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Equity Market Outlook 2Q 2022

Economic and Market Review: Key Considerations for Equity Investors

The financial news cycle has been intense over the past quarter, with much to discuss and speculate about. However, instead of focusing on the many headline topics—the implications of the war in Ukraine, inflation, policy at the Federal Reserve (Fed) or the yield curve—in this report, we will describe our analytical framework for guiding us through these noisy times.

We believe this is important right now because the conflict in Ukraine may turn out to be less critical for equity markets than the upcoming turn we anticipate in the economic growth cycle. A dramatic escalation of the conflict would make us reconsider our no-recession stance. Barring such a scenario, **we expect the war to intensify the approaching growth slowdown, the causes of which pre-date the invasion—but not to the extent that growth turns negative.** Either way, we believe the lower-beta stance we anticipate for later this year would be well calibrated for the coming environment. We hope investors find the discussion additive to the financial news cycle.

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Investment Themes and Views

Value Over Growth, but Lower Beta Choices Within Both Value and Growth

Valuation dispersion in U.S. stocks remains above average. Income, as a subset of value, appears particularly attractive. Dividend payers have lagged growth stocks even more than value over recent years; they have tended to exhibit less interest rate sensitivity; their dividends, being based on nominal earnings, have tended to rise with infla tion and can provide a yield that can help hedge against infl ation in a way that fi xed income yields cannot. Value has also tended to have high economic sensitivity than growth.

We continue to favor value over growth, but believe investors should consider lowering the beta of both value and growth investments to navigate the Slowdown phase effectively. Reduced beta within these styles, we think, is likely to be performance-accretive in the Slowdown phase.

Large Caps Over Small Caps

Leading indicators suggest that the U.S. economy is about to enter the Slowdown phase, which has tended to favor large caps.

High Quality Over Low Quality

Leading indicators suggest that the U.S. economy is about to enter the Slowdown phase, which has tended to favor less cyclical, less leveraged and higher-quality stocks.

U.S. over ex-U.S. Developed Markets and Emerging Markets

The S&P 500 Index has tended to exhibit lower beta to the broad global equity market than both emerging markets and non-U.S. developed markets indices.

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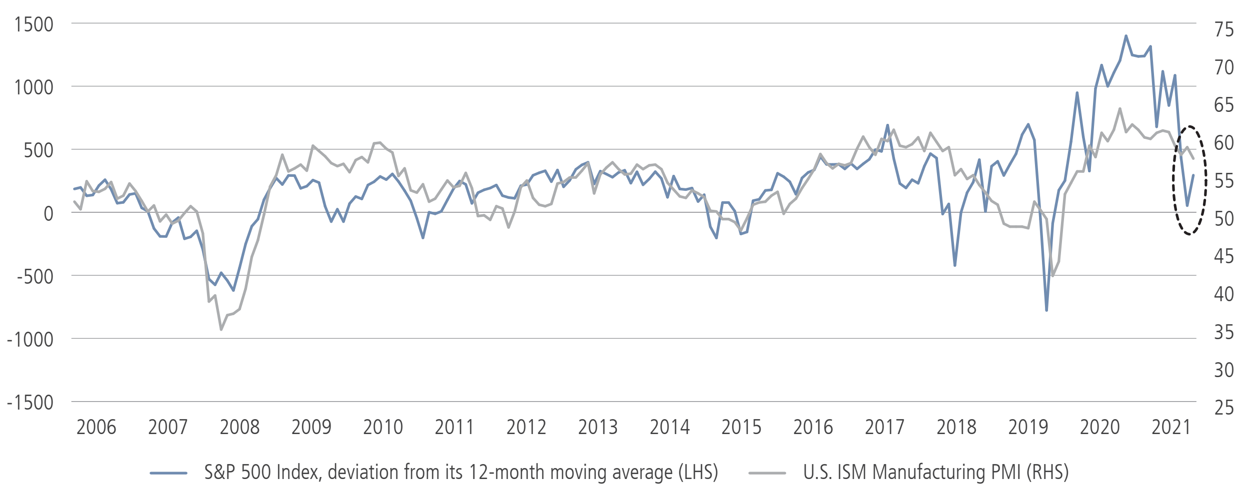
Stocks Could Rebound, But Beware the Slowdown Ahead

In the near term, we expect the S&P 500 Index (S&P 500) to continue to recover from its March trough. Anticipation of monetary tightening, rapidly rising interest rates and the selloff in duration, the flattening yield curve, rising inflation, rising volatility and the economic stresses associated with the conflict in Ukraine have collectively driven the S&P 500 downward. Our model of the relationship between the S&P 500 and the U.S. Institute for Supply Management (ISM) Manufacturing Purchasing Managers' Index, currently at a robust though sequentially declining level of 57.1, suggests an implied value for the equity index of approximately 4,650.

