

A BULLISH CASE FOR US EQUITIES

FEBRUARY 2023

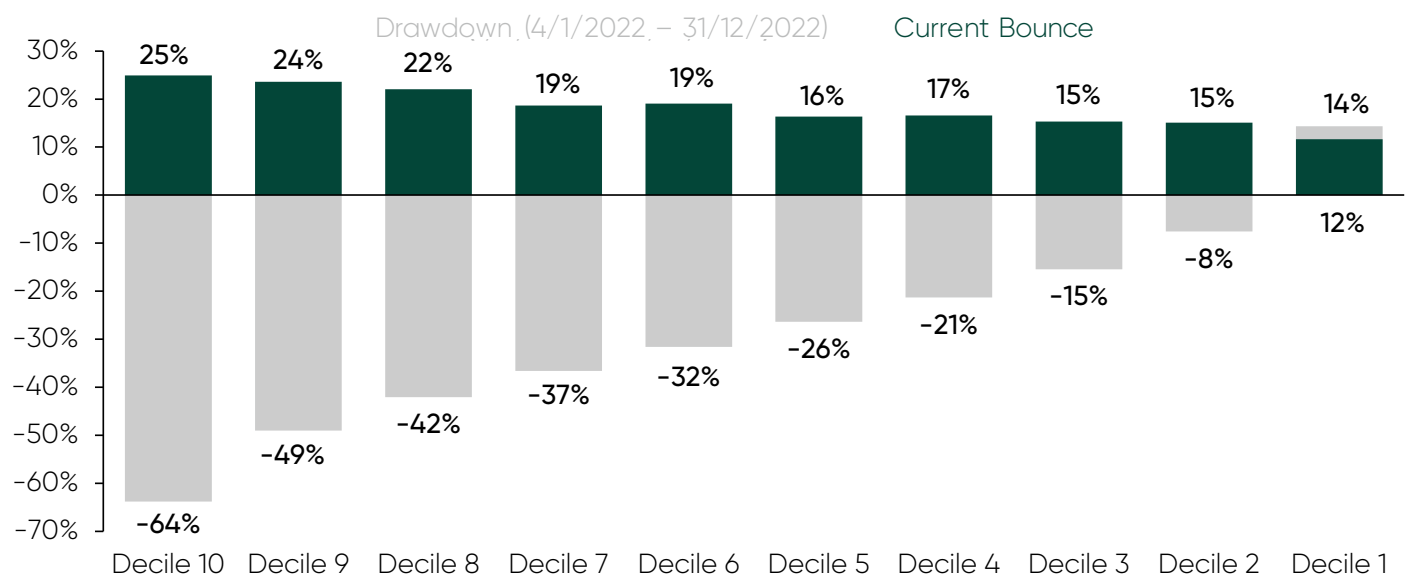
GLOBAL MARKET OUTLOOK

In 2022, we expected early volatility with a late year rally, but the tragic Russia-Ukraine war, high inflation, interest rate hikes, political rancor and more dragged equities into a bear market. Q4 brought some relief from 2022's downturn with the S&P 500 gaining 7.6%.¹ US equities continued rising through the start of 2023 supporting our belief that a global market recovery is likely underway.

2022's constant stream of negative headlines created yearlong uncertainty. Sentiment remains extremely dour, with recession a strong consensus and widespread pessimism over inflation and central bank activity running rampant. This fear likely saps surprise power and helps create an environment that supports positive returns in 2023. Additionally, even when reality turned out better than most feared (like economic data in the 2nd half of 2022), pessimists dismissed it, warning worse was still ahead. This is the typical environment for a recovery, which we believe is close by—if not already underway. While equities could revisit prior lows, we believe sentiment is sufficiently dour to support a positive view on equities in 2023. Markets appear to have reckoned with many of 2022's concerns, likely making 2023 a year of positive surprise.

