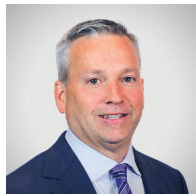
MARKET MINUTE
WITH McGAREL



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Fourth quarter earnings season has largely wrapped up and the S&P 500 Index is on track to post its first year-over-year decline in EPS since the COVID-19 lockdowns of 2020. Revenues did grow as inflation helped companies post solid top line results (revenue is reported in nominal terms). Margins, on the other hand, came under pressure as expenses outgrew revenue leading to the earnings shortfall. Tech+ was a noticeable laggard, particularly e-commerce and communication services names. Without the Tech+ headwinds, the S&P 500 Index would be on track to grow EPS about 5% in Q4.

We believe the chart below is a clear acknowledgment that, over the last year, the market was forecasting that earnings would soften in 2023. Currently, the market expects little or no growth in earnings this year. We expect to see further declines in earnings estimates as interest rate hikes hit the economy more broadly than just housing and autos. In our view, an actual earnings decline is probable this year...the severity and length of the decline is where the disagreement may exist. Stocks didn't really fall 18% in 2022 on inflation and interest rate worries alone, in our view, they fell on what those two developments were going to do to earnings. It's always earnings!

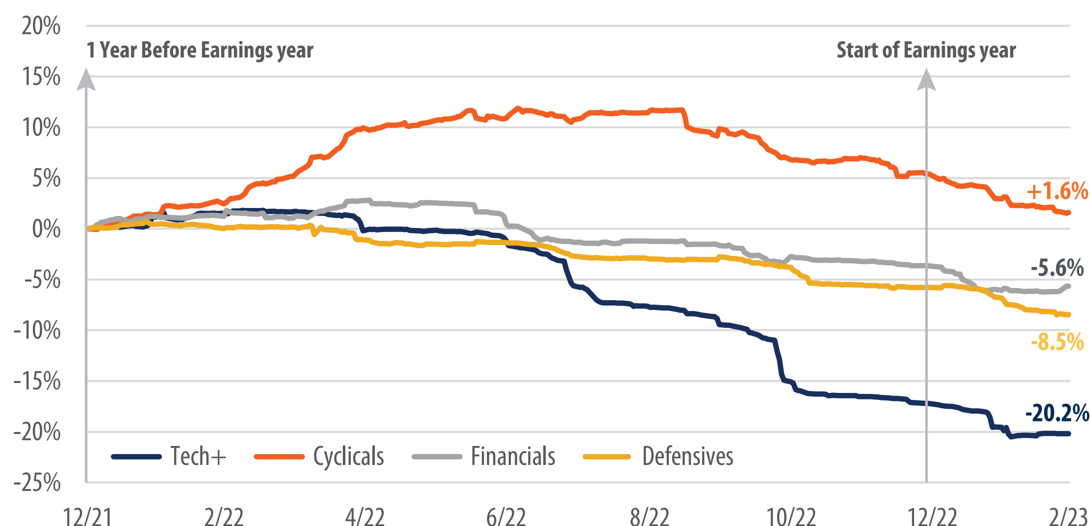
What do we believe is the problem with Tech+? If the Fed does not cut rates this year (we don't believe they will) and earnings forecasts don't turn around (we also don't believe they will) the sector is expensive with little expected growth. Our allocations remain underweight.

What about defensive stocks...utilities, staples, healthcare? Along with energy, these are the 3 worst-performing sectors year-to-date despite the most bearish analysts having warned investors to hide in these areas for months on recession fears. Defensives remain expensive and are generally viewed as bond proxies and therefore susceptible to interest rate pressures, in our view. Why overweight expensive defensives when you can get much better risk-free yields in a simple treasury bond? It's a fair question. We remain underweight.

What's left? Financials and cyclicals (energy, industrials). Are they safe? No. They are risk assets. What concerns us? A potential deep and lengthy recession. Demand destruction may lead to lower oil prices for energy stocks, higher credit losses for banks and lower capacity utilization for industrials. We believe it certainly could happen. Yet we have heard no one forecast a lengthy recession...just a further drop in equity prices through the middle of the year and a rebound back to current levels by year end once we have capitulation. Currently, these 3 sectors have the most resilient earnings forecasts in the market, pricing power if inflation stays elevated, strong balance sheets, and high and increasing dividends with low payout ratios. Energy and Financials, in particular, also rank in the top 3 on forward P/E, P/B and long-term debt to capital ratios.

Make no mistake, cyclicals may be susceptible to a difficult and lengthy recession. If it's a hurricane or a tsunami, we expect all risk assets to trade much lower and the financials and cyclicals to be as bad or worse than other sectors. But if it's a squall or a brief thunderstorm, we like the idea of investing in value and cash generating companies where earnings have held up better and where investors don't have to pay up for them. We also like the dividends. We are still overweight in these sectors.

2023 Estimate Cuts Concentrated in Tech+
Path of S&P 500 Index Super Sectors EPS



Source: Capital IQ. Data from 12/31/21 - 2/28/23.

Past performance is no guarantee of future results.

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Earnings per share (EPS) is calculated as a company's profit divided by the outstanding shares of its common stock. The resulting number serves as an indicator of a company's profitability. There is no assurance any forecasts will be achieved. **Technology Plus (Tech+)** is a combination of the technology sector, interactive home entertainment, interactive media & services, internet & direct marketing, Tesla Inc., and Netflix Inc. **Cyclicals** are defined as the energy, materials, industrials and consumer discretionary sectors ex internet & direct marketing. **Defensives** are defined as the consumer staples, health care, utilities, real estate, and communication services sectors excluding interactive media & services. **Financials** only includes the financials sector as defined by GICS. Estimates are based on fiscal year 2023 aggregate consensus. There can be no assurance that any estimates will be achieved. The **S&P 500 Index** is an unmanaged index of 500 companies used to measure large-cap U.S. stock market performance. Investors cannot invest directly in an index. For illustrative purposes only and not indicative of any investment. **Forward Price-to-Earnings (P/E)** of a stock is the price divided by the estimated EPS for the next 4 quarters. Each factor is comprised of the top 30% of stocks from a universe of the largest 1,000 U.S. stocks with at least $1 million dollars in average daily volume over the last 3 months and 12 months of trading history. **Price-to-Book (P/B)** measures the market's valuation of a company relative to its book value.