CIO View

Americas CIO View

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Marketing material

Companies are preparing for a recession: How about you?

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IN A NUTSHELL

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Companies are preparing for challenges ahead, equity investors not so much

From an earnings resilience standpoint, the good news is that company managers are preparing for challenging economic conditions ahead. The not so good news is that many equity investors don't appear to have adequately adjusted their portfolios or tolerance for high valuations given the growth risks and alternative opportunities of higher interest rates.

The first earnings season of 2023 is still in its early weeks, but beyond the biggest of banks, companies are meeting and in some notable cases missing lowered earnings expectations. Most companies note the macro challenges they've faced and the expectation for many of the old challenges (costs) to continue and newer (a period of stalled growth) likely to come. Thus, many companies are announcing more aggressive personnel and other cost cutting measures and being more selective and careful with inventories, capital expenditure (capex) and buyback plans. As investors, we appreciate corporate managers being realistic in their outlooks and taking protective actions and also how S&P 500 companies have proven themselves to be well run repeatedly through the best and worst of times in recent decades. However, we think equity investors are too complacent about the macro risks or too confident in corporate manager abilities to achieve healthy real earnings growth anyhow through micro execution.

We expect the Fed to hike in May and long-term bond yields should grind higher

Despite disinflation from the highest rates last year, inflation is still too high for too long. We expect the U.S. Federal Reserve (Fed) to hike in May and perhaps again in June, despite the economic slowing and recently added pressures of a credit crunch. Some argue the Fed is making a mistake by hiking because it will cause a recession. We argue it's not a mistake if it's deliberate. Last Federal Open Market Committee (FOMC) meeting minutes reveal the Fed is willing to risk and tolerate a small recession to restore price stability. We do not think the Fed will cut rates this year. We think it would take a larger recession with rapid labor market damage for the Fed to cut. Thus, we expect 5.25% overnight to linger. If inflation doesn't drop more by autumn, more hikes might be.

In addition to many real economic indicators warning of recession with jobless claims on the cusp of joining the bunch, we interpret the yield curve as indicating bond market expectations of at least a small recession looming. This is why we think equity investors are mistaken to be taking refuge among some very high price-to-earnings (P/E) stocks on the idea that long-term Treasury yields have peaked and settled around 3.5% nominal and 1.25% real. We see this retreat in yields as being cyclically driven by higher recession risk. The secular outlook for yields is still very uncertain as future inflation and the real yields required to contain it are very uncertain. Moreover, while we expect the debt ceiling to be lifted, the fight should remind bondholders of risks from deficits and upward government debt/ gross domestic product (GDP). The deficit is quite high for an economy at 3.5% unemployment. In short, we see arguments for justifying an 18.5 PE on this year's S&P earnings per share (EPS) and 21.5 PE ex. Financials & Energy on low yields on shaky ground given downside 2023 EPS risk and upside 2024 yields risk.

Week 2 of 1Q EPS reporting: Low bars, underwhelming beats, cautious tones

Consensus 1Q EPS was cut by 6.2% during the calendar quarter, much more than the 3.2% average cut historically. 1H 2023 continues to be revised down albeit not slashed. S&P EPS will be down 2 quarters in a row y/y after Q1 and likely down again 2Q. Full year 2023 EPS not being down vs. 2022 now depends on a strong 4Q rebound. Bottom-up 1Q EPS is $50.90, -5% y/y. 67% beat on EPS and 29% missed (the rest is in-line), with an aggregate surprise of +3.3%, +2.9% ex Financials, a little weaker than usual. If the rest of companies beat by 3% then 1Q EPS will finish at our $52 estimate. Next two weeks are the heaviest of this earnings season with 41% and 22% of the index earnings reporting.

Regulators and investors watching banks & non-banks: Beware tier 1 variants

Common Equity Tier 1 capital is defined by the Basel standards under Bank of International Settlements as the most immediately available loss absorbing capital. But these measures use local financial and regulatory reports and rules to construct. Some smaller US banks can opt to not include Accumulated Other Comprehensive Income in their reported CET1. Our advice, know the footnote details and construct comparable metrics. We often look at bank generally accepted accounting principles (GAAP) reported equity less intangible and deferred tax assets. The Financial Stability Oversight Committee is signaling it might use its power to classify some non-banks as systemically important and subject them to regulation. We look at bank earnings, balance sheet and lending metrics. Big bank earnings and stocks show strength, concerns linger at small.

S&P sector/industry positioning: Tech isn't a defensive, we're underweight

Glossary

Capital expenditure (Capex) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

Common Equity Tier 1 (CET1) ratio is a measurement of a bank's financial strength.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

The Federal Open Market Committee (FOMC) is the committee that oversees the open-market operations (purchases and sales of securities that are intended to steer interest rates and market liquidity) of the U.S. Federal Reserve.

Generally accepted accounting principles, or GAAP, are a set of rules that encompass the details, complexities, and legalities of business and corporate accounting.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The price-to-earnings (P/E) ratio compares a company's current share price to its earnings per share.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

A share buyback involves a company buying back its own shares.

The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

A yield curve shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

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