

MacroResearchBoard



Independent Investment Strategy

# Positioning In A Late-Cycle Environment

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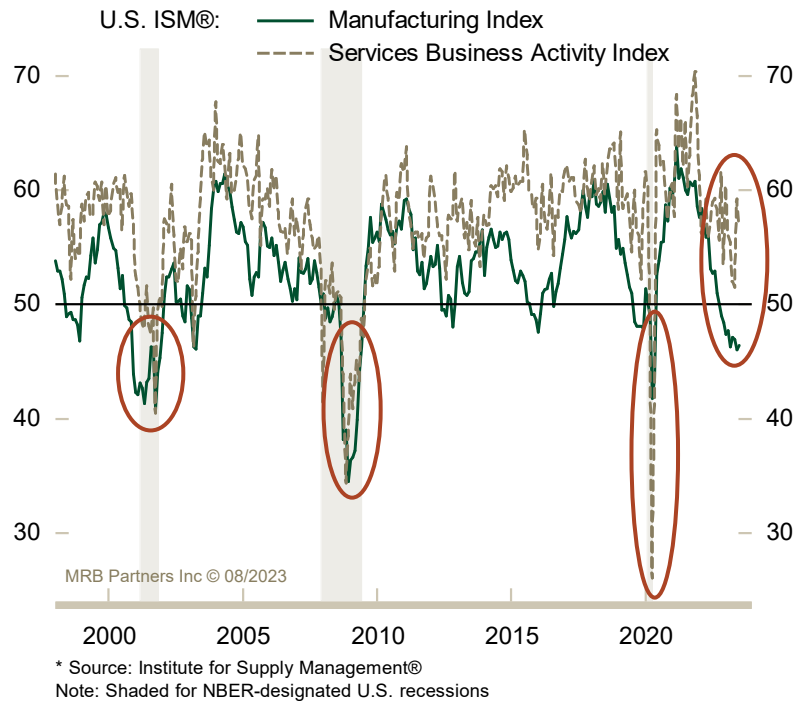
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## Main Highlights

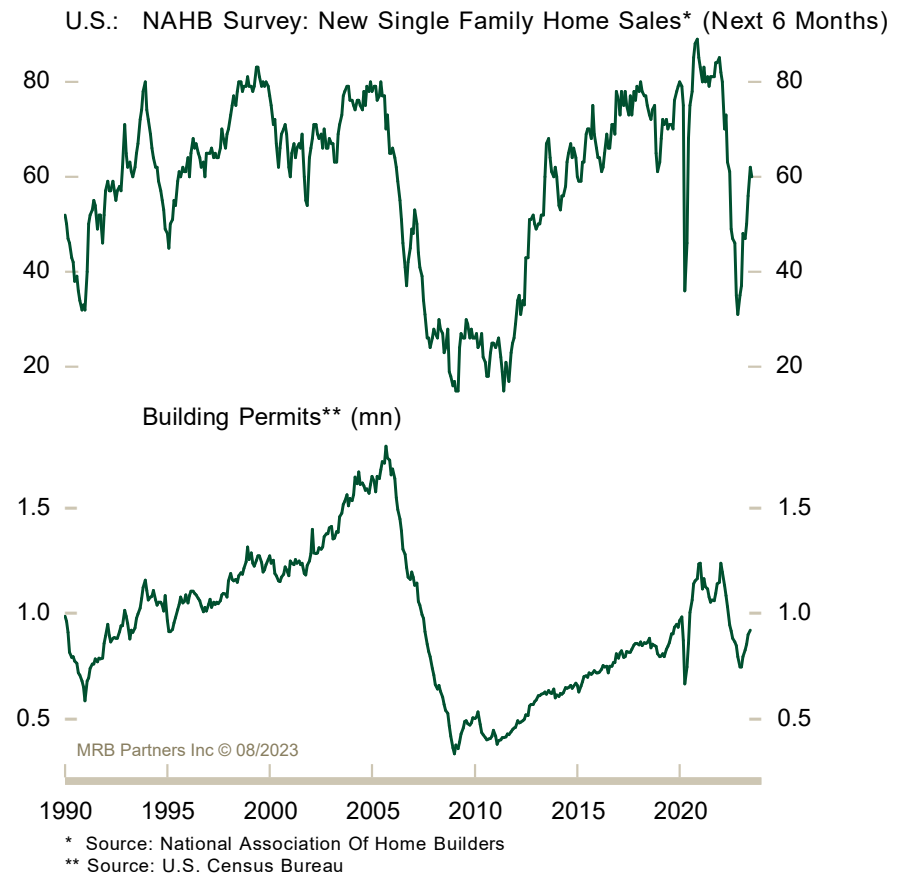
- We remain constructive on the economic outlook, but the macro backdrop is consistent with late-, rather than early-cycle conditions.
- Resilient global growth should support risk assets. However, the uptrend in equity prices is dependent on the bond market remaining calm.
- The deceleration in inflation will cap bond yields in the near run, but we expect the underlying uptrend in long-term interest rates to resume as expectations of Fed rate cuts unwind in the face of ongoing economic resilience and a levelling off in inflation later this year.
- Desynchronized elements of the economic and earnings cycles warrant a more selective and idiosyncratic approach to positioning portfolios.
- We remain advocates of maintaining a balanced investment stance, favoring a mix of defensive equities and selective cyclical stocks with the potential to deliver upside earnings surprises and ample valuation cushions.
- The year-to-date rally in technology stocks has been mostly driven by sentiment, rather than an improvement in underlying fundamentals. We are leery of chasing the move and expect laggard sectors to play catch-up for the balance of the year.
- Preferred sectors: financials, health care, communication services.

# U.S. Economic Growth Has Been Resilient

- Manufacturing and services sentiment have diverged, but remain above recessionary levels

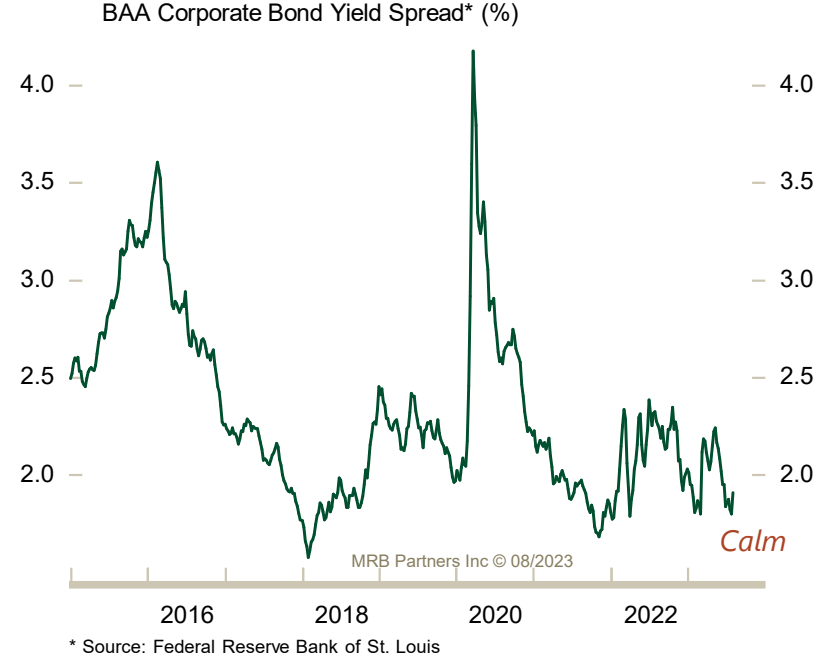
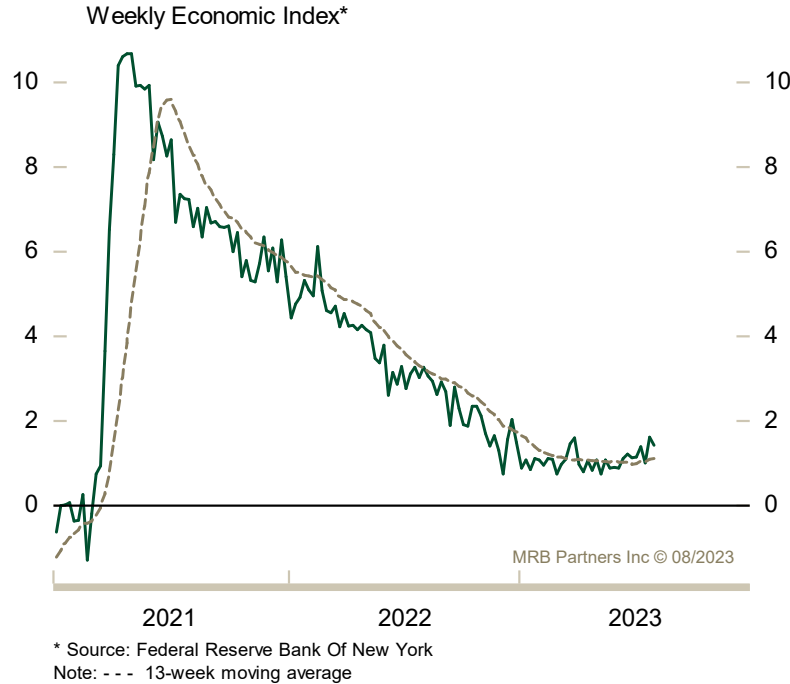


