A long year ahead and opportunity cash now pays interest: Be patient!

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IN A NUTSHELL

— 2023 starts with a global stock market rally: Our strategy is to be patient
— Despite resilient jobs, profit recession in progress: S&P EPS flat / down until 4Q
— Our preference across equity regions/sizes: China, EAFE, US Small, US Large
— Our most favored sectors remain Health Care, Financials and Communications

2023 starts with a global stock market rally: Our strategy is to be patient

After December and 2022 disappointed, 2023 started with glass half full views pushing the S&P 500 up 3.5% in the first three weeks of the year. A rally on signs of softening inflation from 40-year highs, hopes for a US soft landing as jobs still climb, China's tolerance for some decentralization and a frenzied re-opening and just a shallow recession in Europe as winter energy supplies appear adequate. However, the S&P 500 remains range-bound between 3600-4100 since last September with even 4000 putting up resistance. We think this range holds for much of 2023 and our tactical strategy is to be patient. Lots of 2023 is still ahead and markets remain very volatile. Most equity indices, regions and sectors are already at our full yearend targets. It's still good to wait in 4%+ yielding short term bonds.

The fight with inflation isn't over. The most difficult part lies ahead with getting it well under 4% and back toward 2%. Inflation is still far above the U.S. Federal Reserve's (Fed's) 2% target and unemployment at post war lows. Disinflation is narrow to commodities and goods because we are entering a goods consumption/manufacturing led recession. Broad based inflation remains sticky at services and wages are rising at mid-single digit rates with little to no productivity gains supporting it. Markets are not helping the Fed with its inflation fight in the new year; as stocks rally, yields fall and the dollar slips. Oil and commodity inflation could strike again. We expect the Fed to hike 25bp two or three more times to 5-5.25%. Thus, the fight is now likely to spill into spring. And a super hiking cycle might be followed by a mini hiking cycle.

Despite resilient jobs, profit recession in progress: S&P EPS flat / down until 4Q

Whether the economy slips into recession or not, there are now clear signs of an earnings or profit recession in progress. S&P Earnings per share (EPS) will be at best flat y/y in 4Q22 and this is what's likely through 2023 unless there is a sharp rebound in oil prices and industrial activity in US and worldwide. Our standing S&P EPS estimates for 1Q and 2Q of 2023 are $53 and $56, both down 3-4% on y/y basis, but we expect S&P EPS y/y growth to be positive in 2nd half of 2023. 4Q earnings season has just begun with mostly Financials reporting. Bottom-up 4Q EPS is now $53.27 and the aggregate EPS surprise is +2.5%. If the rest of companies beat by similar amount then 4Q EPS will finish exactly at our $54 estimate, flat y/y over 4Q21. Loan growth has been rising to a strong 12% y/y. Banks' net interest margin also climbed to 3.2%, which is near the 3.4% before the pandemic. Loan loss reserves and loan loss provisions are prudent in preparation of a moderate recession. We don't expect credit cost to shoot up in this downturn and Bank profits shouldn't drop.

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Our preference across equity regions/sizes: China, EAFE, US Small, US Large

While we expect a shallow recession, we also expect a shallow recovery, not V-shaped. China is finally re-opening its travel and social interaction economy. This will benefit the service side of China's economy with small impact to its manufacturing and construction. China construction is suffering a housing glut and manufacturing faces sluggish US and European goods demand. We think China's economy will be challenged over the next couple of years, contributing to tepid global growth. But as China gets moving again its oil demand will rise. Moreover, we see growth at China Tech stocks and large valuation upside potential. China Tech is our most favored equity segment right now. We remain cautious on US and Europe large caps. Both Fed and European Central Bank (ECB) are fighting inflation, raising the cost of capital and earnings will be down in 2023 for both regions. Since October end, we prefer Europe over US (especially S&P 500), but we're still cautious about getting good gains for both. In the US, we still prefer small caps over large, but we're still cautious both tactically given our Down 5%+ call on S&P 500. But the decade looks promising for small vs. large.

Our most favored sectors remain Health Care, Financials and Communications

Our global equity team recently upgraded Communication Services to outperform. They expect improving cashflows due to the fading 5G and fiber capital expenditure (capex) cycle. During the past 12 months, social media stocks have seen a significant reset of earnings expectation and valuations. Many defensive stocks have become too expensive in Europe as investors moved to safe havens upon a slowing economy. They can't see sector specific catalysts to extend this 20-30% price-to-earnings (P/E) ratio premium and therefore downgraded Consumer Staples to underweight and Health Care to neutral. In the US, our favored equity sectors remain Health Care, Communications, Financials, Tech Services. Least favored: Cap Markets, Retailers, Auto, Semiconductors, Machinery, Materials and most Staples. We are slightly overweight (OW) Energy mostly Oil Services. We're cautious Industrials, but OW Aerospace & Defense.

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Glossary

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

A company's cash flow is comprised of its inflows and outflows which arise from financing, operational or investing activities.

Disinflation describes a slowing of the pace of price inflation.

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 European Central Bank (ECB) is the central bank for the Eurozone.

The net interest margin of a financial institution is the difference between the average interest rate paid and the average interest rate received by the institution.

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

Productivity measures how much economic output is produced for a given level of inputs (such as capital and labor).

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

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 soft landing is when an economy's rate of growth slows in a controlled fashion without major disruptive effects on employment, external balances etc.

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

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