Equity Newsletter

4th Quarter 2022

First Trust

VALUE IS AS IMPORTANT AS EVER IN TURBULENT TIMES

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. 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.

Despite expectations for an economic slowdown, which is typically bad for cyclical companies, we still expect value stocks to outperform growth stocks going forward. Valuation is the principal reason, as growth stocks still trade above historical norms, while value stocks are currently pricing at levels that forecast a modest slowdown in gross domestic product ("GDP") and earnings.

KEY POINTS

Despite a 30% decline through the first nine months of the year, the S&P 500 Pure Growth Index still trades around 23.5 times next 12 months earnings, while the S&P 500 Pure Value Index trades at only 10 times earnings.

Not only are growth stocks still expensive on an absolute basis, the S&P 500 Pure Growth Index trades at a significantly higher than average premium relative to the corresponding value index (see Chart 1).

Recent 2023 earnings revision trends favor value relative to growth, with the S&P 500 Value Index's estimated earnings for 2023 trending about 2% lower over the last six months, showing more resilience that the S&P 500 Growth Index, which has seen its estimates decline 6%.

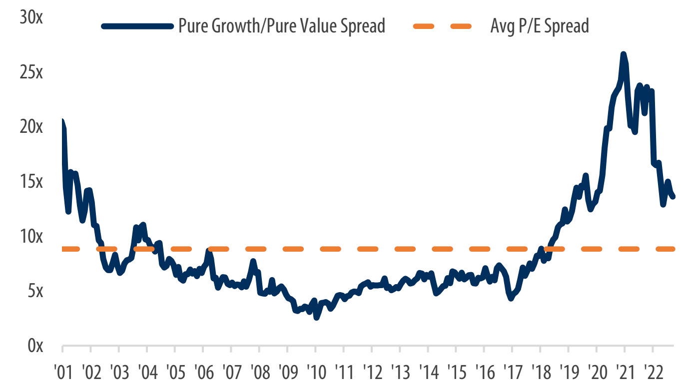
Downward revisions to 2023 earnings estimates over the last six months have been particularly stark for growth-oriented sectors such as the information technology (-8%), communication services (-12%), and consumer discretionary (-15%) sectors.

Key value-oriented sectors, energy and financials, are benefiting from specific tailwinds mitigating the challenging overall macroeconomic environment.

Energy sector equities are enjoying not only strong oil market fundamentals, such as tight crude oil inventories (see Chart 2), and OPEC production cuts, but also a S&P 500 Energy Index free cash flow yield north of 12%.

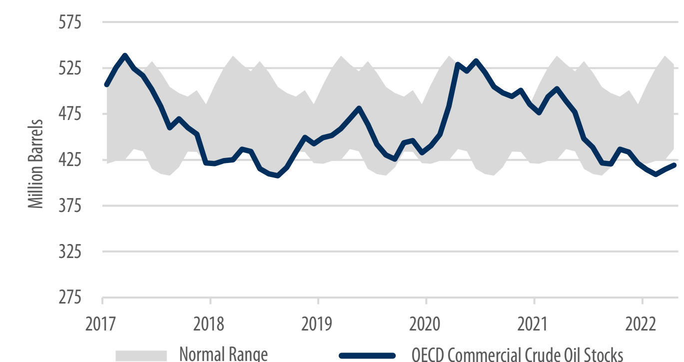
Within the financial sector, banks are benefiting from higher interest rates, which improves net interest margin on loans, while increasing credit utilization has buttressed loan growth.

Chart 1: 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.

Chart 2: U.S. Commercial Oil Inventories



Source: U.S. Energy Information Administration, Short-Term Energy Outlook, September 2022. Data from January 2017 - September 2022.

Past performance is not a guarantee of future results.

SECTOR VIEWS

Communication Services

- Expect to see continued digital advertising spending weakness.
- Increasing competition and a return to more normal demand post-COVID may impact media streaming services.
- Focus on quality within sector.

Consumer Discretionary

- Strong labor market, flush cash balances, and low consumer debt burden continue to support current personal consumption outlook.
- Wavering consumer confidence and continued high inflation are key risks to sector.
- Homebuilding industry pressured by rising interest rates and high labor costs.
- Services industries may be more attractive than goods producers.
- Valuation levels not particularly attractive, in our view.

Consumer Staples

- While a defensive sector, valuation is not cheap for what we see as relatively meager growth.
- International revenue of multi-nationals expected to be impacted by a strong U.S. dollar.

Energy

- Continue to see strong free cash flow generation as exploration & production companies have maintained capex discipline.
- Lack of investment in production in recent years limits supply growth, supporting oil market fundamentals.
- OPEC has signaled a willingness to expend determined effort to curtail production and support oil prices.

Financials

- Increasing credit utilization generating strong loan growth.
- Higher interest rates improve net interest margin on loans.
- Credit quality remains strong as charge-off rates are relatively low.
- Investment banking and trading revenues may be weak given this year's market downturn.
- Current valuations are attractive, in our opinion.

Healthcare

- Provides opportunity to invest in sector with growth potential that is less correlated to business cycle.
- Post-COVID economy lessens the operational challenges faced by health care companies and may increase elective procedures.
- Passage of drug pricing provisions in Inflation Reduction Act of 2022 reduce immediate risk from further increased regulation. Mid-term elections bring possibility for improved sentiment.
- Biotechnology stands to benefit from secular innovation, and potentially increasing merger activity as cash rich Big Pharma motivated to replenish their pipelines.

