STRATIGRAPHIC ASSET MANAGEMENT, INC.

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Investment Outlook

It is axiomatic that investment managers should never "time the market,"[1] as it is an impossible task. The first half of 2023 was a painful object lesson for investors who were underweight in equities. Admittedly there were many reasons supporting a cautious stance: the possibility of a near-term economic recession; the continued downward revisions in 2023 earnings forecasts; persistent inflation at levels that render unrealistic the Fed's long-term objective of 2% per annum; the record low confidence of consumers, purchasing managers, and just about everyone else who has been recently polled; a seemingly hopeless fiscal situation, aggravated by virtually unbridgeable political divisions; and a worsening — potentially destabilizing — international situation with adversaries, China and Russia. Two strategists who had correctly forecasted the decline in equities in 2022 remained bearish: Mike Wilson of Morgan Stanley and Michael Hartnett of Bank of America. Hartnett in May reiterated his call "to sell U.S. stocks, saying that tech and artificial intelligence [stocks] are forming a bubble."[2] It must have been especially painful for him to watch the S&P 500 Index in June rise 6.5%. In the first half of 2023, the Index had a total return of 16.8% recovering around 75% of the losses experienced in 2022.

Although the Federal Reserve hiked the Federal Funds target rate three more times in the first half to the 5.00%–5.25% range, the yields on longer-term U.S. Treasuries and corporates did not rise. As a result, the total return on the Bloomberg U.S. Aggregate Bond Index, which experienced severe losses in 2022, turned positive in the first half, producing a 2.1% return. Currently the most attractive segment of the bond market is in short-term maturities that are yielding 4%–5% per annum. However, the inversion of the yield curve[3] suggests that these elevated short-term rates are not likely to persist.

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We expect few if any gains in the stock market over the balance of the year. Our views of the U.S. economy and corporate profits are moderately favorable.

U.S. Economic Outlook Is Neutral to Cautiously Positive. Compared to the economies of most other developed countries, the U.S. economy is performing very well. First quarter real GDP advanced at 2.0% per annum compared to 2.6% in Q4 of 2022. The consensus holds that Q2 real growth will decrease to 1.1%, with virtually no growth expected in the second half. Economic deceleration is underway as pent-up consumer demand from the pandemic wanes, consumer savings dissipate, the paying down of student loans restarts, and capped government outlays act as a drag on the economy. Bloomberg reports that most economists are forecasting a recession over the next 12 months.

[1] "Timing the market" refers to a short-term strategy of increasing or reducing equity exposure to take into account changes in the portfolio manager's assessment of the current investment outlook.
[2] "BofA Strategist Says Sell US Stocks as AI Seen Forming a Bubble," Bloomberg, May 19, 2023.
[3] A reference to long-term interest rates being abnormally below short-term rates.

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Our position: the economy will clearly slow and may even experience recession. But the danger of recession has been overblown by economists and caused investors to become too guarded. If a recession does occur, the downturn will be shallow and of short duration mainly because employment remains strong. Over the longer-term, U.S. growth will be slow but steady, projected at 1.5%–2.0% per annum.

Inflation Outlook Is Positive. Notwithstanding the complexity of the forces underlying U.S. inflation,[4] the direction of future price increases is quite certain. Last June, the Consumer Price Index (CPI) peaked at 8.9% per annum.[5] By December, the rate had declined to 6.4% and by May to 4.1%. The Bloomberg consensus of economists holds that the CPI will decline to 3.2% in the fourth quarter of this year and to 2.4% in the fourth quarter of 2024.

Our position: while these forecasts are subject to considerable error and may prove too optimistic, inflation is clearly declining. The annual rate may not fall back to the Fed's target of 2%, but more likely will settle in the 2.5%–3.5% range, which is very manageable for the large-capitalization corporations in which we invest.

