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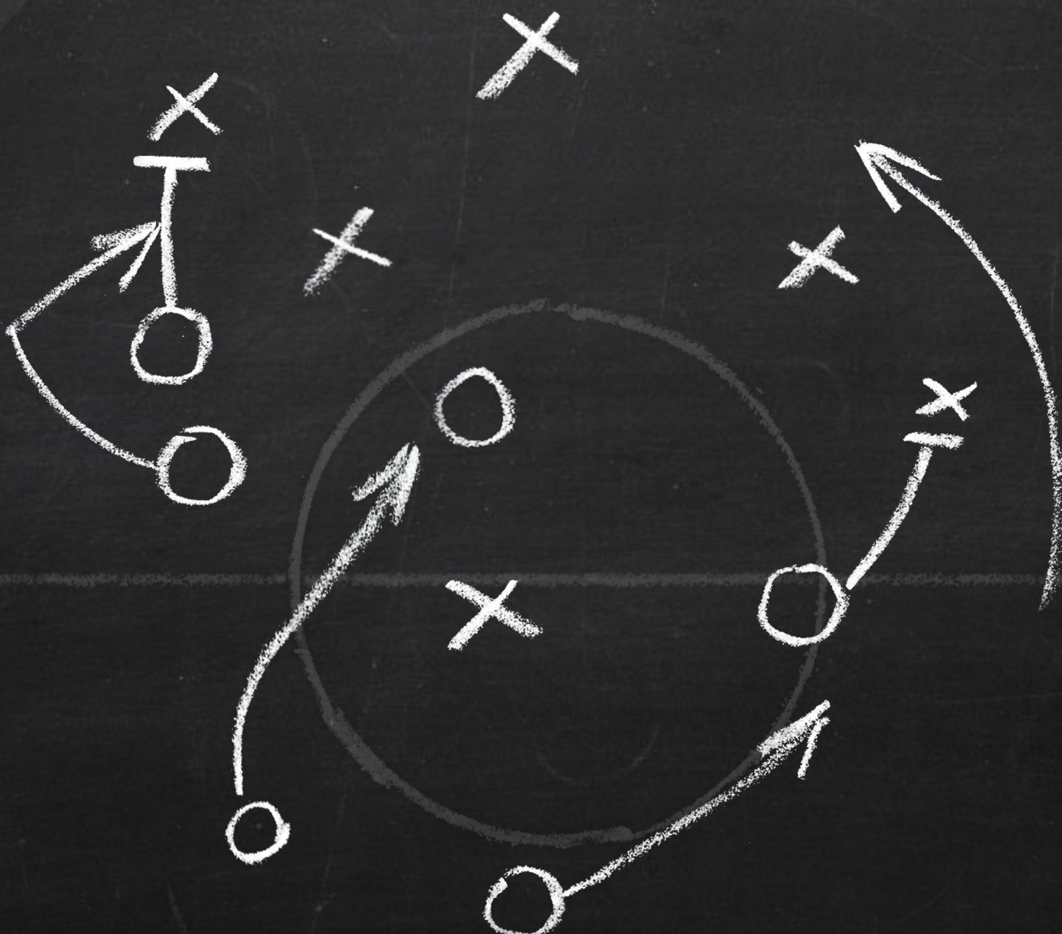
English Version



NOTE FROM THE CIO

The S&P 500 Reached Our Target, So Time for A Quality Shift

insigneo

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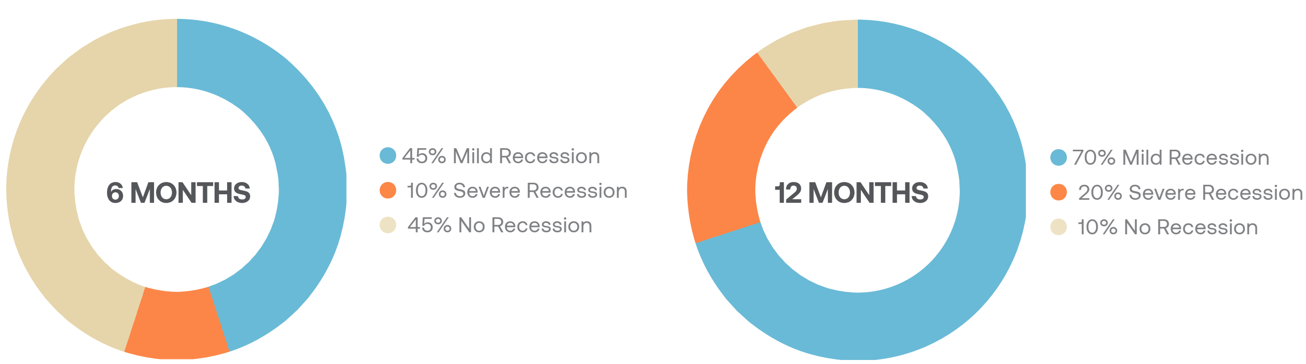
The S&P 500 Reached Our Target, So Time for A Quality Shift

