Asset Class Update: US Stocks

Assessment as of: 3/31/2023

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Current View:
Neutral

S&P 500 Fair-value estimate: 3600

Change Since Prior:
No Change

Executive Summary

We believe US stocks can generate mid-single-digit returns in a base case. However, heightened short-term risks, i.e., rising risk of a recession, have led us to be more cautious on risk assets.

Over the past year, S&P 500 reported GAAP earnings have fallen 13% (based on 3/31/2023 estimate). The earnings slowdown/recession has started. Thus far, topline revenue growth has remained robust—estimated to grow over 9% year-over-year. The hit to earnings over the past year has been due to increased costs and the resulting hit to profit margins. Net income margins have dropped from an all-time high of 13% to around 10%.

Asset Class Returns

	QTD	YTD	One-Year	Three-Year	Five-Year	10-Year
S&P 500 Index	7.50%	7.50%	-7.73%	18.60%	11.19%	12.24%
Russell 1000 Growth Index	14.37%	14.37%	-10.90%	18.58%	13.66%	14.59%
Russell 1000 Value Index	1.01%	1.01%	-5.91%	17.93%	7.50%	9.13%
Russell 2000 Index	2.74%	2.74%	-11.61%	17.51%	4.71%	8.04%

Source: Morningstar Direct. As of 3/31/23.

Performance Update

The S&P 500 ended the quarter up 7.50%—gaining alongside other major equity markets around the world. Within the broad US market, the winners so far in 2023 were the losers in 2022, and the losers this year were the winners last year. The Russell 1000 Growth fell 29.14% in 2022 and gained 14.37% in the first quarter. Comparatively, large cap value stocks (Russell 1000 Value) fell just 7.54% last year but have lagged so far this year with a 1.01% gain.

Performance in the first quarter was dominated by large-cap growth names. The cap-weighted portfolio of FANMAG stocks (Facebook/Meta, Amazon.com, Netflix, Microsoft, Apple, Google/Alphabet) returned 24.6% in the quarter. And two other large-cap growth names, Nvidia and Tesla, joined the party with 90% and 68% gains, respectively. Those eight stocks made up roughly 20% of the S&P 500's market cap at the start of 2023 and account for over 80% of the index's year-to-date gain.

Top 10 S&P 500 Stocks at Quarter End	Q1 Return	Contribution to Return
Apple Inc	27.1%	1.6%
Microsoft Corp	20.5%	1.1%
Amazon.com Inc	23.0%	0.5%
NVIDIA Corp	90.1%	1.0%
Alphabet Inc Class A	17.6%	0.3%
Tesla Inc	68.4%	0.7%
Berkshire Hathaway Inc Class B	0.0%	0.0%
Alphabet Inc Class C	17.2%	0.3%
Meta Platforms Inc Class A	76.1%	0.6%
Exxon Mobil Corp	0.2%	0.0%
S&P 500 Index	7.5%	

The largest growth stocks (shaded in table) accounted for more than 80% of the S&P 500's first quarter return.

