Brompton Insights

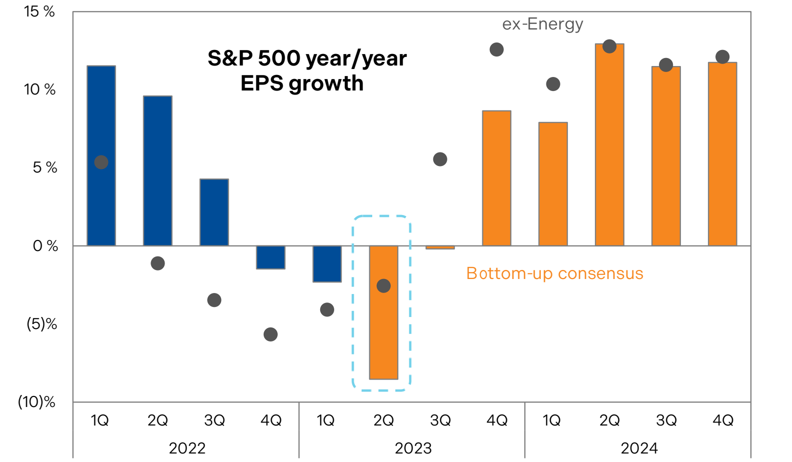
H2/2023 Outlook: Still waiting for a recession

BROMPTON FUNDS

July 27, 2023

With a tough year in 2022, most strategists expected a rough first half of 2023 citing high inflation and a forthcoming recession. Positioning was overly bearish in the beginning of the year. As the year progressed, the labour markets and economy held up better-than-expected. Contrary to expectations, earnings have held in and estimates indicate we are close to the bottom, as shown in the chart below.

Figure 1 – S&P 500 earnings growth is expected to trough in 2Q at -9%



Source: Goldman Sachs Portfolio Strategy Research – US Weekly Kickstart, July 7, 2023.

The second quarter earnings season will be a critical time to verify if earnings are really in the midst of bottoming.

The severity of the recession keeps getting downgraded and pushed out. Unlike other slowdowns, the manufacturing and services sectors are out-of-sync. Leading manufacturing indicators show a slowdown with activity holding in better-than-expected due to shortages of some big-ticket items such as cars and airplanes. Restaurants and airplanes are full despite high prices. Consumers have been surprisingly resilient, especially in the face of the large rate hikes buffered by savings. As a result, we believe the earnings drawdown typically seen in recessions will be smaller this time around. Could we have a "full employment" recession?

Since the labour markets have been so resilient, Central Banks have continued their rate hikes, with the peak in Fed hikes expected in the second half of the year. Inflation has dropped, but we believe inflation will be higher than the 2% Fed target. After the initial drop, we believe inflation will be stickier. Labour markets are tight and starting to loosen but collective agreements have negotiated wage increases substantially higher than 2%. We expect real wages to rise as inflation falls, supporting consumer spending.

First half performance has been better than anyone had expected with the S&P 500 +16.9%, all of which was valuation expansion. Part of the outperformance was driven by tech stocks and the euphoria of Artificial Intelligence ("AI"). We believe that the hype is real. AI has the potential to herald in the next Industrial Revolution with substantial efficiency gains. We have initially taken a "picks and shovels" approach. Much like the Yukon Gold rush, the early winners will be the hardware and software companies that enable and provide AI tools and solutions. As AI matures and is adopted by more enterprises, we believe that much of the value should accrue to other industries that can increase their productivity and improve efficiency.

Despite the perception that only a handful of stocks have been going up, breadth is improving. One measure of breadth is the percentage of stocks trading at a price greater than the 200-day moving average. Note that breadth was low around the market low of October 2022.

Figure 2 – Market Breadth (% of S&P 500 stocks trading above 200-day moving avg.)

Source: Bloomberg, as at July 17, 2023.

From the chart below, in the past, when the S&P 500 increases 10-15% in the first half of the year, gains continue in the second half.