- Housing activity has bottomed out



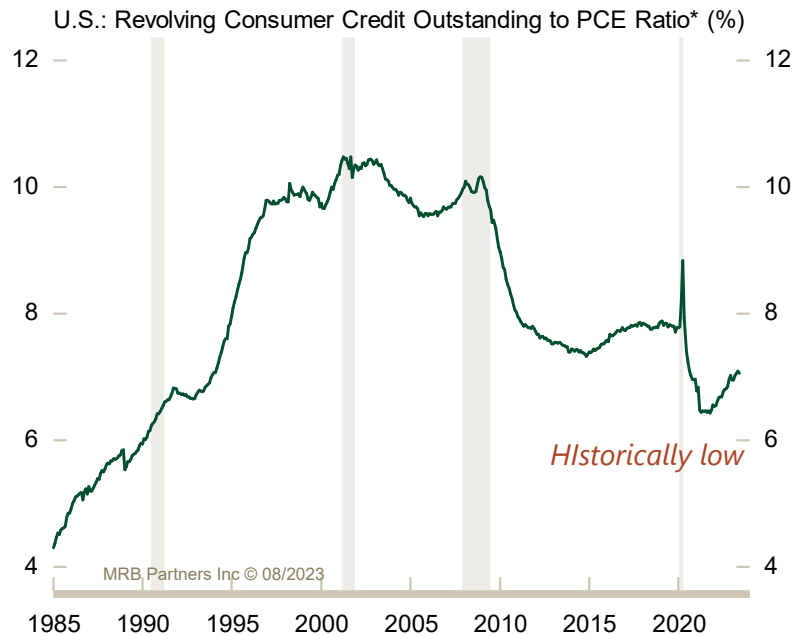
# High Frequency Indicators Signal That The Economic Expansion Is Continuing

- The Weekly Economic Index has a positive reading
- Corporate bond spreads have recently narrowed



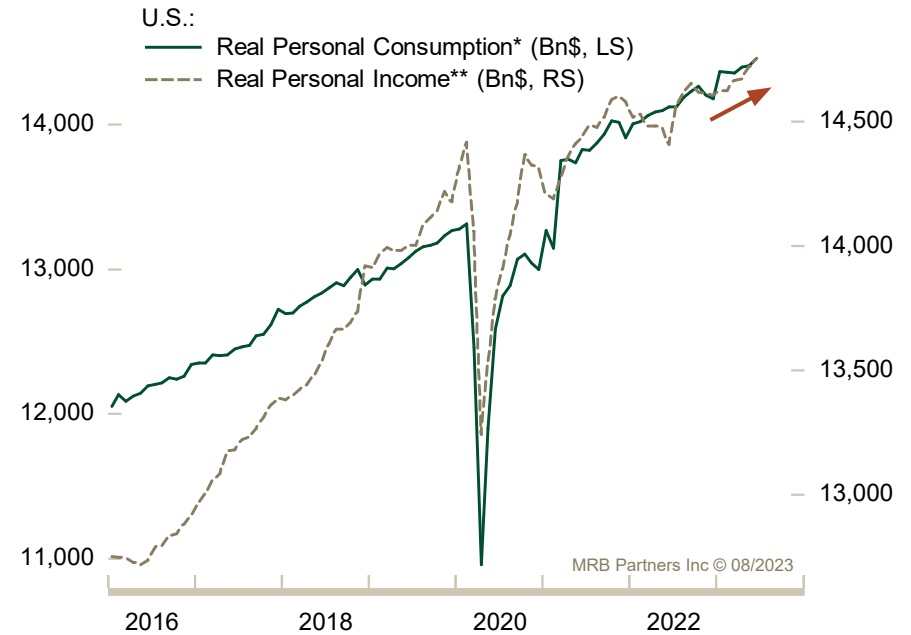
# The Prospects For Consumption Remain Solid

- Loan balances-to-spending are historically low



\* Source: Federal Reserve & U.S. Bureau of Economic Analysis  
Note: Shaded for NBER-designated U.S. recessions

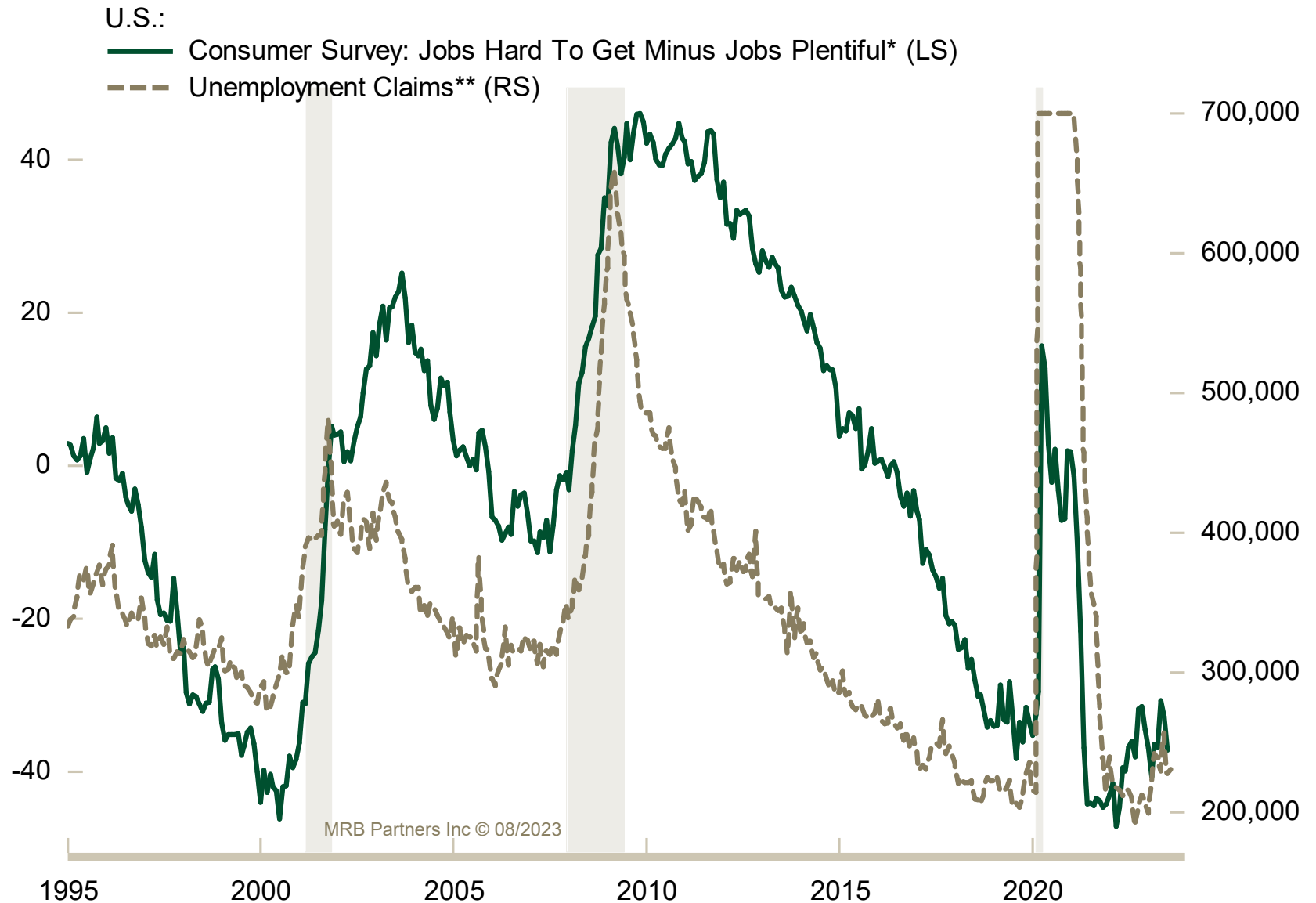
- As inflation moderates, real income growth should improve, thereby supporting consumption



