have further reduced the chances of weak growth. In other words:

- The Fed will likely hike the policy rate by an additional 50 bps ahead to 5-5.25%, and keep the policy rate at least at that level through year-end.

- We do not anticipate a U.S. recession this year, and only a certain recession would trigger such rate cuts in our view. The Fed is expecting that the ongoing disinflation in goods prices, and the in-the-pipeline disinflation in housing will eventually extend to non-shelter services. We are less optimistic in this regard. Our out-of-consensus view is that the Fed will have to eventually hike rates further to achieve its 2% inflation goal in 2024.

The bottom line is that the policy rate will be much higher for much longer than the bond market is currently expecting. Unless a recession becomes inevitable, the outlook for Treasuries could turn bearish as the year unfolds.

The Economic Landscape:

Economic uncertainty is elevated for valid reasons. This sentiment reflects so many atypical developments this decade, starting with the pandemic, the massive policy response, the stop-start nature of re-opening with a very de-synchronized pattern between and within the major economies, the war in Ukraine and resulting energy crisis last year, and the surge in German inflation to 40-year highs. We anticipate somewhat better overall growth conditions, due to the euro area and China/Asia rebounding. Of course, the cessation of the free money era and lifting in policy rates will remain economic drags. However, the amount of prior policy stimulus was massive, and some of it has still not been spent. The key going forward will be the health of corporate profitability, which has been underestimated in our estimation by the recessionary enthusiasts and has manifested in a slowing but still positive employment and hiring conditions. No doubt, U.S. profitability should be under pressure going forward. However, it remains resilient which is very favorable for long term prospects.

While there are many (supposedly leading) recession indicators that paint a downbeat picture, we suspect that the unique economic environment since 2020 has distorted these gauges. We would particularly ignore the mega-bearish "signal" from the deeply inverted U.S. 2/10 yield curve. It is the change and level of borrowing rates that ultimately drives/undermines growth. The long end of the curve reflects misplaced (and entrenched) expectations for a quick, and sustainable, return to 2% inflation.

In our view, declines in core CPI reflect an unwinding of some unsustainable surges last year, rather than a true resetting due to an inflation-busting recession. The result will be a levelling off in core inflation later this year at a rate above levels recorded in recent decades. While the rebound in government bond yields was sizable last year, one must keep in mind the extremely distorted starting point: a massive undershoot in yields and record overvaluation. The rebound in 2022 allowed yields to return to fair value. However, it appears that "fair value" may start to drift higher after a 40-year steady downtrend.

Whether fair value will now rise or flatten off depends on central banks' tolerance of inflation and their willingness to risk a recession. The Bank of Canada recently confirmed that the major central banks are not yet willing to deliver an economic blow without at least giving inflation a chance to return to the levels of the past two decades without a recession. While this will provide a relief to bond and risk asset markets in the coming months, it may be only temporary and result in another up leg in bond yields down the road.

IN SUMMARY:

We believe there is not sufficient slack in the U.S. economy to return underlying or core consumer price inflation to near 2% - and bond investors may be too complacent. We think that although the Fed and other central banks may pause their tightening policy/rhetoric in the next few months, further rate hikes may be required before the cycle ends. We are maintaining a pro-growth investment bias, justifying our bullish equity exposure, while investors revise their global growth expectations higher. This assumes that global bond yields stay relatively calm. This backdrop supports our view that cyclical stocks offer better relative valuation and earnings upside. We are emphasizing financials and industrials, while hedging portfolios with the defensive healthcare group, should inflation prove to be more stubborn than expected.