THE ECONOMIC STRENGTH SUGGESTED IN THE ISM IS NOT REFLECTED IN THE MARKET



Source: Neuberger Berman, FactSet. As of April 1, 2022. 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 or any historical results. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

Investors Appear Under-Positioned in Equities

Positioning data for systematic and discretionary investors appear to corroborate this dislocation. Discretionary investors' equity exposure now looks to be at a level consistent with a moderate ISM of 54, supported by the data in our model mentioned above. The reduction in equity exposure among systematic and algorithmic investors has been even more dramatic. Their collective exposure appears to be consistent with an ISM of 50, which would put business activity on the brink of contracting.

In fact, the March ISM Manufacturing Index level of 57.1, which is in the top 28% of all monthly readings since 1948, suggests that the U.S. economy is robust. Industry-specific surveys are similarly consistent with a strong economy.

We expect the disconnect between the ISM and investor positioning to resolve. Indeed, the latest ISM was sequentially lower, and its forward-looking subcomponents pointed to further weakness in the months ahead. Given this dynamic, valuation dispersion, while still in the 63rd percentile of data going back to 1926, is no longer compellingly attractive.

In our previous notes, we had expected the Slowdown phase to arrive by mid-2022, give or take a quarter; we now think that the Slowdown phase is in sight. In anticipation of the transition from the ongoing Boom phase, we are switching our bullish view on equity exposures to a more conservative mix— although we could still see a market rebound given economic strength and current investor positioning.

It's Getting Late in the Game: Slowdown Phase Up Ahead

Our analytical framework guides our sequential bullish and cautious stances on risk assets in phases lasting roughly 12 – 24 months. Having been in the risk-on Recovery and Boom phases for the past 24 months, we now see gathering evidence that the risk-off Slowdown phase may be upon us soon. The discussion below is offered in anticipation of this Slowdown.

We believe a change of phase from Boom to Slowdown would favor assets with characteristics fundamentally different from those have outperformed during the Boom phase. Asset allocators with medium-term investment horizons, and those seeking a framework for understanding the subsurface rotations within the stock market, may find this discussion of interest.

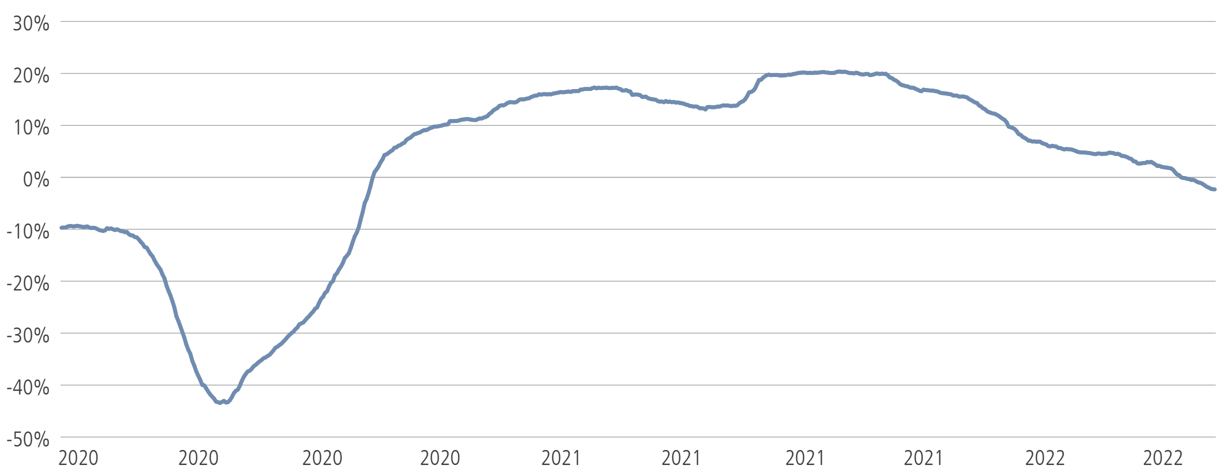
The drivers of the transition from Boom phase to Slowdown phase are often slow-moving, observable and intuitive in hindsight. We will list six of these drivers, some specific to the current economic dynamics and others more general, which inform our opinion that the Slowdown phase is up ahead.

