A BULLISH CASE FOR US EQUITIES

JUNE 2023

GLOBAL MARKET OUTLOOK

Thus far in 2023, market movement is increasingly looking like the new bull market. Pessimism remains rampant, especially after several small or long-troubled banks failed in mid-March, igniting fears of a 2008 redux. Such worries overlook the unique nature of these banks' issues and the global financial system's robust general health. Overall, prevalent pessimism is a common feature of new bull markets, as well-known worries like recession and high inflation overshadow a reality that isn't as poor as feared. Muddling economic growth can exceed low expectations and positively surprise—a powerful force underpinning what we believe is a new bull market.

Since the bear market low last October, growth equities, like Tech and Tech-like firms, have performed well despite growth leadership being unusual early in a bull market. The outperformance follows a simple-yet-unseen reality: In early bull markets, the categories of equities hit hardest in the preceding bear market usually lead early in the rebound. Normally that is economically sensitive value equities as they are typically punished the most in a recession. However, the most widely anticipated recession in modern history has failed to materialize.

Value could lead later if a recession does strike, but the category would likely be punished first. We carefully watch markets for such signs, but we ultimately think it is best to maximize the likelihood of participating in the bull market bounce by overweighting previously hard-hit growth equities.

Entering the new year, we said that whether the bull market started last October or began this year, we believed global equities would most likely end 2023 far higher than where they began it, fueled by big early bull market returns. We still think so. As we wrote in Q4 2022's Review and Outlook: "A year from now, the reality of partisan gridlock will have dawned on all, with few major bills to rock the boat. Inflation should keep slowing. And Fed rate hikes will have proven feckless, as banks' high deposit bases mute the fed-funds rate's impact on loan profitability and enable banks to lend enthusiastically at big profits. On all fronts, we believe 2023 should bring sweet relief."

WHY OVERWEIGHT US?

As previously mentioned, we believe equities hit hardest during the 2022 bear are likely to perform best in the early stages of the new bull—which has largely played out since October 2022. US equities are skewed toward these types of high gross margin, mega-cap firms, particularly in the Technology sector. Relative to the MSCI World, the US has significantly more weight to Information Technology, Communication Services and Health Care, all sectors with significant growth exposure. A strong overweight to the US means a strong overweight to many of the bottom-decile performing equities in 2022—a category that has strongly rebounded in 2023.

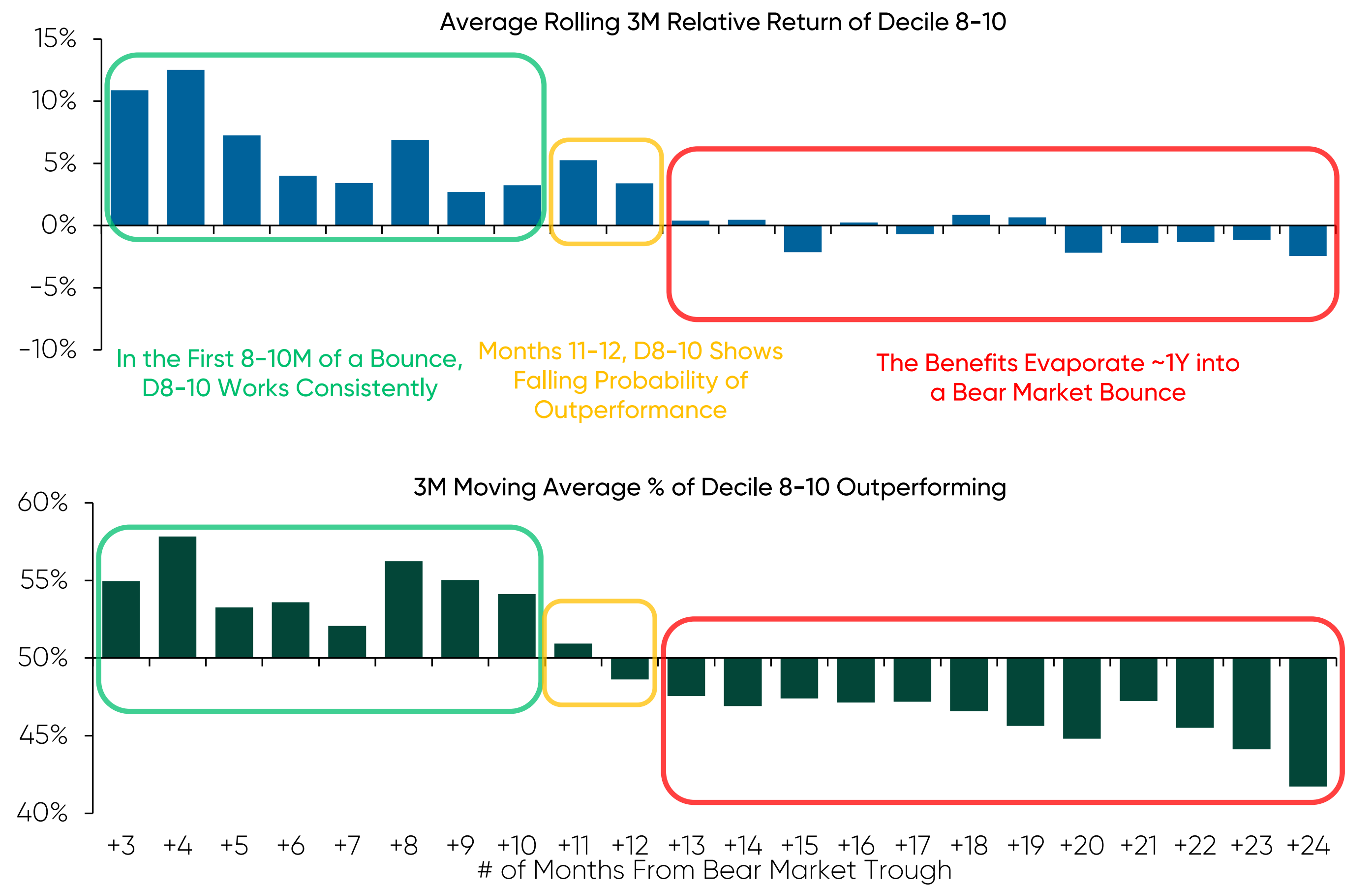
Exhibit 1: MSCI USA Sector Weights vs. MSCI World