Bear markets are painful but can present opportunities. It is common for the worst performing equities in a bear market to perform best in the early stages of a new bull. We believe this is likely to be the case for this new bull market cycle. This "bounce effect" has played out well so far for global equities, with the bottom decile equities performing best since the bear market trough. (Exhibit 1) We believe there are opportunities to select unduly punished equities among these worst-performing cohorts.

Exhibit 1: MSCI World Bounce Effect



Source: FactSet, as of 5/1/2023. MSCI World Price Returns from 4/1/2022 – 12/10/2022 and 12/10/2022 – 31/12/2022. Data in USD.

Turning points are impossible to predict and clear only in hindsight, and thus it is still too soon to know if the October 2022 low marked the bear market's end. However, whether the new bull market began in Q4 or arrives this year, we think equities are most likely to end 2023 higher.

WHY OVERWEIGHT US?

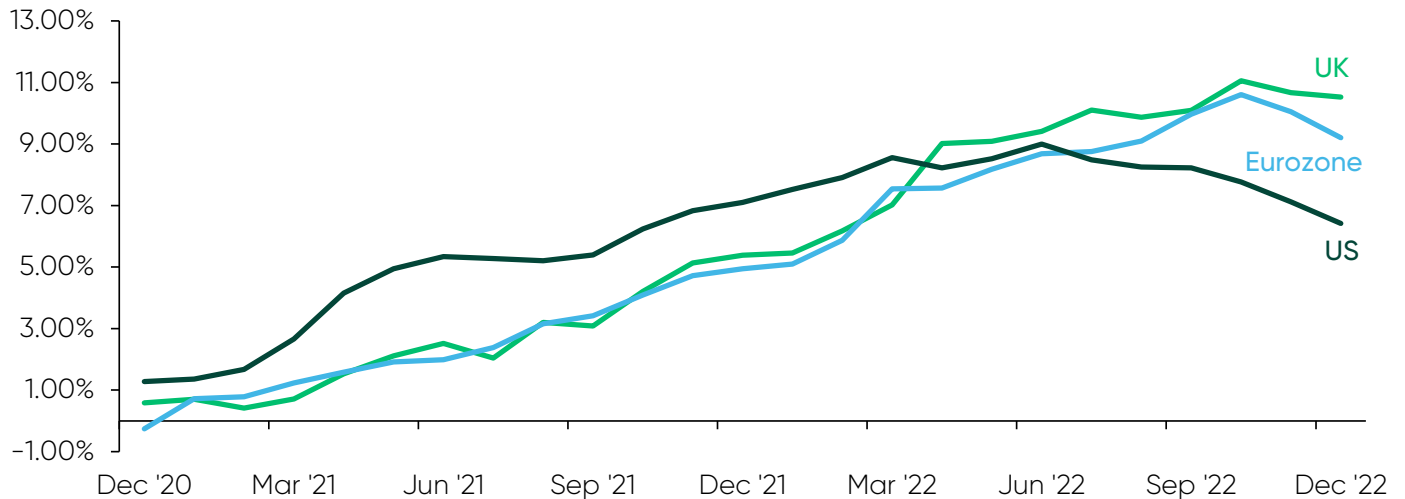
2022's fears weighed heavily on sentiment, but especially towards predominantly growth equities and Tech and Tech-like firms. Growth-like categories substantially underperformed on the year over fears around rate hikes and rising inflation with the MSCI World Growth (-29.2%) significantly underperforming the MSCI World Value Index (-6.5%).² 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. (Exhibit 2) A strong overweight to the US means a strong overweight to many of the bottom-decile performing equities in 2022—a category we expect to strongly recover in 2023.

