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Equity Market Outlook 4Q 2021

Economic and Market Review: Key Considerations for Equity Investors

After 18 months of strong equity market performance, and a year of outperformance by value stocks and sectors geared to reflationary forces, many investors are questioning whether valuations are now stretched, and the bull market is about to run out of steam.

By contrast, we think this bull market could have many more months to run. Leading economic indicators, investor positioning and market valuation dispersion all point to the possibility of further equity upside well into 2022, while the dynamics around the U.S. dollar suggest that equity factors, sectors and regions that are more geared to reflation could continue their relative outperformance for years to come.

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TABLE OF CONTENTS

BOOM PHASE IN EQUITIES COULD PERSIST THROUGH MID-2022 1

EQUITY POSITIONING IS STILL RELATIVELY BENIGN 2

EQUITY VALUATION DISPERSION STILL SHOWS SIGNS OF STRESS 3

WE THINK THE DOLLAR HAS TOPPED OUT—AND THAT MATTERS FOR ALLOCATIONS 4

Boom Phase in Equities Could Persist Through Mid-2022

Leading economic data suggests that U.S. growth remains in the BOOM phase, where growth is positive and accelerating. Reported economic data in aggregate appears to confirm this outlook. The labor market remains solid: Jobs and wage growth are accelerating. Non-residential fixed investment and corporate capex growth are also accelerating.

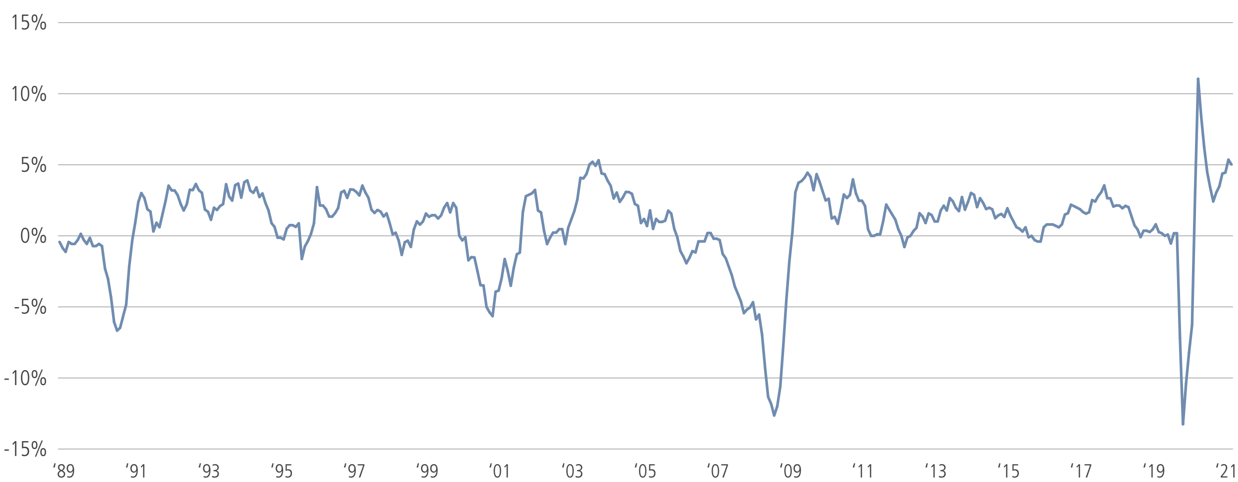
We can also point to a number of strong supports for our current growth outlook: financial conditions are extremely accommodative by historical standards; the ratio of new orders to inventory is historically high; corporate pricing power is robust; households and corporations together hold a stock of spendable liquid assets some $3.5 trillion larger than it would have been under the pre-Covid growth trend; and the additional fiscal stimulus currently being negotiated in Washington.

The Boom phase, which typically lasts 12 – 24 months, is rarely without its list of investor concerns. But it also happens to be the phase where risk-taking in equities has tended to be most rewarded. Historically, the value style, small caps, lower profitability/higher economic leverage and high-volatility stocks and sectors tend to outperform growth, large caps, higher profitability/low economic leverage and low volatility.