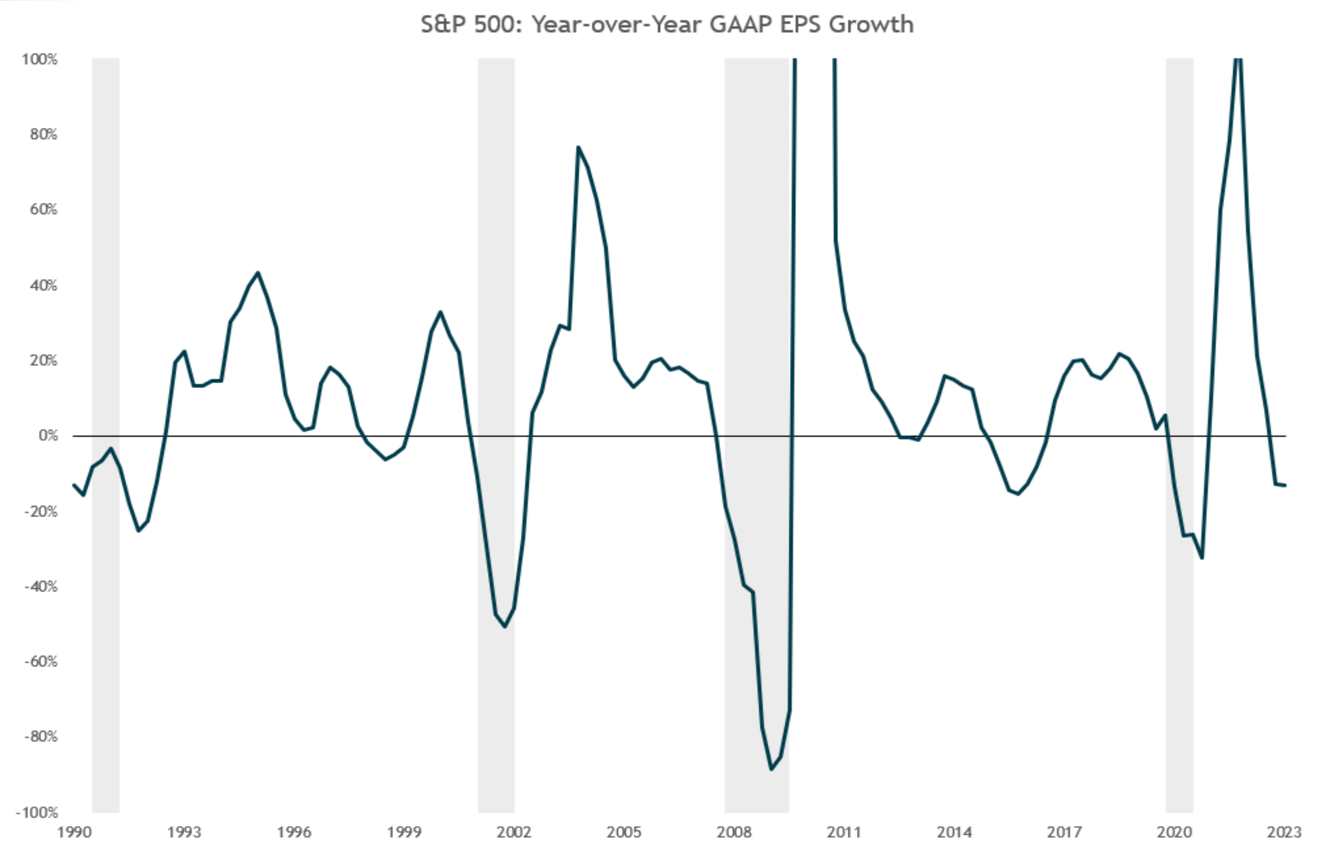
Update

Return Estimates:

Updated Five-Year Expected Returns for US Equities					
	Current Level	Downside/Bear	Base Case Lower	Base Case Upper	Upside/Bull
US Equities	4,109	-5.2%	2.2%	8.3%	13.1%

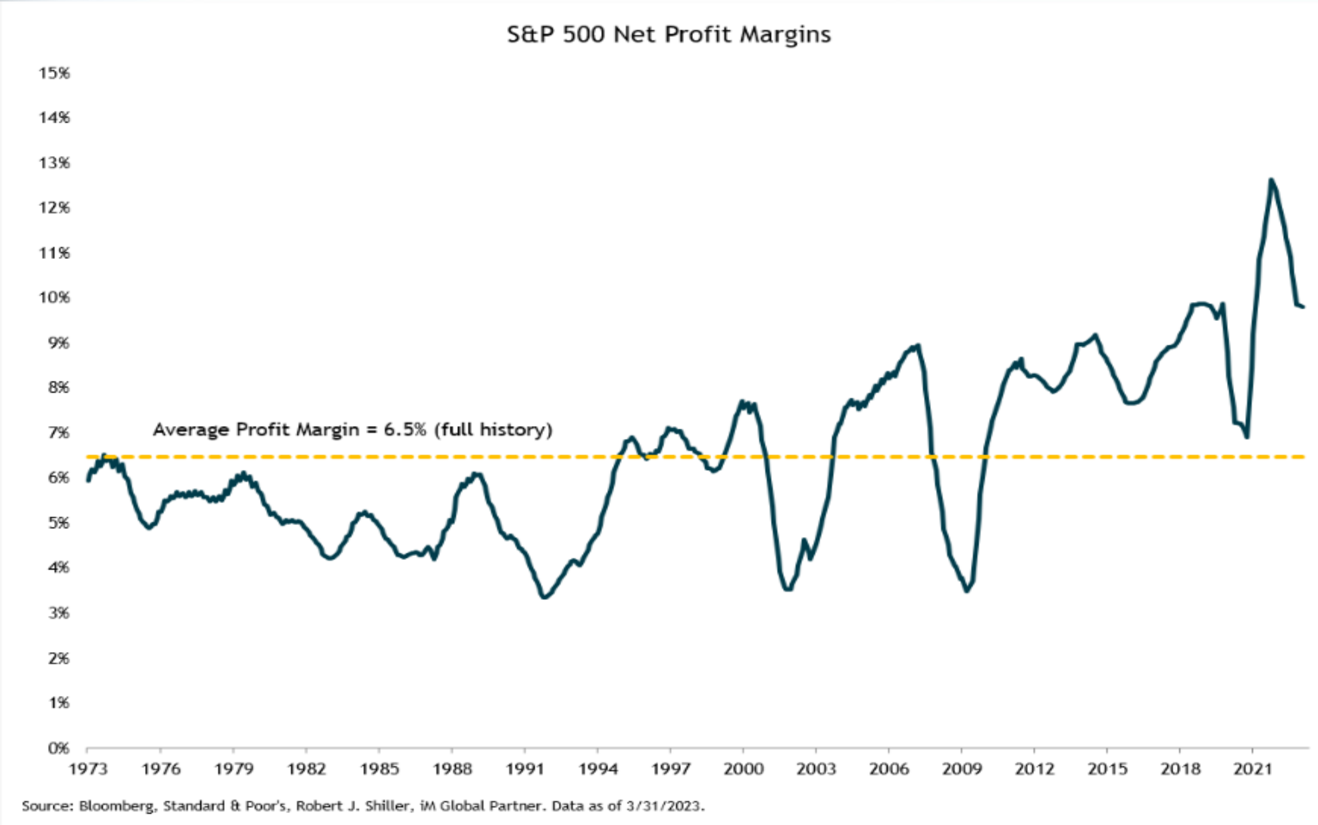
Estimated returns are annualized and generated by iMGPFM. This table shows our five-year, annualized asset class return estimates across several broad macroeconomic scenarios we believe are possible. Collectively, the scenarios encompass the range of outcomes we believe are reasonably possible and therefore worth considering in creating our portfolio allocations. We make assumptions for various fundamental and valuation metrics we believe are consistent for each asset class within each macro scenario then incorporate current prices to generate an estimated return. The macroeconomic scenarios and estimated returns can change. When this happens, we will clearly note it and give guidance on new estimates. See disclosure for more information on macro scenarios and fundamental/valuation metrics used in the analysis. S&P 500 Index at 4109. MSCI Europe Index at 1861. MSCI EM Index at 59416, Bloomberg Aggregate yield at 4.40%, BofA ML High Yield Cash Pay Index at 8.2%. Data as of 3/31/2023.

