

# LAURELHURST ASSET MANAGEMENT

## John's Market Outlook – December 12, 2022

Since my last Market Outlook on September 12, the S&P 500 fell 13%, then rose 11%, ending up a little lower than where it started. Fixed income (bond) prices have done a similar round trip.

The Federal Reserve raised the Fed Funds rate by another 150 bp to 3.75-4.00%. The Fed will continue raising until it thinks rates are high enough to force inflation down to 2%/yr. During 2023, the Fed Funds rate is likely to reach or exceed 5.0%.

Leading economic indicators continued declining. Falling LEIs preview more slowing in the US economy. Housing has already weakened substantially. The job market and wage growth remain strong, but pockets of weakness are emerging - layoffs in technology and housing, less demand for temporary help.

S&P 500 earnings are deteriorating. Forecasts were rising until mid-year, and then started falling. 3Q's earnings for the S&P 500 were weaker than 2Q's. 4Q22 and 2023 forecasts fell again.

Inflation passed its peak but remains very high. Inflation in goods has decelerated while rising wages continues to drive very high inflation in services. Shelter (housing) inflation is still high but should slow mid next year due to housing market weakness.

Yield curves are inverted, which has nearly always predicted a recession. I continue to believe the recession will be mild to moderate.

I try to keep these notes short, so for charts with more detail, please see the **Appendix**.

We are *starting* to see some of the things on my September 12 list of "what to expect in coming months". That list was: inflation trends lower, employment weakens, housing market slumps, a recession emerges, S&P 500 margins revert to pre-pandemic levels and 2023 earnings forecasts fall.

The S&P 500 fell to about 3,600 in October. Was that "the bottom"? I think not, for two main reasons.

First, we are still waiting for the conditions to create a bottom. My list is only *starting* to get checked off. Inflation has only just started easing, jobs are stubbornly strong, the Fed is not ending its rate increases, S&P 500 profit margins are far above normal, and forecasted S&P 500 EPS looks too high.

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Second, S&P 500 price level did not go low enough. Here is a “back-of-envelope” estimate: in my view, 2023 S&P 500 EPS is likely to be about \$195-210. A price-earnings (PE) ratio range of 16-17X implies a S&P 500 price range of about \$3,100-3,400. A more detailed analysis using margins and cash flows suggests S&P 500 fair value range of about \$3,200-3,500. Pre-pandemic, before the flood of liquidity unleashed in 2020/21 and now being withdrawn, the S&P 500 reached about \$3,350.

In short, I think the S&P 500 – and, by extension, most equity indices – is likely to turn down in coming months. Between now and mid 2023, I think the S&P 500 is likely to reach new price lows in the \$3,100-3,500 range. Then we will, in my opinion, be at or near the *durable bottom* for equities.

No-one has a crystal ball and these are unusual times. We may not fully check off every item on my list. If the expected recession is *particularly mild* or just a mid-cycle downturn, the S&P 500 *could* bottom in the upper part of the ranges discussed. With the economy slowing, earnings forecasts falling, and rates rising, I would rather be patient than get pulled in for the last market downturn.

In the past two months, most portfolios were moved *slightly* more aggressive. Going into year-end, I plan to move them more conservative. I will also be realizing losses to reduce capital gains taxes.

As for sectors and asset classes:

- I still favor US markets. UK/Europe have yet to face the brunt of winter energy demands. The war in Ukraine will drag into 2023 with no clear end in sight. China is trying to end its “zero-Covid” lockdown, but its economy has deep challenges, the economic benefits of “reopening” may be delayed by the pent-up Covid wave, and US-listed Chinese stocks may yet be delisted.
- Metals and other commodities provide exposure to a China re-opening. Longer-term, copper is vital to renewable energy and is likely to be in tight supply.
- Expensive US oil names are being replaced in the portfolios by natural gas and LNG names, and European majors diversified in oil, gas, and renewables. Energy also provides exposure to China.
- Many consumer and real estate names are attractive here, *if* the recession is mild. Larger healthcare names have become more expensive, but many smaller ones remain buyable.
- I am adding, selectively, to technology names that have dropped to reasonable valuations. Defense names have been trimmed on valuation.
- In financials, I continue to favor insurers over banks.
- High-quality bonds are getting more attractive but in the short term, prices look somewhat high.
- In general, smaller and mid-sized companies are more attractively valued than the large-cap companies that are household names.

I would be happy to go deeper into this outlook and other investment topics than was possible in this brief summary. Please email [johnliu@laurelhurstasset.com](mailto:johnliu@laurelhurstasset.com) or call 510 847 0070.

Thank you!

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