In this cycle, these value investment categories have been outperforming growth since October of 2020 and we expect them to continue to outperform through mid-2022. We therefore favor a broad procyclical investment stance through mid-2022.

U.S. GROWTH SUSTAINS ITS BOOM PHASE STATUS

Conference Board U.S. Leading Economic Index, six-month change (in %)



Source: Conference Board, LEI as of August 31, 2021. 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.**

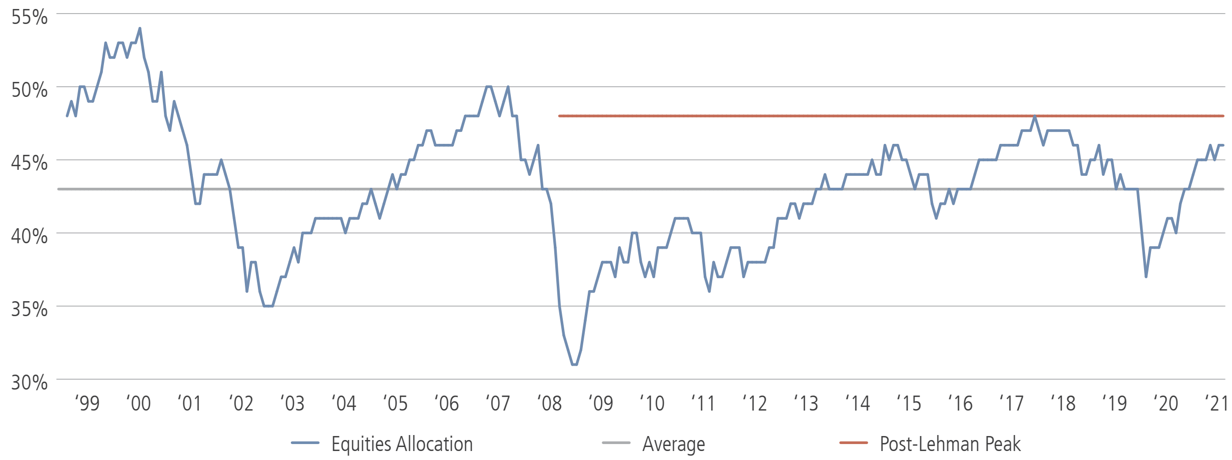
Equity Positioning Is Still Relatively Benign

A comprehensive measure of the allocation to equities (versus cash and bonds) by all non-bank investors globally remains below the 47.7% post-Lehman peak seen in 2018. This positioning is likely to be supportive of the market. For illustration, if all else remained equal, getting to the 47.7% allocation would imply an S&P 500 Index level of approximately 5,000—a rise of some 12% from its level at mid-September.

Moreover, we believe this is a conservative estimate, given the current accommodative monetary and fiscal policy stance relative to the prior cycle. We think the peak allocation to equities in this cycle could be several percentage points higher than in 2018. While we do not offer a timeframe in which this allocation would be reached, our reasonable estimate is that the S&P 500 is likely to be 20 – 30% higher than it is today at the next peak in equity allocation.

INVESTORS RETAIN RELATIVELY CAUTIOUS ASSET ALLOCATIONS

Non-bank investors' allocation to equities, versus cash and bonds (in %)



Source: JP Morgan, as of September 20, 2021. 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.**

Equity Valuation Dispersion Still Shows Signs of Stress

How attractive are equity market valuations?

The answer to that question often centers around an index's current valuation relative to its history, using one or more of the usual metrics: the Forward Price-to-Earnings (P/E) ratio, the Cyclically-Adjusted Price-to-Earnings ratio (CAPE), the Earnings Yield or Equity Risk Premium (ERP), and so on. The problem we see with this approach is that a genuine apples-to-apples comparison of current and historical valuations needs adjustment according to macro variables such as treasury yields, economic growth rates, inflation, dividend yields, payout ratios, margins, volatility, and more—and modelling those variables back into the past introduces unavoidable complexity and subjectivity.