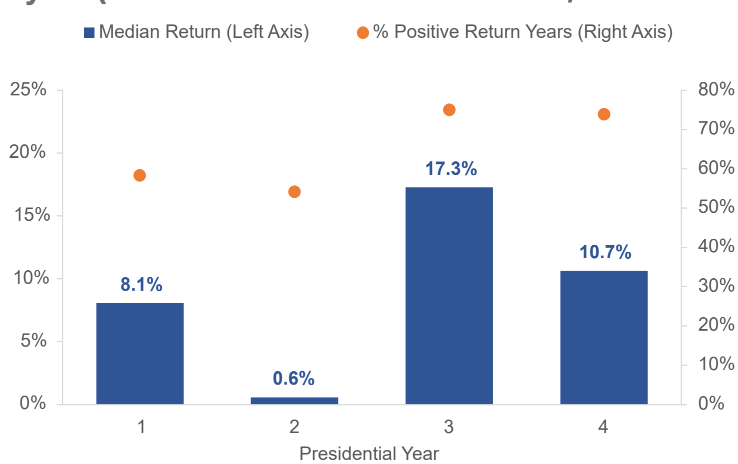
Figure 3 – S&P 500 2H Performance During Calendar Years When 1H Price %Chg is 10% to 15% (since 1950)

Year	First-Half S&P 500 Price %Chg	Second-Half S&P 500 Price %Chg
1955	14.0%	10.8%
1958	13.1%	22.0%
1961	11.2%	10.7%
1967	12.8%	6.4%
1985	14.7%	10.1%
1988	10.7%	1.5%
1989	14.5%	11.1%
1991	12.4%	12.4%
1999	11.7%	7.0%
2003	10.8%	14.1%
2013	12.6%	15.1%
2021	14.4%	10.9%
2023	*13.8%*	*????*
Average	**12.8%**	**11.0%**
Median	**12.7%**	**10.9%**
Prob of Gain		**100%**
Prob of >10% Gain		**75%**

Source: BMO Capital Markets – US Strategy Snapshot: 2023 Mid-Year Outlook, June 29, 2023.

Particularly since this is the third year of the President cycle which is typically the strongest.

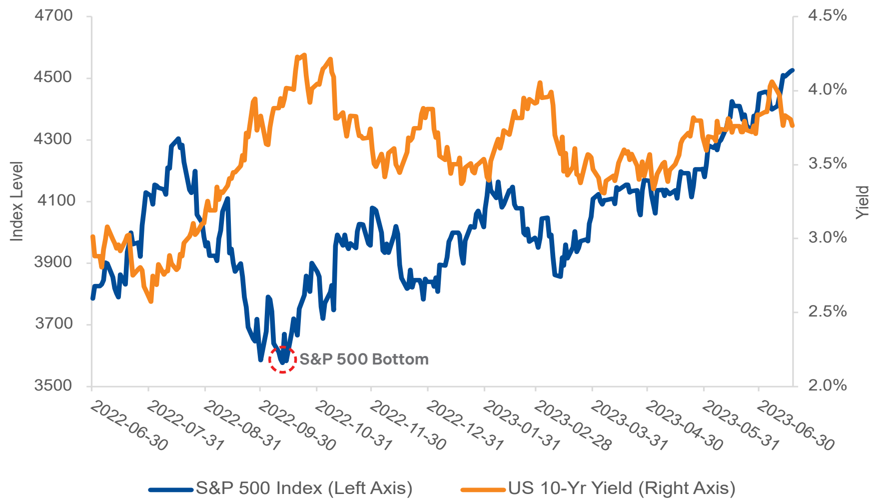
Figure 4 – S&P 500 Performance Through the U.S. Presidential Cycle (Median S&P 500 Price Return, 1928-2022)



Source: Bloomberg, as at December 30, 2022.

The S&P 500 has officially started a new bull market, defined as the market rising over 20% off the October 2022 lows. The market is increasingly reducing the probability of the worst-case scenario of a severe recession. The market is climbing the wall of worry that typically occurs after a bear market. Who would have expected the S&P 500 to be so strong after a regional banking crisis? There is still cash on the sidelines and money chasing returns after missing out on the big move this year. The market typically looks forward and is looking through this earnings trough of the "most anticipated recession ever". Brompton believes the market bottom for this cycle occurred in October 2022 when long-term interest rates and inflation expectations likely peaked for this cycle.

