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Equity Market Outlook 2Q 2023

Economic and Market Review: Continue to Recommend Defensive Positioning, Focus on Quality

What happens when the lowest interest rates in 400 years meet the fastest hikes in 100?

In March, two high-profile implosions at Silicon Valley Bank (SIVB) and Signature Bank (SNB) sent tremors throughout the financial sector, reminding markets that the economy remains a complex ecosystem of causes and consequences. We believe the banks were casualties of the cumulative monetary tightening that is just beginning to stress the economy and expose the excesses in the financial system. In the coming months, we expect more unexpected financial accidents and maintain our view that lower-beta and higher-earnings-quality portfolios should continue outperforming riskier ones, regardless of style, thematic or regional focus.

In this edition of our quarterly *Equity Market Outlook*, we discuss several headwinds that keep us on the sideline: the increasing number of deteriorating economic indicators, still-rich valuations, stubbornly high inflation and underwhelming growth in Europe and China. Meanwhile, both top-down and bottom-up consensus have been slowly gravitating toward our view—unchanged since June 2022—that the S&P 500 could trough in the 2900–3200 range, with an estimated $180–$190 earnings per share and at a roughly 16–17x multiple. (For more context, see our 3Q 2022, 4Q 2022 and 1Q 2023 *Equity Outlook* reports.)

Given the potential disconnect between consensus and deteriorating reality, we believe it is still not too late to reduce portfolio risk, stay defensively positioned and focus on quality.

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Investment Themes and Views[1]

Based on their relative sensitivity to changes in inflation and financial conditions, and their historical beta to the stock market, we offer the following as our overweight and underweight views:

OVERWEIGHT VIEW ON:

Factors and Styles:

- Low beta
- High quality
- Large caps
- Momentum
- High earnings visibility
- U.S. stocks

Industry Groups:

- Household & Personal Products
- Telecom Services
- Food & Staples Retailing
- Health Care
- Utilities
- Food Beverage & Tobacco
- Equity Real Estate Investment Trusts (REITs)

UNDERWEIGHT VIEW ON:

Factors and Styles:

- High beta
- Low quality
- Small caps
- Low earnings visibility
- Speculative growth
- Ex-U.S. stocks

Industry Groups:

- Automobiles & Components
- Energy
- Banks
- Consumer Durables & Apparel
- Transportation
- Semiconductors & Semiconductor Equipment
- Technology Hardware & Equipment
- Capital Goods

NEUTRAL VIEW ON:

- Value
- Growth

[1] For illustrative and discussion purposes only. This material is general in nature and is not directed to any category of investors and should not be regarded as individualized, a recommendation, investment advice or a suggestion to engage in or refrain from any investment-related course of action. The firm and its portfolio managers may take positions contrary to any views and themes expressed.

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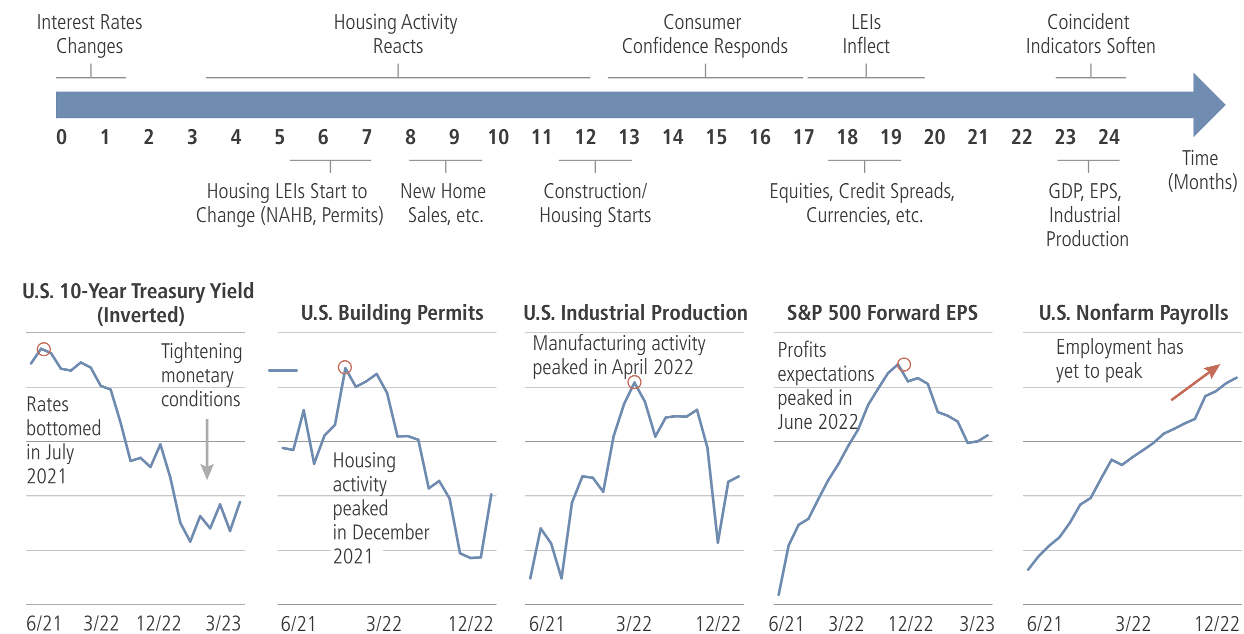
A Solemn March

Extracting the vector of the economic cycle from myriad economic releases can be a frustratingly confusing enterprise. Economic indicators tend not to rise and fall at once, which can lead to picking and choosing those that agree with one's existing views—especially at confounding inflection points, such as the onset of a recession or the beginning of an economic recovery.

