EQUITY MARKETS: A TEST OF COURAGE… & PATIENCE

While market participants brace themselves for a recession that is yet to unfold, few are preparing for a long protracted one or the eventuality of a mild, shallow recovery. Investors contemplating both: long recession and a shallow recovery are a rarity. Our conviction is that equity markets will need more patience to recover than most investors are willing to make room for.

"IN THE NEAR TERM, THE TROUGH IS PROBABLY WORSE, BUT THE RECOVERY SHOULD NOT BE IN DOUBT".

This quote comes from one my favourite sell-side research houses, regarding semiconductors earnings. I decided to use it since it is a good testament to the current mood: we can discuss the depth of the recession, but the economy is cyclical, and we should all be comfortable that we will come out of it sooner or later. How comfortable should we be?

THE MARKET IS BETTING ON A "GET AND FORGET" RECESSION, WHICH IS NOT A GIVEN.

Especially in the tech space and semiconductors area, where earnings are currently correcting. It is expected that this latest peak will be surpassed in the next two years, which suggests a pronounced v-shape recovery is on the cards. This is no small feat given the height of the previous peak, turbocharged by Covid.

What I just described about semiconductors could be applied to a larger swathe of the stock market. Therefore my growing concern is that the market reaction might be more severe than expected when investors will come to realize that they need to be more patient. The odd thing currently happening is that sectors and companies not experiencing downward numbers are sanctioned, as "recession is yet to come": better to print bad numbers to some extent than wait…

DOES A SLOWLY DETERIORATING ECONOMY IMPLY A SLOW RECOVERING ONE?

A typical economic recession is triggered by a shock[1], a brutal adjustment, leading to under-consumption and under-investment, which once exhausted begets the need for a restocking cycle[2]. In the current situation, there is nothing close to what was just described: on the contrary, households and corporates have been warned about a recession for more than a year, and have gradually adjusted their spending and investments in a soft and maybe more

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[1] Can be brutal variation in inputs costs, external event causing economic damages or loss of confidence, it can be an asset bubble bursting.

[2] https://www.imf.org/external/pubs/ft/fandd/basics/recess.htm#:~:text=As%20energy%20becomes%20expensive%2C%20it,contractionary%20monetary%20or%20fiscal%20policies

linear way. As a result, corporates and households do not have to restock, or re-invest as massively as in a classic cycle, therefore creating a more modest, shallow recovery.

SO WHAT TO MAKE OF THE "MOST AWAITED" RECESSION?

The endless recessionary rhetoric is not synonymous with investors' preparedness.

First, earnings' expectations so far for 2023 having been revised down only very modestly from highs –or 4.4% lower YTD for the S&P500[3]. Second, while human investors might be ready to withstand downward revisions of numbers linked to the recession, how will algorithms and CTAs (Commodity Trading Advisors) cope? Third, many investors were not able to de-risk some asset classes given their illiquid nature, sometimes even doubling down to support existing credit lines or stakes.

Equity-market valuations show an interesting story: it seems the market has been slicing its components differently this time around. This is not a "cyclical versus defensive sectors" debate as many stocks have been underperforming in both camps this year. This time it is more about "quality", "cash" and "balance sheets" significantly outperforming the rest, meaning the market is rewarding the companies (like Microsoft and Apple) that will definitely be there tomorrow and the morning after. Few are questioning their valuation or earnings prospects. But they should be.

Therefore, we are quite enthusiastic about the potential for stock picking and alpha creation by sticking to what matters in the long term: valuations and growth.

Value & Growth investors often are pitted against another, this time around they could team up against a greater evil: QAAC! Quality at all costs.

GOING FURTHER

US equities: Cyclical deceleration, this time is different

Looking at the US, the Covid recovery has created pent up demand in many sectors such as the homebuilding, aeronautics and air travel market. The under-investment in natural resources and energy sectors over the last decade has also created a distinct supply dynamic with a multi-year cycle in energy services that has just started. Therefore, one could argue that we are not having "a cycle" but multiple sector-level cycles and some of them will be strong. In the US Value strategy, we consider this to be a very attractive and contrarian opportunity, to capitalize on these under-appreciated trends as investors brace for a "binary" scenario.

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[3] Source: J.P. Morgan. Data as of 25/04/2023.

Why we are incrementally even more positive regarding Healthcare equities

Despite its defensive attributes, the healthcare sector performance has been underwhelming so far this year. It just makes it even more attractive on a relative basis. Structural tailwinds and cyclical ones are combining to make this sector a must-own.

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