Exhibit 2: MSCI USA Sector Weights vs. MSCI World

Sector	MSCI USA	MSCI World	Relative Weight
Information Technology	26.1%	20.2%	5.9%
Health Care	15.7%	14.5%	1.2%
Communication Services	7.4%	6.4%	1.0%
Real Estate	2.8%	2.7%	0.1%
Utilities	3.1%	3.2%	-0.1%
Consumer Discretionary	9.8%	10.0%	-0.1%
Energy	5.3%	5.7%	-0.4%
Consumer Staples	7.0%	7.9%	-0.9%
Materials	2.7%	4.5%	-1.7%
Industrials	8.8%	10.7%	-1.9%
Financials	11.4%	14.3%	-2.9%

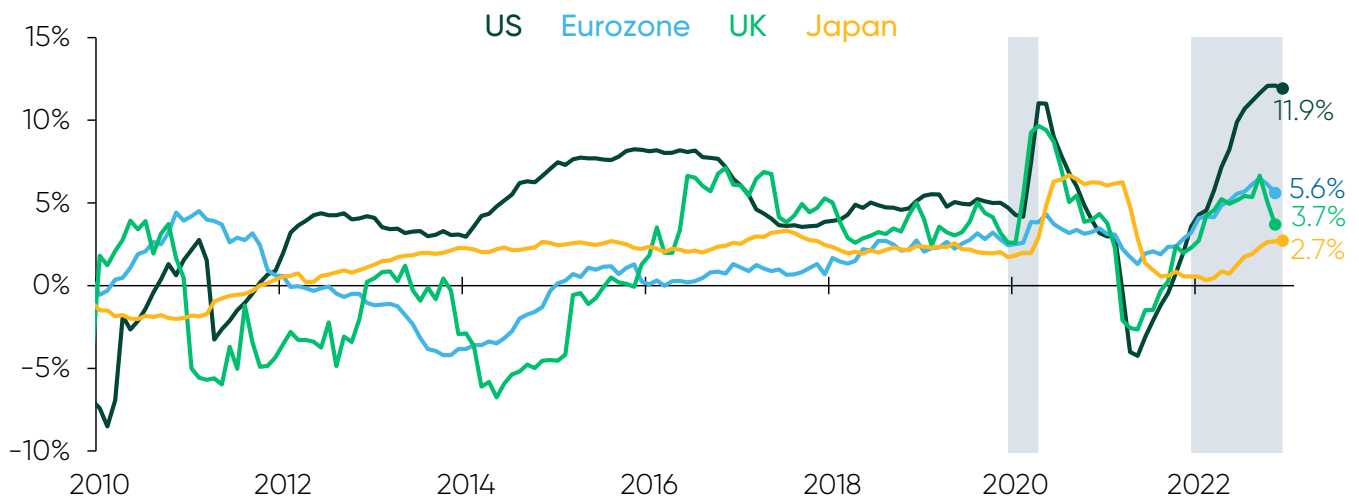
Source: FactSet as of 31/12/2022.

The underappreciated economic fundamentals in the US represent another reason for optimism. While fears and negative news drew the headlines all of 2022, a plethora of positive economic data was mostly dismissed. US inflation started to significantly ease toward the back half of the year, slowing from its peak of 9.1% y/y in June to 6.5% in December. (Exhibit 3) We have suggested inflation would slow for months with an array of indicators pointing to such. Among them: broad money supply growth slowing, global supply chain pressures easing and energy costs decreasing to pre-Ukraine invasion levels. Inflation levels in most developed countries are also falling, but not nearly as quickly as the US. As shown in Exhibit 3, inflation levels in both the UK and the Eurozone remained elevated for slightly longer than the US due to spiking electricity and natural gas prices in Europe following Russia's invasion of Ukraine.

Exhibit 3: Europe vs US Inflation Rate (Y/Y %)

Source: FactSet, CPI, year-over-year change, monthly, as of 31/12/2022.

Plenty of other positive US economic data went unnoticed as well as corporations have proven incredibly resilient throughout 2022. Despite COVID-19 lockdowns, supply chain issues, high inflation and spiking resource prices, US corporate earnings and margins have held up quite well.³ Strong buybacks and investments during the year also reflect the forward-looking optimism. US households also remain healthy, and consumer spending (adjusted for inflation) rose throughout the year.⁴ Importantly, despite the negativity on rate hikes and an inverted yield curve, loan growth also ended the year extremely strong. US commercial bank loan growth closed at +12% y/y in 2022 and bank net interest margins remain strong—showing there are few signs of financial-system stresses today. (Exhibit 4) Similar to other economic metrics, US loan growth has accelerated significantly more than other developed nations.

