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INVESTMENT MANAGEMENT

SLIMMON'S TAKE > TAKEAWAYS & KEY EXPECTATIONS

Equity Market Commentary

SOLUTIONS & MULTI-ASSET | APPLIED EQUITY ADVISORS TEAM | SLIMMON'S TAKE | NOVEMBER 2022

1. We continue to believe, regardless of the Fed Chair's potentially hawkish tone today, when the final closing bell sounds on December 31st, 2022, equity investors will look back and think, "2022 didn't turn out nearly as bad as it felt at times throughout the year".

As I have said since January, I still think the market will end the year not too far from where it started the year.

2. Consensus view is that early next year, earnings will collapse, bringing down the stock market.

However, market sectoral leadership suggests a different narrative. Financials, industrials, and materials have outperformed in October and November. As my friend John Raphael wrote recently:

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 was going to collapse in Q1, or if we should expect a wave of earnings resets, these economically cyclical groups would not be leading today.

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¹ John Raphael, November 20th, 2022

Not to mention, the breadth of the market has been great. Keep in mind, the S&P 500 equal-weighted is down -11% YTD versus the S&P 500 Index (cap-weighted) 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 still expect a rather slow earnings drip downward which will be frustrating for the bears.

Meanwhile sentiment and positioning remain incredibly negative waiting for some collapse.

Mix continuing improvements on the inflation front into the brew, and you have *the ingredients for a strong Q4 to continue into Q1*.

3. Having said that, yield curves are inverted. I do think you have to *respect that message*.

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

Could the scenario of a weaker second half following a surprisingly strong first half occur in 2023?

In essence, could the narrative change into “*weakness in the market but from higher levels?*” That is certainly not consensus.

4. At the peak of the love affair with technology in the year 2000, the five largest technology-related stocks comprised just over 20% of the S&P 500.

Those same stocks bottomed 5 years later, comprising only 5% of the S&P 500 at that point.³

At the peak this year, the five largest tech stocks comprised roughly 25% of the index.⁴

Are they headed to 5%?

² Bloomberg as of 11/29/2022

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

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

On one hand, in no way did the average valuations of the five largest today ever reach those at the peak of 2000. Valuations were roughly 30x on average today versus nearly triple digit P/Es in 2000.

However, what has consistently brought down the biggest members of the S&P 500 over time is the US government's desire to slow their dominance.

We are seeing that occur again with *increased regulatory scrutiny*.

Bolt on acquisitions have been a key ingredient to these mega-sized companies' growth in sales, averaging roughly 100 per year during the 2010s. Year-to-date, only 22 acquisitions have been achieved.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. That is good for active managers willing to underweight these darlings.

For this reason, *we are reducing our exposure to these mega-cap stocks in our strategies*.

5. The dollar's unrelenting grind higher peaked in late September. The result has been non-US markets finally beginning to outperform the US.⁶

Since the end of October, the leader has been Asia ex Japan, outperforming Europe and Japan, which in turn have outperformed the US.⁷

Our global strategies have maintained a bigger weighting in Asia ex Japan than in Europe or Japan. While painful the past two years as the US dollar has appreciated, we are beginning to see some green shoots in this regard.

6. China's zero covid policy runs completely counter to President Xi's common prosperity goals. Moving millions out of poverty and into the middle class is difficult to achieve while the economy remains stagnant due to lockdowns.

We think it's only a question of when, not if, their zero covid policies begin to moderate.

That, combined with a weaker dollar, could make China an intriguing equity area for 2023. After all, China is one of only two major countries with a yield curve NOT inverted.⁸

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

⁶ Bloomberg

⁷ Factset

⁸ Japan is the other, but in our opinion, they have more secular demographic problems.

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