To cut through the confusion, we analyze data releases through a sequential framework. Over many cycles, we observe that economic indicators exhibit a fairly repeatable response to monetary tightening, which does not affect all sectors of the economy simultaneously and to the same extent.

Instead, we find that monetary tightening *cascades* through the economy, starting with the most interest rate-sensitive sectors. As shown in figure 1, the reaction times to rising rates vary from six months for acutely rate-sensitive sectors, such as housing, to 12 – 18 months for equities and credit spreads, and 18 – 24 months for the broader economy and jobs. As job losses and economic contraction work off the excesses of the past cycle, we see inflation and unit labor costs eventually recede. We believe this restores consumer purchasing power and corporate profitability, ultimately setting the stage for the next economic expansion.

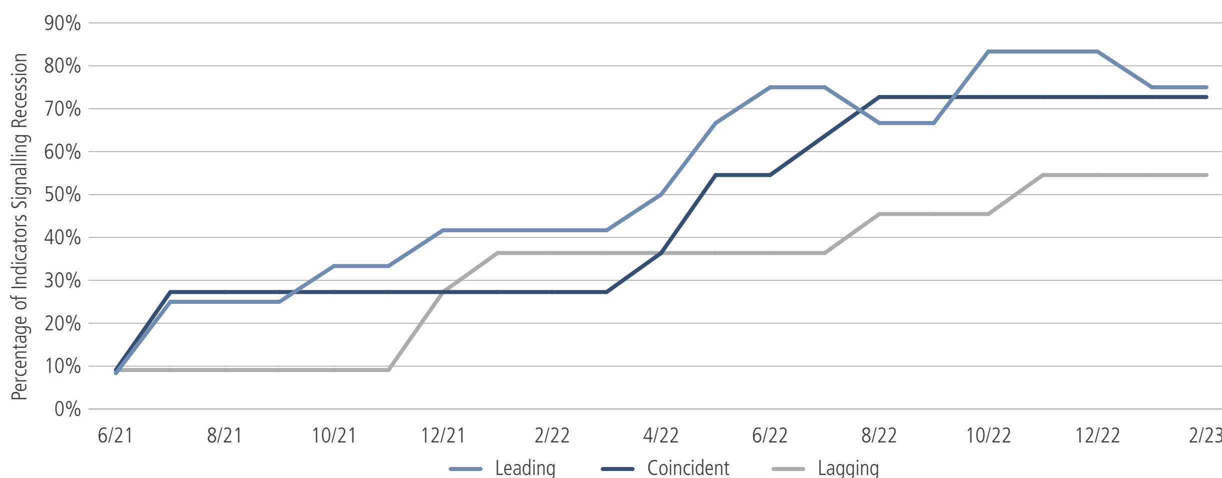
FIGURE 1: THE CASCADING EFFECTS OF MONETARY TIGHTENING—NOT EVERYTHING PEAKS AT ONCE



Source: Neuberger Berman research, FactSet and TMR. Data as of March 31, 2023. For illustrative purposes only. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

For illustrative simplicity, we have charted 34 economic indicators—aggregated into leading, coincident and lagging categories—since mid-2021 (see figure 2). While the market has swung up and down several times during this period, challenging many investors' bearish convictions, the total fraction of indicators flashing recessionary signals continues to grow. *(For a complete list of indicators, see the Appendix.)*

FIGURE 2: ECONOMIC INDICATORS CHART A SOLEMN MARCH TOWARD RECESSION

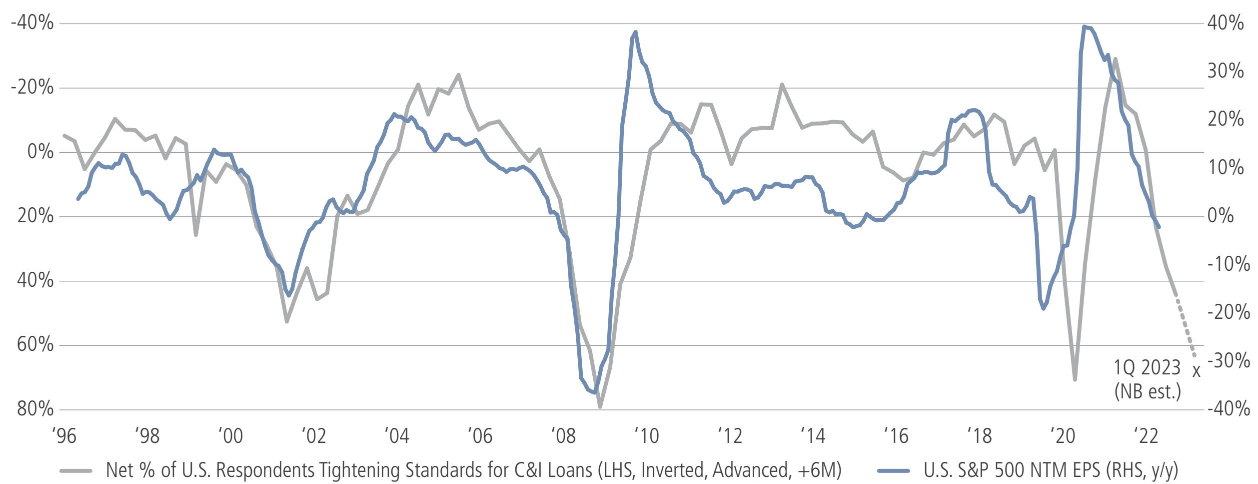


Source: Neuberger Berman research and FactSet. Data as of February 28, 2023.