\* Source: U.S. Bureau of Economic Analysis

\*\* Excluding current transfer receipts; source: U.S. Bureau of Economic Analysis

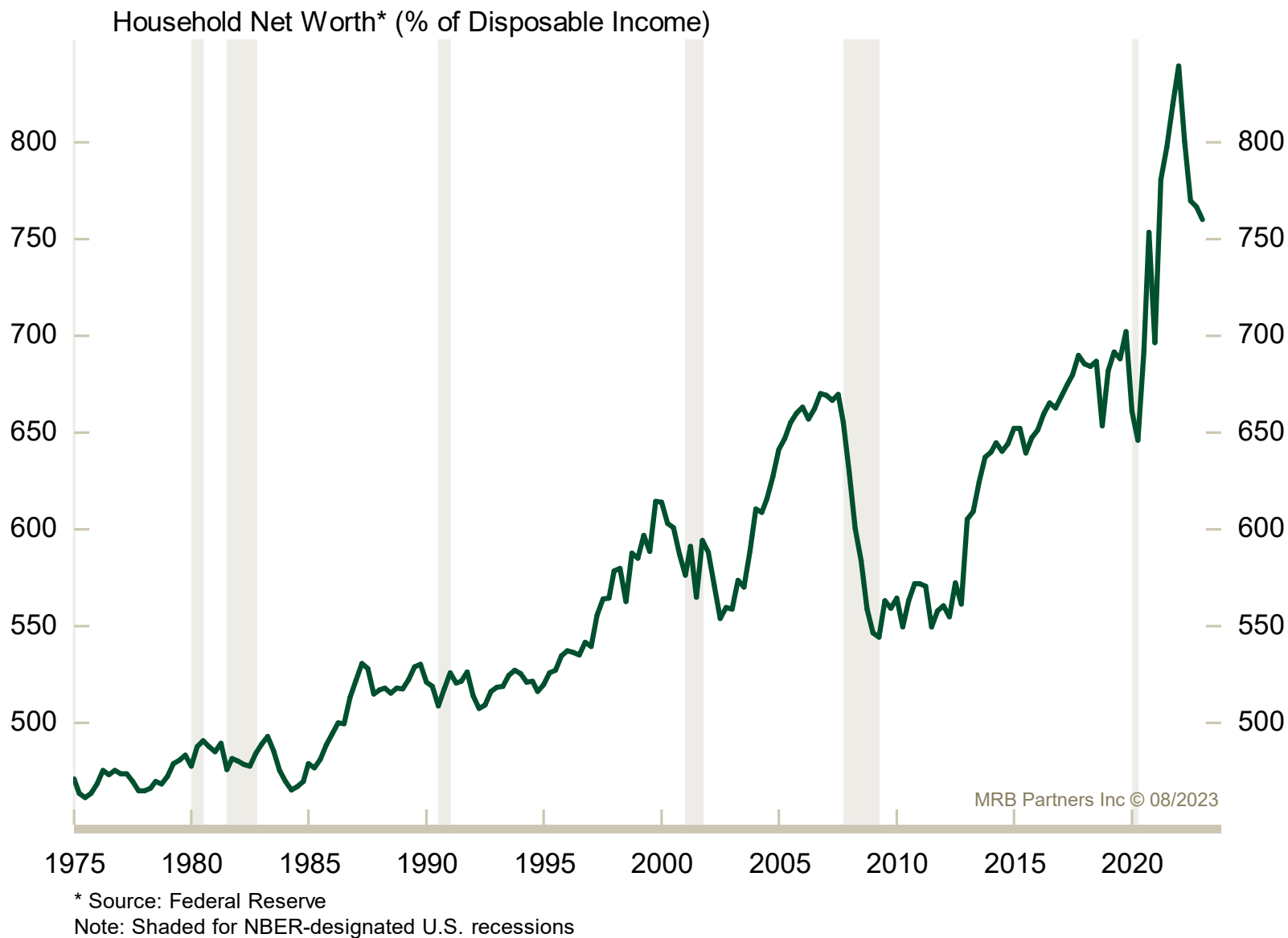
# Consumer Sentiment Is Not Pointing To A Major Deterioration In Labor Demand



\* Source: The Conference Board

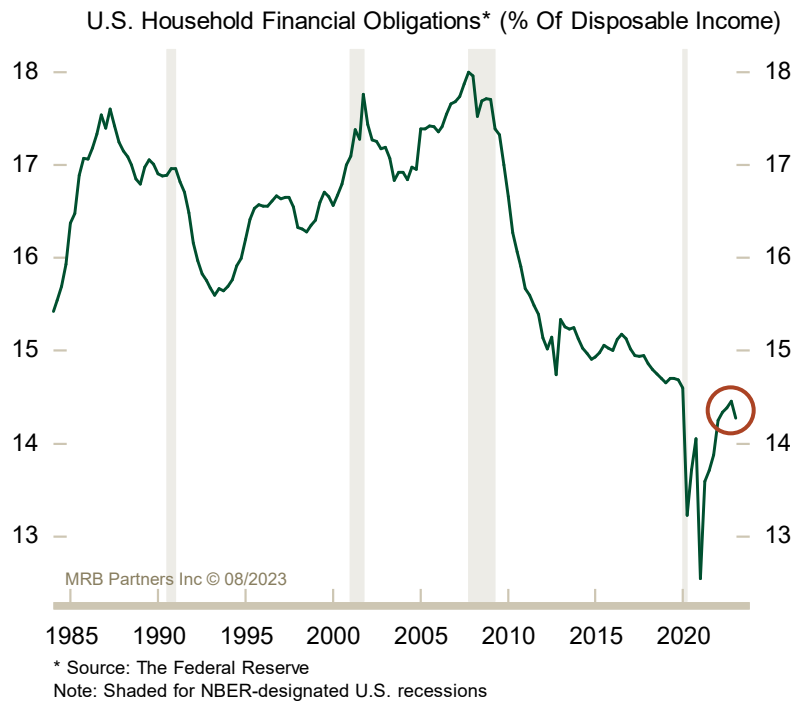
\*\* Truncated at 700,000; 4-week moving average

