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SUMMARY

- We expect inflation to moderate by the end of the year.
- We believe earnings can show resiliency, even as the economy moves closer to recession.
- Based on these beliefs, we favor value and smaller-capitalization stocks.

1.23.2023

What Does '23 Hold for Stocks? A Conversation with Global Equity CIO Adam Grossman, CFA

After a difficult 2022, equity investors have begun this year in a slightly more optimistic mood. Is it warranted? RiverFront's Chief Investment Strategist Chris Konstantinos sat down with Global Equity Chief Investment Officer (CIO) Adam Grossman to discuss the prospects for the stock market, both in the US and overseas.

Some of the topics we covered include inflation, recession, the eternal 'growth vs value' debate, whether energy stocks can follow up on their banner '22, whether international will (finally) perform, and what risks investors may be underestimating in the new year. Here is a transcript of that interview, edited for clarity.

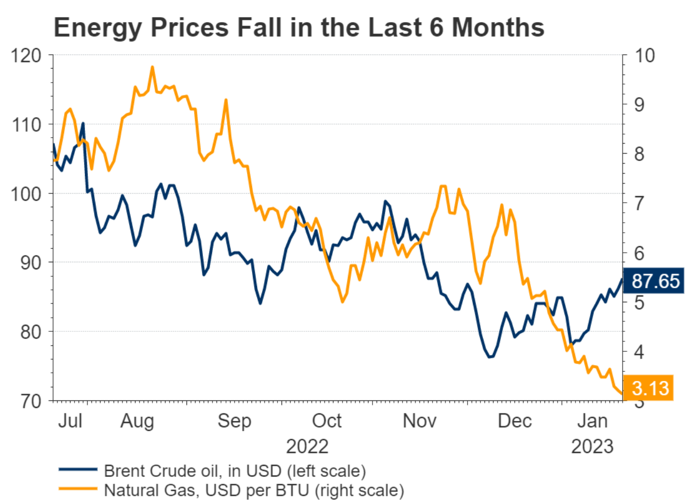
Chris Konstantinos:

ON THE PATH OF INFLATION:

In the '23 Outlook, the team's base case forecast is for the core consumer price index (CPI) to moderate to around 3.7% by the end of 2023. What do you believe will be the catalysts for inflation to moderate so meaningfully from its current 6% core level?

Adam Grossman:

There are three major factors that we believe will provide downward pressures to inflation. The first is the large drop in energy prices we saw during the second half of 2022 (see chart, right). The energy prices are not directly in core CPI calculations; however, we believe that they have an effect on most of the components of core CPI.



Source: Refinitiv Datastream, Riverfront; data daily, as of 1/20/2023. Chart shown for illustrative purposes.

The second disinflationary pressure is the supply chain. Data has begun to show that the supply chain issues that have defined the past two years are beginning to clear up. We all can see this anecdotally as well, as stores are beginning to have much more in stock than a year ago. According to CNN, most (64%) new cars are being sold below sticker price compared to just 20% a year ago.

Finally, we believe that a slowing housing market will cause core inflation to fall. Housing inflation metrics, such as Owner's Equivalent Rent (OER), is calculated using surveys that assume one would rent their house each month rather than actual pricing data. Due to this fact, we tend to believe that it lags the true housing market by a couple of months. With the housing market's beginning to show signs of slowing, we believe that CPI's housing components will soon follow.

Chris Konstantinos:

ON THE US ECONOMY

Among our investment team, there was spirited internal debate in '22 around the potential severity of the economic slowdown. Our recession indicators continue to send mixed - and in many cases, contradictory - signals as it relates to the potential for recession in '23. What are your expectations for how the US economy shapes up as we head through the year?

Adam Grossman:

As a starting point, our base case is for a shallow recession to occur in late 2023 or early 2024. Piggybacking off the last question, if inflation continues to moderate through the year, the Fed will be able to slow their pace of rate hiking. However, we do not believe they will lower rates this year since the Fed continues to posture that inflation is their number one concern. We believe this higher rate environment should cause growth to slow. While this slower growth is synonymous with fighting inflation, in our view, it is important to note that we believe the economy will continue to expand in 'nominal' terms (before taking the effects of inflation into account), but lower than the level of inflation.

Chris Konstantinos:

ON EARNING FOR THE S&P 500:

We are in print with our view that earnings and margins will stay resilient in '23. How do you reconcile that with the recent downward revisions in earnings, and the historical record of major earnings declines in the '00, '08 and '20 recessions?