Exhibit 4: Global Loan Growth (Y/Y)

Source: FactSet loan growth y/y monthly, seasonally adjusted except for the UK. Data shown from 01/01/2010 – 31/12/2022.

A final reason underpinning our confidence in US markets is the coined “US Midterm Miracle”. From the beginning of reliable data in 1925, the three calendar quarters commencing with the midterm years’ fourth quarters are the most positive of any three sequential quarters in history. Historic S&P 500 returns in that nine-month span an average of 19.6% and up are 91.7% of the time.⁵ Additionally, no president’s third year has been negative since 1939, and even then it was just down -0.9%.⁶ Historically, these strong returns can be attributed mostly to political gridlock from a divided government. Markets love gridlock tied to fears of large change or legislation. The recent US midterm election in November offered up more of this same

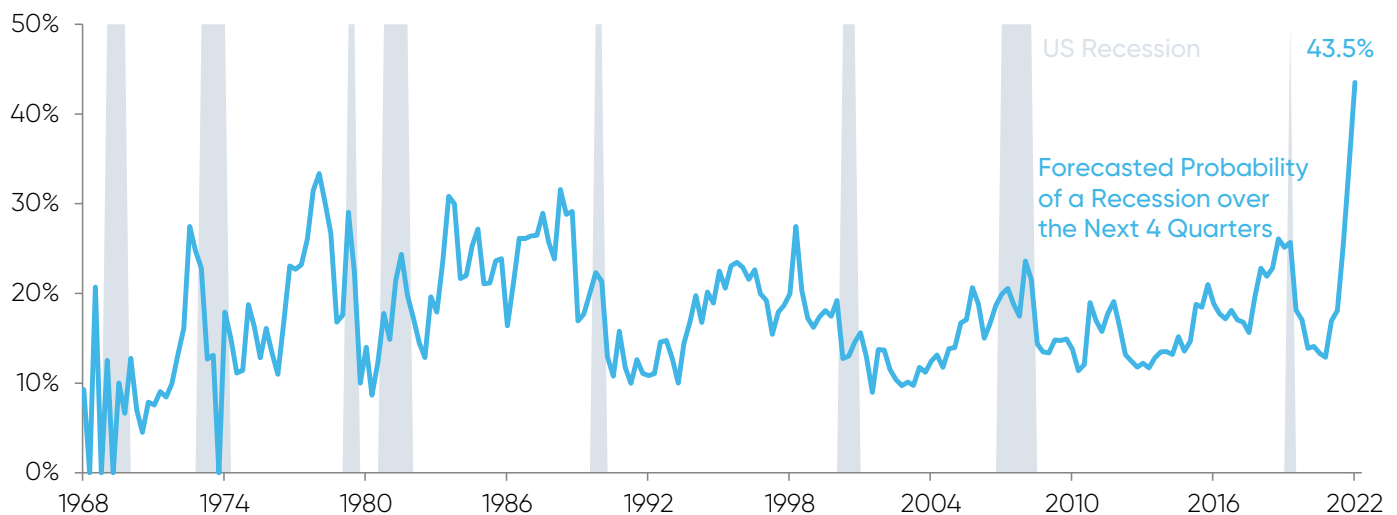
gridlock with Republicans in control of the House and Democrats in control of the Senate. This should bring a very calm legislative environment, with only essential or watered-down bills passing.

ALLEVIATING COMMON CONCERNS

US RECESSION

A US recession was one of the largest fears throughout 2022 and remains a key talking point going into 2023. Bank of America's Global Fund Manager Survey showed 68% of respondents (in December) expecting a recession over the next 12 months.⁷ The Philadelphia Fed's long-running survey—tracking professional forecasters' recession probability expectations over the next four quarters, hit a record high 43.5%. (Exhibit 5) Therefore a US recession, should it happen, appears unlikely to pack much (if any) negative surprise power and is likely reflected in equity prices. Any recession would arguably be history's most expected downturn—extremely contrary to historic recessions. Additionally, if one strikes it is likely to be short and shallow, as each week we see companies anticipate one, with cost cutting, paring down investments and hiring freezes in preparation for lean times.