# Households Have Benefited From A Positive Wealth Shock Since The Pandemic Lows

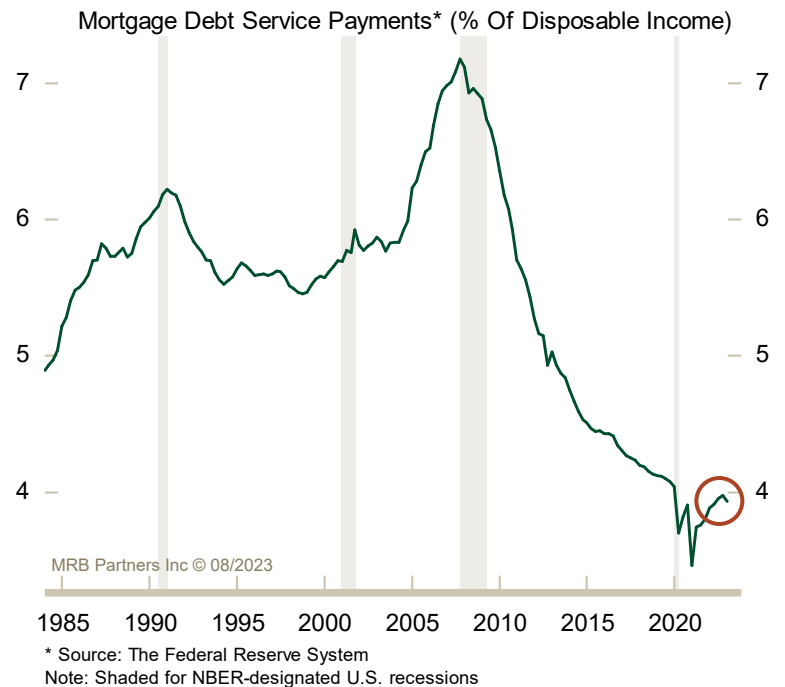


# The Fed Is Not Crimping Households

- Debt service burdens are still low by historical standards

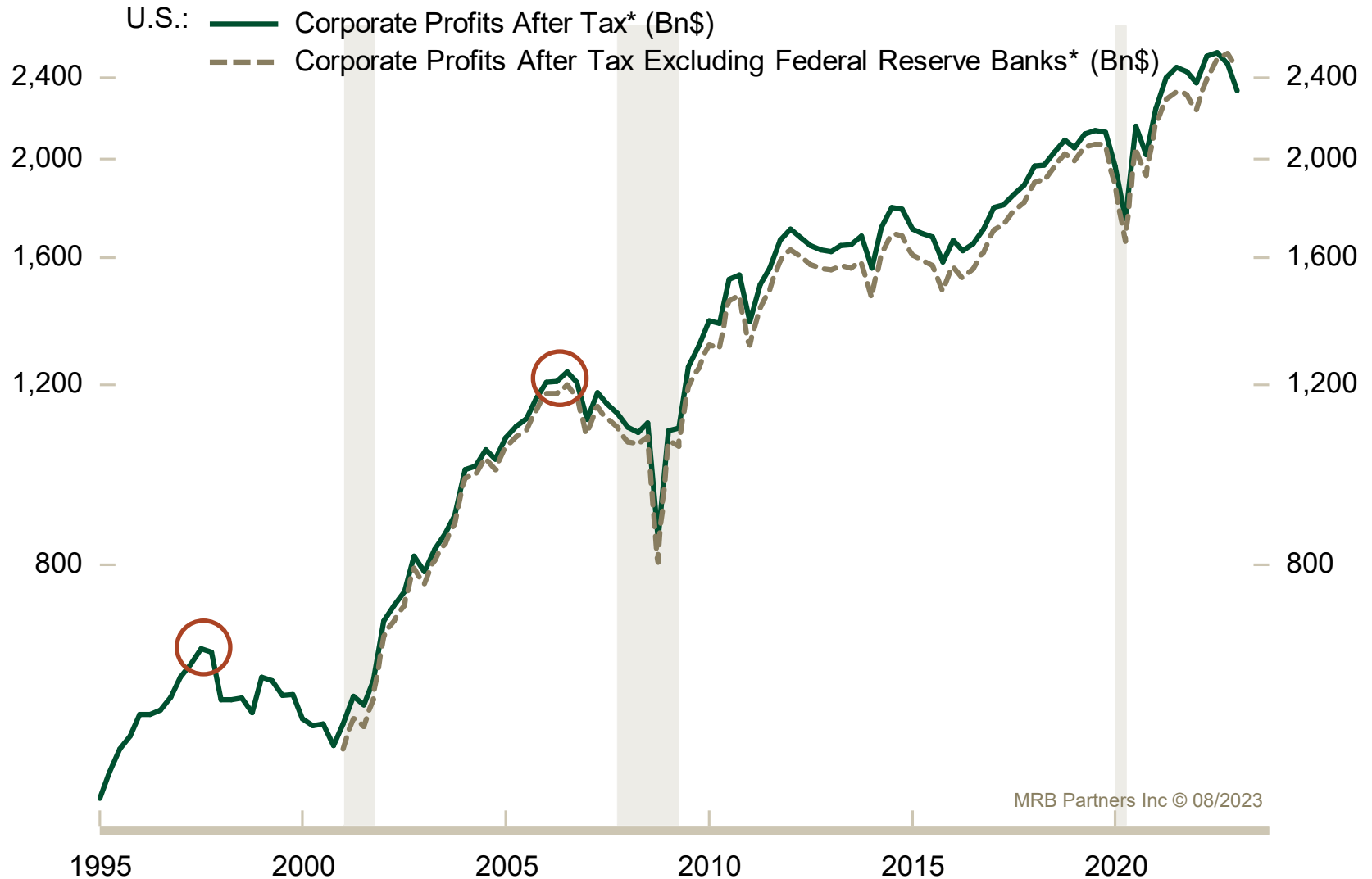


- Mortgage debt service payments are manageable



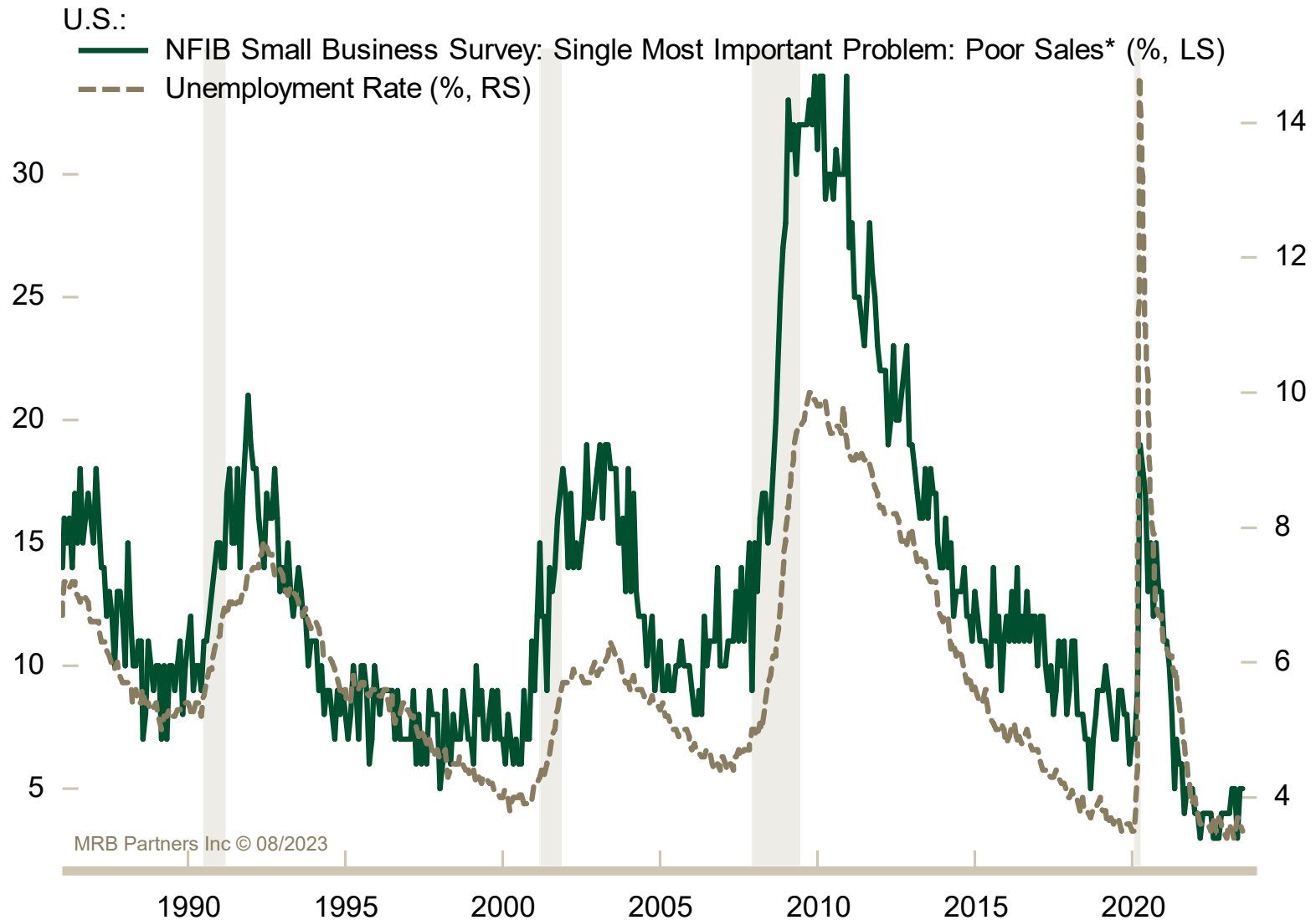


# Corporate Profits Are Showing Tentative Signs Of Rolling Over



\* With inventory valuation adjustment (IVA) and capital consumption adjustment (CCAdj); source: U.S. Bureau of Economic Analysis