S&P 500 GAAP earnings growth has officially turned negative. The last two quarters have registered year-over-year declines of 13%. Sales growth has remained positive in recent quarters, thus lower net income figures are due to falling profit margins. The S&P 500 has fallen 7.7% over the past year—thus the 13% earnings decline has been buffeted by a modest expansion in the P/E multiple. (Recall equity returns can be decomposed into three elements: valuation expansion/contraction, earnings growth, and dividend yield.) The trailing P/E multiple expanded about one point (22.9x to 23.9x). Valuation multiples have remained resilient in the face of high inflation and increasing interest rates.



Source: Bloomberg. Data as of 3/31/2023.

Net income margins exploded to all-time highs in 2021 and have started to reverse—going from over 13% to 10% today. Our reassessment of US equities last summer led us to believe that 13% margins were not going to be sustainable over the long run. Instead, we assume that margins revert to the 9-10% range in our base case. Should margins fully return to their 50-year average of 6.5%, earnings growth will be difficult to come by in the years ahead (absent very strong sales growth).



If the recessionary scenario plays out, there are heightened risks to earnings in the short term given revenues have yet to take a hit. There would also be risks around valuation—the trailing P/E multiple of nearly 24x is lower than it was in 2021, however, well above most long-term averages. Though one could argue it's roughly an average multiple in the post-GFC era (though, of course, interest rates were much lower through that period).

Turning to valuations, P/E multiples have expanded over the past six months despite continued hikes by the Federal Reserve. Six months ago, the trailing 12-month GAAP P/E ratio was 19.2x. Today it stands at 23.9x—a valuation expansion close to 25%. This has more than offset the earnings decline we've seen in recent quarters and is the reason why the S&P 500 has gained 15% since last September.

Economic recessions are typically associated with a significant drop in corporate earnings. Our internal analysis of historical S&P 500 peak-to-trough EPS declines during post-WWII recessions indicates a median decline of around 20%. We've seen analysis from other investment strategists that calculate a 15% average recessionary EPS decline. We think assuming between a 10-20% EPS decline in our recession base case is reasonable. So far, earnings have been put under pressure by margin compression, but should revenues fall, there is further downside for earnings.

Our estimated fair-value point for the S&P 500 is 3600. Our fair-value range for the S&P 500 is 3100 to 4150, with the lower end of this range capturing what we think is the potential downside risk in US stocks in a recession.