1. **The Earnings Revisions Ratio (ERR):** The ERR is a ratio of the total number of analyst upgrades net of downgrades over the past 100 days, as a percentage of the total number of ratings. It has tended to lead the trend in aggregate earnings-per-share (EPS) estimates at the index level by a few months, and is helpful in assessing the state and direction of the regional and global earnings cycle.

   The pace of net upward revisions has been declining since mid-2021 and downward revisions now exceed upward revisions. We expect S&P 500 and MSCI ACWI earnings estimates to begin getting revised downward shortly. Just as positive earnings revisions have typically signaled a strengthening profit cycle and improving sentiment for risk-taking, a negative ERR typically implies an impending slowdown in the profit cycle and an accompanying reduction in investor risk appetite.

ANALYSTS ARE BECOMING MORE PESSIMISTIC ON EARNINGS

Global Stocks, Earnings Revision Ratio (upgrades net of downgrades as a proportion of total ratings, past 100 days)



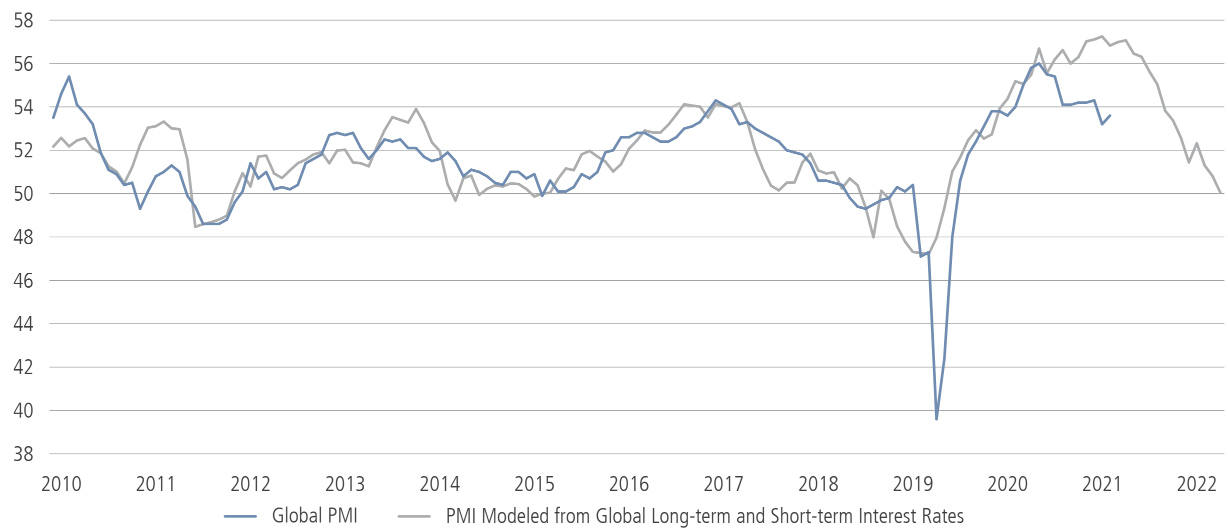
Source: Mill Street Research. As of March 25, 2022. For illustrative purposes only. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

2. **Monetary Tightening:** Though the Fed raised interest rates for the first time in this cycle only in March, GDP-weighted global short rates have already been rising for 15 months, and long rates for 24 months. We think the lagged effect of tightening global monetary and financial conditions outside the U.S., along with the expected monetary tightening within the U.S., is likely to slow global growth meaningfully in the second half of this year and into 2023.