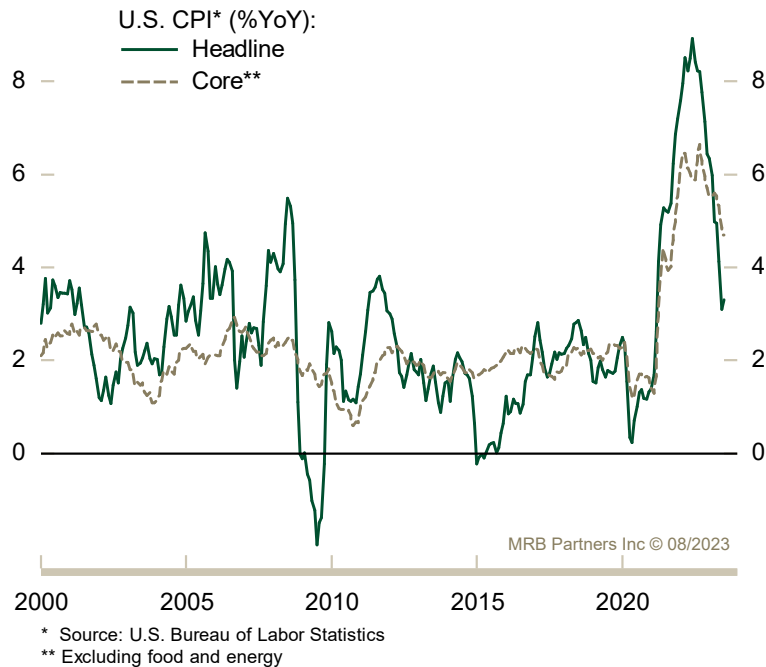
# Companies Usually Do Not Cut Costs Unless Their Sales Prospects Deteriorate



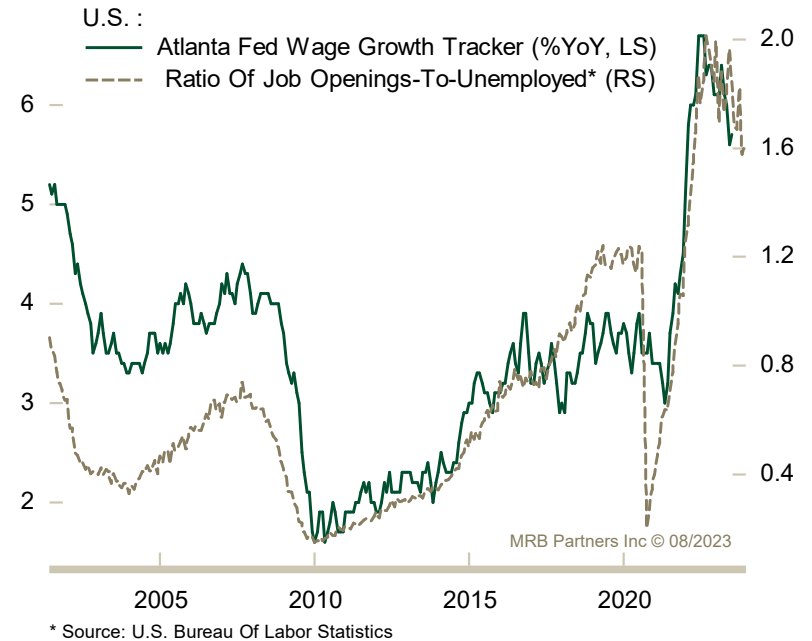
\* Source: National Federation of Independent Business  
 Note: Shaded for NBER-designated U.S. recessions

# The Fed Will Have To Hold The Policy Rate Higher For Longer

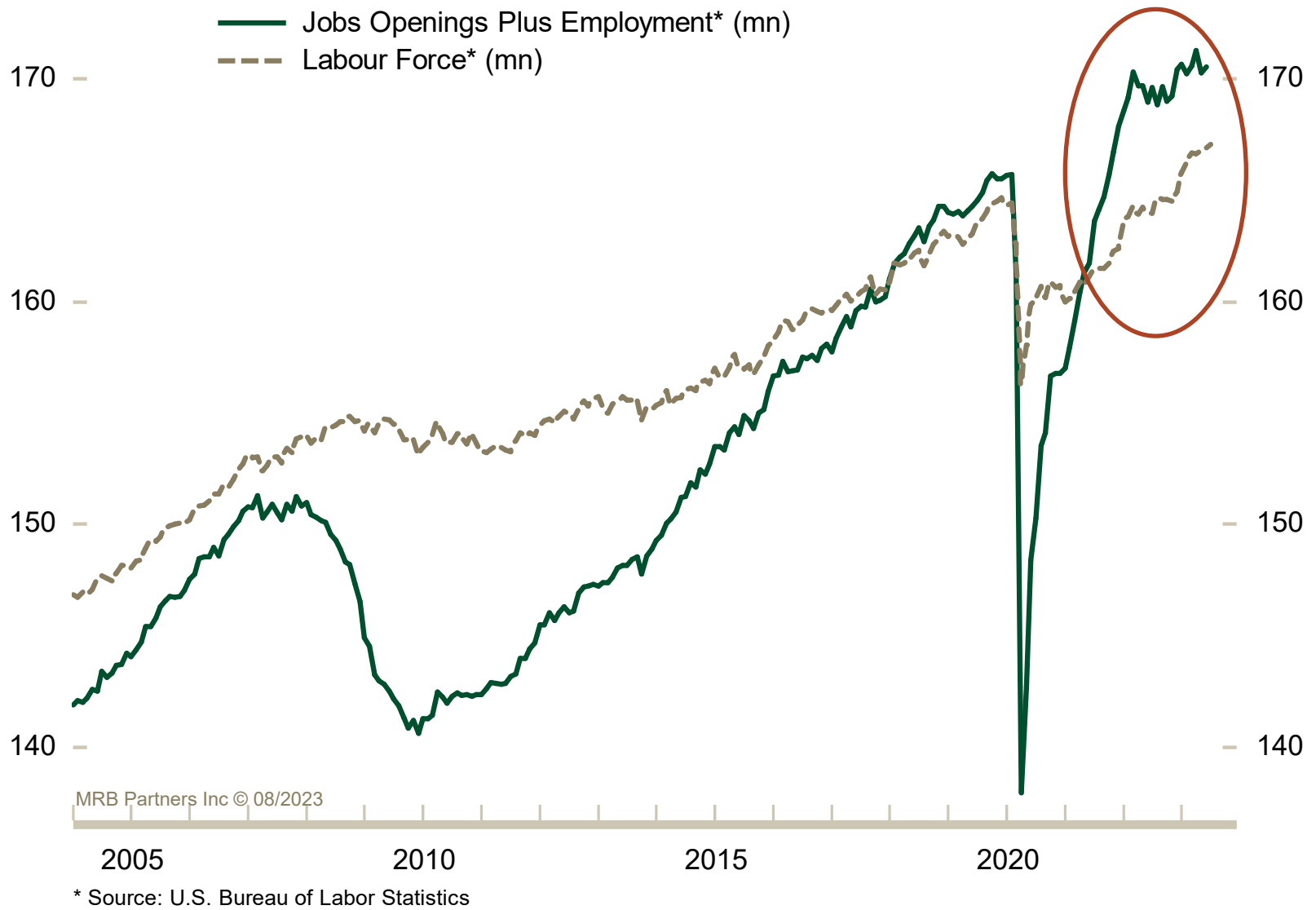
- Headline and core inflation have moderated



- ...but the tight labor market will keep a higher floor under wages and core CPI