Industrials

- Capital intensive businesses with high fixed cost structures may provide margin upside as capacity utilization increases. Strong pricing power enjoyed in current business environment may also be a profitability tailwind.
- Demand for capex typically benefits sector as firms are motivated to improve supply chains and increase productivity in a tight labor market.
- ISM Manufacturing Purchasing Managers Index (PMI) has softened in recent months, but still indicates expansion. Further deterioration may signal industrial contraction.

Information Technology

- Secular growth opportunities abound in information technology, but cyclical challenges and valuation keep us on the sidelines in the near term.
- Prefer quality within the sector, in particular strong corporate balance sheets and reasonably valued names.
- High multiple, unprofitable cloud software names are currently risky, in our view, as higher interest rates pressure discounted cash flow valuation of long duration growth firms.
- We see cyclical risk in semiconductors overall, especially certain end markets such as PCs, gaming, and mobile devices, while demand remains strong for data center chips. Artificial intelligence, industrial, Internet of Things and vehicle electrification end markets stand to benefit from secular tailwinds. Due to geopolitical tensions with China, increased export restrictions are a risk to the industry.

Materials

- A rising inflation environment should benefit the natural resource exposure within this sector.
- We currently have a somewhat less favorable view on the materials sector than energy due to greater exposure to China in metals and mining relative to energy.

Utilities

- Defensive sector but we currently view as low growth opportunity.
- Higher yielding regulated utilities are tantamount to bond proxies and therefore sensitive to higher interest rates.

Real Estate Investment Trusts (REITs)

- Sector as a whole is interest rate sensitive.
- Fundamentals for hotel and industrial REITs currently favorable in our view, but would be negatively impacted in economic slowdown.
- Data center REITs may provide strong secular opportunity, but there is risk of a cyclical IT spending slowdown.
- Office REIT fundamentals are challenged as shift to work from home has impacted occupancy.

This report was prepared by First Trust Advisors L.P. and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.

INTERNATIONAL VIEWS

DEVELOPED MARKETS

Europe

- Consumer savings and a rebound in services demand post-COVID, and fiscal subsidies for consumer energy outlays are positives, but inflation is weighing heavily on real incomes, increasing risk for recession.
- Any re-acceleration of growth in China potentially stimulates demand for Europe's exports.
- Easing auto semiconductor shortage may benefit troubled German auto industry.
- Continued geopolitical risk as Russia's war on Ukraine impacts supply chains, and heightens energy uncertainty, particularly with winter heating season approaching.
- European Central Bank is tightening policy due to uncomfortably high inflation, but may have to slow pace of tightening if recession occurs.
- Inexpensive valuation in comparison to U.S. stocks.

United Kingdom

- Persistently high inflation and a weak pound not only weigh on disposable incomes, but may also drive a tighter Bank of England monetary policy.
- Fiscal policy support and strong consumer balance sheets mitigate pressure on consumption to a degree, but industrial activity is softening, increasing risk of recession.
- Less directly impacted by war on Ukraine than the rest of Europe.

Japan

- The Japanese economy is industrial-heavy and exposed to global appetite for capital equipment, which implies risk if developed economies pull back on investment.
- Softer inflation enables the Bank of Japan to remain more dovish than the Fed, which could potentially weaken the yen further against the U.S. dollar.
- Structurally low return on equity.
- Challenging demographics may limit long-run potential economic growth.

Australia

- Commodity exporter which benefits from higher commodity prices.
- Exports of raw materials to China key driver of economic growth.

Canada

- Energy and Metals exporter which benefits from commodity inflation and would suffer from a U.S. recession.

EMERGING MARKETS

Emerging Asia

- Despite some improvement in Q3, Chinese growth has been disappointing overall in 2022, both from pandemic lockdowns, and a credit growth slowdown, which has significantly impacted fixed asset investment.
- Policymakers in China have recently taken steps to stimulate growth by easing monetary policy and enacting fiscal stimulus to encourage infrastructure investment, but efforts will take time to flow through to the real economy, and it remains to be seen if the scale of stimulus is sufficient.
- Additional monetary easing could potentially pressure Chinese yuan against the U.S. dollar.
- Chinese zero COVID policy still weighing on economic activity, potential future easing may improve growth outlook.
- Geopolitical tensions with U.S. reduce possibility of tariff reductions, and complicate U.S. firms' decisions to invest in China.

Latin America

- The Mexican economy benefits from exports to U.S., which remain robust, but would be negatively impacted by a U.S. recession. Over time, supply chain diversification away from China may be a structural tailwind to exports.
- Brazil continues fiscal policy easing for now, including fuel, electricity and telecom services tax cuts, but may have to tighten policy in 2023.
- Recent conservative gains in Brazil's congressional elections reduce political risk of a potential victory by socialist Lula da Silva in upcoming Presidential election.
- Overall, Latin America is sensitive to demand for commodity exports, and commodity price inflation.
- Latin American central bank policy is an increasing risk, as aggressive tightening policy stance has been necessary to better manage currency volatility and high inflation.

Definitions

The **S&P 500 Index** is an index of 500 companies used to measure large-cap U.S. stock market performance.

The **S&P 500 Growth Index** contains those securities with growth characteristics from the S&P 500 Index.

The **S&P 500 Value Index** contains those securities with value characteristics from the S&P 500 Index.

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.

The **S&P 500 Energy Index** comprises those companies included in the S&P 500 that are classified as members of the GICS® energy sector.

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