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US equities 2023 outlook: From inflation to growth

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With pressure on corporate profits for the next few quarters, equity markets could slip in the near term. However, the outlook should improve later in the year and into 2024.

It goes without saying that 2022 has been a very challenging year for equity investors. As of this writing, the S&P 500 is down 17% so far this year. Since 1927, there have only been six calendar years with lower returns. Surging US inflation due to the war in Ukraine, snarled supply chains, prior fiscal and monetary stimulus, and a tight labor market have prompted the most aggressive Federal Reserve interest rate hikes since the 1980s to rein in inflationary pressures. The rapid increase in interest rates in the US has driven an aggressive de-rating in the value of all assets, including stocks. The adjustment has been especially painful because the starting point for equity valuations was quite elevated at the beginning of 2022. The good news is that S&P 500 valuations are now much more reasonable, so valuations don't look as vulnerable.

Profit recession on the horizon

But that doesn't mean US stocks are out of the woods. While inflation in the US is clearly coming down, there is still uncertainty about the level that it will fall to and if the Fed has done enough to get it close to its 2% target (over time). But perhaps the bigger questions center on economic and corporate profit growth. It usually takes time for Fed actions to impact the US economy. As a result of these lags, The UBS Chief Investment Office (CIO) thinks downward pressure on corporate profit growth will continue in the coming quarters.

The Fed's quarterly Senior Loan Officer Opinion Survey, which measures the extent to which banks are tightening or loosening lending standards for commercial and industrial loans, has been a good leading indicator for profit growth and suggests a high-single digit decline in S&P 500 EPS by the middle of 2023. Our expectation for a moderate increase in the unemployment rate from 3.7% to more than 4%—roughly in line with the Feds forecast of 4.6%—would also indicate a decline in profits as consumer spending softens. Additionally, S&P 500 profits are now about 13% higher than trend

earnings since 1960. It's normal for profits to rise above trend during an expansion. But when profit growth begins to decelerate while earnings are substantially above trend, S&P 500 profits typically decline over the next year by about 5%.

As a result, we have fairly high conviction that earnings will contract next year. We have penciled in a 4% fall in S&P 500 EPS in 2023 to USD 215. This is well below bottom-up consensus expectations for EPS growth of 5% to USD 231 and suggests continued negative earnings revisions, a somewhat challenging backdrop for the equity market.

With the S&P 500 now 9% higher than the low on 12 October, some investors are asking if the worst is over for this bear market. It's certainly possible, but the low in October is very different from a typical bear market low. Before a bear market bottom, usually the 2-year Treasury yield has already started declining, the equity risk premium has risen quite a bit, and investors are starting to anticipate a re-acceleration in economic and corporate profit growth. Unfortunately, none of these conditions were met at the market low in October. We think investors have to be prepared for another leg down in this bear market in the months ahead, potentially driven by weaker corporate profits.

Trends should improve in 2024. The Fed thinks the normal federal funds rate is about 2.5% compared to the current rate of 4.5%, and there are indications from the Fed that it will rise to slightly more than 5% in early 2023. So, once inflation is under control, it seems likely that the Fed will begin to cut interest rates, which should lead to a re-acceleration in corporate profit growth, which could be realized in 2024. While it appears too early to position for Fed interest rate cuts, the equity market backdrop should begin to improve at some point in 2023, perhaps in the second half.

Finding Value in the Year Ahead

Valuations for growth companies have certainly declined from elevated levels, but growth stocks still look expensive versus value. While inflation is peaking from very elevated readings, we believe it will settle above pre-pandemic levels. Higher interest rates likely means valuations for growth companies will not return to relative highs any time soon.

We remain neutral across size segments, but there will likely come a point in 2023 when it makes sense to move to a most preferred stance on small and mid- (SMID) caps. SMID caps tend to perform best in the early stages of an economic recovery because they are more cyclical than large caps. The slope of the yield curve (the spread between 10-year and 2-year Treasury yields) can be a good gauge to time the entry into SMID caps. When the curve starts to steepen—which will likely happen at some point in 2023 as the 2-year yield starts to decline in anticipation of Fed interest rate cuts—it is a good signal to move into SMID caps. We will continue to watch this closely.

Our most preferred sectors are consumer staples, healthcare, and energy. Consumer staples and healthcare are both classic defensive sectors since consumer spending on things like toothpaste, diapers, soda, and pharmaceuticals tends to be fairly steady. And though energy has been a standout performer in 2022, we still see oil prices in the mid USD 70s/bbl as having more upside than downside potential due in part to a likely rebound of demand in China, Saudia Arabia's budgetary interest in a price above USD 80/bbl and potential US interest in refilling its Strategic Petroleum Reserve. Within cyclicals, we prefer global versus domestic segments, and we have downgraded financials to least preferred status and upgraded materials to neutral.

Although our discussion has focused mostly on the outlook for 2023, we know that most investors are in the equity market for the long term and (wisely) tend to look beyond the difficult-to-anticipate monthly twists and turns. Over the next decade, we think large-cap stocks can produce annual returns in the 6-9% range. This is certainly not bad and will likely be better than inflation and the bond market, but it is still on the lower end of the long-term average of about 9-10% for the equity market. With valuations slightly above long-term averages and earnings more than 10% above trend, we think it makes sense that forward returns will be a bit below normal.

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