

NOVEMBER & DECEMBER 2022

US Equity Perspectives

2023 Outlook – Defense is Still the Best Offense

Terminal rate repriced upward post FOMC¹, but later tempered by weaker CPI² data

As expected, the US Federal Reserve lifted its benchmark interest rate by 75bps³ in November 2022, with the federal funds rate now at 4.0%.

The key message of the November 2022 FOMC meeting was that a downshift in the pace of rate hikes is coming soon. However, the Fed now expects a higher terminal rate than it projected in September 2022, due to strong labour market data and elevated CPI data. They also expect rates to be on hold for 2023. Fed funds futures immediately after the November meeting pointed to an expected peak in rates at 5.1% by May 2023, and staying near 5% for the rest of 2023.

Nonetheless, upcoming CPI prints and employment reports will, in the near term, weigh heavily on the path of Fed policy. With the October 2022 CPI data weaker than expected, this opens up the case for a 50bp hike in December 2022. Peak terminal rates quickly repriced downwards post-CPI print to 4.9%, with rates expected to be 4.4% by end-2023. What a difference a day makes.

Have we reached the point of “peak Fed”? It is much too early to say at this point. The Fed would likely need to see a string of weak month-on-month CPI prints before they are comfortable pausing. In the near term, growth stocks stand to benefit the most from the peak-Fed narrative, due to the severe valuation compression over the past 12 months.

Tech vs Energy Dichotomy

Tech megacap results for 3Q22 could only be characterised as weak, with many topline and

earnings misses (uncharacteristic of this group of companies) coupled with tepid forward guidance. The strong dollar was a significant headwind.

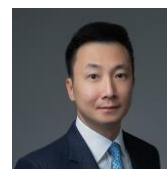
Macro factors are already starting to impact digital advertising revenues, while expense cuts are slow to come through. In the case of a key social media/digital advertising behemoth, capital expenditure was guided to *increase* in 2023 despite revenue headwinds, something which was not well received by the market.

Software spending, especially on the enterprise front, remained rather resilient though not immune to macro headwinds. E-commerce continued to be plagued by inflationary pressure (labour, energy, transportation) in 3Q22 with cost rationalisation hard to come through.

Post an uninspiring results season, consensus has revised 2023 earnings forecasts sharply lower for big techs. As shown in Chart 1, Tech and Communications 2023 earnings per share (EPS) forecasts have been reduced more aggressively compared to other sectors over the past three months. The share of big techs in the S&P 500 Index in terms of market cap has also fallen significantly (see Chart 2).

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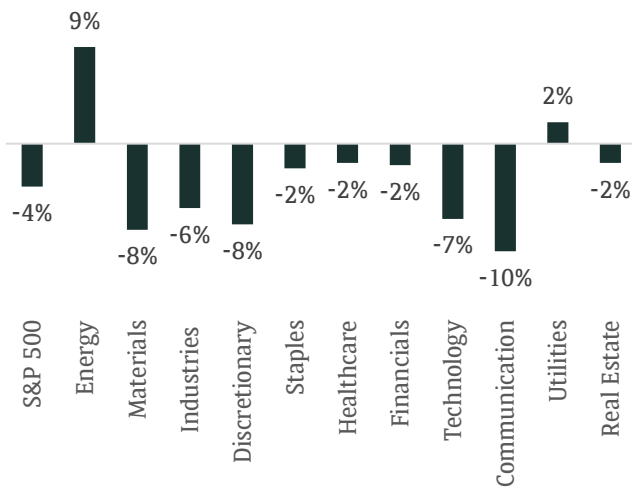


1. FOMC: Federal Open Market Committee; 2. CPI: Consumer Price Index; 3. bps: basis point(s)



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CHART 1. S&P 500 3-MONTH CHANGE IN 2023 EPS FORECAST

Source: Scotiabank, 2 November 2022
 Past performance is not indicative of current or future performance.

CHART 2. US BIG TECH STOCKS' SHARE OF S&P 500 MARKET CAP

Source: Jefferies, 10 November 2022
 Past performance is not indicative of current or future performance.

In contrast to Technology, Energy has been the best-performing sector quarter-to-date given companies' continued focus on capital expenditure discipline and capital returns, encouraging 3Q22 results, as well as OPEC's⁴ announced supply cut to support oil prices, though we do see inflationary pressures and tight supply chains impacting production costs/tempering supply growth.

2023 Outlook - Defense is Still the Best Offense

In our October 2022 issue, we recommended defensives (e.g. healthcare, staples, selected green infrastructure stocks) as a way to play a potential market rebound. The broad market was sold off indiscriminately in September 2022, while we held the thesis that these group of companies would be more impervious to macro headwinds. The tactical buy call worked out well as many of these defensive names we had highlighted rebounded strongly after reporting encouraging 3Q22 results.

Looking ahead, we continue to hold the view that the S&P 500 Index could be range bound into year-end with an upward bias (3600-4200), given oversold conditions, negative pre-announcements setting a more balanced stage for 3Q22 earnings, as well as positive seasonality effects.

However, 2023 will likely be a volatile year much like 2022, with the ultimate low in the markets for this cycle yet to be seen. Easing inflation and Fed pivot expectations may provide temporary relief, but this has to be juxtaposed against the coming deceleration in growth and earnings.

With heightened recession risk in 2023, current earnings estimates are clearly too positive (consensus expecting 6.5% growth). Looking at past recessions, earnings have fallen ~10-20% peak to trough, depending on the severity of the recession. We think companies may finally readjust their 2023 guidance in the 4Q22 reporting season, which would take place in early 2023.

All in all, we don't think this year-end rally is sustainable. And should S&P 500 trade towards the higher end of our technical range, we would recommend investors to manage their equity exposure defensively.

4. OPEC: Organization of the Petroleum Exporting Countries



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