We believe we are entering the final six to 12 months of the two years it takes for monetary tightening to dampen GDP. In this period of the cycle, economic weakness becomes widespread and starts putting pressure on companies' toplines and, in turn, their earnings and the broader stock market. In our view, the totality of evidence suggests that, since mid-2021, the U.S. economy has been on a solemn march toward recession. To those wondering why their defensive positioning hasn't been as effective as they had hoped, we counsel patience until the full force of monetary tightening takes hold, which we think could start in the next one to two quarters.

An additional risk looms, in our view: As the economy slows, lenders tend to get stingier with credit. In fact, banks had already tightened underwriting standards before trouble emerged at SIVB and SNB (see figure 3).

FIGURE 3: TOUGHER LENDING STANDARDS LEAD EARNINGS DECLINES



Source: Neuberger Berman research and FactSet. Data as of March 31, 2023. For illustrative purposes only. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

Credit is the oxygen of economic growth. If the economy turns increasingly recessionary in the coming months, we believe more banks will likely feel the need to shore up their balance sheets and further tighten lending standards, which could rapidly push up the cost of capital, reduce the availability of credit, and ultimately accelerate—and deepen—our anticipated decline in corporate earnings.

Temporary Relief

The 16% stock market rally between mid-October and February has left investors questioning whether the economy is still on a recessionary path. The rally had three fundamental drivers: China's post-COVID reopening, Europe's economic relief from elevated energy prices, and the rapid conversion of order backlogs into economic activity, driven by smoother-functioning supply chains. As output ran ahead of weakening underlying demand, estimated growth in U.S. GDP increased from a negative 2% pace, in mid-2022, to a positive 2.5% rate in the first quarter of 2023 (see figure 4).

FIGURE 4: BACKLOG CONVERSION PROVIDED A 6% BOOST TO GROWTH

Source: Neuberger Berman research and FactSet. Data as of March 31, 2023. For illustrative purposes only. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

Yet all three drivers, in our view, will likely amount to temporary relief rather than durable growth. If we are right, the economy should soon follow the downward trajectory historically foreshadowed by deteriorating indicators and credit availability—and, with it, the market.

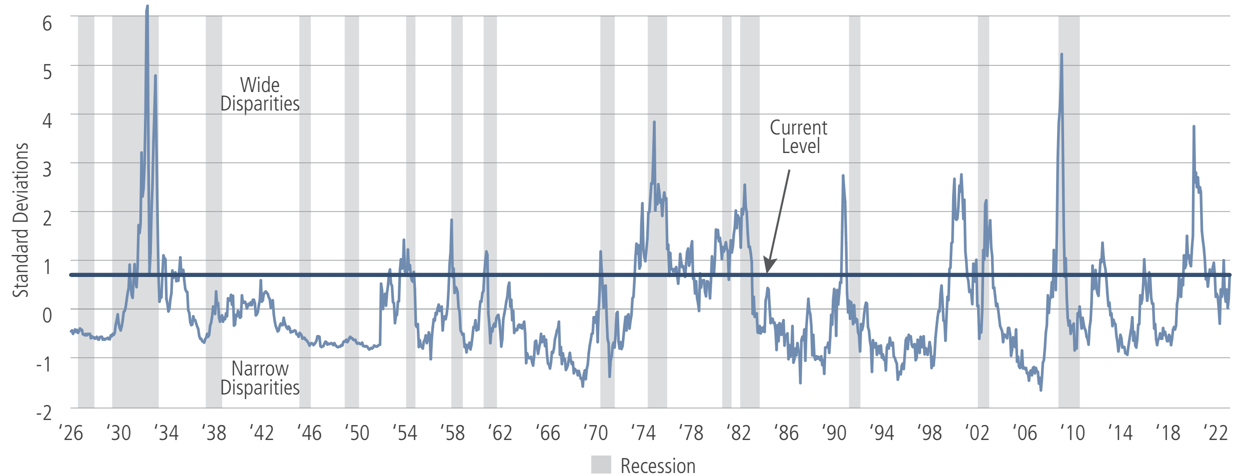
Valuations Still Look Rich

While economic indicators can be useful guides, astute investors must also discern the extent to which markets have already priced in good or bad news.

As discussed in our *4Q Equity Outlook*, we prefer equity-valuation dispersion as a measure of economic stress internalized by the stock market. Based on data back to 1926, this gauge measures the valuation gap between the cheapest stocks and the median; wider dispersion implies greater skepticism among market participants (as well as greater potential for generating excess return from value-based stock selection). We believe calculation and interpretation of value dispersion leave little room for subjectivity, allowing comparisons across periods without arbitrary adjustments for time-varying macroeconomic variables, such as inflation and interest rates.

In March 2020, when the COVID pandemic first struck, dispersion reached 4.5 standard deviations above the mean (see figure 5). This was the third-highest reading in almost a century, suggesting to us that the stock market had internalized tremendous economic stress. In contrast, the current measure is only +0.7 standard deviations above its mean—even in the wake of the recent bank failures and ostensible concern about the underlying health of the banking system.

