Equity Newsletter

3rd Quarter 2023

We expect a mean reversion in sector relative performance in the second half as valuation returns to focus:

The first six months of 2023 saw the reemergence of the growth trade, and with it the reversal of much of the damage in Technology Plus (Tech+) stocks that paced the 18% market selloff in 2022. We believe three dynamics drove the Tech+ outperformance in the first half:

- The outperformance of Tech+ began in January with a rebound trade from last year's disaster along with expectations that China reopening its economy would spur faster worldwide GDP growth.
- Tech+ was favored in March as a shelter from the banking crisis, then moved higher on the market pricing in rate cuts this year.
- Finally, in May, Tech+ rocketed higher as NVIDIA announced a massive increase in future revenue estimates due to surging demand for its specialized AI chips.

Today, the banks appear more stable, or at least less threatening to the economy, especially after the stress test, China's reopening was a dud, the Federal Reserve is almost certainly not cutting rates this year, and evidence of widespread, near-term tangible benefits of AI aside from NVIDIA are generally lacking, in our view.

The market seems to have embraced a narrow group of high performing companies and may be betting that little can stop them even if the thesis for the outperformance doesn't materialize, *but there were some signs of market broadening in June.*

- In his June Market Minute, First Trust's Chief Investment Officer, Dave McGarel, pointed out that the year-to-date (YTD) return through May 31, 2023 of the S&P 500 Index was incredibly narrow.
- Specifically, just 7 Tech+ stocks accounted for all of the return of the S&P 500 Index to that point.
- Only the three big growth sectors (Information Technology, Consumer Discretionary, and Communication Services) had positive YTD returns through the end of May.
- In June, the market climbed another 7% but broadened out and was actually led by cyclical sectors, not Tech+. As per chart 1, there are now seven sectors with positive YTD returns.

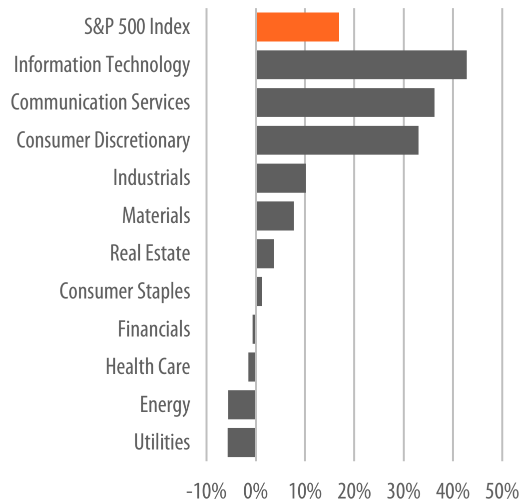
In our view, the market is much more likely to broaden further at the sector level than to revert back to the narrow Tech+ trade of the first five months.

Regardless of market direction, up or down, in the second half of the year, we also believe positioning in stocks 11-500 will produce better returns than the largest stocks (1-10) in the S&P 500 Index.

- The S&P 500 Index is currently quite concentrated. Chart 2 shows that 31.5% of the S&P 500 Index weight sits in just 10 stocks. After the 7 tech+ companies (Apple, Microsoft, Alphabet, Amazon.com, NVIDIA, Tesla and Meta), Berkshire Hathaway, UnitedHealth and Exxon Mobil are the next 3 biggest.
- Berkshire Hathaway, UnitedHealth and Exxon Mobil only make up 13% of the top 10's weight, so despite much cheaper forward multiples for those 3 companies, the top 10 still trade at 30x the next four quarters' estimated earnings. 30x is a starkly higher multiple than even stocks 11-50, which are also mega-cap stocks (the 11th biggest stock is Johnson & Johnson ($430 billion equity market cap) and the 50th is Nike (still a $169 billion company).

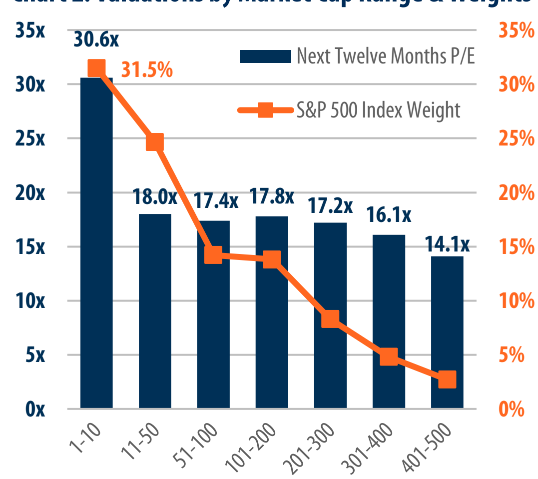
The current disparity in valuation is disconnected from the fundamentals in the large cap index, and speaks to looking backward instead of forward, in our opinion. History tells us that, at some point, fundamentals will take over and investors will be better served by putting fewer dollars in the 10 largest stocks and more in the rest of the big companies in the S&P 500 Index.