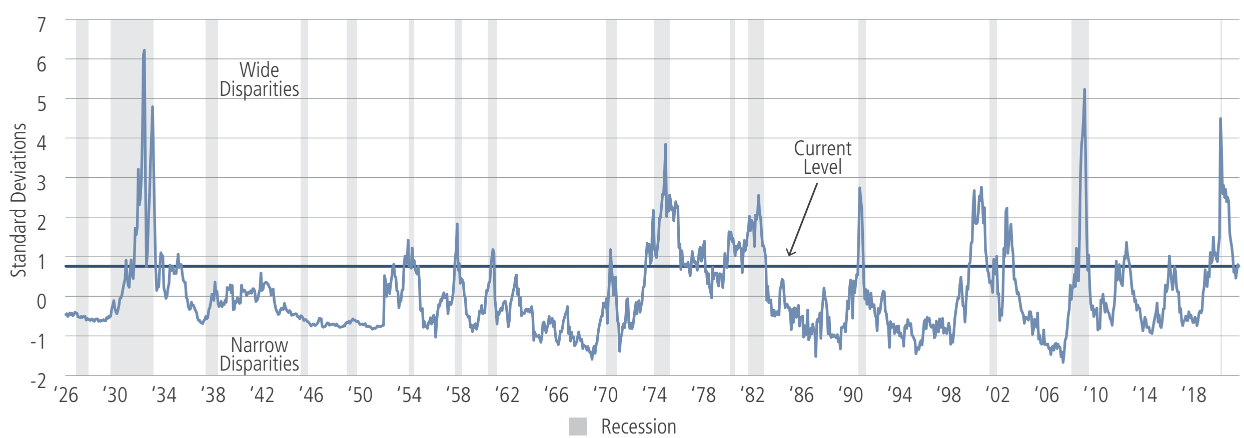
We believe a simpler, intuitive way to think about market valuation is to focus on the dynamics of valuation within the index itself, rather than the dynamic through history. The valuation dispersion measure is the difference between the composite valuations of the cheapest quintile of stocks versus the median stock in the index, expressed as a z-score (or number of standard deviations, derived from the full history of the index). Essentially, it is a measure of how much value there is in the index's cheapest stocks and, by extension, how much potential opportunity there is for generating excess return from value-based stock selection. As the chart of valuation dispersion in the largest 1,500 U.S. stocks over the past century suggests, however, it is also a measure of the amount of economic stress that is being priced into the index: peaks have tended to coincide with peak economic stress during recessions.

Unsurprisingly, valuation dispersion in the current cycle peaked in March of 2020, and hit the 99.5th percentile of monthly results going back to 1926. Despite their extraordinary run over the past 18 months, equities are still pricing in a fair amount of economic stress: the valuation dispersion z-score currently stands at 0.76 standard deviations above historical average, which may sound low relative to the z-score above four in March last year, but is still in the 81st percentile of monthly results going back to 1926.

We also expect the value style to continue to outperform growth until valuation dispersion drops well below zero, which would imply a near exhaustion of the opportunity to pick stocks based on valuation. At the beginning of the last growth cycle, in April 2014, the Valuation Dispersion z-score had fallen to -0.8, or the 16th percentile in the full history.

VALUE REMAINS RELATIVELY ATTRACTIVE

Valuation Dispersion (z-score), top quintile of 1,500 largest U.S. stocks versus average, 1926 to August 2021



Source: Empirical Research Partners, National Bureau of Economic Research as of August 31, 2021. 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 Think the Dollar Has Topped Out—and That Matters for Allocations

The strategic decision to select stocks, sectors, factors, regions and asset classes that benefit from reflation or disinflation tends to be among the most consequential for performance over a five- to 10-year horizon.