Adam Grossman:

If the scenario I laid out in the last question plays out, then we believe US-based companies, particularly those that comprise the S&P 500, can grow their revenues and earnings from 2022. In fact, while we agree with market sentiment that US earnings numbers are not likely to be as strong as expected a year ago, we believe that they have the potential to beat current estimates.

In addition, we believe that the positive effects of moderate inflation (around 2.5-4%) on revenue growth are underappreciated by the market. We believe stronger earnings would allow for the S&P 500 to produce reasonable stock price returns (we are predicting modest single-digit total returns for '23) without the need for sentiment-driven expansion of valuation multiples.

It is also worth noting that in a scenario where companies can continue to generate earnings growth, we would expect defaults in the US credit markets to remain around or even below historical averages, due to the large amount of debt refinancing that occurred during the pandemic.

Chris Konstantinos:

ON GLOBAL GEOPOLITICS AND MACROECONOMICS:

How do you think Europe's and China's geopolitical and economic issues will impact the US in 2023?

Adam Grossman:

Each area you mentioned is interesting for a couple of reasons. Europe is contending with higher inflation and is likely three or four moves behind the Fed in fighting it. There is also a land war going on where European Union nations are supplying weapons to Ukraine in a fight with their primary energy supplier. We believe resolution or even status quo would be good enough to calm inflation fears, so that would bode well for all equity markets. This would also be positive for economic growth in Europe, which helps drives global revenues, in our view.

The less likely view is that this conflict escalates in a handful of severe ways, like nuclear weapons or countersanctions against the EU. If that were to happen, the current projected glide-path of falling inflation could disappear, and we could face a tough environment where rate increases are not enough, and a deep recession in activity is needed to slow prices. This would probably kick off a the 'bear case' outcomes from our 2023 Outlook.

China is another interesting one. We believe China's anti-US political stance is structural. While we believe that US companies have largely anticipated this and have begun re-directing supply chains and manufacturing routes, it will impact direct business relationships for decades to come, and generally slow growth for all parties. Indirectly, China continues to be a global economic force as it soaks up natural resources in order to bolster its economic and military strength. This will continue to be a big driver of global Gross Domestic Product (GDP) growth and inflation, in our view.

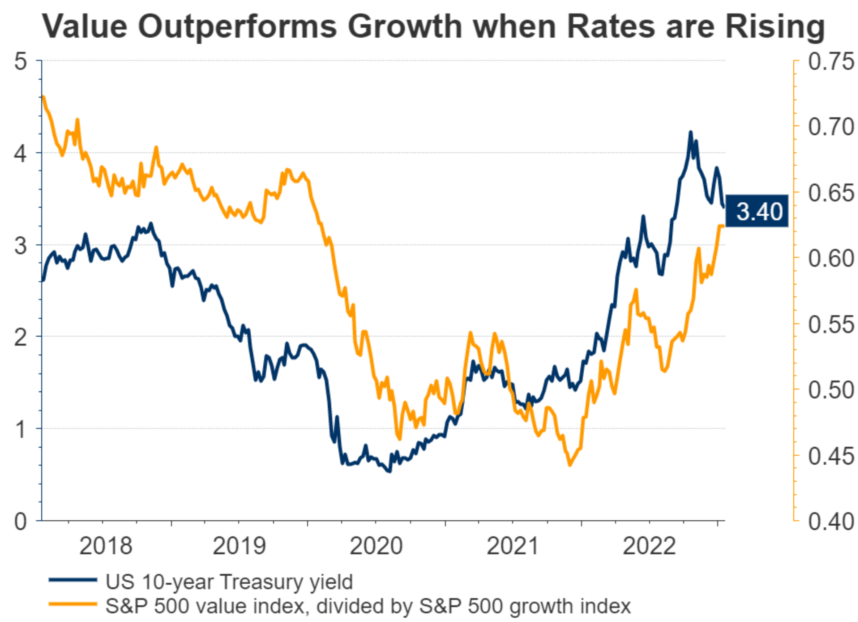
Chris Konstantinos:

ON THEMATIC PORTFOLIO POSITIONING:

After significant long-term underperformance, the back half of '22 saw some signs of life on a relative basis for US 'value' stocks, as well as small-caps, emerging markets and developed international. What is your view on all four?

Adam Grossman:

These are the four asset classes that I think of as being "value-oriented" asset classes, while we tend to think of the technology-heavy S&P 500 as a growth asset class. All four are likely net beneficiaries of inflation being in our forecasted longer-term range of 2-4%. While higher inflation and interest rates may be a headwind for all equities, we have found a historical relationship between value stock outperformance relative to growth and the absolute level of rates (see chart, right). We think that increases in inflation, coupled with reasonable starting valuations, can be a net positive for value-oriented asset classes.



