EQUITIES | OUTLOOK

2023 Investment Outlook: Value Equity

By: EV Forward | December 29, 2022

We Continue to Find Value in Quality Cyclicals

KEY POINTS

1 We believe quality cyclical stocks, which have been outperforming the S&P 500, will continue to offer opportunity in 2023.

2 In our view, industrials, financials, basic materials, consumer discretionary and aerospace offer the most opportunities.

3 We are observing China's reopening, how the world reacts to energy security and the ongoing Russia-Ukraine war, and the shifting dynamics of global consumer health.

What We Are Seeing

The market has already priced in many of the lag effects of the Fed's tightening regime, so the risk-reward for equities will likely become more favorable in 2023.

We see many misconceptions, as investors are too focused on the short term. Markets are overplaying consumer credit woes; we are seeing the best rate structure for financial stocks in over a decade. Meanwhile, higher interest rates create potential for more restructuring opportunities. Utility yields are trading inside the 10-year Treasury risk-free rate, which is atypical.

As of December 12, 2022, the cyclical recovery will likely accelerate over time as economies continue to fully reopen from the pandemic. The reopening of China's economy is likely to fuel a spike in commodities. We believe equity markets strengthen over the year and create more opportunity in 2023 than in 2022.

In 2022, the Russell 1000 Value Index has outperformed the Russell 1000 Growth Index, as of December 12, 2022. Looking at historical environments like today, we believe this could be the case for the next few years.

What We Are Doing

We continue to invest in companies that have strong balance sheets, excellent management and quality businesses. We seek companies in industries that can maintain optimal pricing while their costs are moderating. Eschewing short-termism, we are focused on the midcycle earnings power of companies. We seek companies that are mispriced or misunderstood by the market and are trading at a discount to their intrinsic value.

In our view, industrials, financials, consumer discretionary and aerospace offer the best opportunities. As supply chains begin to normalize, we see margin opportunities for basic materials stocks. Within industrials, reshoring and nearshoring[1] will play meaningful roles, as will electrification and decarbonization.

In financials, we believe well-capitalized, asset-sensitive regional banks will benefit from higher rates. Rate sensitivity and (in some cases) limited credit risks in nonbank financials are also underappreciated.

In consumer discretionary, we are focused on U.S. consumer companies that bring value to consumers as well as those able to grow within a tougher environment. Internationally, we believe consumer spending power is impaired due to structurally higher energy costs and a stronger dollar.

We favor companies with sustainable business models, strong returns on capital as well as balance sheets built on financial discipline and a resilient free cash flow profile.

What We Are Watching

Continued 2022 trends could be a challenge for the market, but we believe there will be some major shifts.

China's slow reopening and commodity supply-demand problems continue to hamper the global economy. Typically, a sagging dollar boosts commodities, and right now, we have a strong dollar and hot commodities. One of those could break. We anticipate a positive outcome if the Fed signals a peak in rates and the dollar weakens.

Consumer stocks are shifting toward a more positive risk-reward scenario, and we're waiting to see how consumer balance sheets hold up. Consumer credit has normalized.

We are observing how the global economy reacts to energy security and the ongoing Russia-Ukraine war, and what that means for European inflation and supply scarcity.

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Past performance is no guarantee of future results.

S&P 500® Index is an unmanaged index of large cap stocks commonly used as a measure of U.S. stock market performance.

Russell 1000® Value Index is an unmanaged index of U.S. large cap value stocks.

Russell 1000® Growth Index is an unmanaged index of U.S. large cap growth stocks.

[1] Reshoring refers to returning the manufacturing and production of goods from a foreign country back to the company's original country. Nearshoring is when a company transfers work to another organization within its own region.

Risk Considerations: *The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the U.S. and global markets. The value of equity securities is sensitive to stock market volatility. Diversification does not eliminate the risk of loss.*

Active management attempts to outperform a passive benchmark through proactive security selection and assumes considerable risk should managers incorrectly anticipate changing conditions.

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