First Trust

Equity Newsletter

1st Quarter 2023

Resetting expectations:

Historically low interest rates from 2019 through 2021, along with massive fiscal stimulus, helped GDP grow at an unsustainable 5.7% in 2021. For the three calendar years ending prior to 2021, the price appreciation of the S&P 500 Index was 90%. Even with 2022's decline of 18% in the S&P 500 Index, equities produced an average annual return of 13% over the last four calendar years. In our view, huge earnings beats, price-to-earnings multiple expansion, a large dose of speculation plus a lack of regard for valuation drove stocks higher.

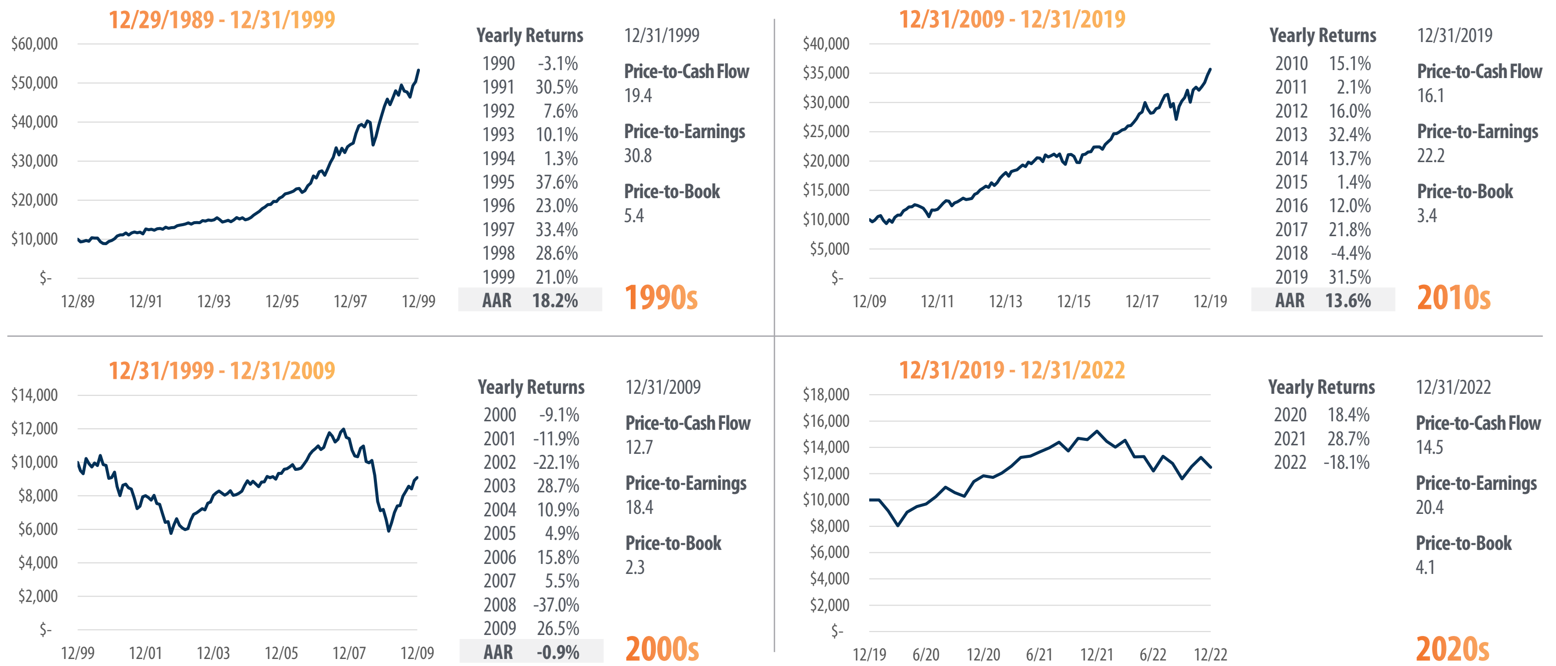
Last quarter, we wrote, Fed Chairman Jerome Powell was very clear in his September 21st press conference when he said "First, we'll want to see growth continuing to run below trend [. . .] We think of trend as being about 1.8% or in that range." Powell's hawkish comments tell us that equity investors should expect a more challenging environment in the near future. Slower GDP growth ultimately leads to slower earnings growth. Slower earnings growth means no multiple expansion to goose stock returns, in our view.