Chart 1: S&P 500 Economic Sectors Total Return



Source: Bloomberg. Data from 12/30/22 - 6/30/23.

Chart 2: Valuations by Market Cap Range & Weights



Source: Capital IQ. Data as of 6/30/23. Estimates are based on the next four quarters earnings per share.

Past performance is no guarantee of future results.

Sector Views

Communication Services

- Digital advertising spending starting to recover but would be impacted in event of recession.
- Increasing competition may impact media streaming services.
- Internet and streaming firms have taken 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.
- Consumer staples retailers and grocers face risk of reduced pricing power as inflation slows.

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 economic growth is a key source of international demand for petroleum and is a risk to energy if growth disappoints.

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.
- Net interest margin on loans still healthy, but deposit rates rising.
- Credit quality reasonable as charge-off rates are still 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.
- Elective procedures and office visits continue to rebound post-COVID.
- 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 year-to-date offers valuation opportunity.

Industrials

- Demand for capex is a secular driver than benefits sector, as firms are motivated to reshore supply chains and increase productivity in a tight labor market.
- Sector benefits from fiscal spending on infrastructure as well as national defense.
- ISM Manufacturing PMI index continues to indicate a cyclical contraction in industrial activity, as firms reduce precautionary inventories built up during supply chain difficulties.
- 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 constrain risk capital.
- We see cyclical risk to semiconductors overall, and we expect slower semiconductor capital equipment growth in 2023. That said, key semi end markets such as artificial intelligence (AI) and vehicle electrification benefit from secular tailwinds. Valuation is a risk for some well-known semis benefiting from investor enthusiasm towards AI. Due to geopolitical tensions with China, increased export restrictions are a risk to the industry.

Materials

- 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

- Low growth sector but defensive, dividend paying nature more attractive in times of macroeconomic uncertainty.
- Interest rate sensitivity less of a concern as Fed nears end of tightening cycle.

Real Estate Investment Trusts (REITs)

- Fundamentals for industrial and hotel 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.

DEVELOPED MARKETS

Europe

- Inexpensive valuation in comparison to U.S. stocks, but no clear near-term catalyst.
- Waning recovery in industrial activity raises growth concerns.
- European Central Bank (ECB) is still tightening policy to reign in uncomfortably high inflation, but the ECB has announced that further hikes will be dependent on economic data.
- 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 French pension reform elevate geopolitical risk in region.

United Kingdom

- Still elevated inflation and higher rates impacting disposable incomes.
- Bank of England expected to continue tightening policy in response to persistent inflation.
- 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

- Robust wage growth improving near term domestic demand prospects, driving inflation and corporate pricing power.
- Japan domestic economy in cyclical recovery, with later re-opening than U.S., resulting in more services demand, such as inbound tourism.
- Rising wages and core inflation raise possibility that the Bank of Japan may revise its "yield curve control" policy, potentially lifting Yen.
- Industrial-heavy Japan exposed to global appetite for capital equipment, which implies risk if developed economies pull back on investment.
- Structurally low return on equity, although some corporate governance reforms have been recently implemented by the Tokyo Stock Exchange.
- Challenging demographics 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

- While the re-opening of the Chinese economy, as well as easing lending restrictions and fiscal stimulus provide a source of upside risk, recent economic data has been softer than expected.
- 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 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.
- Brazilian inflation is cooling, raising possibility that the Brazilian Central Bank will have scope to ease policy.

Definitions

The S&P 500 Index is an unmanaged index of 500 companies used to measure large-cap U.S. stock market performance. Investors cannot invest directly in an index. Forward Price-to-Earnings (P/E) is the price of a stock divided by estimated forward earnings. Forward Multiple is a valuation ratio that reflects a company's value on the basis of an estimated financial metric. Forward estimates are divided by the trailing four quarters of earnings to derive future growth rates. There can be no assurance that any estimates will be achieved. Cyclicals are defined as the energy, materials, industrials and consumer discretionary sectors ex internet & direct marketing. Technology Plus (Tech+) is a combination of the technology sector, interactive home entertainment, interactive media & services, internet & direct marketing, Tesla Inc., and Netflix Inc.

References to specific securities should not be construed as a recommendation to buy or sell and should not be assumed profitable.

First Trust