2023 Investment Outlook: Equity

By: EV Forward | December 14, 2022

We See A Resilient Economy Without a Looming Collapse

KEY POINTS

1. In our view, the first quarter of 2023 has the ingredients to build on strengths of the fourth quarter of 2022.
2. An inverted yield curve hints at a potential economic slowdown at some point in the year ahead.
3. We're scaling back on megacap stocks after a mega run-up.

2022 Recap

We continue to believe when 2022 is over, equity investors will think, "That didn't turn out nearly as bad as it felt at times."

The State of Future Earnings

The consensus view is that early in 2023, earnings will collapse, bringing the stock market down with them.

Sectoral leadership in the market suggests otherwise. Financials, industrials and materials have all outperformed in October and November. As noted by market consultant John Raphael: "It's puzzling to me why these brokers and investment banks are acting so well. Would you buy these stocks if the SPX had 10% downside?"[1]

If the economy were going to collapse in the first quarter of 2023, these economically cyclical groups would not be leading today.

The S&P 500 equal-weighted is down -11% while the S&P 500 cap-weighted is down -17%.[2] Broader breadth is a bullish signal.

My conclusions? The economy is proving too resilient, causing the "looming collapse" in earnings to remain elusive for yet another quarter. I expect earnings to drip down slowly, frustrating market bears.

With continuing improvements on the inflation front mixed in, you have the ingredients for a strong first quarter.

What We Can Learn from Yield Curves

Yield curves are inverted (when interest rates on long-term bonds fall lower than those of short-term bonds), a fact that requires attention and respect.

Yield curves are not very good at predicting *when* a slowdown occurs, only that it *will* occur at some point in the future.

Could the scenario of a weaker second half following a surprisingly strong first half occur in 2023? Said another way, could the narrative change to "weakness in the market-but from higher levels?" Maybe, but that is not the consensus.

What About Those Mega Tech Stocks?

At their peak in 2000, the five largest tech-related stocks comprised just over 20% of the S&P 500. Those same stocks bottomed five years later, dropping to only 5% of the S&P 500.[3] At their peak in 2022, the five largest tech stocks comprised roughly 25% of the index.[4] Are they now headed to 5%?

On one hand, the 30 times average valuations of the five largest tech stocks today will never reach the triple-digit valuations of 2000.

But what has historically stunted the growth of the mega S&P 500 stocks is the U.S. government's desire to abate their dominance—and we are now seeing that with increased regulatory scrutiny.

Bolt-on acquisitions have boosted megasized companies' sales growth, averaging roughly 100/year during the 2010s. Year-to-date, however, only 22 acquisitions have been completed.[5]

We believe slowing growth rates combined with premium valuations will allow the S&P equal-weighted to continue to outperform the S&P 500 cap-weighted.

We are reducing our exposure to these megacap stocks for these reasons.

Overseas Considerations

Non-U.S. markets finally began outperforming the U.S. when the dollar peaked in late September.[6]

Asia ex Japan has lead since the end of October, outperforming Europe and Japan, which have both outperformed the U.S.[7]

As China's zero-COVID policies begin to moderate, combined with a weaker dollar, that could make China an intriguing equity area for 2023.

Andrew Slimmon
Head of Applied Equity Advisors

[1] John Raphael, November 20, 2022.

[2] Bloomberg, November 29, 2022.

[3] Microsoft, Cisco Systems, Nokia, Intel and IBM. S&P 500 weighting. Bloomberg.

[4] Apple, Microsoft, Google, Amazon and Tesla. Bloomberg.

[5] US Weekly Kickstart, Goldman Sachs, November 11, 2022.

[6] Bloomberg.

[7] FactSet.

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

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