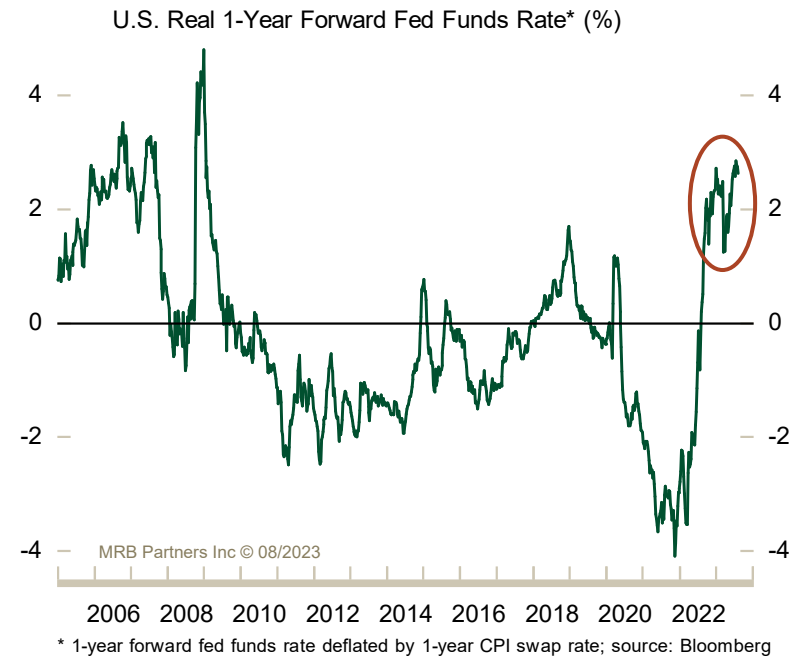
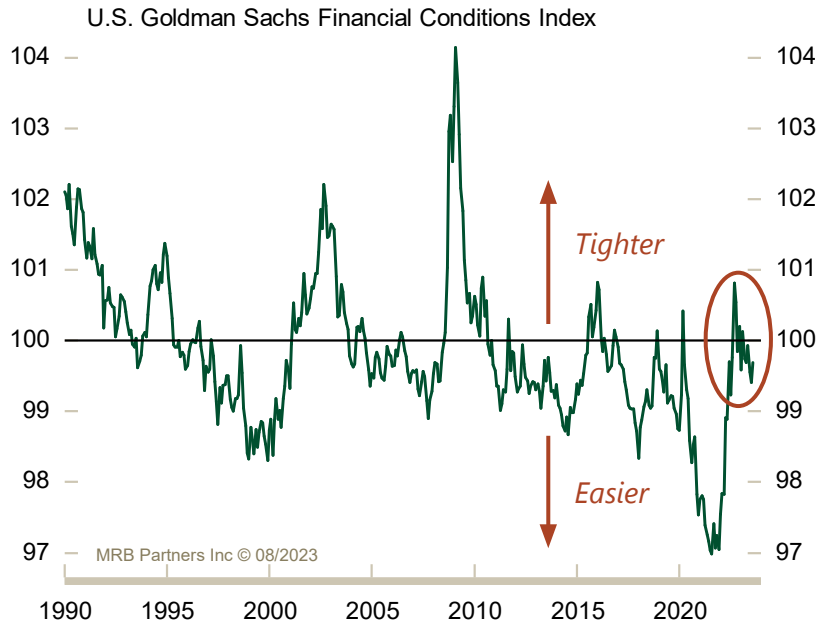


# Labor Demand Exceeds Labor Supply

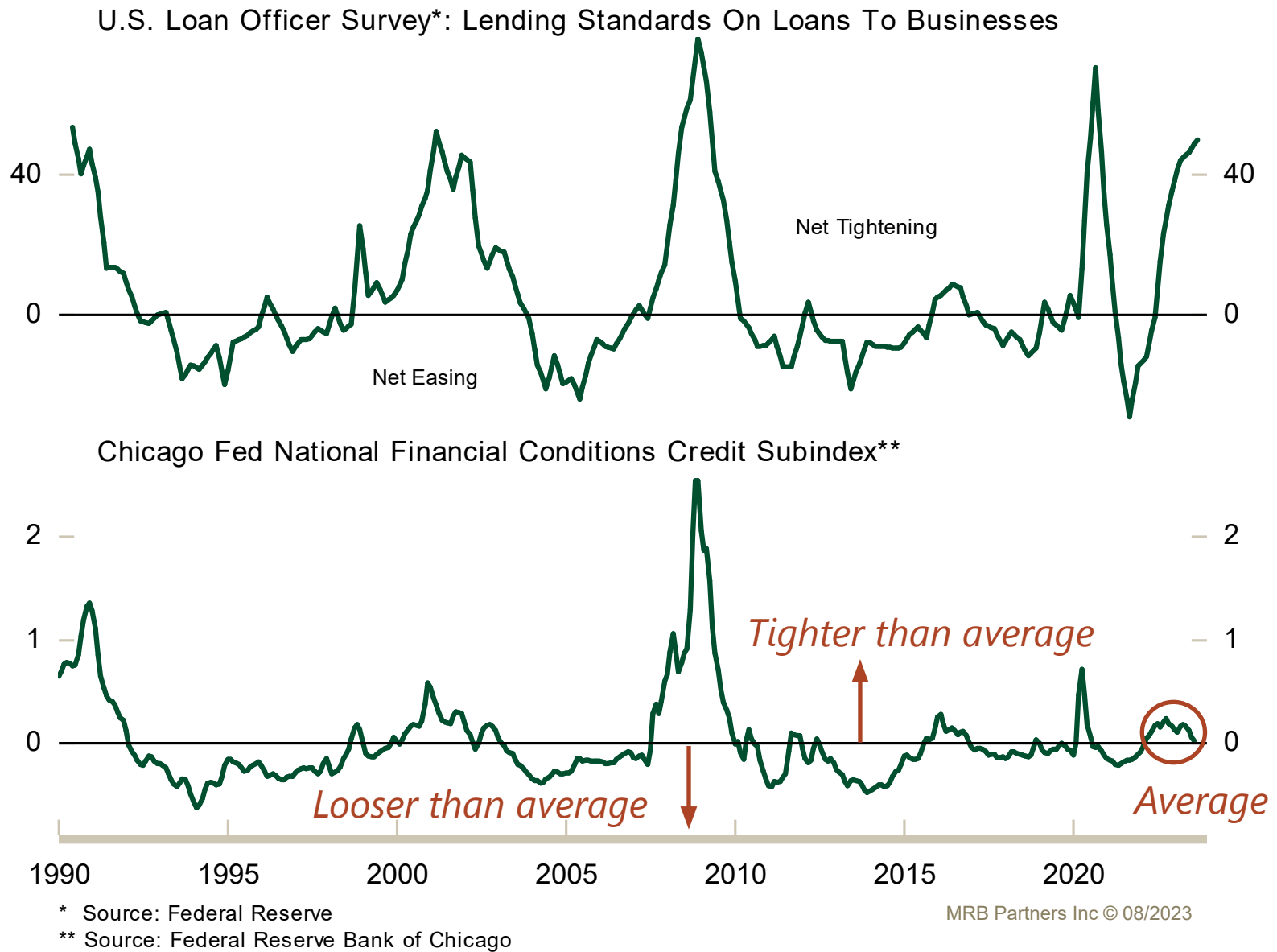


# Monetary Policy Is Not Highly Restrictive

- Financial conditions never got super-tight and have recently eased
- The one-year forward real policy rate is only moderately elevated by historical standards