FIGURE 5: RECESSIONARY STRESS NOT EVIDENT IN U.S. LARGE-CAP VALUATION DISPERSION*



*Valuation dispersion measures the Z-score of the cheapest quintile of the largest 1,500 stocks versus the median valuation.
Source: Empirical Research Partners, National Bureau of Economic Research as of March 15, 2023. For illustrative purposes only. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

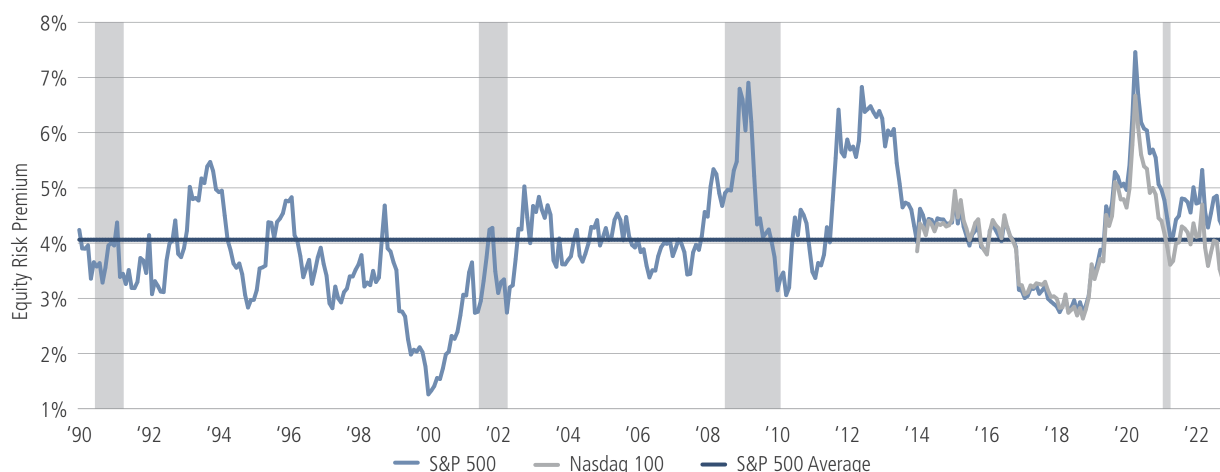
To put that comparison in context, we find that dispersion typically jumps three to four standard deviations from its trough during recessions. Therefore, it seems the recessionary concerns we have been highlighting in our past three quarterly outlooks are still nowhere near being discounted by the stock market, which, in our view, remains vulnerable.

Another key measure we track is the equity risk premium (ERP), defined as the estimated excess return above the risk-free rate. The expected return from equities equals the rate at which future dividends are discounted to match the current market price. (As perceived risk mounts, investors naturally demand to be compensated with greater expected returns—so a higher ERP implies that investors are discounting the value of future earnings at a higher rate, which lowers their value in present dollars.) Earnings growth in developed markets is calculated as 10-year average nominal GDP growth multiplied by the 10-year average dividend payout ratio.

In periods of fluctuating bond yields, as seen over the past 18 months, we believe the ERP provides valuable insight into relative valuations beyond what can be gleaned from popular stock-only metrics, such as the price-to-earnings (P/E) ratio. Currently, the S&P 500 is trading 0.4% below its historical ERP (see figure 6); however, during recessions, the ERP tends to *rise* by about 3%, which puts the index at risk of trading below 3000. In our view, this suggests the market is still significantly overvalued.

As for the NASDAQ, it trades at an even lower ERP than the S&P 500, *despite* the recent pullback in growth-stock valuations. So while the S&P 500 is expensive in our view, growth stocks appear *richer still* and remain at risk of underperforming during the market sell-off we anticipate.

FIGURE 6: THE EQUITY RISK PREMIUM, NOW AT A CYCLE LOW, RISES SUBSTANTIALLY DURING RECESSIONS



Source: Societe Generale calculations. Data as of February 2023. For illustrative purposes only. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

A third key valuation measure is corporate earnings relative to trend. Currently, the S&P 500 is over-earning our estimate of its normalized earnings by about 8%. As noted in our *1Q 2023 Outlook Report*, EPS typically *falls* 10 – 15% below the normalized level during recessions.

