

APRIL-MAY 2023

US Equity Perspectives

When the Tide Goes Out

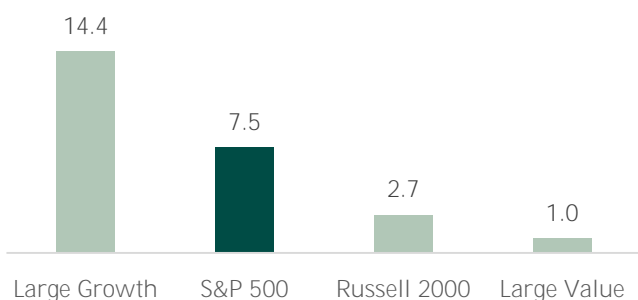
With the US experiencing its fastest interest rate hike cycle in decades, the rate increases appear to have broken something before they managed to tackle inflation. At the current juncture, the Fed must balance combating inflation with stabilising the financial system.

Our house view is that the Fed will continue its rate hike cycle with a 25bp¹ increase at its next meeting in May this year. This would bring the benchmark rate to a terminal rate of 5.25%, and we expect the Fed to maintain this end-of-cycle rate throughout the rest of the year.

Where are we trading now?

Despite stress in the regional banks, the S&P 500 Index rose 3.7% in March 2023, 7.5% in 1Q23, and 15.8% since its October 2022 lows (see Chart 1). This rally has been largely driven by growth stocks, particularly technology-related stocks, while value stocks, especially financials and energy, have been key underperformers.

CHART 1. TOTAL RETURN – Q1 2023 (%)



Source: S&P, Russell, MSCI, FactSet, Credit Suisse, 4 April 2023
Past performance is not indicative of current or future performance.

1. Basis point; 2. Price-earnings ratio; 3. FY: Fiscal year; 4. Earnings per share

In terms of valuations, the US market P/E² has increased from 16.7x since the start of the year to the current 18x. On earnings, 1Q23 and FY2023³ EPS⁴ estimates have declined -6.3% and -3.8% since the start of the year.

The market is now expecting 1Q23 and FY2023 EPS to grow -5.2% and 0.3% respectively (see Chart 2). This suggests that we have seen an expansion in valuation multiples despite weakening earnings momentum.

Focus on high quality

It is worth recognising that recent events suggest that high interest rates are creating stress in the system, and corporates that do not manage their liquidity and duration risk well will be exposed in a high-rate environment.

Legendary investor Warren Buffett says that you only find out who is swimming naked when the tide goes out. The dynamics of globalisation have already been changing, and navigating the high interest rate environment is currently the biggest challenge for businesses and households.

Now that the tide is receding, this will inevitably lead to the flushing out of low-quality corporates, which is, after all, a natural process of evolution.

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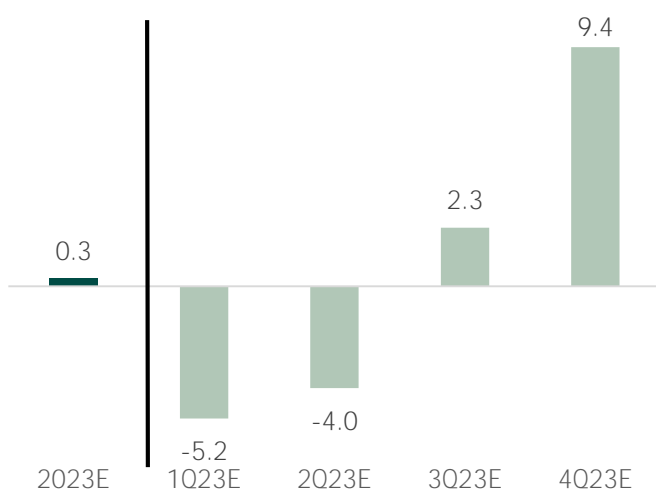
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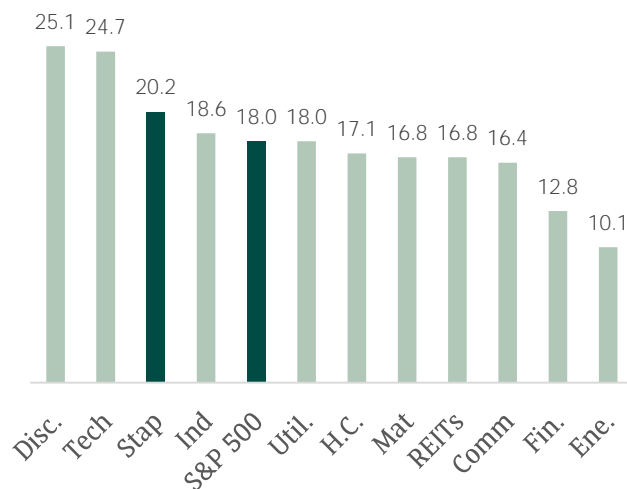


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**CHART 2. CONSENSUS
EPS GROWTH ESTIMATES (%)**

Source: S&P, Refinitiv, FactSet, Credit Suisse, 4 April 2023
Past performance is not indicative of current or future performance.

CHART 3. S&P 500 SECTOR P/E (X)

Source: S&P, Refinitiv, FactSet, Credit Suisse, 4 Apr 2023
Past performance is not indicative of current or future performance.

What's up with the banks?

Following the recent incidents, the Fed reassured the market that the capital and liquidity positions of the US banking system "are strong" and the US financial system is "resilient".

Turning to the large US banks, the risk of crystallising unrealised losses on bond portfolios to the detriment of capital is less of an issue. As a matter of course, bonds held by those big banks for liquidity are marked-to-market, and unrealised losses are deducted quarterly from the banks' capital base.

However, the Fed changed the regulation in 2019 for US regional banks, which allowed some small- and mid-sized regional banks to no longer deduct any unrealised losses from their capital base.

On a relative basis, we remain more comfortable with exposure to the big money centre banks over the regional banks. We can also expect tighter regulation on regional names going forward, which could mean even more reason for capital inflows into the major US banks.

Higher funding costs may well be more of a headwind for the banking industry, which could start to come through in the upcoming quarterly results. Nonetheless, the pressure will more likely be on net interest margin and profit, rather than balance sheet liquidity.

Food for thought

With the outperformance of growth stocks since 4Q22, it is interesting to note that the valuation of US consumer staples has corrected to 20x P/E (+12% premium vs. S&P 500), which is largely in line with its +18%/+2%/+6%/+14% one/three/five/ten-year average historical premium range (see Chart 3).

Consumer staples will not be immune if the US economy does go into a recession, but we believe that consumers will look for any opportunity to save money and trade down to beat rising prices.

Beverages, chocolate, and snacks are also an affordable "indulgence" even in the midst of consumers potentially trading down and eating out less as the global economy slows down.

While there is no standout thematic for the sector, we favour names that have an idiosyncratic angle and have higher exposure to emerging markets.

In our view, the biggest risks to the sector are relative valuation and market rotation out of staples when investors are ready to take on more risk. However, this is less clear at the current juncture, clouded by macro uncertainty.

That said, adopting a balanced approach and complementing a portfolio with selected staples names can provide a degree of resilience in the current volatile market.



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