

AUGUST 2022

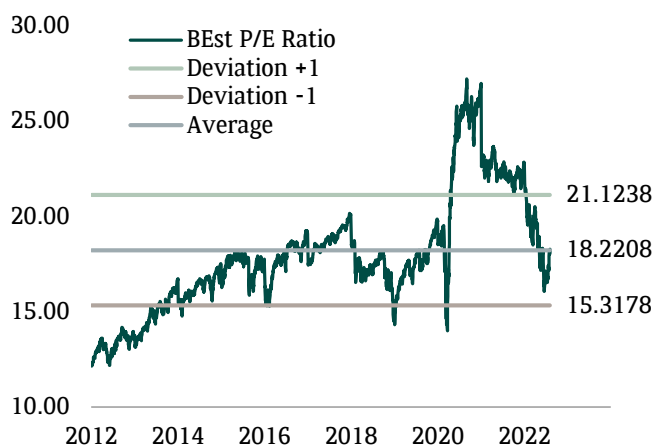
US Equity Perspectives

A Welcome Relief for Equities – Is It Sustainable?

What is behind the recent market rally?

Global equities snapped a 3-month losing streak in July 2022. The S&P 500 Index rallied ~9% during the month, supported by peak inflation/peak Fed narrative, already bearish investor sentiment and positioning, as well as a lowered bar set for earnings in 2Q22 (see Chart 1).

CHART 1. S&P 500 INDEX HISTORICAL P/E¹ RANGE



Source: Bloomberg, as of 4 August 2022
Past performance is not indicative of current or future performance.

Peak Fed hawkishness?

July 2022 saw fed funds rate being raised by 75 basis points (bps) to 2.25-2.5% by the Federal Open Market Committee (FOMC), with Chairman Powell reiterating the Fed's commitment to bring inflation back down to its 2% target, and the high probability of another large hike in September 2022. Nonetheless, investors dovishly interpreted his

comments that: (i) the policy rate was now in the "range of neutral"; (ii) it will become "appropriate to slow the pace of increases" as monetary policy tightens further; and that (iii) the Committee will become more data dependent going forward.

2Q22 earnings not as bad as feared

2Q22 earnings only comes in at a 3% beat against consensus (narrowest beat since 1Q2020), while 2H22 earnings-per-share (EPS) has been revised down 2% since 1 July 2022.

On the consumer front, key mass retailers have been guiding down earnings, highlighting pressure on margins due to inventory build/higher markdowns, greater-than-expected shift mix, and cost pressures. This is despite stronger than expected sales led by groceries. These trends reflect ongoing pressure on the consumer, especially on the low end. However, with mass retailers targeting to normalise inventory issues by year-end, we think margins are likely more derisked for the rest of the year.

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1. P/E: Price Earnings Ratio

Despite rather muted trends, our feel is that overall quarterly results were better than more-pessimistic-than-consensus investor assumptions. Earnings misses have not been punished as much as in recent quarters. For example, tech megacap names largely traded in positive territory post results, despite some companies missing consensus earnings expectations for 2022 and highlighting macro challenges going forward.

Growth stocks outperformed

Against the backdrop of a perceived dovish FOMC meeting and growing recessionary risks (as the US economy contracted for two consecutive quarters), Treasury yields trended lower as market focus switched from inflation to growth concerns, supporting the outperformance of growth stocks (see Chart 2).

CHART 2. GROWTH HAS OUTPERFORMED VALUE OVER THE PAST 2 MONTHS



Source: Bloomberg, as of 4 August 2022
Past performance is not indicative of current or future performance.

The sell-off in the market started with a rate-induced correction in long duration growth stocks. With peak rates within sight, this begets the question: is it time to jump back into the Technology sector with both feet?

We certainly think that risk/reward is much more attractive now than at the beginning of the year, given the extreme valuation derating that has taken place within the tech sector.

Nonetheless, earnings risk remains. Despite the perception that Tech earnings are defensive, we note that consensus earnings of the tech-centric Nasdaq 100 has been lagging that of S&P 500 for the past 9 months. Tech revenue has historically also been more cyclical than that of the broad market in a downturn.

We remain selective within Tech. We are most constructive on megacaps, viewing this segment to be most defensive, with earnings reset already well underway. Despite some slight/rare earnings misses and decelerating revenue trends, 2022 results highlighted the resiliency of these tech giants supported by their formidable moats.

As growth decelerates, Software may regain some favor, as many business models enjoy recurring revenue and cashflow, offering visibility. The main pushback for Software is that the sector continues to trade at a premium over the broad market, and expectation reset has not yet begun in earnest.

Semiconductors may see more volatility with inventory adjustments underway, led by weak PC/smartphone related markets. Estimate cuts are just beginning, and probability is high that order cancellations may start to materialise when semiconductor supply improves, leading to further inventory build. It is tough for the sector to sustainably perform given inventory levels have yet to peak. However, we are getting closer to a bottom in terms of sentiment and valuations.

Overall market view

Our view is that the market may be getting ahead of itself when it comes to an aggressive Fed pivot in 2023. According to sell-side estimates, even if CPI month-on-month trend is 0% till the end of the year, we will end the year at 6% inflation rate. Moreover, with stocks and credit markets rebounding, and financial conditions improving, there is less reason for the Fed to back off on the rates front.

On the flip side, should inflation fall more sharply than expected, the key reason may be due to more intense macro headwinds, which means forward earnings estimates may have much more room to fall.

We continue to be biased towards more defensive positioning, with our preferred sectors being Healthcare, selective Consumer staples with pricing power, and green/traditional infrastructure plays.

Of note, green infrastructure stocks have been on the move as the Democrat's rebranded "Inflation Reduction Act of 2022" moves forward in Congress. The bill contains ~\$370bn in spend/tax credits for Energy Security and Climate-related efforts. While not matching the spending scope of the Build Back Better proposal in 2021 (with \$550bn on climate), it's a sizeable step forward in terms of funding initiatives towards climate change.



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