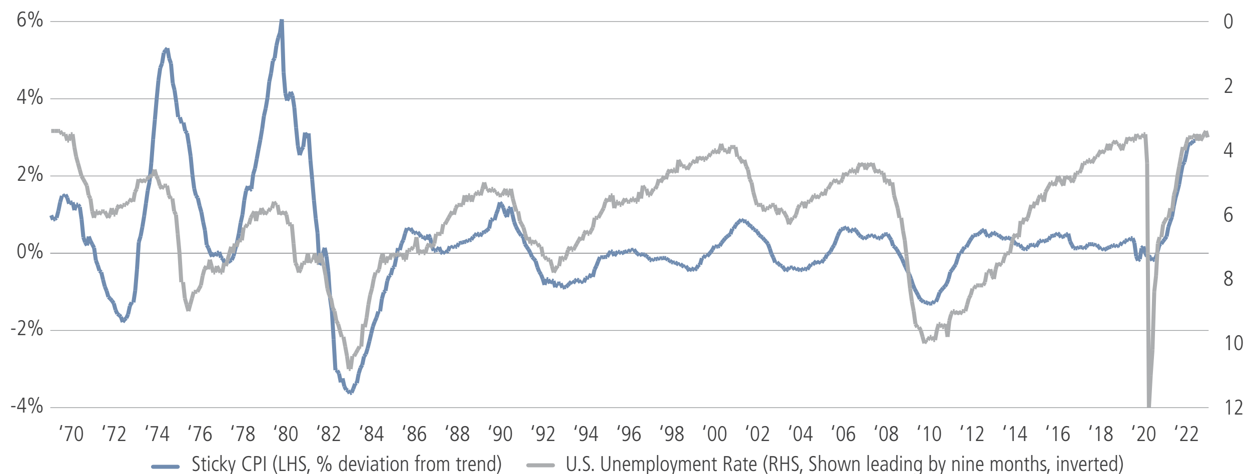
Finally, earnings quality remains the poorest we've seen in three decades. In our view, the above-average use of accounting accruals at this stage of the cycle suggests the potential for larger-than-usual write-offs during the recession, which would be a drag on EPS.

Taking these measures together, we continue to expect declining valuations and earnings in what will likely be a disinflationary recession (our base case). If correct, this could lead to a steeper drop in equity prices than consensus anticipates—hence we maintain our trough estimate of 2900 – 3200 for the S&P 500 and $180 – $190 for EPS. In line with our view, we suggest reducing the beta of equity portfolios and emphasizing earnings quality, regardless of style or regional focus, to navigate the volatile markets likely ahead.

Inflation and Monetary Policy

We believe the most telling indicator in the Fed's ongoing battle with rising prices is the Sticky CPI, which accounts for about 70% of headline inflation and is primarily driven by price-inelastic goods and services (and thus wages). Sticky inflation tends to lag employment and only begins to fade when hiring contracts substantially (see figure 7). In short, employment is the horse, and inflation is the cart, not the other way around.

FIGURE 7: STICKY INFLATION HAS YET TO RELENT



Source: Federal Reserve Bank of Atlanta. Data as of February 28, 2023. For illustrative purposes only. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

Based on more than six decades of empirical evidence, we maintain that Sticky CPI should remain elevated until the labor market weakens enough to trigger job losses, eventually restoring the equilibrium between demand and supply of resources. By all measures, we aren't there yet—in fact, the labor market appears to remain extraordinarily tight.

For context, the 3.6% unemployment rate is near its lowest level since May 1969, and there are currently 1.7 job openings for every unemployed person—or 3.5 times the pre-COVID average. This barometer of labor supply-demand imbalance tends to lead wage movements by about six months and now points to 6 – 7% median wage *growth,* well above the 3.4% average since 2000.

All signals combined, there appears to be no imminent loosening of the labor market in the near term (suggesting that February's inflationary tick-up should not have caught the market so off-guard). More telling, perhaps, is that the slow-moving Sticky CPI has been accelerating for the past four months; meanwhile, the Flexible CPI (the more volatile, goods-driven components of CPI) also turned positive in February on a quarter-over-quarter basis after steady declines over the previous five months.

While we believe labor market conditions suggest that sticky inflation could remain elevated through summer's end, we believe there is at least some risk that inflation could *reignite*. On February 3, FIBER, a research firm that specializes in analyzing business cycles, wrote: "The leading index of inflation for the U.S. increased significantly in January. It appears that U.S. inflation may remain untamed in the near term. The main components that contributed to the increase in the index were the growth rate of the industrial material

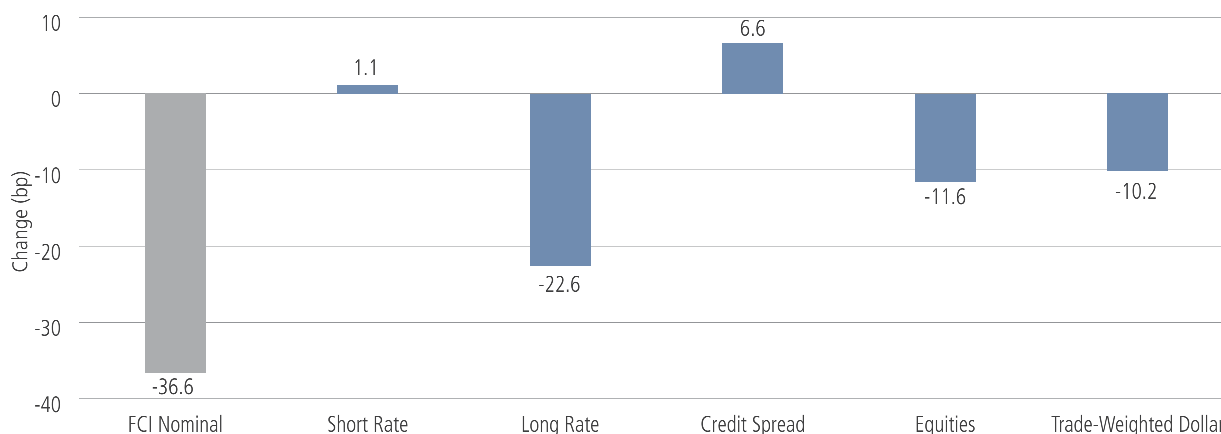
price index, ISM's selling prices, ISM's vendor performance, the employment-population ratio, and the U.S. dollar exchange rate." Since then, the leading index went on to increase even more in February.