Longer-Term View
The valuation excess that was in the markets has largely been let out over the last two years. Forward P/E ratios have contracted towards 40-year averages and trailing GAAP P/E ratios roughly in line with its post-1980s average. While there is always the risk of further multiple contraction, the bigger risk is to fundamentals in the event of an economic recession.

Much of the margin improvements we have seen in this cycle can be retained. That being said, we have not seen enough evidence to convince us that 13% margins will be the new norm. We'd expect profit margins to normalize at lower levels in the future, though not all the way back to the 6.5% average over the last 50-plus years. In our base case we expect profit margins to normalize in the 9-10% range. Should margins settle at levels lower than that, it would leave earnings susceptible to disappointment (unless it was accompanied by significant topline growth). The key medium to long term risks to S&P 500 margins we are watching include: higher regulation on tech companies, labor getting a larger share of the economic pie than they have the past few decades via higher wages, and the fracturing of globalization and global supply chains (re-shoring/onshoring/"friend-shoring") that will be less efficient (higher-cost) but more secure.

Key Factors in Our Assessment

We are estimating what the normalized earnings power of S&P 500 is looking over five or so years and what is a reasonable multiple to pay for it, given its quality, consistency, and growth prospects. We learn from history where and when we believe it has relevance. The assessment of normalized earnings power of an asset and what is a fair multiple to pay is a function of both quantitative and qualitative analyses, such as current fiscal and monetary conditions, where we are in the business cycle, unemployment levels, debt levels, trade and fiscal deficits, demographics, currency, bond yields, flows for both stocks and bonds, market sentiment etc.

As part of assessing the normalized earnings power we utilize insights from our conversations with expert stock pickers. We assess how the drivers of profitability might be changing versus history and what it may mean for profits looking out five years and beyond. We try not to fall into the false-precision trap of relying on one expected-return number, knowing markets are multivariate and nearly impossible to quantify in one number, especially with equities which inherently have a wide range of outcomes. We focus on the long term because that's how we believe we can more consistently add value. We believe markets are largely efficient in pricing news and events but are susceptible to overreacting, on both the upside and downside. As long-term investors, we can add value by keeping a very high bar before deviating from our strategic allocations, which are based upon a 10-plus-year view, weighing both longer-term risks and opportunities.

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Estimated Returns Disclosure

Scenario Definitions:

Downside*: The economy falls into a deep recession for any of various reasons, such as deleveraging/deflation, unexpected systemic shock, geopolitical conflict, Fed or fiscal policy error, etc. At the end of our five-year tactical horizon, S&P 500 earnings are below their normalized trend and valuation multiples are below-average reflecting investor risk aversion. Inflation, 10-year Treasury nominal and real yields are below the Fed's long-term targets.*

Base*: Consistent with long-term economic and market history, reflecting economic and earnings growth cycles that are interspersed with recessions around an upward sloping normalized growth trendline. Inflation is moderately higher than the Fed's 2% target level (i.e., around 3%) and 10-year Treasury real yields are slightly positive. For equity markets, we bookend our Base Case with Lower-end and Upper-end estimates:*

- *In our Base Lower scenario, we assume nominal economic growth is higher than the average due to moderately higher inflation. We assume some additional profit margin compression and moderately lower valuations compared to the Base Upper scenario.*
- *In our Base Upper scenario, we assume nominal economic growth is higher than average due to both moderately higher inflation and strong real growth. As such, we assume S&P 500 profit margins*

remain elevated (although below their all-time highs) and valuation multiples are also elevated versus historical averages.

Upside: This is the "Goldilocks" scenario for stocks. S&P 500 earnings end the period well above their Base Case trendline, driven by both higher sales growth and high profit margins. Valuation multiples are well above average and higher than the Base Upper assumption. Inflation is under control, around or slightly higher than the Fed's 2% long-term target. The fed funds rate is around the Fed's estimate of "neutral," the yield curve is positively sloped, and 10-year Treasury real yields are modestly positive.

What the Table Shows: Our five-year, annualized asset class return estimates under several broad economic scenarios. Collectively, the scenarios we use encompass the range of outcomes we believe are reasonably possible and therefore worth considering in creating our portfolio allocations.

Why We Use Scenarios: Considering how each asset class might react under a consistent set of scenarios allows us to calibrate our return expectations across asset classes. We believe this helps us make better asset allocation decisions.

These Scenarios Can Change: As the overall economic environment changes it will at some point necessitate changes to the scenarios we consider. Therefore, there could be times when we are reassessing scenarios and temporarily suspend providing updates for one or more scenarios. When this happens, we will clearly note it and give guidance on when we expect to complete this process.

Any projections provided regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. Investing involves risk, including the potential loss of principal, and investors should be guided accordingly.