First Trust

Equity Newsletter

2nd Quarter 2023

Focused on fundamentals, not rates:

The stock market displayed remarkable resilience in the first quarter of 2023, led by growth stocks, *even as earnings forecasts for 2023 were revised downward.*

- The S&P 500 Index was up 7.5% in the first quarter of 2023; Information Technology (+22%), Communication Services (+21%) and Consumer Discretionary (+16%) were up even more, led by mega-cap growth companies.
- Defensives and cyclicals returns were mixed with some up slightly while others were modestly lower, and financials was the worst-performing sector due to the banking tumult.
- Earnings growth does not explain the growth rally, as forecasted EPS growth for 2023 had been revised down from 5% as of December 2022 to only 1% by the end of March 2023.

Interest rates, rather than earnings, appear to be the key focus of investors and the dominant factor in equity positioning so far this year.

- Expectations are high that the Federal Reserve (Fed) will soon end its interest rate hiking cycle, and expectations have even risen for *rate cuts by the end of 2023*.

We believe investors should return to fundamentals and focus on valuation and earnings rather than myopically fixating solely on the near term trajectory of interest rate movements.

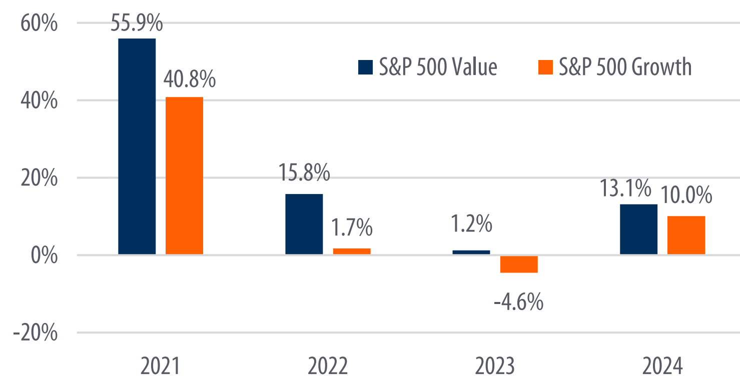
- Calling the interest rate cycle correctly is difficult; Going into 2022, the Fed was expected to move the fed funds rate higher by 75 basis points (bps) from zero starting in July through December of 2022. Instead, the Fed started increasing rates in March, sooner than expected, and ultimately raised interest rates 425 bps throughout 2022.
- Since the Silicon Valley Bank failure led to a banking crisis in early March, expectations have risen for rate CUTS toward the end of 2023. Even if the Fed doesn't raise rates again and then lowers rates 75 basis points in the second half of this year, the fed funds rate would still be at 4.00%, a level much higher than the start of 2022.

Earnings growth is slowing, not accelerating, especially for growth stocks (see Chart 1). Profit margins are under pressure due to a combination of slowing revenue growth, higher wages and other increased costs.

We continue to believe that the valuation spread between growth and value stocks remains excessive (see Chart 2), and will tighten as investors realize overall earnings growth will be very modest in a "higher for longer" rate environment. We advocate using this opportunity to rebalance portfolios away from the highfliers and into areas of the market with better valuations.

We believe none of this has to be disastrous to the stock market but the data does not indicate higher earnings expectations or increased multiples any time soon. In our view, investors need to focus on the windshield and not the rearview mirror. We believe a world of "higher for longer" rates and slower growth than the last four years is much more likely than a return to the abnormally low interest rate environment where long duration growth stocks dominate and high valuations are accepted.

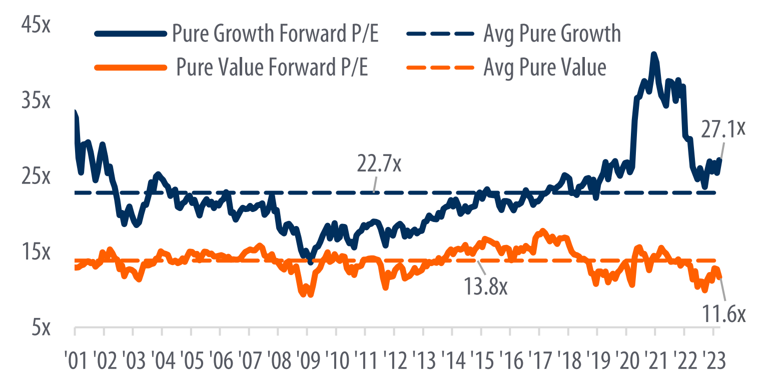
Chart 1: Expected Earnings Growth Rates: S&P 500 Value and Growth



Source: Bloomberg. As of 3/31/23. Earnings growth rates are based on aggregate sell-side estimates. For illustrative purposes only and not indicative of any investment.

Past performance is no guarantee of future results.

