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From Rates Fears in 2022 to Earnings Fears in 2023

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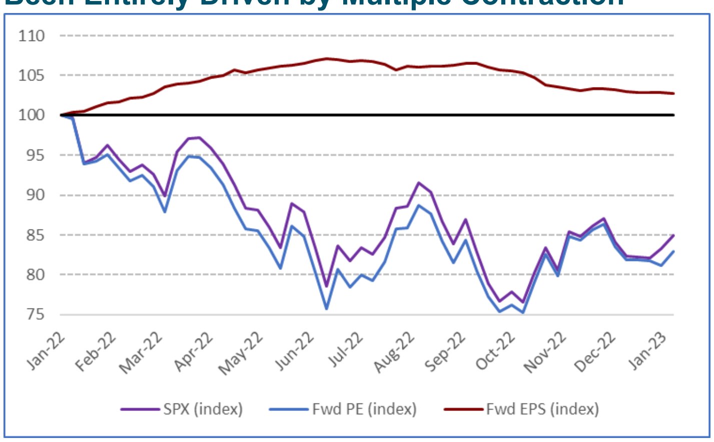
Results season kicked off this week and we believe earnings will be the key focus for investors during 2023. Last year everyone was almost exclusively fixated on the Fed, and rightly so, as higher policy rates drove significant multiple contraction. In a typical bear market, a lower multiple accounts for about 80% of the decline in the S&P 500. However, during 2022 earnings estimates actually rose, meaning lower valuations were responsible for the entire market decline (**Figure 1**). During 2023 we expect this situation to be reversed, with earnings returning as the key market driver.

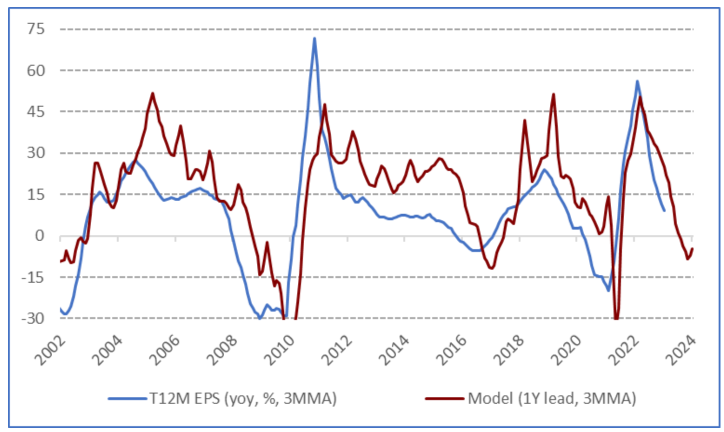
FIGURE 1 – U.S. Earnings Are Higher Now Than a Year Ago: The Market Decline Has So Far Been Entirely Driven by Multiple Contraction



Source: Bloomberg

We believe a recession this year is more likely than not, although we anticipate it being "short and shallow," with earnings falling by about 8% (**Figure 2**). While painful, this could be much worse – on average, earnings decline by 20% during recessions, with much larger air pockets occurring when funding markets freeze up (as happened fifteen years ago).

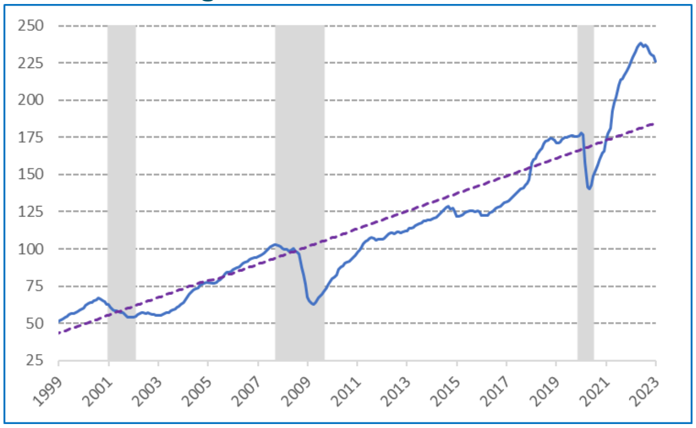
FIGURE 2 – S&P 500 Earnings Model: Suggests an 8% Decline This Year



Source: Bloomberg

A second downside risk stems from top-line growth and margins having been turbo-charged by the massive policy stimulus that accompanied the economy's reopening from early 2021. As a result, S&P 500 earnings surged to a record 30% above trend in mid-2022 (**Figure 3**). While this has moderated somewhat over the last few months, it still suggests a significant downside risk to earnings as we revert back toward the long-term trajectory.

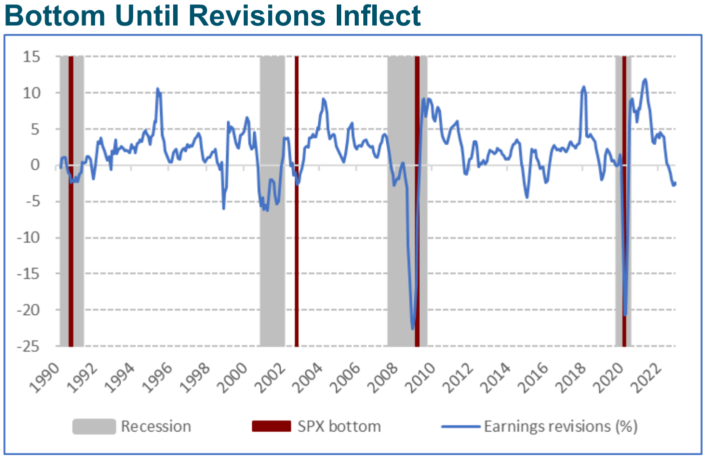
FIGURE 3 – Gravity Beckons: U.S. Earnings Was Turbocharged by Reopening Stimulus, and is Still Running 20% Above Trend



Source: Bloomberg
Note: EPS growth has averaged 6% over the last twenty-five years.

Earnings estimates are finally coming back down to earth, with revisions having turned negative in July (**Figure 4**). In a typical cycle, earnings revisions remain negative for 4-6 quarters, with equity markets usually bottoming about 3 months before revisions turn positive. Also note that, if we are headed toward a recession, since WWII the SPX has never bottomed before the downturn began.

FIGURE 4 – Earnings Revisions Turned Negative in July: Equity Markets Usually Don't Bottom Until Revisions Inflect



Source: Bloomberg

Implications for Investors

While 2022 was all about rate fears we believe 2023 will be all about EPS fears. This is not yet in the price as the bottom-up consensus is looking for 4% earnings growth this year. The outlook discussed above suggests equities will remain choppy for another quarter or two until the end of negative earnings revisions is in sight.