   To illustrate the point, the 30-year fixed mortgage rate in the U.S. has risen over 60% since its low point 13 months ago. That, along with a 15% increase in the median home price during the same period, has reduced the housing affordability index close to the lows last seen in 2009. We believe the cyclicality of housing activity is an important contributor to overall economic cyclicality. An affordability-induced slowdown in housing activity is therefore likely to catalyze or accelerate economic slowdown.

TIGHTENING MONETARY CONDITIONS ARE LIKELY TO WEIGH ON GROWTH

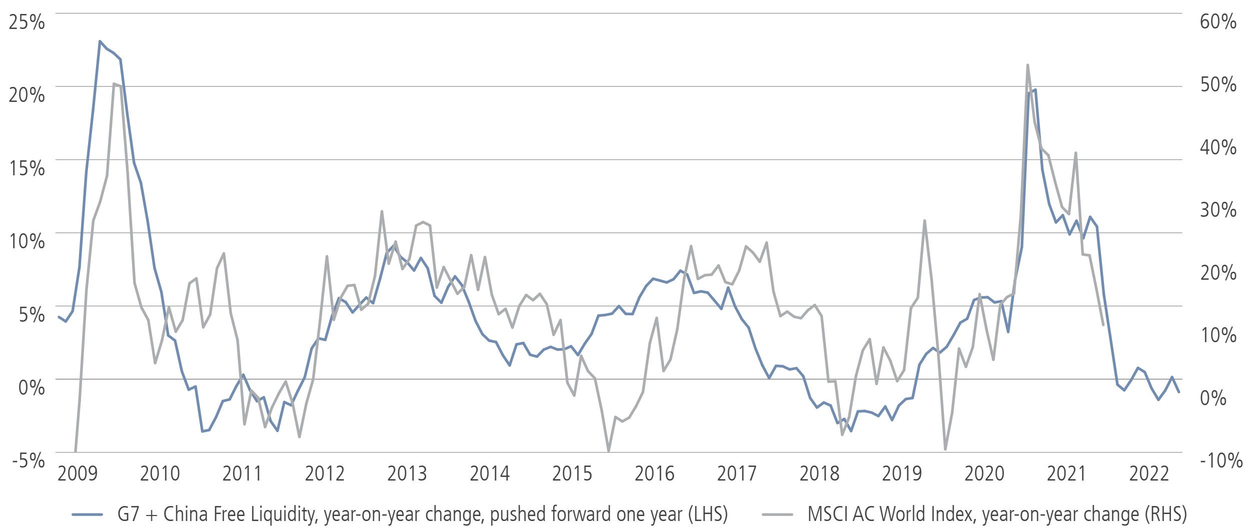
Interest rates-based model of Purchasing Managers' Index (PMI) suggests a coming slowdown



Source: Neuberger Berman, Bloomberg. As of February 28, 2022. 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 or any historical results. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

3. **Unsupportive Free Liquidity Growth:** Free liquidity growth, which is the growth in global M2 in excess of nominal global economic growth, is now negative. A waning tide of free liquidity growth has historically presaged depressed risk appetite among investors, with sub-par MSCI AC World Index (MSCI ACWI) performance coming over the subsequent 12 months along with poor risk-adjusted returns. This reinforces our view on navigating the slowdown phase with de-risked portfolios.