Monetary Policy Outlook Is Neutral to Positive. It is amazing to consider that the Federal Reserve maintained the target interest rate for federal funds in the 0%–0.25% range for the two-year period ended March 2022, only three months before the Consumer Price Index peaked. The Federal Open Market Committee (FOMC) moved forcefully to correct its own policy mistake of not having responded sooner. Over the next 14 months, the federal funds target rate was hiked 10 times to its current level of 5.00%–5.25%. Recent deliberations of the FOMC suggest that two more rate increases are possible.[6]

Our position: if the trend in inflation deceleration continues as we expect, at most one further rate hike would be justified. However, the Powell Fed is likely to err on the cautious side since its reputation depends almost entirely on its success in taming inflation. Less important for now are the implications of higher interest rates tipping the economy into recession and the rapidly growing costs of servicing the expanding Federal debt. Our sense is that companies for the most part are performing reasonably well at the current level of interest rates as evidenced by the recovery in new home sales, car sales, and similar indicators.

Corporate Profits Outlook Is Positive. A major unknown in assessing equity markets is the extent corporate profits will disappoint in the current year. Standard & Poor's reported S&P 500 Index earnings last year at $197. Based on analyst surveys, the firm currently estimates 2023 corporate earnings at $218, which is significantly lower than the initial unrealistically high 2023 estimate of around $247 issued in March 2022. A further revision downward may be required. The most recent survey of leading strategists by Bloomberg released June 16 placed estimated earnings in 2023 at $210. Importantly, only 2 of the 22 estimates were below $200, implying that earnings this year will probably advance at a satisfactory mid-single-digit rate.

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[4] U.S. inflation is generally attributable to the dislocation in supply chains caused by the global pandemic, massive federal deficit spending to support businesses and their employees, and very low interest rates that stimulated excessive consumption.
[5] Consumer Price Index for All Urban Consumers: all items in U.S. city average, Bureau of Labor Statistics.
[6] Economic projections of Federal Reserve Board members (PDF), June 14, 2023. See dot plot, page 4.

Preliminary June estimates from Bloomberg and Standard and Poor's indicate double-digit earnings growth is probable in 2024. These forecasts may not be farfetched. Moderate inflation often confers pricing power on companies, enabling them to increase their prices by more than the increase in costs. As prices decline, businesses are understandably slow to adjust their prices to reflect lower costs. Core S&P 500 operating margin estimates have nearly recovered to their 2022 peak after declining over the past year. Contributing factors are falling import prices and the expansion of the spread between the consumer and producer price indices.[7] McKinsey regularly surveys corporate executive sentiment. In the most recent March survey, managers were more upbeat than in the previous three quarters as 63% of the companies surveyed are expecting profits to increase over the next six months.[8]

Our position: investors have been too negative concerning corporate profits, focusing more on downward earnings revisions rather than earnings growth. There is a high probability that earnings will increase in 2023 and experience some acceleration in 2024.

Market Outlook Is Neutral to Very Cautiously Positive. The 15.9% appreciation of the S&P 500 Index in the first half was driven by a small number of technology stocks. The rise in share price of the seven largest companies in the Index by market capitalization amounted to an astonishing 89.0%. The share price of the remaining 493 companies fell by around -4%. In short, portfolios that kept up with the market in the first half had to have meaningful technology exposure.

Table 1
S&P 500 Index Holdings, Weightings and Forward P/Es

	S&P 500 Index, Market Cap			S&P 500 Index, Equal Weight		
Company	Market Cap % of Total	YTD Appreciation	Forward P/Es	Equal Weight % of Total	YTD Appreciation	Forward P/Es
Apple	7.7%	49.2%	28.70	0.2%		
Microsoft	6.8%	42.0%	30.45	0.2%		
Amazon	3.1%	55.1%	36.30	0.2%		
Nvidia	2.8%	189.5%	41.10	0.2%		
Alphabet	3.6%	36.3%	22.00	0.2%		
Tesla	1.9%	112.5%	58.20	0.2%		
Meta	1.7%	138.5%	17.80	0.2%		
Sub-Total	27.6%			1.4%		
Average		89.0%	31.70			
All Other	72.4%	-3.9%	13.30	98.6%		
Total Index	100.0%	15.9%	18.40	100.0%	6.0%	14.59

Source: Bloomberg

[7] "Inflation is suddenly margins' best friend," Adams and Wolff, Bloomberg Intelligence, June 20, 2023.
[8] McKinsey & Company, "Survey results: Expectations for company performance, by industry," May 1, 2023.