Figure 5 – S&P 500 Index and U.S. 10-Year Treasury Yield

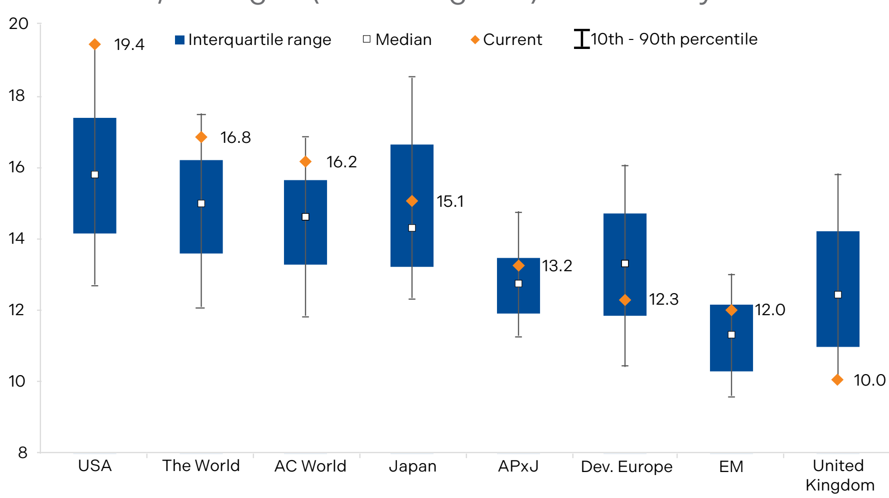


Source: Bloomberg, as at July 18, 2023.

Valuations in the US are high versus historical levels which tends to occur post a bear market as investors expect earnings to trough.

Figure 6 – The US equity market is trading at valuations well above the historical averages

12m fwd P/E ranges (MSCI Regions) over a 20-year timeline

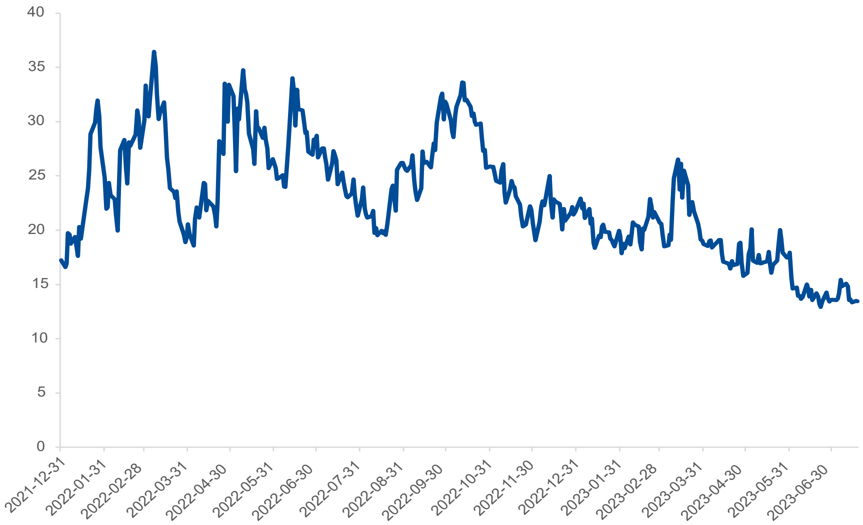


Source: Goldman Sachs Portfolio Strategy Research – Global Equity Views: 'Fat & Flat' strikes back, June 27, 2023.

Without the "Magnificent Seven" tech stocks of Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia, and Tesla, valuation multiples are 2-3x lower. We see more attractive valuations in Europe and Japan. In terms of sectors, we see value in Financials for contrarians and Health Care where there is discounted growth.

After a volatile 2022, volatility has been unusually low as shown with the VIX, or fear index, shown below.

Figure 7 - CBOE Volatility Index (VIX)



Source: Bloomberg, as at July 18, 2023.

Since volatility is mean reverting, we expect volatility to increase in the second half of the year. With the uncertainty over Fed policy and the level of long-term interest rates, fixed income markets have been the primary source of volatility across all asset classes over the past year.

We expect the easy money has been made in the first half of the year, but the second half should still generate positive returns. Inflation is decelerating. Interest rates are peaking. The labour market is strong.

It is difficult to time the market. The best days in the market are often coupled with the worst days. Rather than trying to time the market, we believe investors should embrace strategies that offer attractive risk-adjusted returns, such as dividend growth, low volatility, preferred shares, defensive sectors (staples, healthcare, real assets), and the ability to monetize volatility through covered call writing.

We believe investors should remain defensive in this inflationary and volatile market regime. In this environment, firms that generate inflation resistant cash flows and have a consistent track record of returning capital to shareholders in the form of dividends and buybacks are an attractive investment opportunity, in our view. In that regard, we believe real assets, staples and healthcare should perform well. In high volatility market regimes, strategies that lower portfolio correlations, such as investing in low volatility styles and preferred shares, should enhance risk-adjusted returns. Additionally, Brompton's ability to lean on its covered call writing program to harvest volatility risk premia augments risk-adjusted returns, lowers portfolio volatility, and aids in funding distributions.

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