Chart 2: Pure Growth vs. Pure Value Forward P/E Ratios



Source: Capital IQ. Monthly data is calculated from 12/29/2000-3/31/23. Universe: largest 1,000 U.S. firms with $1 million in average daily volume over the last 3 months and 12 months of trading history. The median monthly forward price-to-earnings ratio is used for the pure growth and pure value baskets. Only firms with positive earnings are used. Pure growth names are the 30% of names with the highest price-to-books versus the pure value basket of the 30% of names with the lowest price-to-books. For illustrative purposes only and not indicative of any investment.

Communication Services

- Expect to see continued digital advertising spending weakness.
- Increasing competition may impact media streaming services.
- Internet and streaming firms taking steps to rationalize costs with headcount reductions.
- 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, including an early production cut in April 2023.
- China's re-opening supportive of international demand for petroleum.

Financials

- Tightening lending standards after recent bank failures likely to negatively impact loan growth in 2023, in our view.
- Deposit guarantees lower risk of contagion, but may lead to increased regulation of regional banks
- Higher interest rates improve net interest margin on loans, but deposit rates rising as well.
- Credit quality remains reasonable as charge-off rates are relatively low.
- Investment banking and trading revenues may be weak given market volatility.
- While near term risk remains in the sector, current valuations are quite attractive after the recent sell-off, providing a compelling long-horizon opportunity, in our view.

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.
- Relatively weak performance in Q1 2023 offers valuation opportunity.

Industrials

- Demand for capex is a secular driver that benefits the sector, as firms are motivated to improve supply chains and increase productivity in a 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 is a risk and may signal broad economic weakness.
- We believe valuation in sector is reasonable.

Information Technology

- Secular growth opportunities abound in information technology, but slowing IT corporate spending and the risk of recession are cyclical challenges for the sector. Additionally, in our view, technology stocks are still too expensive relative to value stocks.
- 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.
- Despite the strong performance of semiconductor stocks in the first quarter of 2023, we still see cyclical risk to semis overall, and we expect slower semiconductor capital equipment growth in 2023. That said, certain semi end markets such as artificial intelligence, industrial semis, Internet of Things and vehicle electrification 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.
- Materials sector poised to benefit from any recovery in Chinese fixed asset investment spending from policy stimulus, but prolonged slowdown in Chinese real estate construction would negatively impact demand outlook.
- Incremental demand from clean energy grid infrastructure and electric vehicle transition is a secular positive.

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 impacted by softer macroeconomic outlook.
- Data center REITs may provide strong secular opportunity, but there is risk of a cyclical IT spending slowdown.
- Office REIT fundamentals remain challenged as shift to work from home has impacted occupancy, although utilization of office space may improve over time.

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DEVELOPED MARKETS

Europe

- Inflation is currently weighing heavily on real incomes.
- European Central Bank (ECB) is tightening policy to reign in uncomfortably high inflation, but the ECB has announced that further hikes will be dependent on economic data given recent turmoil in wake of Credit Suisse's financial difficulties.
- Any re-acceleration of growth in China potentially stimulates demand for Europe's exports.
- Easing auto semiconductor shortage may benefit German auto industry.
- Russia's war on Ukraine and France's pension reform elevate geopolitical risk in region.
- Inexpensive valuation in comparison to U.S. stocks.

United Kingdom

- Still elevated inflation and higher rates impacting disposable incomes.
- Bank of England has been tightening policy in response to inflation, and to buttress the pound after the currency's volatility in September of 2022, but is nearing end of cycle, in our view.
- Fiscal policy becoming less supportive in 2023.
- Downturn in U.K. housing market a risk to broader economy.
- Inexpensive valuation in comparison to U.S. stocks.

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 2022, the timing of further revisions to the central bank's "yield curve control" policy is uncertain.
- 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

- Policymakers in China have recently taken steps to stimulate growth by easing monetary policy and enacting fiscal stimulus to encourage infrastructure investment.
- The lifting of Chinese zero COVID policy restrictions is a positive, not only for global supply chains, but also services and housing demand in China.
- Moderating export growth to Developed Markets is weighing on Chinese manufacturing.
- 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 unmanaged index of 500 companies used to measure large-cap U.S. stock market performance. The **S&P 500 Growth Index** contains those securities with growth characteristics from the S&P 500 Index. The **S&P 500 Value Index** contains those securities with value characteristics from the S&P 500 Index. Investors cannot invest directly in an index. **Earnings per share (EPS)** is calculated as a company's profit divided by the outstanding shares of its common stock. The resulting number serves as an indicator of a company's profitability. **EPS growth** illustrates the growth of earnings per share over time. There is no assurance any forecasts will be achieved.

Defensives are defined as the consumer staples, health care, utilities, real estate, and communication services sectors excluding interactive media & services. **Cyclicals** are defined as the energy, materials, industrials and consumer discretionary sectors excluding internet & direct marketing.

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