When performance depends on the appreciation of a narrow base of securities, it stands to reason that any adjustment in the same stocks would negatively impact market performance. Indeed, the forward multiples based on estimated 2024 earnings of the seven technology stocks is currently around 31.7x or about twice the 25-year average of the S&P 500 Index forward P/E of 16.8x.[9] While there is risk in these stocks owing to their valuation, it is worth noting that the average P/E of the remaining 293 stocks is estimated at only 13.3x, which suggests that many may be undervalued and could have attractive appreciation potential. John Authers of Bloomberg recently pointed out that "market gains have historically been prevalent once stellar runs by the five largest stocks have ended, with the S&P 500 rising 6.7% on average in the subsequent six months."[10]

Additional insight is provided by looking at the S&P 500 Index on an equal-weighted basis, in which every company in the Index has the same weighting of 0.2% (1/500). The year-to-date returns are positive at 6.0%, but most importantly the average forward P/E on 2024 earnings is 14.6x. On this basis the market does not appear to be overvalued. The challenge is to make the case for holding high valuation technology companies.

One final point supporting common stocks exposure — there is evidence that in 2023 institutional and high-net-worth individual investors have been significantly underweighted equities. A Bank of America survey conducted in early June indicated that equity allocations had been cut to a five-month low.[11] Capgemini, an investment consulting firm, recently reported that in January 2023, the equity holdings of high-net-worth individuals had declined to only 23% of total portfolios while cash and equivalent increased to 34%.[12] Money market assets are currently at record levels. It makes sense that the stock market will benefit as portfolio managers restore their equity allocations.

Our position: the appreciation of equities in the second half will likely be limited. While the short-term market outlook of the tech leaders is a question mark, investors should bear in mind their sound financial positions, solid earnings prospects, and attractive long-term potential. The shares of other companies which are priced at reasonable valuations offer moderate stock price appreciation potential.

Long-Term Considerations Favor Over-Weighting Technology

U.S. Growth Dilemma. Over the long-run, U.S. common stock prices will depend on the rate of real growth of the United States, which in turn significantly influences corporate profits. Most forecasts estimate long-term growth around 2% or less. The highly regarded Congressional Budget Office (CBO) projected the real annual growth rate of U.S. GDP at 1.8% between 2023 and 2033, declining to 1.6% per annum between 2034 and 2043, and 1.5% between 2044 and 2053. These averages compare with the considerably higher 2.4% annual real rate of growth achieved between 1993 and 2022. The CBO points out that slower growth is a function of the declining growth rates in the labor force and productivity, the two components that determine GDP growth.[13] See below, Table 2.

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[9] JPMorgan, "Guide to the Markets U.S. 2Q 2023," as of March 31, 2023, page 5.
[10] "Is Narrow Breadth Bad Breadth?" John Authers, Bloomberg, May 31, 2023.
[11] "Investors Cut Cash and Stock Allocation, BofA Survey Shows," Michael Msika, Bloomberg, June 13, 2023.
[12] Capgemini, World Report Series 2023 (PDF), Wealth Management, June 2023, page 5.
[13] The 2023 Long-Term Budget Outlook, Congressional Budget Office, June 2023, see Figure 3-3.

Labor force growth in the United States is being adversely affected by an increasingly aging society and declining fertility rates that are approaching the minimum level necessary for a generation to replace itself. According to the CBO, beginning in 2042, immigration will account for all of U.S. population growth. Given the current state of U.S. immigration policy and government dysfunction, it seems likely that the flow of legal immigrants will be insufficient to supply our country's future labor requirements.