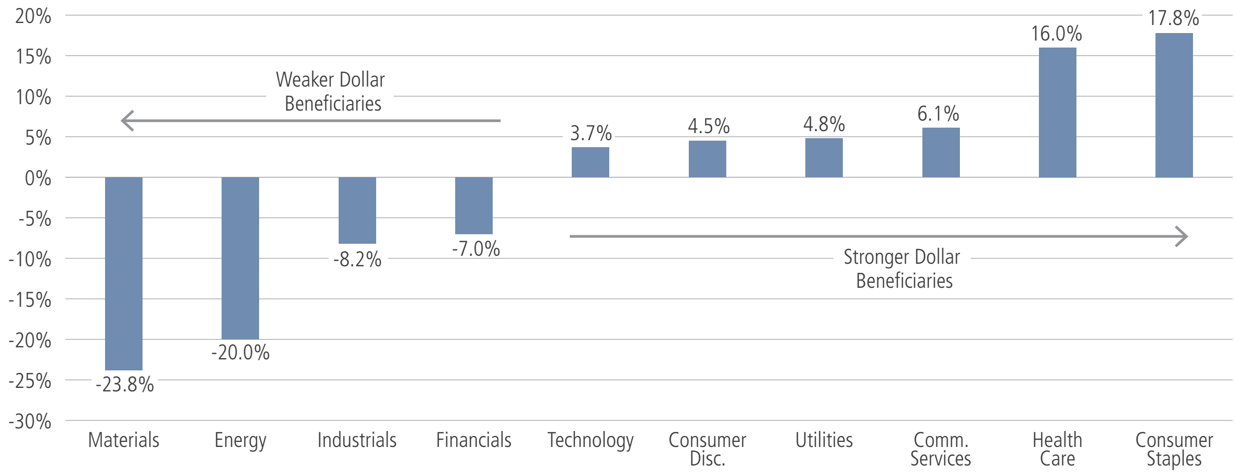
We think an awareness of whether we are in a bull or bear cycle for the U.S. dollar can act as a useful guidepost for making this decision. A bear cycle implies higher U.S. inflation, and a bull cycle implies lower inflation, relative to the rest of the developed world. As such, U.S. dollar bear cycles tend to favor reflationary assets, regions, sectors and factors, while bull cycles tend to favor allocations geared more to disinflation.

U.S. dollar cycles have tended to exhibit a cadence of seven to 10 years, and we think the dollar completed a nine-year bull run in March 2020 and has entered a multi-year bear market. Our view is supported by, among other things, GDP growth projections from the International Monetary Fund (IMF), which forecasts a decline in the U.S.'s proportional contribution to world GDP starting in 2022—another dynamic that has historically been associated with a weaker dollar.

Over the past 40 years or so, a weakening dollar and relatively stronger U.S. inflation has historically coincided with the outperformance of European over U.S. stocks, and emerging markets over the developed markets. Among the U.S. sectors, traditionally reflationary sectors such as Materials, Energy, Industrials and Financials have tended to outperform sectors such as Consumer Staples, Healthcare and Communication Services. The pattern typically holds outside of equity assets, as well: a weakening dollar tends to coincide with outperformance of gold over U.S. treasuries, and industrial metals such as copper over gold.

THE DOLLAR MAKES A DIFFERENCE

Correlation of daily relative returns of S&P 500 sectors with the Trade-Weighted U.S. Dollar Index, 2001 – 2021 (in %)



Source: Neuberger Berman, Bloomberg as of September 17, 2021. Trailing outperformance of Emerging Markets over S&P 500, against the inverted U.S. Dollar Index. 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. 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.**

DOLLAR CYCLES MATTER: U.S. VS. EX-U.S. ALLOCATION

Emerging market equities have tended to outperform when the U.S. dollar has weakened

Source: Neuberger Berman, Bloomberg as of August 31, 2021. 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. 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.**

Investment Views

Value Over Growth

Valuation dispersion in U.S. stocks remains relatively high, despite a year of outperformance by value stocks.

Small Caps Over Large Caps

Leading indicators suggest that the U.S. economy is still in a Boom phase, which has tended to favor small caps.

Low Quality Over High Quality

Leading indicators suggest that the U.S. economy is still in a Boom phase, which has tended to favor more cyclical, more leveraged and lower-quality stocks.

Ex-U.S. Developed Markets and Emerging Markets Over U.S.

We believe we may have started a multi-year bear cycle for the U.S. dollar, and a weaker dollar has tended to favor reflationary assets in general, and ex-U.S. equity markets in particular.

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