GLOBAL EXCESS LIQUIDITY GROWTH NO LONGER SUPPORTS RISK-TAKING



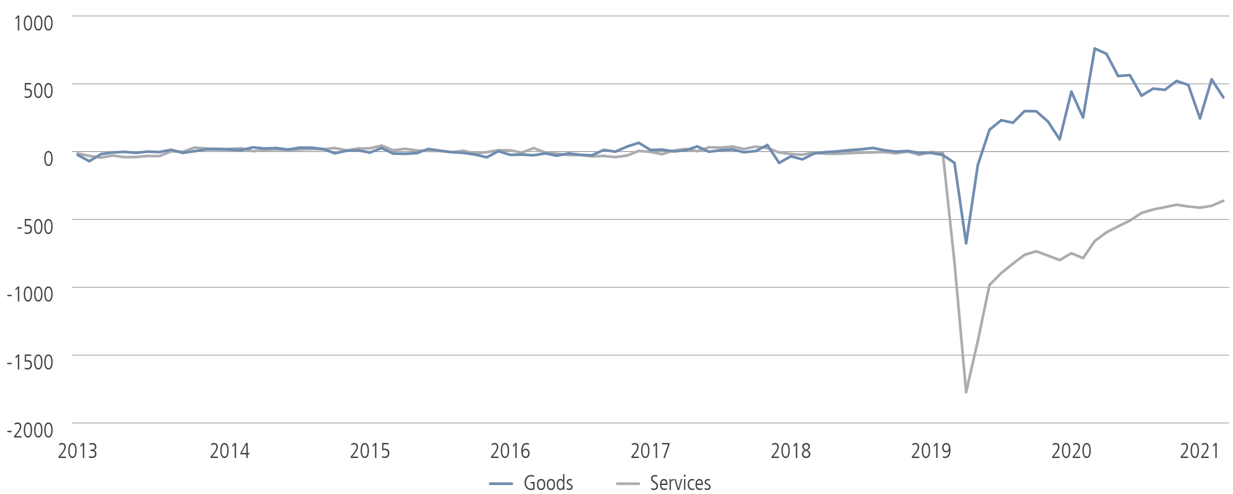
Source: Bank of America. As of February 28, 2022. For illustrative purposes only. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

4. **Goods to Services Transition:** Goods consumption spiked relative to long-term trend during the pandemic as lockdowns depressed consumer spending on services. While fine dining, travel and leisure, and other everyday services were often difficult or impossible to order online during the lockdown, online goods orders were made in trend-altering quantities.

   The goods economy exhibits substantially higher cyclicality than the services economy. A spurt in goods consumption drove the Boom phase. In a post-vaccine economy, however, we would anticipate a rebalancing to services consumption, with the knock-on effect of goods consumption falling back toward trend. This is likely to put downward pressure on the cyclical economy and the S&P 500; since 2008, the Index has exhibited just 23% correlation with year-on-year changes in services consumption, but 66% correlation with changes in goods consumption.

GOODS CONSUMPTION IS LIKELY TO FALL BACK TOWARD TREND

Consumption relative to pre-COVID trend, $ billions



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5. **Inventory:** The inventory-to-sales ratio for durable goods had reached a near historically depressed level in 2021. Rebuilding of inventories in this cyclical and important part of the economy supported economic acceleration, but now the ratio is back at its 30-year average. Slowing inventory restocking from here is likely to cause a net subtraction from GDP growth.

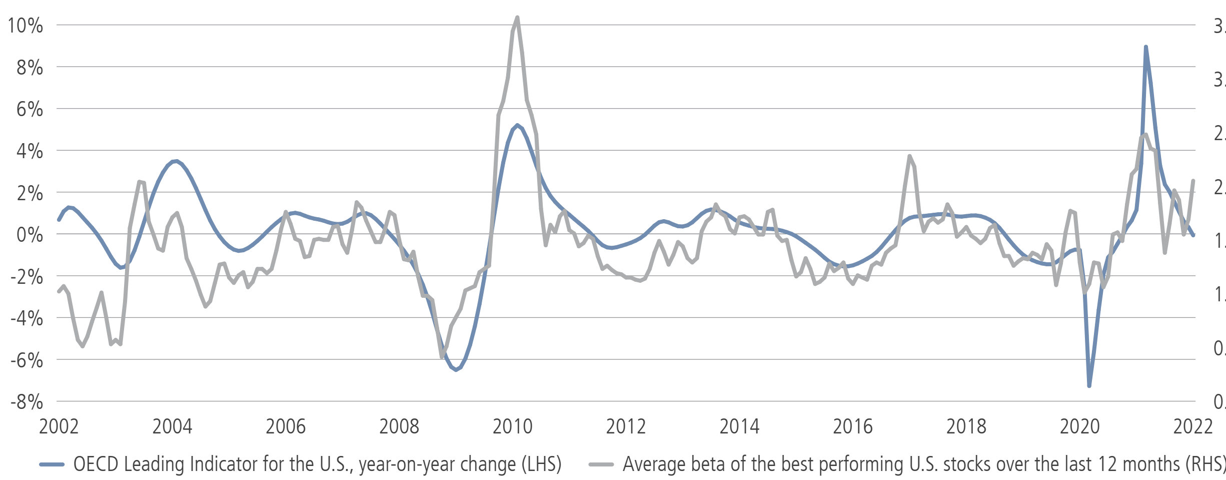
6. **Inflation:** We expect headline U.S. CPI inflation to peak in the summer as the current rise in commodity prices inflation begins to slow and strong base effects kick in. Declining inflation would contribute to a slowing of the nominal economy and nominal earnings, bringing out the volatile and risk-off character of the Slowdown phase, as the stock market adjusts to downward earnings and economic growth revisions.

