THE OUTLOOK FOR GLOBAL DEVELOPED MARKET EQUITIES:
ONE LAST CHANCE TO BUY?

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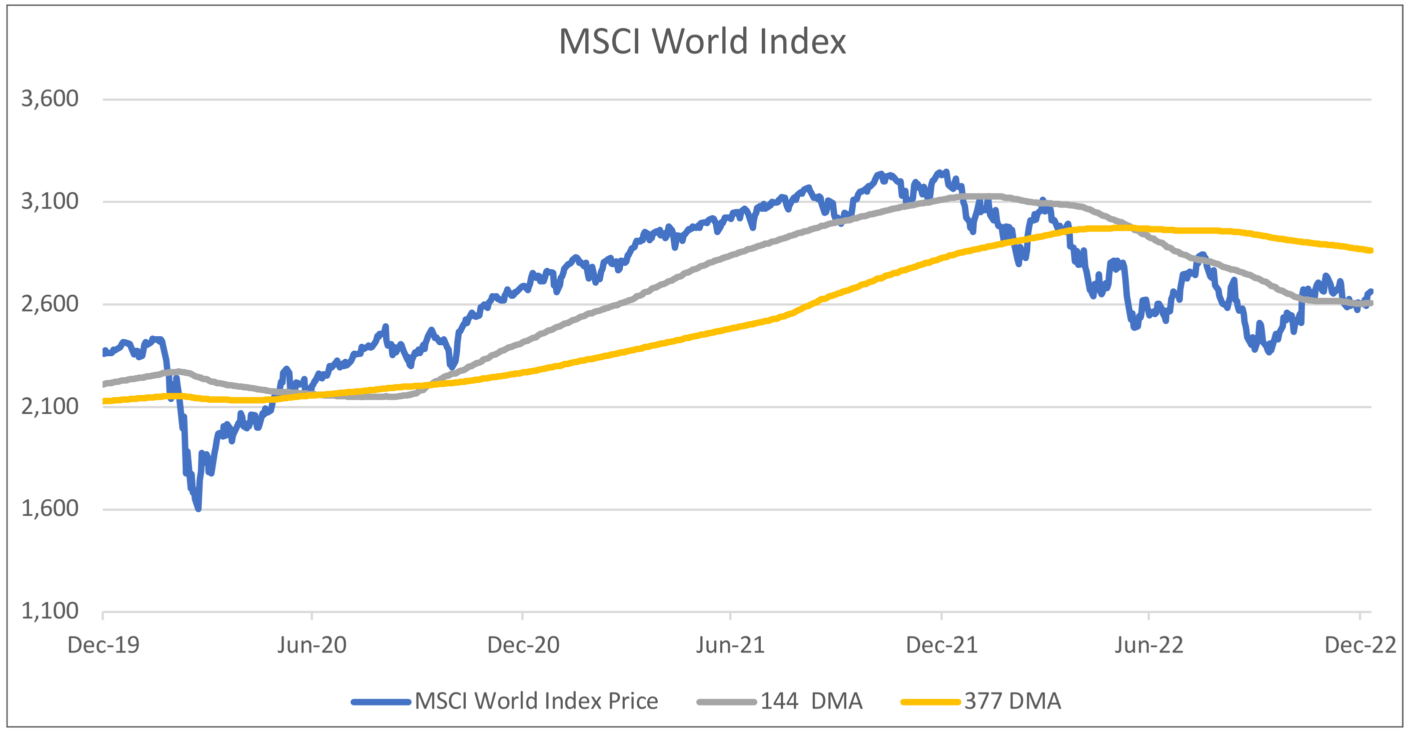
Chart: MSCI World Index (Developed Country Equities, excluding EM)



Source: Bloomberg, FABAM

Introduction:

Fortunately, 2022 is now history. The MSCI All World County Index fell by 19.8%, the MSCI World Index (which includes developed countries only) fell by 19.4%, and the MSCI Emerging Markets Index fell by 22.3% last year (all excluding dividends). The S&P500 Index closed 19.4% lower, although this fall was substantially exceeded by the 33.1% loss in the NASDAQ Composite Index, which was dragged lower by its technology, communications and media emphasis. Looking at large-cap 'value' versus 'growth' within the MSCI World universe, value outperformed growth by a huge amount, given their performances of -5.0% and -29.7% respectively, with the former supported by energy (especially), utilities, staples, and healthcare. The global environment continues to be challenging as we enter 2023, detailed elsewhere within the GIO. The markets are still contending with geopolitical issues, an energy crisis (particularly in Europe), inflation that although coming down is still too high, and the fine line that central banks are walking between choking-off inflation on one hand, whilst avoiding serious recession on the other. Supply chains still need to normalize, while any end to the conflict in Ukraine would clearly be welcomed by delighted bulls. In the meantime there is the Chinese Lunar New Year, which many are viewing as a potential Covid 'super-spreader'.