Sector	MSCI USA	MSCI World	Relative Weight
Information Technology	28.3%	22.1%	6.2%
Communication Services	8.5%	7.1%	1.4%
Health Care	13.4%	13.0%	0.5%
Real Estate	2.4%	2.3%	0.1%
Consumer Discretionary	10.9%	11.1%	-0.2%
Utilities	2.5%	2.8%	-0.3%
Energy	4.0%	4.5%	-0.5%
Consumer Staples	6.5%	7.5%	-0.9%
Materials	2.5%	4.1%	-1.6%
Industrials	8.8%	11.0%	-2.2%
Financials	12.1%	14.5%	-2.4%

Source: FactSet as of 22/06/2023.

It is also worth noting that the bounce phase of early bull markets tend to last between 8 to 10 months on average. However, there is minimal risk in exiting these equities even 12 months after the bear market trough. Exhibit 2 illustrates how the bottom deciles typically continue to outperform nearly a year into the new market cycle, emphasizing how market timing is overvalued and adhering to core convictions is key.

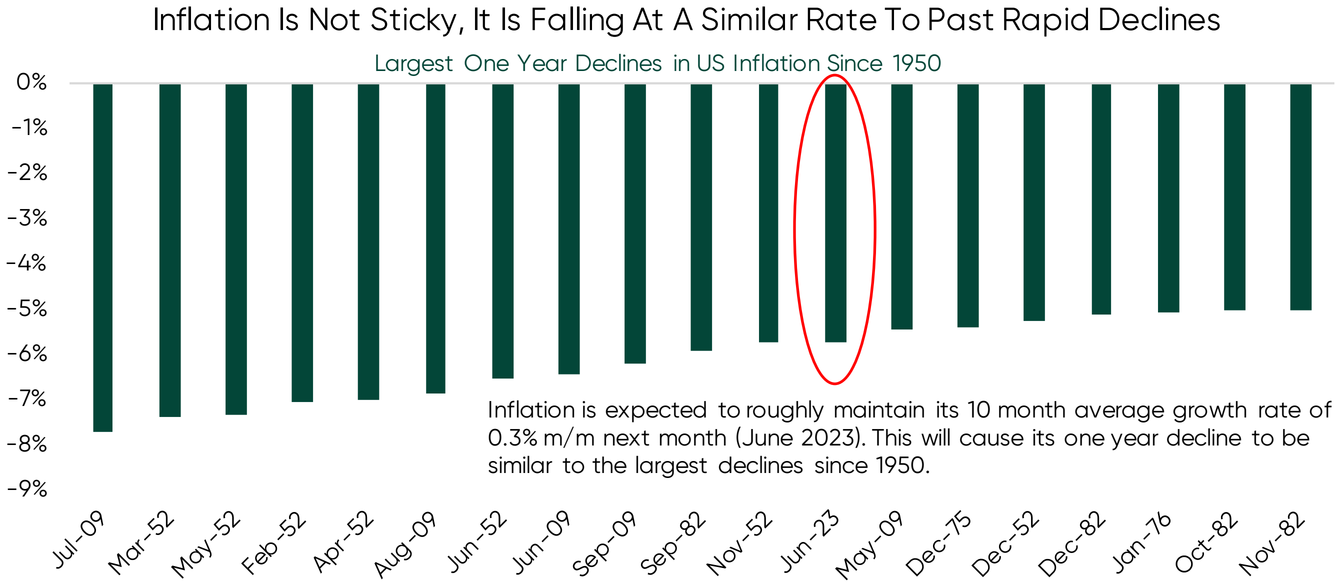
Exhibit 2: Bounce Effect Duration



Source: Clarifi and FactSet, Monthly S&P constituent total returns based on S&P 500 bear markets from 1966-2020. Returns based on the bottom 8 to 10 deciles during each bear and the average following returns.