Whether we have a recession starting tomorrow or next December, we expect that higher rates and slower GDP growth will affect earnings. We believe earnings are going to grow slower than in the past several years as the Fed Funds rate stays higher and the Fed is determined to hold down the potential growth of the economy. It will certainly show up in earnings starting this year and that means equity returns are going to be more muted, in our opinion.

Why own stocks if growth is slowing?

- U.S. companies can navigate a higher interest rate environment that actually just looks normal for most seasoned investors, in our opinion.
- We believe stocks are still better hedges against inflation than bonds.
- No longer distracted by speculative "story" stocks or make-believe currencies or Non-Fungible Tokens, we believe investors will likely return to a focus on fundamentals such as cash flow and dividends. A more rational market is a better backdrop for investors who remain focused on value and quality, in our view.
- We believe a lower market multiple is a better starting point for a long-term investor: see below charts illustrating the historical importance of valuation on long horizon returns:

S&P 500 Index Decade Returns and Valuation



Source: Bloomberg and Compustat. **Past performance is no guarantee of future results.** For illustrative purposes only and not indicative of any investment. Indexes do not charge management fees or brokerage expenses, and no such fees or expenses were deducted from the performance shown. AAR is the average annual return. S&P 500 Index is an unmanaged index of 500 companies used to measure large-cap US stock market performance. Investors cannot invest directly in an index.

SECTOR VIEWS

Communication Services

- Expect to see continued digital advertising spending weakness.
- Increasing competition and a return to more normal demand post-COVID may impact media streaming services.
- Risk of increasing regulation.
- Focus on quality within sector.

Consumer Discretionary

- Low unemployment, strong wages are positives for consumption, but wavering consumer confidence, continued high inflation are key risks to sector.
- Homebuilding industry pressured by rising interest rates and high labor costs.
- Services industries may be more attractive than goods producers.
- Valuation levels not particularly attractive, in our view.

Consumer Staples

- While a defensive sector, valuation is not cheap for what we see as relatively meager growth.
- International revenue of multi-nationals expected to be impacted by a strong U.S. dollar.

Energy

- Continue to see strong free cash flow generation as exploration & production companies have maintained capex discipline.
- Lack of investment in production in recent years limits supply growth, supporting oil market fundamentals.
- OPEC has signaled a willingness to expend determined effort to curtail production and support oil prices.
- China's re-opening supportive of international demand for petroleum.

Financials

- Increasing credit utilization generating strong loan growth.
- Higher interest rates improve net interest margin on loans.
- Credit quality remains strong as charge-off rates are relatively low.
- Investment banking and trading revenues may be weak given market volatility.
- Current valuations are attractive, in our opinion.

Healthcare

- Provides opportunity to invest in sector with growth potential that is less correlated to business cycle.
- Post-COVID economy lessens the operational challenges faced by health care companies and may increase elective procedures.
- Passage of drug pricing provisions in Inflation Reduction Act of 2022, and legislative gridlock after Republican takeover of the House reduce risk of further increased regulation.
- Biotechnology stands to benefit from secular innovation, and potentially increasing merger activity as cash rich Big Pharma motivated to replenish their pipelines.

Industrials

- Demand for capex benefits sector, as firms are motivated to improve supply chains and increase productivity in tight labor market.
- Sector benefits from fiscal spending on infrastructure as well as national defense.
- Operational challenges are lessening for manufacturers as supplier delivery times are improving.
- ISM Manufacturing Purchasing Managers Index (PMI) has softened in recent months and is now pointing to a contraction in activity. Further deterioration may signal industrial contraction.
- We believe valuation in sector is reasonable.