• **US recession risk has receded in the near-term but remains elevated over a 12-month horizon.** According to our modeling, the probability of a mild US recession over the next six months has fallen from 50% to 45% due largely to a stabilization in the US banking sector. In addition, the firmness in the labor market continues to defy alternative measures of economic activity which are much weaker. Ultimately, we hypothesize that labor market data will converge with the softer economic data, rather than the other way around. Over the next 12 months, our proprietary recessionary probit model is signaling an exceedingly high chance of a US recession (>95%). Our overall subjective recessionary probabilities incorporating all factors, suggests that the probability that the US will enter a mild recession (i.e., the unemployment rate will breach 4% but remain below 6%) is at 70%. Our US real GDP forecasts for the year are unchanged at 1.1%. Bloomberg consensus forecasts have migrated to our US growth forecast throughout the year.

Subjective Recessionary Probabilities Over 2-Quarters & 4-Quarters Incorporating All Factors



Source: Insigneo

• **Recent US economic resilience also implies that the forward path of Fed rate policy remains more salient than many expected a few months ago.** At this point, the market has largely removed expectations for cuts in the Fed Funds rate this year and pushed it out to 2024, in line with the Fed's stated preferences and our own economic timeline. In fact, some have started to price the possibility that the Fed will pause in June only to raise rates by a quarter point again in July, although that is not our base case. Much of that repricing comes after surprise moves by the Australian and Canadian central banks which surprised markets over the past few days with unexpected rate hikes. It is premature, in our view, to extrapolate the Australian or Canadian domestic inflationary dynamics to the US. **Although progress on the disinflationary front has been slower than what the Fed would like, there is now sufficient deceleration across a broad array of indicators that suggest a disinflationary trend is indeed in place.**

— "Much of that repricing comes after surprise moves by the Australian and Canadian central banks which surprised markets over the past few days with unexpected rate hikes."

• With respect to China, investor sentiment remains negative, due to doubts regarding the robustness of the country's short-term growth momentum. There are also lasting concerns regarding longer-term issues like the Mainland's unforgiving demographic issues, Xi Jinping's increasingly state-centrist and command structure, a structural property market malaise, and permanent geopolitical tensions with the US. Although we harbor similar longer-term concerns and do believe that, overall, the Chinese equity market has become less attractive over the long run, we similarly think that the short-term concerns over growth have been overstated and overshot fundamentals. The data for May have already shown a reversal of the April weakness. In addition, there is some signaling from the government that further stimulus measures are forthcoming. Our forecast for 2023 real GDP growth in China is unchanged at 5.9%.

Market Implications

• For much of the year, we resisted the Wall Street consensus and subsequent investor pessimism to be underweight equities versus our strategic asset allocation bands. In our previous CIO Note (see here), we stated that "more defensive portfolio positioning will likely be necessary later this year." **With the S&P 500 reaching the upper band of our 4100 to 4300 target range, we think it is prudent to shift our portfolios more defensively by increasing our overall Quality-factor exposure.**