This means that the fate of our economic growth will depend on raising the level of productivity. Data on U.S. productivity shows that in the post-World War II period, U.S. labor productivity has been in a steady decline from 3%–4% per annum in the 10 years following the war to 1.6% in the last 20 years. As Table 2 indicates, the CBO forecasts assume that productivity will continue to decline over the next 30 years.

Table 2
Congressional Budget Office
Annual Average Growth of Real Potential GDP and Its Components

Real Potential GDP Growth= Potential Labor Force Productivity Growth + Potential Labor Force Growth

	1993-2022	2023-2033	2034-2043	2044-2053
Real Potential GDP	2.4%	1.8%	1.6%	1.5%
Potential Labor Force Growth	0.8%	0.4%	0.3%	0.2%
Potential Labor Force Productivity	1.6%	1.4%	1.3%	1.3%

Source: CBO, The 2023 Long-Term Budget Outlook, June 2023

Robert Gordon of Northwestern University has studied U.S. productivity in depth. He regards the 250 years from 1750 to 2000 as unique and that "economic growth was a one-time-only event." The high productivity and economic growth during this period were attributable to major inventions including the steam engine, cotton spinning, railroads, electricity, the internal combustion engine, even running water and indoor plumbing! Gordon noted that the impact of the computer and the Internet on productivity over the last 40 years has not been nearly as consequential, in part because entertainment and communication devices did not fundamentally change labor productivity or the standard of living.[14] (No argument here!)

Artificial Intelligence (AI). The essential question: will this technology be transformational to the point that it could significantly raise the level of U.S. productivity leading to markedly higher growth in the economy and personal incomes than current forecasts provide? Goldman Sachs recently estimated that productivity growth could be boosted by AI on the order of 1.5 percentage points over a 10-year period to around 3.0% per annum or nearly double the CBO forecast. An increase of this amount would be huge. Based on its forecast of AI's impact on corporate earnings, Goldman

[14] "Is U.S. Economic Growth Over? Faltering Innovation Confronts the Six Headwinds," National Bureau of Economic Research, Robert J. Gordon, August 2012. His *Rise and Fall of American Growth* (Princeton University Press) is considered a seminal study on U.S. productivity.

Sachs estimated that the fair value of the S&P 500 Index should be about 9% higher — 4800 compared to the mid-June level of 4400.[15]

McKinsey in June released a detailed study estimating the total potential impact of AI on the global economy at $17.1 to $25.6 trillion.[16] This compares with the size of the global economy in 2022 of around $100 trillion.[17] The point is that these numbers are not trivial.

Other studies have published some amazing statistics. One calculated that the amount of computing power used for machine learning in AI systems has been doubling every six months over the past decade. The capabilities of generative AI systems have grown in tandem, allowing them to perform many tasks that used to be reserved for cognitive workers, such as writing well-crafted sentences, creating computer code, summarizing articles, brainstorming ideas, organizing plans, translating languages, writing complex emails, and much more. Not only can output per worker be boosted in real world settings, but there is evidence that AI can accelerate innovation, which could be the major driver of future productivity gains.[18]

Every major corporation in the United States is now exploring how AI can be adopted to transform its business. Obviously, no one knows how AI will play out, but there is little doubt that this new technology will be transformational and impactful at the society and company levels. The valuations of the technology companies that seem to be leading the development and application of AI are very high, but the opportunity to participate in AI seems to be worth the investment risks involved.

The Bottom Line

We are staying the course — maintaining equity exposure at peak levels with an overweighted position in technology shares.

Alan S. Bernstein

[15] Goldman Sachs *Briefings*, June 16, 2023.
[16] "The Economic Potential of Generative AI: The Next Productivity Frontier," McKinsey & Company, June 2023. See Exhibit 2. What is noteworthy about this study is that McKinsey looked at specific uses/applications where AI could create meaningful value.
[17] Statista, "Global gross domestic product" (run cursor over blue line in chart to reveal annual amounts).
[18] "Machines of mind: the case for an AI-powered productivity boom," Baily, Brynjolfsson, Korinek; Brookings, May 10, 2023.