These developments, in our view, may soon increase pressure on the Fed to stay the course on maintaining tighter monetary conditions, despite concerns emanating from the banking sector. We think loosening the reins might be warranted if credit spreads widened substantially; stocks sold off aggressively; and the U.S. dollar got even stronger, which would tighten U.S. financial conditions meaningfully. But looking at the Goldman Sachs Financial Conditions Index (FCI) paints a different picture.

The FCI weighs signals from the rates, credit, equity and currency markets in a way that's predictive of future growth. A rising FCI could signal a weakening economy—and thus the need to ease—while a falling FCI can indicate more tightening ahead. Since March 8, following the failures at SIVB and SNB, the FCI has *dropped* by 37 bps as rising equities and falling long-bond rates and the trade-weighted dollar have more than offset widening spreads (see figure 8).

FIGURE 8: FINANCIAL CONDITIONS SIGNAL POTENTIAL MONETARY TIGHTENING AHEAD

Change In U.S. Financial Conditions Index Since the SIVB Collapse Began (in BPs)



Source: Goldman Sachs. Data represents change in FCI between March 8 and March 31. For illustrative purposes only. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

We believe a falling FCI—combined with potentially resurgent inflation—could compel the Fed to keep the monetary reins tight. This would surprise the futures market, which rapidly repriced the policy trajectory from 100 bps *hikes* to 60 bps *cuts* by year-end in the aftermath of SIVB and SNB. In our view, recent Fed projections suggest that future policy moves will likely fall between prior and current market expectations.

While unclogged supply chains and normalized post-COVID demand for goods helped bring inflation down from 9% to 5%, we believe getting to the Fed's 2% target will demand further monetary tightening. Sustained higher rates could lead to a deeper recession—reinforcing our low-risk, low-beta and higher-quality stance within equities.

Phantom Tailwinds: China and Europe

China: Lukewarm stimulus, tepid recovery

Investor enthusiasm about China's potential to drive global growth and mitigate a U.S. or global recession is likely misplaced, in our view. Recent Chinese stimulus, in the form of Total Social Financing, is the weakest in 20 years relative to the size of the Chinese economy (see figure 9). The government's GDP growth target for 2023 is also the lowest since 1976, suggesting to us low levels of fiscal support for growth. The issuance of special-purpose bonds, which are a form of off-budget debt that cash-strapped local governments use to raise funds (usually for large infrastructure construction projects), came in less than expected for 2023, and there has been a marked deceleration in total bond issuance in China to finance future growth.

FIGURE 9: CHINESE STIMULUS IS HAVING A DIMINISHING IMPACT ON GDP GROWTH

Source: Neuberger Berman research and FactSet. Data as of February 28, 2023. Red circles indicate peaks in credit impulses, which have been trending lower. For illustrative purposes only. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

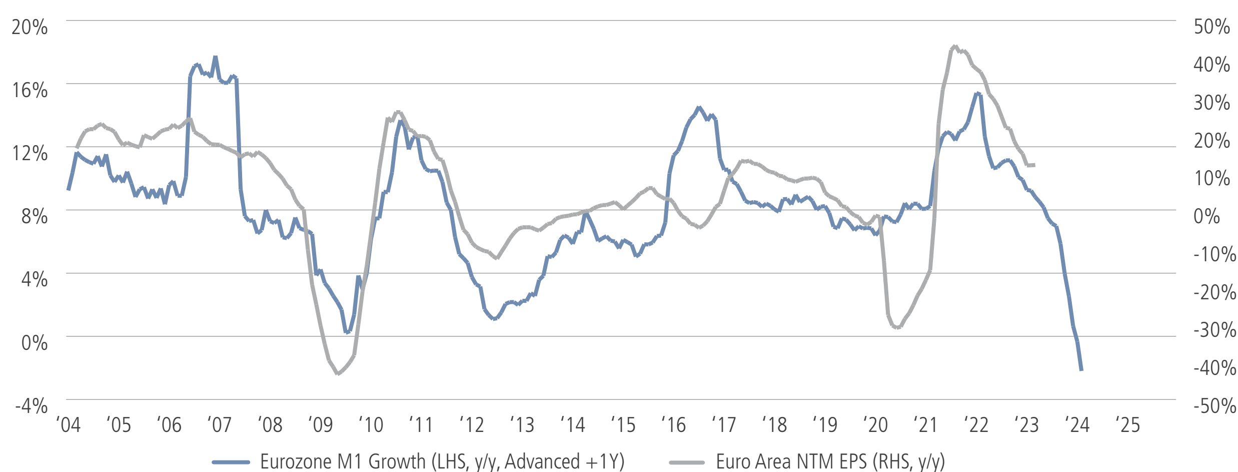
In addition, there are early signs that consumption growth is beginning to ebb, while housing activity (measured by the months it takes to sell a property in Tier 1 and 2 cities) remains weak and mortgage growth is decelerating. Chinese exports are slowing as well, evidenced by the decline in imports of input products, as well as the lack of strength in the currencies of commodity-rich trading partners, including Australia, Canada, New Zealand and Brazil.

Finally, China is currently experiencing low and falling inflation, which doesn't suggest to us that the country will become an engine of global reflation anytime soon.