Exhibit 5: Probability of a Recession Over Next 4 Quarters



Source: Federal Reserve Bank of Philadelphia Research Department, as of 19/12/2022. Survey of Professional Forecasters' Anxious Index mean responses for the probability of a decline in the level of chain-weighted real GDP in the current quarter, quarterly, 31/12/1968 – 31/12/2022.

Additionally, we don't see recession as a foregone conclusion. While economic data on the topic is mixed, several key factors don't signal typical recession. Double digit robust loan growth as already discussed is contrary to a typical recession signal, as is growing consumer spending and reasonably strong durable goods orders in 2022. Typically during a recession, discretionary spending cuts tend to be large enough to tip overall spending negative but that does not seem to be the case thus far. While it is impossible to say if recession is currently underway, we think recession expectations along with mixed economic data and corporations given time to brace should sap some if not all of its magnitude should one come.

ELEVATED VALUATIONS

Despite a challenging year for US equities in 2022, traditional valuation metrics are slightly higher for US equities than their developed market peers. While at their extremes, some valuation metrics can give an indication of sentiment, but they do not help 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.⁸ This is because most valuation metrics (such as P/Es) are backwards looking, while equities price in the next 3–30 months. Even forward P/Es are based on estimates made at a point in time. These metrics are also widely watched and understood, eliminating a lot of 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.

THE DEBT CEILING

On January 19th, the US hit its statutory debt ceiling, leading the Treasury to begin operating under “extraordinary measures” which allow the Treasury to stay under the debt limit for a while. These measures are expected to last until June, although the exact date changes as monthly federal reserves fluctuate. The debt ceiling and fears surrounding it are historically a highly politicised issue. Politicians often use the debt ceiling as leverage in negotiations, but find a way to come to an agreement—typically at the last minute. While uncertainty over how or when congress will act can contribute to some short-term volatility, history shows these political fights often don’t derail equity markets. Congress has a long history of contentious debt ceiling fights and has raised it well over 100 times. Additionally, US monthly federal tax revenues significantly exceed interest expenses.⁹ Given the Treasury has the ability to prioritise interest payments over other federal expenditures, we believe this makes an actual US government default highly unlikely.

CONCLUSION

Our preference for US equities ultimately stems from our 2023 market outlook. Fears involving recession, inflation, rate hikes 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 strong recovery coming, continuing 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 and this structure of equities along with the underappreciated economic fundamentals stronger than other developed markets supports our overweight to the US. The largely discussed fears such as a US recession or the debt ceiling likely impacts equities far less than the talk may suggest and we remain bullish on the US heading into 2023.

¹Source: FactSet using gross index returns from 01/10/2022 – 31/12/2022. Data in USD.

²Source: FactSet using net dividend index returns from 01/01/2022 – 31/12/2022. Data in USD.

³Source: FactSet. S&P 500 earnings per share and net margins as of 31/12/2022.

⁴Source: BEA, as of 04/01/2023.

⁵Source: Global Financial Data as of 31/12/2022. Average S&P 500 total return and frequency of gains from 30 September of midterm years through 30 June of the following, 1926–2021

⁶Source: Global Financial Data, Inc., as of 31/12/2022. S&P 500 total return, 31/12/1938 – 31/12/1939.

⁷Source: BofA Survey Says Investors Are Less Gloomy on Growth Over China,” Sagarika Jaisinghani, Bloomberg, 13/12/2022.

⁸Source: Global Financial Data and FactSet as of 07/09/2022. S&P 500 trailing 12 month P/E, monthly, and subsequent rolling 1-year and 20-year annualised price returns from December 1925 – August 2001.

⁹Source: FactSet as of 12/1/2023. US Treasury, Federal Budget Receipt and Interest on Treasury Debt.

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