Source: Refinitiv Datastream, Riverfront; data daily, as of 1/19/2023. Chart shown for illustrative purposes. An investment cannot be made directly in an index.

The key for all four will be to see if they are able to turn the macro environment and the inflation tailwind into sustainable earnings growth. For Europe, the primary challenge will be the war in Ukraine and the next bout of rate increases. We have been in a "show me the earnings" mode with International in general and Europe in particular. While the markets have done well recently, we are worried that if earnings do not materialize, it will become just the latest in a string of international 'false starts' since 2008. Emerging markets are a similar story, with geopolitics and levels of global trade directly affecting cyclical businesses and currencies in those regions.

Small caps and US Value stocks should benefit from the same general trends as international – the additional key question for them will be the rate and credit environment they will face. That will determine whether the revenue they make from inflation is able to be retained as profit. At present, we believe that the COVID-19-related monetary accommodation allowed for a generational clean-up in US Corporate Debt should help keep defaults below historic averages, even in a recession. If earnings come through for US Value and Small cap, even as inflation adjusted economic data weakens, we could see the stage set for a powerful multi-year period of outperformance in these stock prices as earnings grow and the Fed signals the beginning of lowering interest rates in 2024.

As to which is our favorite of these themes, we are inclined to think US Value and Small Cap will be the first to benefit from a value rotation and are the strongest companies of the bunch. If a pattern of earnings growth can be established, international will also be an attractive multi-year theme for us. We are still skeptical this has occurred, and will follow our process and wait for more evidence before we dive in.

Chris Konstantinos:

Technology and energy were 'bookends' in '22, with Tech/Comm Services the worst performer and Energy the best. We are constructive on certain parts of both sectors for '23. What are the characteristics you like in each?

Adam Grossman:

I love this question because I get to highlight some of the research that our equity selection team is consistently producing. As you mentioned, these two sectors could not have had more different years, but we believe the selection themes within them moving forward are similar. In both spaces, we believe it is important to "Pay Attention To The Yield," (PATTY) a term you coined last year. (Thanks for the plug, Adam!)

The nuance comes in which yield we need to pay attention to for each sector. For Technology, we will be looking for earnings and cash flow yield. We believe it is important to identify companies that are currently generating strong cash flows. We also think it will be important to avoid companies that currently operate at a loss, or ones whose earnings growth engine is handicapped by rising rates.

On the Energy side, we are paying attention to the size and sustainability of dividend yields. Specifically, we want to identify companies that have management teams that are dedicated to returning cash flows to shareholders and balance sheets that are healthy enough to back these cash flow returns. We recognize the inherent cyclicality of energy prices, and while 2022's commodity boom made energy a winner across the board, a recessionary environment will require us to be more judicious in our selections.

Chris Konstantinos:

ON MARKET RISKS IN '23:

What is the single largest risk to the market in 2023 that you think is being underappreciated by investors?

Adam Grossman:

The single largest underappreciated risk we see is the risk of the market underestimating the Fed's resolve in the near term – Kevin Nicholson, RiverFront's Global Fixed Income CIO, nailed this point well in his interview last week. The implication we face as equity investors is a potential downward shift in risk appetite now that bonds pay higher nominal interest rates. As of the writing of this piece, we are forecasting 3-month Treasury bills will be paying roughly 5%, versus 3.5% inflation by the end of the year. This creates a powerful disincentive for long-term investment in equities.

The risk of a downward rerating in valuation multiples is greater for companies and sectors that miss earnings even more so than in low interest rate environments, as it can lead to a dramatic negative re-appraisal of their forward prospects. We see this both as an opportunity and a peril for stock pickers, since a lot of the behavior will be temporary if rates do not stay high for more than the next 2-3 years. This is why we believe our 'bottom-up' research team's insights are going to be critical for the next phase of the market.

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Index Definitions:
Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

Definitions:

Small-, mid- and micro-cap companies may be hindered as a result of limited resources or less diverse products or services and have therefore historically been more volatile than the stocks of larger, more established companies.

Interest rate sensitivity is a measure of how much the price of a fixed-income asset will fluctuate as a result of changes in the interest rate environment. Securities that are more sensitive have greater price fluctuations than those with less sensitivity. This type of sensitivity must be taken into account when selecting a bond or other fixed-income instrument the investor may sell in the secondary market. Interest rate sensitivity affects buying as well as selling.

Technology and internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them. Changes in the CPI are used to assess price changes associated with the cost of living. The CPI is one of the most frequently used statistics for identifying periods of inflation or deflation.

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