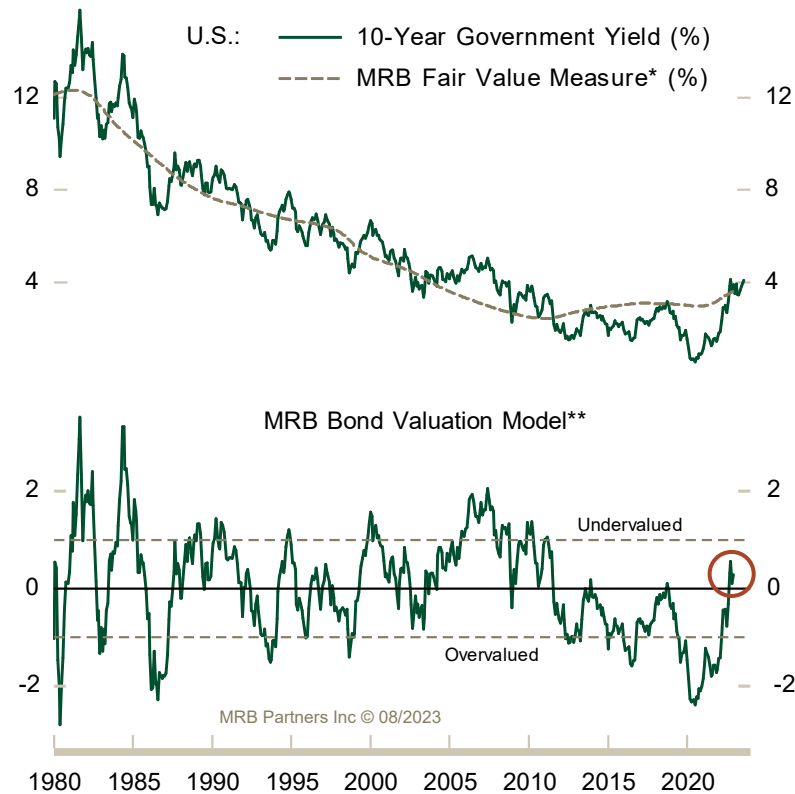


# The Senior Loan Officer Survey Looks Like An Outlier



# Bond Valuations Are Not Compelling

- Bonds have only returned to roughly fair value



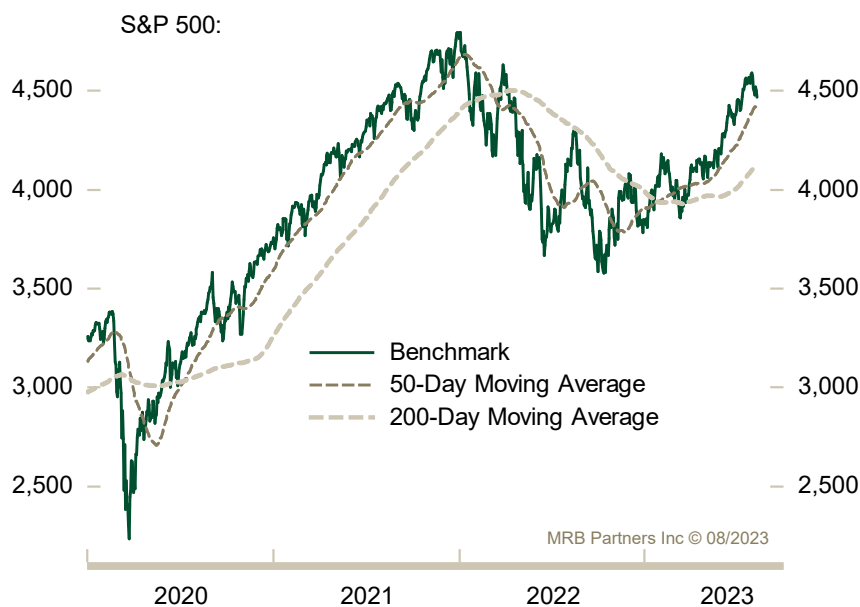
\* Includes long-term economic growth and inflation measures  
 \*\* 10-year government bond yield minus MRB Fair Value Measure

- The market is extremely confident about inflation returning to roughly 2.0%



# The Technical Picture For Stocks Is Positive

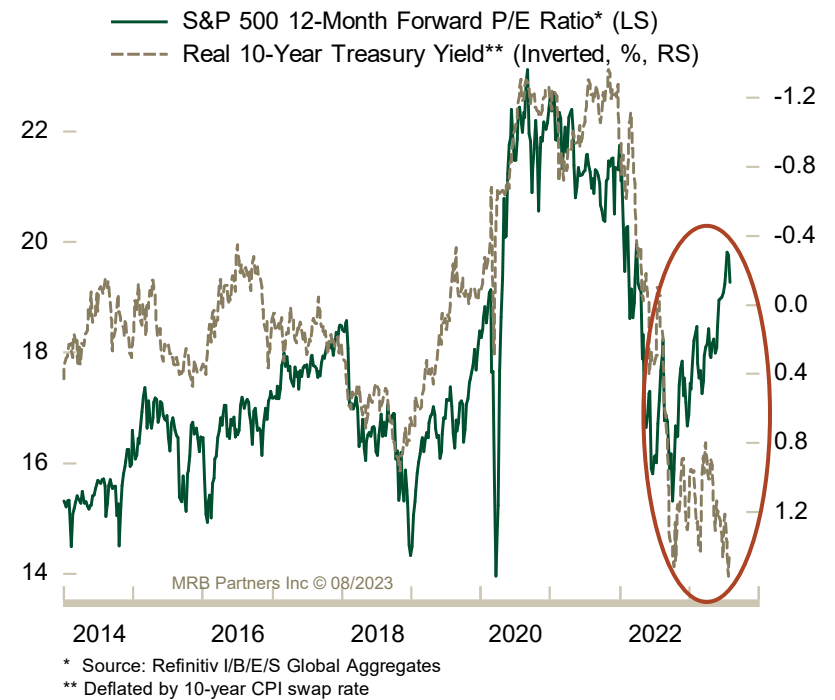
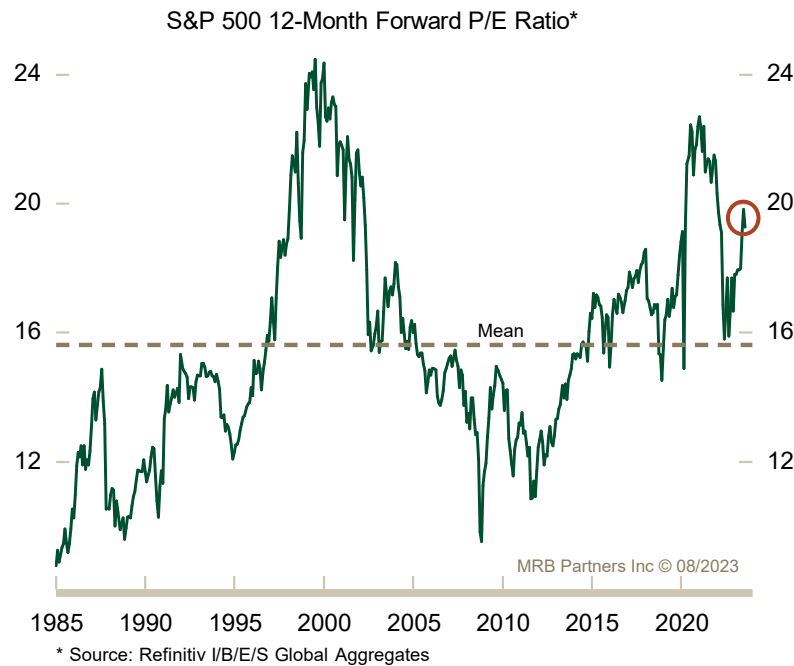
- Stocks have been in a clear uptrend since the market low in October 2022
- Breadth has recently improved, with the average stock catching up





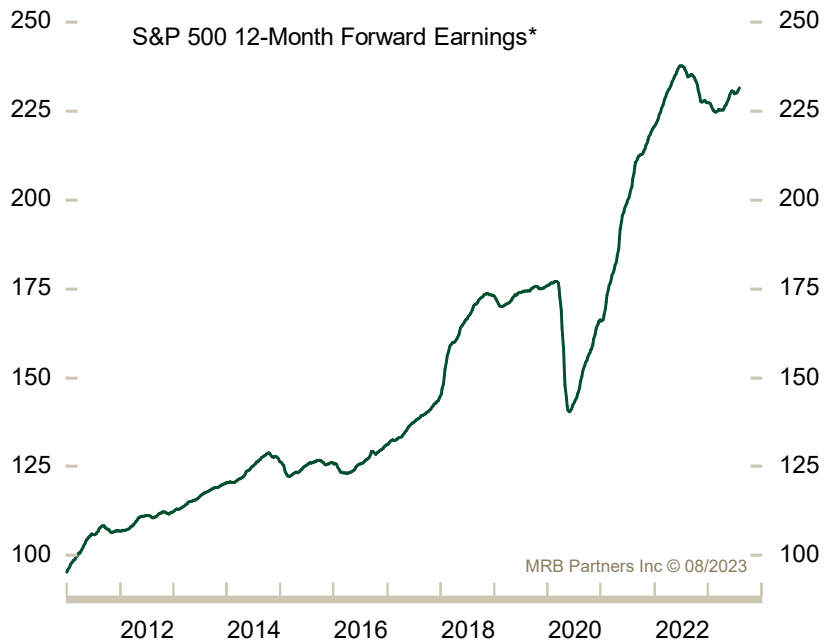
# The Equity Market Is Priced For A Lot Of Good News

- The forward P/E multiple has seldom been higher
- Valuations have recently diverged from interest rates

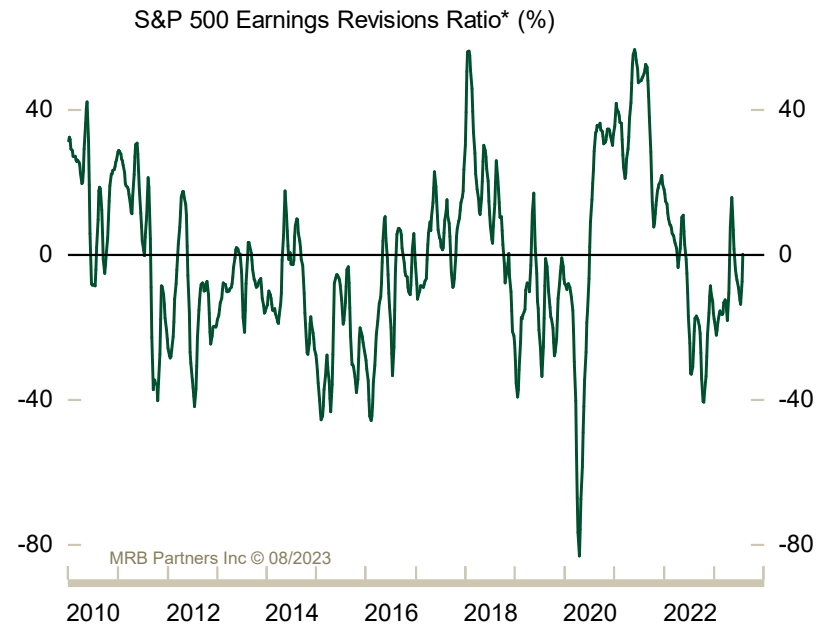


# Earnings Have Shown Some Minor Green Shoots

- 12-Month forward earnings have recently hooked up
- Negative revisions have eased