Europe: Transitory growth impulse

Though European stocks rallied hard as falling commodity prices offered relief to companies and consumers, this respite—and the rally—are temporary, in our view. In response to broader elevated inflation that has outlived the drop in energy prices, we believe Europe and its stock market will soon have to contend with the fastest monetary tightening and sharpest reduction in liquidity in history (see figure 10). Absent a recession, the ECB appears unlikely to turn dovish anytime soon.

FIGURE 10: EUROPE'S MONETARY TIGHTENING COULD WEIGH ON EPS THROUGH 2024



Source: Neuberger Berman research and FactSet. Data as of March 31, 2023. For illustrative purposes only. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

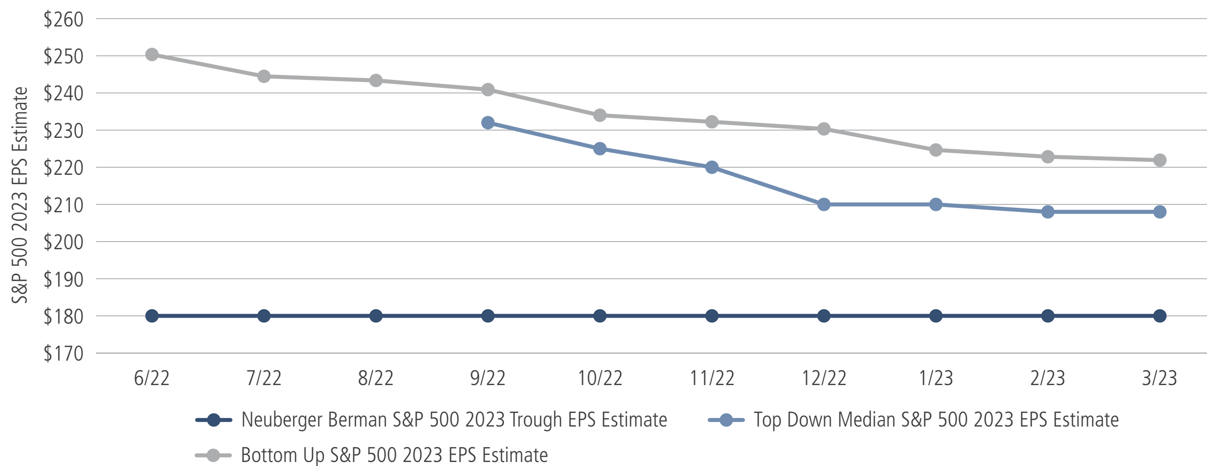
Other data gives us pause about the direction of Europe's near-term growth. Lending standards to consumers and corporates have tightened significantly; corporate bankruptcies are on the rise; housing data show signs of potential economic weakness; and the fiscal impulse for the Euro Area is about to turn negative in the second half of 2023 and into 2024. Meanwhile, we believe slowing overall global demand potentially threatens to put further pressure on European corporate profits. The way we see it, the headwinds to growth are rising rapidly in Europe.

Despite this chorus of concerns, the 2023 consensus earnings estimate for the Stoxx 600 remains relatively bullish. Given this backdrop, we remain cautious about the European stock market and believe it has likely overshot relative to its lackluster economic outlook and is prone to a substantial correction.

Quality Still Matters

Leaning on our framework-oriented economic and market analysis, we began urging equity investors to assume a more defensive posture a year ago. Indeed, consensus has been slowly gravitating to our more conservative view (see figure 11).

FIGURE 11: CONSENSUS EXPECTATIONS ARE SLOWLY CONVERGING TOWARD OUR TROUGH EPS ESTIMATE

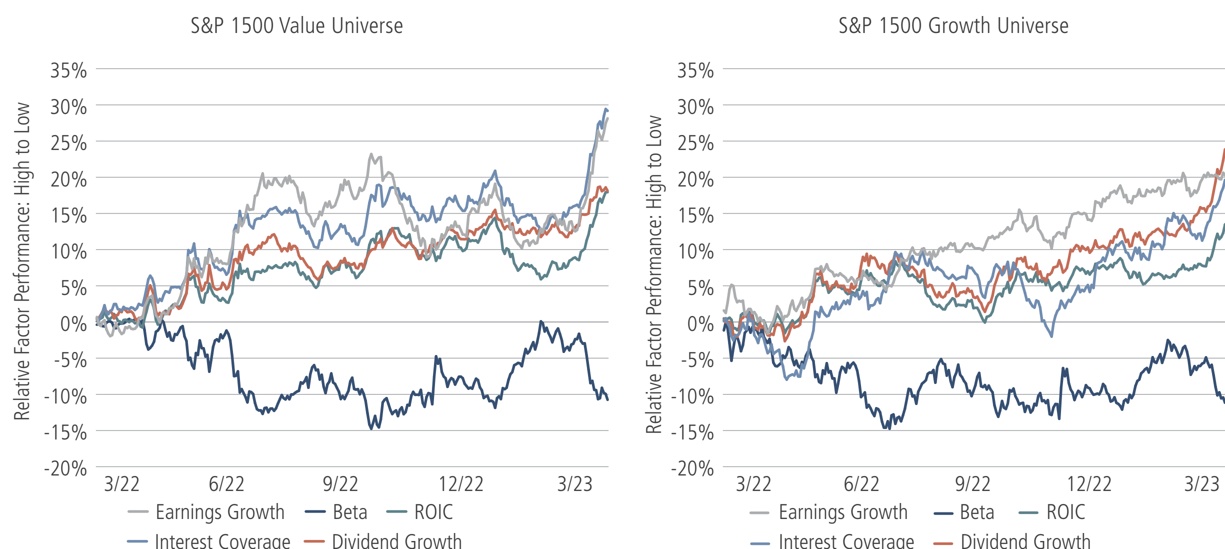


Source: Neuberger Berman, Bloomberg and FactSet. Data as of March 31, 2023.