Growth has slackened substantially in the European Union, while recession is definitely apparent in the UK. China's recent PMIs suggest a recession there, and with a sharp (but short) one expected in the US (see the lead GIO article). The main message for equity investors as far as we are concerned is probably as follows: when interest rates rise - and certainly as they did last year - global economies and markets will be under pressure. Some companies might go bust, and knock-on effects will be felt - but with a time lag. Investors should, although this will sound trite, 'expect the unexpected'. As investors, while we expect the so-called 'sticker shock' of bad Q1 earnings to provide realised short-term downside, we would under such circumstances be looking to put money to work. Bear markets do not last forever, and neither will this one. In fact the risk could now be that investors who did raise cash last year face the possibility of not getting back in. Elsewhere, a weaker dollar would particularly benefit the emerging market currencies, and we have begun to see the dollar index (DXY) trending lower. If this persists there would likely be selected upside potential in emerging market equities, with our choice here being India (see Abhishek Shukla's article elsewhere in the GIO).

Discussion:

The IMF recently said it expects growth in the Advanced Economies to average 1.1% in 2023, following 2.4% last year. They expect growth in Emerging Market & Developing Economies to be 3.7% this year, the same as 2022. However, common sense alone suggests these numbers still look too optimistic, and in any case such statistics are usually adjusted incrementally. We expect a 'sharp-but-short' economic slowdown in the US, while China PMIs at below 50 suggest contraction, likely to leave the IMF GDP growth estimate of 4.4% for China in the current year very much offside.

Japan has entered 2023 with perhaps a better economic outlook than it has had in some years, as the country seems to be heading into a period of moderate yet sustainable positive inflation. After decades of deflation the Bank of Japan is likely to be the only major central bank happy to see some external upward pressure on inflation, from higher energy prices and the (until recently) sharp weakening of the yen. Producer prices have been rising for some time, and there has been more evidence of companies looking to pass on these increases to end-consumers, despite the latter remaining very price-sensitive after two decades

of deflation. The current IMF growth estimate for the country stands at 1.6% for the current year, broadly unchanged from 2022's 1.7%. We are closer than we have been for a few years to seriously considering Japanese equities.

Emerging market (EM) economies remain critical for global growth recovery, with a question mark hanging over when China will once again be a driving force. We have increasingly seen the EM growth discussion couched in terms of China vs. India, and we touch on this in the GIO India article. China's challenges (real estate-related debt, and fluctuating policies to its technology sector, and so on) are well known, in addition to more multinational companies seeking to de-emphasize China as a production base. The Indian economy, in comparison has been relatively resilient on the back of supportive government policies, its drive towards a 'digital' economy, and the fact that supply chains have shifted in favour of India (and some other Asian countries) as Chinese labour costs are now less competitive.

Current Sector Allocation:

We at FABAM remain under-weight across the majority of sectors versus the S&P500 Index (using this as a proxy for global equities), except Energy, where we have maintained an overweight position on the back of the energy supply shock and OPEC+ coordinated efforts to manage supply to balance any negative price shocks. In other sectors, Consumer Discretionary will continue to be impacted by the high inflationary environment as the real purchasing power of consumers erodes. Elsewhere, high interest rates remain a headwind for the real estate sector. We are cognizant that a resurfacing of pandemic concerns could once again support healthcare. Overall, quality dividend stocks should be a source of stable returns, with these preferably coming from the Telecommunications and Utility sectors.

