MARKET MINUTE
WITH McGAREL

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Cyclicals in a Recession?

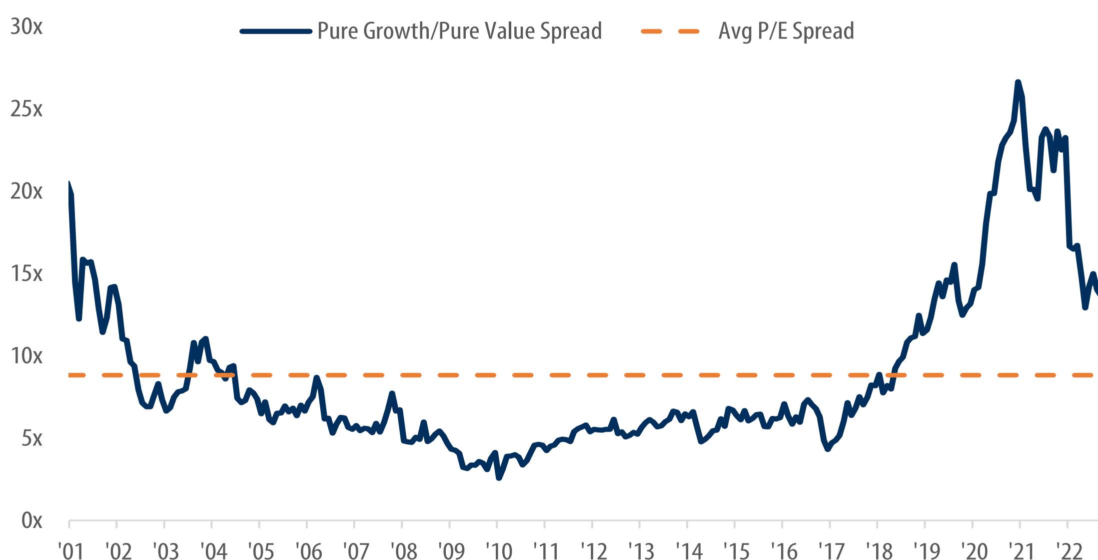
The S&P 500 Index dropped 9% in September alone and has fallen 24% in the first nine months of 2022 as the Federal Reserve (Fed) attempts to combat inflation with interest rate increases.[1] Fed Chairman Jerome Powell was very clear in his September 21st press conference when he said "First, we'll want to see growth continuing to run below trend [. . .] We think of trend as being about 1.8% or in that range." The market clearly expects the Fed rate hikes to result in slowing growth and potentially send the economy into an outright recession. In either scenario, a growth slowdown or a recession, the earnings growth forecasts for next year are expected to be lower or even contract from the record earnings being reported for 2022.

In previous Market Minutes, we have written that we expect value stocks to outperform growth stocks over the next several years. Here is a fair question, however. Isn't a slowing economy typically bad for cyclical companies? And doesn't the value style have large exposures to cyclical stocks? The answer to both questions is yes. We believe, however, that value stocks are currently priced at levels that forecast a modest slowdown in gross domestic product ("GDP") growth and earnings. Growth stocks, by contrast, still trade above their 20-year average.

If we look at the chart below, we can see the large valuation spread between pure growth and pure value stocks from 2001 until 2022. Despite that spread tightening this year as value has outperformed growth, it is still quite wide. In fact, it's much wider than the period from 2004 until 2018 when GDP growth was averaging around 2%. Powell is attempting to slow the economy below those meager GDP growth numbers. Even if we avoid a modest recession, we believe it's more likely both growth and value multiples will trade at lower levels in a high interest rate, slow growth environment. But value stocks already trade at a much more attractive valuation. They never got overvalued like growth stocks. Additionally, if the growth/value spread narrows further, we expect it will be growth multiples coming down much faster to reflect the slowdown that is already reflected in the value multiple. We see today's current multiples in energy and banks (cyclical companies) near trough multiples during the recessions in 1990, 2000 and 2008.

In an environment not particularly attractive to risk assets, valuation becomes more important, in our opinion. Today, both defensive and growth stocks trade much higher than we would expect in a recession. Value stocks appear to have priced in at least some of the coming slowdown. In a world of limited options, we believe value stocks, even those tied to the cyclical economy, look to be the best place to ride out this storm.

Forward P/E - Spread between S&P 500 Pure Growth Index and S&P 500 Pure Value Index



Source: S&P CapitalIQ.. Monthly data is calculated from 12/29/00 - 9/30/22. Forward Price-to-Earnings (P/E) is calculated by taking the price divided by next twelve months earnings per share. For illustrative purposes only and not indicative of any investment. ***Past performance is no guarantee of future results.***

[1]Source: Bloomberg

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The **S&P 500 Index** is an unmanaged index of 500 companies used to measure large-cap U.S. stock market performance. The **S&P 500 Pure Growth Index** measures growth stocks based on three factors: sales growth, the ratio of earnings-change to price, and momentum. It includes only those components of the S&P 500 Index that exhibit strong growth characteristics, and weights them by growth score. The **S&P 500 Pure Value Index** measures value stocks based on three factors: the ratios of book value, earnings, and sales to price. It includes only those components of the S&P 500 Index that exhibit strong value characteristics, and weights them by value score.