Underappreciated economic fundamentals in the US present another reason for optimism. While fears and negative news drew the headlines all of 2022, much of the positive economic data since the start of 2023 has been dismissed. For example, despite many media reports on the subject, inflation is not "sticky" and is declining similar to the fastest rates of deceleration we have seen since 1950. (Exhibit 3) On a year-over-year basis May US inflation, measured by headline Consumer Price Index (CPI) data, slowed from +5.0% to 4.1% while Core CPI decelerated from +5.5% y/y to +5.3%.[i] As US CPI continues to decelerate and prices for stubborn component-level contributors like shelter and used cars moderate in the coming months, the acceleration of the disinflationary trend should buoy equities nicely.

Exhibit 3: Inflation Is Not Sticky



Source: Global Financial Data and Factset, monthly data, Cleveland Fed Inflation Nowcast forecast used for June 2023's inflation rate.

On the political front, our Midterm Miracle forecast, the US midterm election phenomenon where increased political gridlock ignites market rallies, has played out quite well by historical standards. As the election came and went, the reality of gridlock seemingly set in. Political rhetoric didn't subside, especially during the debt ceiling debates, but little legislation has squeaked through, reducing the threat of government action creating winners and losers. Prior to the 2022/2023 period, the three quarters starting in the midterm year's Q4 average 6.3%, 6.6% and 5.5% gains, respectively, rising 83.3%, 87.5% and 87.5% of the time.[ii] Q4 2022 and Q1 2023 have proven no exception, rising 7.6% and 7.5%. Q2 2023 is shaping up nicely as well.

ALLEVIATING COMMON CONCERNS

REGIONAL BANK FAILURES

Following Silicon Valley Bank's and Signature Bank's failures, fears abounded about contagion. However, we believe the Fed's and US Treasury's swift response helped prevent these banks' idiosyncratic issues from creating a larger-scale banking crisis. There is little fundamental sign of trouble, either. Emergency Fed lending remained well below March and April levels.[iii] Discount window uptake ended May below pre-SVB failure levels.[iv] To us, this revealed little sign of a growing crisis. While the Fed's Bank Term Funding Program, rolled out in March, saw little decline in use, it also didn't see a material rise, and there could be benign reasons for the continued use—such as its low rates and the lack of a requirement to mark collateral to market.[v]

RECESSION

While Q1 GDP growth seemingly rules out the notion recession was underway in Q1, it doesn't preclude one ahead. However, the inventories that detracted from headline growth may have a silver lining: companies may be cutting fat amid recession talk. Anticipation is mitigation, in our view. Preemptive stockpile reduction would mean the economy is working off excess before an economic contraction. Such advanced preparation suggests that if we get a recession, it should be quite mild and may be priced into equities.

LOAN GROWTH

The Fed's Senior Loan Officer Opinion Survey showed slightly tighter credit standards and moderately weaker demand in May 2023, merely extending the trend from before March's banking failures.[vi] However, we believe it is important to note that global loan growth led by the US has been an unappreciated bright spot. As of Q1 2023, loan growth in the US exceeded inflation, Japan's matched, while the UK and eurozone's were below. Additionally, while the Fed's rapid rate hikes have inverted the US yield curve, a situation that tends to weigh more heavily on Financials, we believe low bank deposit costs could help limit the risk of a potential contraction in lending.

HIGH VALUATIONS

Traditional valuation metrics are slightly higher for US equities than their developed market peers. While at their extremes valuation metrics can give some indication of sentiment, but as a whole they do not predict equity market returns. Taking historic S&P 500 P/Es and mapping them against future returns shows no relationship between the two over the short term and a weak relationship over the long-term. This is because most valuation metrics (such as P/Es) are backwards looking, while equities price in the future; even forward P/Es are based on estimates made at a point in time. These metrics are also widely watched and understood, eliminating their surprise power. What moves markets most, in our view, is the gap between reality and expectations, and at best, valuations at their extreme can be a slight gauge of sentiment.

CONCLUSION

Our preference for US equities ultimately stems from our 2023 market outlook. Fears involving recession, inflation and many others punished equities throughout 2022, but what matters for equities going forward is how reality turns out relative to expectations. Sentiment reflecting near universal pessimism likely lowers the bar for a continued recovery, echoing the trend from the past few months. We believe the equities likeliest to outperform were those unduly hit during the drawdown, growth-oriented equities found mostly in Tech and Tech-like industries, as well as some firms within cyclical industries punished by recession fears. US equities are skewed towards these types of companies, supporting our overweight to the US. The widely discussed fears such as a US recession, regional banking fears or high valuations likely impacts equities far less than feared, and we remain bullish on the US heading into the second half of 2023.

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[i] Sources: US BLS, FactSet
[ii] Source: Global Financial Data, Inc., as of 4/11/2023. S&P 500 average total return and frequency of positive returns by midterm quarter. 1925 – 2023.
[iii] "Federal Reserve Balance Sheet: Factors Affecting Reserve Balances – H.4.1," Federal Reserve, 25/5/2023.
[iv] Ibid.
[v] Ibid.
[vi] "Senior Loan Office Opinion Survey on Bank Lending Practices," Federal Reserve, April 2023

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