SPX 500 Index Sectors Performance and Multiples

	2022 (%)	P/E 2022	P/E 2023
Energy	65.4	9.8	10.9
Utilites	1.6	19.0	17.6
Consumer Staples	(0.6)	21.6	20.1
Healthcare	(2.0)	17.4	16.2
Industrails	(5.5)	18.6	16.6
Financials	(10.6)	12.6	11.5
Materials	(12.3)	16.3	15.7
Real Estate	(26.2)	33.6	31.5
Technolog	(28.2)	21.0	18.4
Consumer Discretionary	(37.0)	21.0	17.7
Communications	(39.9)	13.7	11.8

Source: Bloomberg, FABAM

Concusions:

Soon after each year end we find that the Bloomberg consensus earnings estimate on Bloomberg for the S&P500 Index can move sharply, presumably because analysts update their forecasts for the companies they follow. For some months, like other commentators, we have expected the 'bottom-up' yearly forecasts for 2022 and 2023 to fall, and although this had been tracking downwards for a while, in the last week or so a sharper fall has occurred i.e. the earnings estimate for 2022 has fallen from $220, to $206, and for 2023 it has fallen from $235, to $226. Although market participants can discuss news items for hours, what actually happens in the real world of earnings is a key driver of equity prices. Clearly if earnings expectations

come down when - due to margin pressures, revenue shortfalls, and so on - they should, logically be closer to bottoming, eventually helping to draw a line under a bear market.

In our regular team meetings we discuss our view of the 'fair value' of the S&P 500, and as imperfect as this may be it serves as a starting point. Our worst-case earnings scenario is that there is a US recession of average length (of ten months), which could see S&P earnings fall by circa. 10%, to about $186, as mentioned in the GIO lead article. However on the desk we expect a very short recession, reduced by a pivot in the Fed's language (but not in actual rate cuts this year). We think a short recession would only hurt annual S&P earnings by 5-6%, to about $195, down from $206 estimated for last year (2022) according to Bloomberg. Experience suggests that in the first year of earnings recovery - again borrowing from the lead article - operational gains and the statistical comparison as the few weak quarters of 2023 drop out could see S&P earnings gain by as much as 20-22% in 2024, prior to a return to the long-run average of 9% or so growth in 2025. Equity markets look ahead by about 9-15 months, so it will be 2024 earnings that will matter this year, especially once we get into the second half-year.

The above - albeit simplistically - deals with the 'E' (earnings) assumptions, but what about the 'P' (price, or multiple) of those earnings? For this our team members typically use the so-called 'Rule of 20' (good discussion of which can be found online, under Investopedia), which suggests that a fair value market P/E is 20 minus the annualized inflation rate. We don't agree with the inflation verdict from the current US one-year breakeven, suggesting that inflation in a year will be 1.79%, or the two-year breakeven indicating 2.19%. Instead, for 2024 earnings to be discounted this year we would use either 3% (a 17x P/E ratio), or 2.5% (a 17.5x P/E). An operationally-geared earnings recovery of 22% could see 2024 S&P earnings of $238, and 17.5x that equals an index level of 4,165 in the second half of this year, or 6.9% above the current level of 3,895. Using 17x would result in a reduced target of 4,046, or 3.9% from current levels.

In the short-term, say over the next three or four months, there are likely to be some surprise bankruptcies, (or off-balance sheet events, perhaps) in line with the adage from our lead article that "bad things happen when interest rates go up" (and especially by the amount that they have). This 'sticker shock' could, we guess, perhaps see the index fall by between 7-8%, or maybe in response to some poor corporate results in the current half. While we don't advocate so-called 'bottom-spotting', if the index fell to 3,622 (7% lower), or to 3,583 (8% lower) on a closing basis, we believe the downside risk would be very limited. Market watchers will know that the low point so far in the current bear market was 3,577.03, on 12th October last year, so we are not expecting that low to be taken out. Of course we could be wrong, although as we have noted above, the bottom-up analysts are finally revising their forecasts downwards. By this time next year we think they will be revising them upwards.

We know that many investors will always attempt to guess the bottom, although scaling-in can make this easier, committing cash in stages. Of course by successful stock and sector selection it is possible to outperform the indices. For those who can make regular investments, we strongly advocate Dollar-Cost Averaging (please see our GIO article on this subject).

In essence: we believe it is too late to sell, while if investors are able to add to S&P-equivalent positions about 7-8% below current levels, their return to the current year-end could be in the region of 14%, or about 5-6% from current levels. So buying cheaply at what we believe will be the end of the current bear market will be important in maximizing equity returns this year. NASDAQ stocks (aka Technology, and with some biotech) are probably beginning to look very beaten down, and their time will almost certainly come again, although as always, using successful stock selection factors is crucial to realizing alpha.