What to Expect During the Slowdown Phase

History suggests some typical Slowdown phase characteristics:

- Stock market volatility rises: over the past 20 years, on average it has been 11% during Booms, but 13% during Slowdowns
- Lower-beta stocks within their respective styles have tended to outperform, as do lower-beta styles, factors and regional exposures
- S&P 500 annualized returns have averaged around zero in the Slowdown phases of the past 20 years
- Most of the largest non-recessionary market corrections have occurred in this phase
- Earnings continue to grow, although more slowly, and earnings growth expectations decline
- The stock market forward P/E multiple has tended to decline
- A Slowdown phase usually lasts 12 – 24 months

ECONOMIC SLOWDOWNS HAVE TENDED TO FAVOR LOWER-BETA STOCKS



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When we select the top 20% of stocks by best performance over the past 12 months, we find that the average beta of that group of stocks varies with the phase and direction of the economic growth cycle, proxied in the chart above with the U.S. OECD Leading Indicator. The data in the chart suggests that when the economy is accelerating (shown by the dark line rising), higher-beta stocks are over-represented among the best performers. Likewise, when the economy is slowing, lower-beta stocks dominate the top outperformers.

The observation is intuitive, yet it is worth pointing out how intertwined the economic growth cycles are with the cycles in beta of the best-performing stocks. Given the strong correspondence between the two, investors could consider using growth cycle indicators as signals for when to increase or decrease the beta of their equity or aggregate investments.

During the Slowdown phase in the past two decades, equities have delivered near-zero percent return, and exhibited 50% greater volatility than during the Boom phase. We would favor low-beta investments during the Slowdown phase. Within equity styles, we would favor lower-beta value and growth strategies, and lower-beta small caps portfolios. Investors could also benefit from rotating parts of their portfolios toward defensive sectors, and toward less-cyclical industries and stocks within the traditionally cyclical sectors, such as Financials and Industrials, or, if those changes are not possible or desirable, we would consider lower-beta stocks in these categories.

Recession, No; Intensified Slowdown, Yes

Investors have been voicing concern about the negative impact of the conflict in Ukraine on consumption and production, and ultimately on investments, particularly as inflation was already uncomfortably high and monetary policy tightening. Supply-side shocks tend to subtract from growth, and the disruption from the war in Ukraine is likely to be no different. However, the shock has come at a time when the U.S. economy is robust, and there are impressive mitigating factors to cushion against it:

- **Wealth effect:** By our estimate, U.S. household net worth is $23 trillion above pre-pandemic trend.
- **Excess cash:** Excess consumer and corporate cash are at $2.2 trillion (15% of consumption) and $2.3 trillion above pre-pandemic trend, respectively, according to MKM Partners, Empirical Research Partners and Credit Suisse, as of February 2022. Goldman Sachs research suggests that corporate capex growth is near a multidecade high.
- **Lending conditions:** Bank lending conditions appear easy, and lending to private sector has been accelerating.
- **Financial conditions:** While we anticipate some tightening in the second half of the year, financial conditions indices, which measure the net tightening in financial conditions due to monetary policy, the state of economic growth and exogenous factors, have barely budged from a year ago and only a little since Ukraine was invaded. Broad financial conditions are not suggesting financial stress consistent with a recession in either the U.S. or eurozone.
- **Robust economy:** Aggregate economic activity is currently robust and accelerating in the indicators we track, and evident in the labor market uptake data.

A dramatic escalation of the conflict, one that doubles the price of oil, for instance, would make us reconsider our no-recession stance. Barring such a scenario, **we expect the war to intensify the approaching growth slowdown, the causes of which pre-date the invasion—but not to the extent that growth turns negative.** Either way, we believe the lower-beta stance we anticipate for later this year would be well calibrated for the coming environment.

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