Information Technology

- Secular growth opportunities abound in information technology, but cyclical challenges and valuation keep us on the sidelines in the near term.
- Prefer quality within the sector, in particular strong corporate balance sheets and reasonably valued names.
- High multiple, unprofitable cloud software names are currently risky, in our view, as higher interest rates pressure discounted cash flow valuation of long duration growth firms.
- We see cyclical risk in semiconductors overall, especially certain end markets such as PCs, gaming, and mobile devices, while demand remains strong for data center chips. Artificial intelligence, industrial, Internet of Things and vehicle electrification end markets stand to benefit from secular tailwinds. Due to geopolitical tensions with China, increased export restrictions are a risk to the industry.

Materials

- A rising inflation environment should benefit the natural resource exposure within this sector.
- We currently have a somewhat less favorable view of the materials sector than energy due to greater China exposure in metals and mining, but a future recovery in Chinese fixed asset investment spending would be a tailwind to demand.

Utilities

- Defensive sector but we currently view as low growth opportunity.
- Higher yielding regulated utilities are tantamount to bond proxies and therefore sensitive to higher interest rates.

Real Estate Investment Trusts (REITs)

- Sector as a whole is interest rate sensitive.
- Fundamentals for hotel and industrial REITs currently favorable in our view, but would be negatively impacted in economic slowdown.
- Data center REITs may provide strong secular opportunity, but there is risk of a cyclical IT spending slowdown.
- Office REIT fundamentals are challenged as shift to work from home has impacted occupancy.

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INTERNATIONAL VIEWS

DEVELOPED MARKETS

Europe

- Inflation is weighing heavily on real incomes but easing energy prices provide optimism that a severe winter recession may be avoided.
- Any re-acceleration of growth in China potentially stimulates demand for Europe's exports.
- Easing auto semiconductor shortage may benefit troubled German auto industry.
- Continued geopolitical risk as Russia's war on Ukraine impacts supply chains, and heightens energy uncertainty, particularly during winter heating season.
- European Central Bank is tightening policy due to uncomfortably high inflation, but may have to slow pace of tightening if recession occurs.
- Inexpensive valuation in comparison to U.S. stocks.

United Kingdom

- Still elevated inflation and higher rates impacting disposable incomes.
- Bank of England tightening policy in response to inflation, and to buttress pound after the currency's volatility in September of 2022.
- Fiscal policy becoming less supportive in 2023 under new Prime Minister Rushi Sunak.
- Downturn in U.K. housing market a risk to broader economy.
- Less directly impacted by war on Ukraine than the rest of Europe.

Japan

- Industrial-heavy Japan exposed to global appetite for capital equipment, which implies risk if developed economies pull back on investment.
- While the Bank of Japan unexpectedly increased its 10-year bond yield target by 25 basis points in December, Governor Kuroda emphasized a continuing commitment to its dovish "yield curve control" policy.
- Structurally low return on equity.
- Challenging demographics may limit long-run potential economic growth.

Australia

- Commodity exporter which benefits from higher commodity prices.
- Exports of raw materials to China key driver of economic growth.

Canada

- Energy and Metals exporter which benefits from commodity inflation and would suffer from a U.S. recession.

EMERGING MARKETS

Emerging Asia

- Chinese growth has been disappointing in recent quarters, both from pandemic lockdowns, and a credit growth slowdown, which has significantly impacted fixed asset investment, particularly in real estate.
- Policymakers in China have recently taken steps to stimulate growth by easing monetary policy and enacting fiscal stimulus to encourage infrastructure investment, but efforts will take time to flow through to the real economy, and it remains to be seen if the scale of stimulus is sufficient.
- The lifting of Chinese zero COVID policy restrictions is a positive for growth and global supply chains.
- Additional monetary easing could potentially pressure Chinese yuan against the U.S. dollar.
- Geopolitical tensions with U.S. reduce possibility of tariff reductions, and complicate U.S. firms' decisions to invest in China.

Latin America

- Mexican economy benefits from exports to U.S., but would be negatively impacted by U.S. recession. Over time, supply chain diversification away from China may be a structural tailwind to exports.
- Brazil and Latin America overall are sensitive to demand for commodity exports, and commodity price inflation.
- Brazil's newly elected socialist president Lula da Silva may propose policies that undermine the country's fiscal credibility, potentially resulting in a weaker currency and weighing on sentiment.

Definitions

The **S&P 500 Index** is an index of 500 companies used to measure large-cap U.S. stock market performance.

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