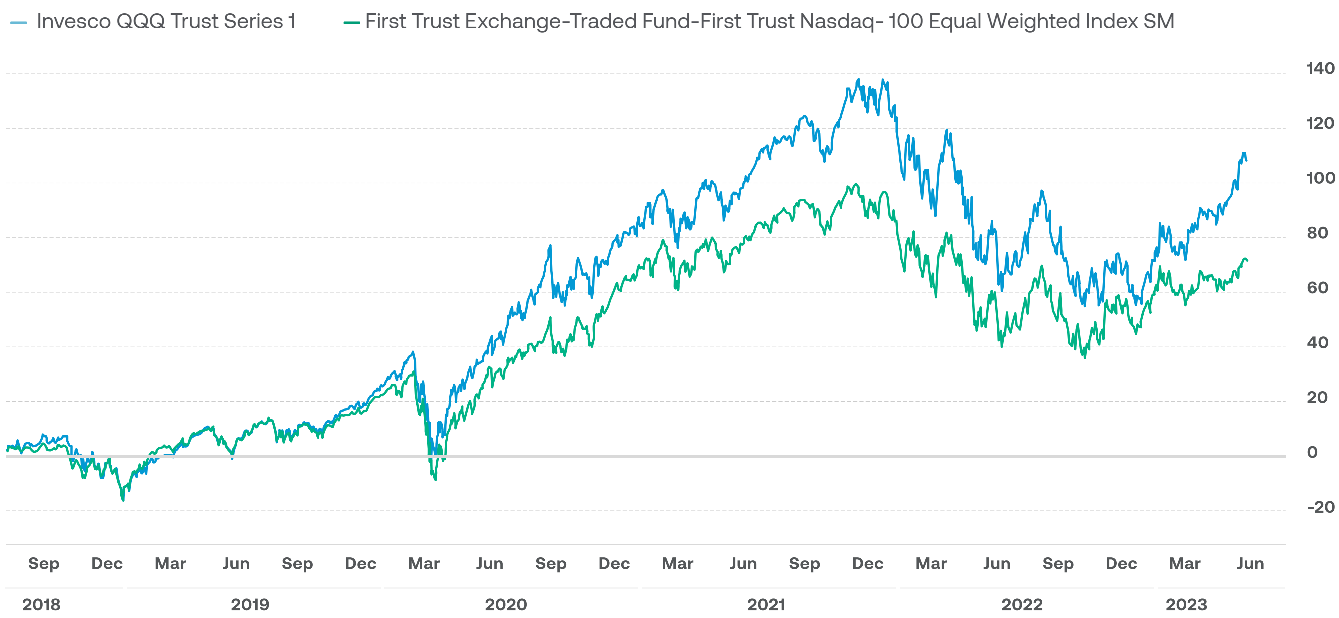
• With valuation levels high on both an absolute and relative basis, we think US broad market equity upside is fairly limited from current levels. At the same time, downside risk is fairly limited as well given the resiliency of the US economic growth landscape and the potential positive knock-on effects from the widespread adoption of large language models to enhance productivity.

• Recall that Quality-factor investing emphasizes both a company's profitability, as measured by return on equity, and its financial leverage, as measured by its debt to capital. **In an environment of slowing growth and higher-for-longer rates, companies with high factor exposure to Quality should outperform.**

• While the downside risk scenarios are fairly well understood (e.g., inflation reaccelerating, Fed policy

Short-term Trade Idea: Long QQEW vs. Short QQQ

Source: Bloomberg (as of 06/07/23)



mistake, a more severe recession, etc.), there is some considerable upside risk as well and it stems largely from an AI-driven productivity boom. So far this year, all of the gains in the S&P 500 have been driven by AI-linked stocks. In fact, if you strip the seven companies associated with the use, deployment, and/or development of large language models, the remaining index stocks (i.e., the 493 other companies that comprise the index) are marginally down for the year. In other words, market breadth is very narrow and argues for a reversal. That said, if investors begin to price productivity and profit boosts from AI, then the S&P 500 could trade even higher from current levels. And while we agree that the long-term productivity and profit-boosting potential of AI is significant and should be expected, there is little evidence in the macroeconomic data that AI has lifted productivity growth yet. **Investors may be getting ahead of themselves in pricing this in while ignoring the looming recessionary risks.** So, while we do acknowledge that the upside risk is there, we think it is too early to start meaningfully pricing it into EPS estimates. Additionally, the 1990s dotcom bubble taught us that productivity increased before resulting profits followed suit.

• Short-term Trade Idea: Earlier, we discussed the narrowing of market breadth described previously in the S&P 500 with gains materially disproportionately related to AI-linked stocks. This is true in the Nasdaq as well, and **a reversal of this trend makes for an interesting short-term trade idea where an investor goes long an equal-weighted Nasdaq 100 index fund and goes short the broader Nasdaq 100.** As this graph suggests, we have seen gaps like this reverse over time, as occurred in late 2020 and late 2021. ■

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