With a sizable contractionary impulse in the pipeline, perhaps the most consequential decision in navigating this phase of the cycle is the degree of risk one is willing to take in their equity portfolios.

For over a year, quality and conservative factors have outperformed as investors chose greater certainty over greater risk. As shown in figure 12, stocks with the highest interest coverage, dividend growth, profitability and lowest risk have added 10 – 30% of return relative to those with the lowest interest coverage, dividend growth, profitability and highest risk. As the economic environment gets more challenging, we expect these factors to continue to deliver.

FIGURE 12: QUALITY AND LOW-RISK FACTORS HAVE OUTPERFORMED IN BOTH GROWTH AND VALUE STYLES



Source: PSC. Data from March 1, 2022, to March 24, 2023. For illustrative purposes only. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

In summary, we maintain that lower-beta and higher-earnings-quality portfolios should continue outperforming riskier ones—regardless of style, thematic or regional focus—over the next six to 12 months. We remain **overweight** defensive vs. cyclical sectors, **neutral** growth vs. value, and **overweight** U.S. vs ex-U.S. Developed Markets and Emerging Markets. (For a quick summary of our suggested strategic weightings, see the table of "Investment Themes and Views" at the beginning of this report.)

Appendix

OUR DOWNTURN SCENARIOS

Peak-to-Trough Change Estimate	Mild Recession	Disinflationary Recession	Severe Recession
Real GDP	-1%	-3%	-4%
Nominal GDP y/y	-3%	-10%	-8%
CPI Inflation	-3%	-5%	-6%
WTI Oil	-32%	-69%	-69%
Unemployment Rate	1.9%	3.9%	5.4%
Duration (Months)	8	12	16
Peak S&P 500 NTM EPS ($/share)	240	240	240
Est. EPS y/y	-15%	-25%	-35%
Est. NTM EPS at Trough	204	180	156
Peak NTM P/E	21.3	21.3	21.3
Est. Change in NTM P/E Ratio	-20%	-25%	-35%
Est. S&P 500 NTM P/E Ratio at Trough	16.5	16.0	14.0
Est. S&P 500 at Trough	**3350**	**2900**	**2200**
Est. S&P 500 Peak-to-Trough Decline	**-30%**	**-40%**	**-54%**

Mild: 1960, 1969, 1980, 1990, 2000, Δ Agg. Economic Activity >-4%, or ΔRGDP>-2%
Disinflationary: 1948, 1953, 1957, 1981, 2008, 2020, NGDP>6%
Severe: 1973, 2008, 2020, Δ Agg. Economic Activity <-6.5%, or ΔRGDP<-3%
*Analysis includes only the recessions starting in 1980 onward.

Source: Neuberger Berman. IMPORTANT: Estimated returns or market levels are hypothetical estimates generated by Neuberger Berman based on various assumptions and inputs, including current market conditions, historical market conditions and subjective views and estimates. These hypothetical returns are for discussion purposes only and are not intended to represent, and should not be construed to represent, predictions of future rates of return. Actual returns may vary significantly. Estimated returns should not be used, or relied upon, to make investment decisions. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal.

ECONOMIC INDICATORS	
SLOS Tightening Standards for C&I Loans	Leading
Industrial Production	Leading
CEO Confidence	Leading
Building Permits	Leading
New Home Sales	Leading
U.S. Leading Economic Indicator	Leading
U.S. Leading Economic Indicator 6M Chg.	Leading
ISM Manufacturing New Orders	Leading
Average Loan Delinquency Rate	Leading
ISM Manufacturing PMI	Leading
Manufacturers' Inventories to Sales Ratio	Leading
C&I Loans Delinquency Rate	Leading
Yield Curve 2/10	Coincident
Consumer Confidence	Coincident
Consumer Expectations Index	Coincident
Consumer Current Expectations Index	Coincident
Consumer Goods New Orders	Coincident
Initial Unemployment Claims	Coincident

New Housing Starts	Coincident
Average Weekly Hours	Coincident
Continued Unemployment Claims	Coincident
S&P 500 EPS Deviation	Coincident
Industrial Capacity Utilization	Coincident
Real Retail Sales	Lagging
S&P 500 Price Index	Lagging
Real GDP	Lagging
Private Nonfarm Payrolls 3M Chg.	Lagging
Real Retail Sales y/y	Lagging
S&P 500 Net Margin	Lagging
Unemployment Rate	Lagging
Industrial Production y/y	Lagging
Private Nonfarm Payrolls	Lagging
New Orders: Nondefense Capital Goods Excluding Aircraft	Lagging
Real GDP	Lagging

Source: Neuberger Berman.

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Index Definitions

The S&P 500 Index consists of 500 U.S. stocks chosen for market size, liquidity and industry group representation. It is a market value-weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value.

Goldman Sachs Financial Conditions Index (FCI) is a weighted average of riskless interest rates, the exchange rate, equity valuations, and credit spreads, with weights that correspond to the direct impact of each variable on GDP.

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