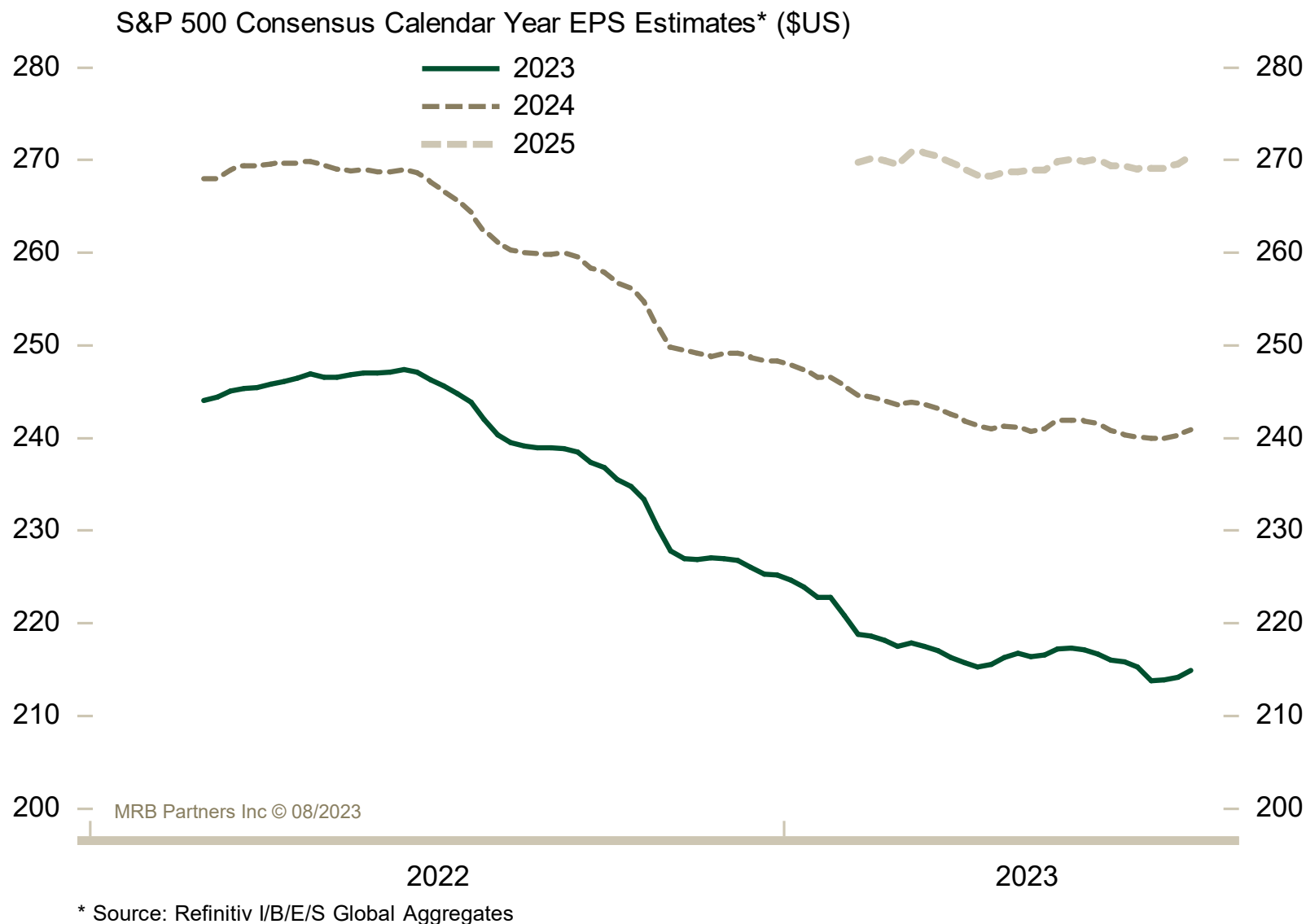


\* Source: Refinitiv I/B/E/S Global Aggregates



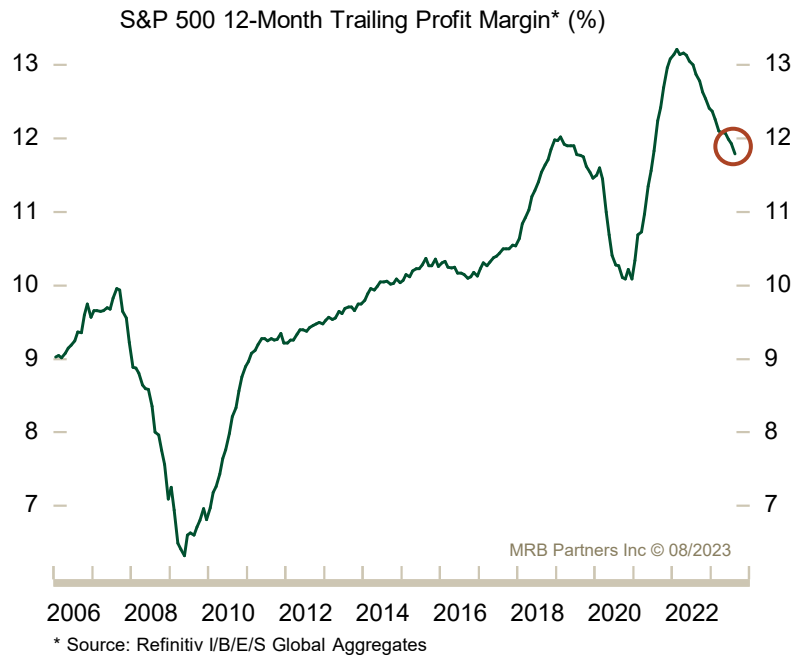
\* Upward revisions minus downward revisions divided by total revisions; 4-week moving average; source Refinitiv I/B/E/S Global Aggregates

# Full-Year Earnings Estimates Are Not Being Upwardly Revised

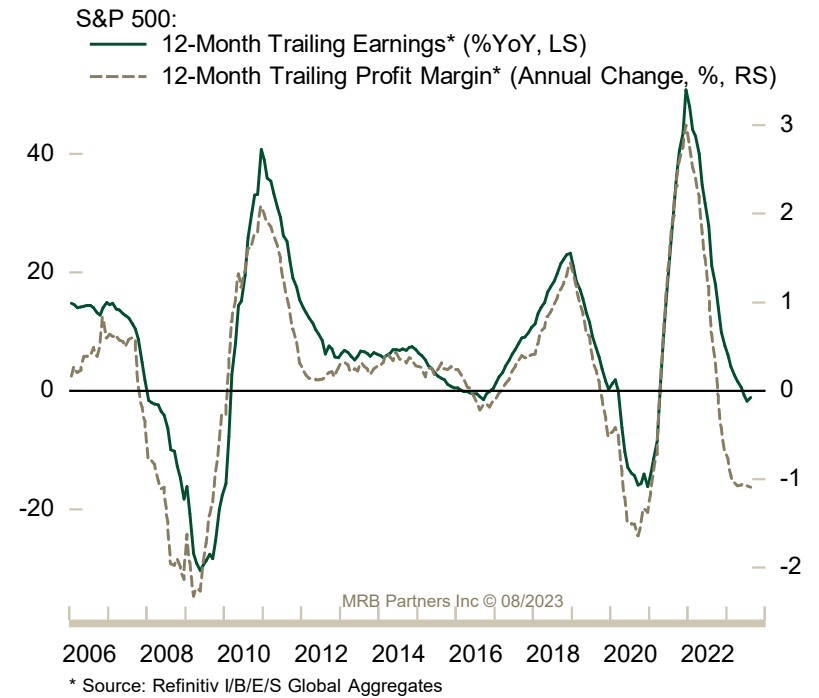


# Profit Margins Are Critical To The Earnings Outlook

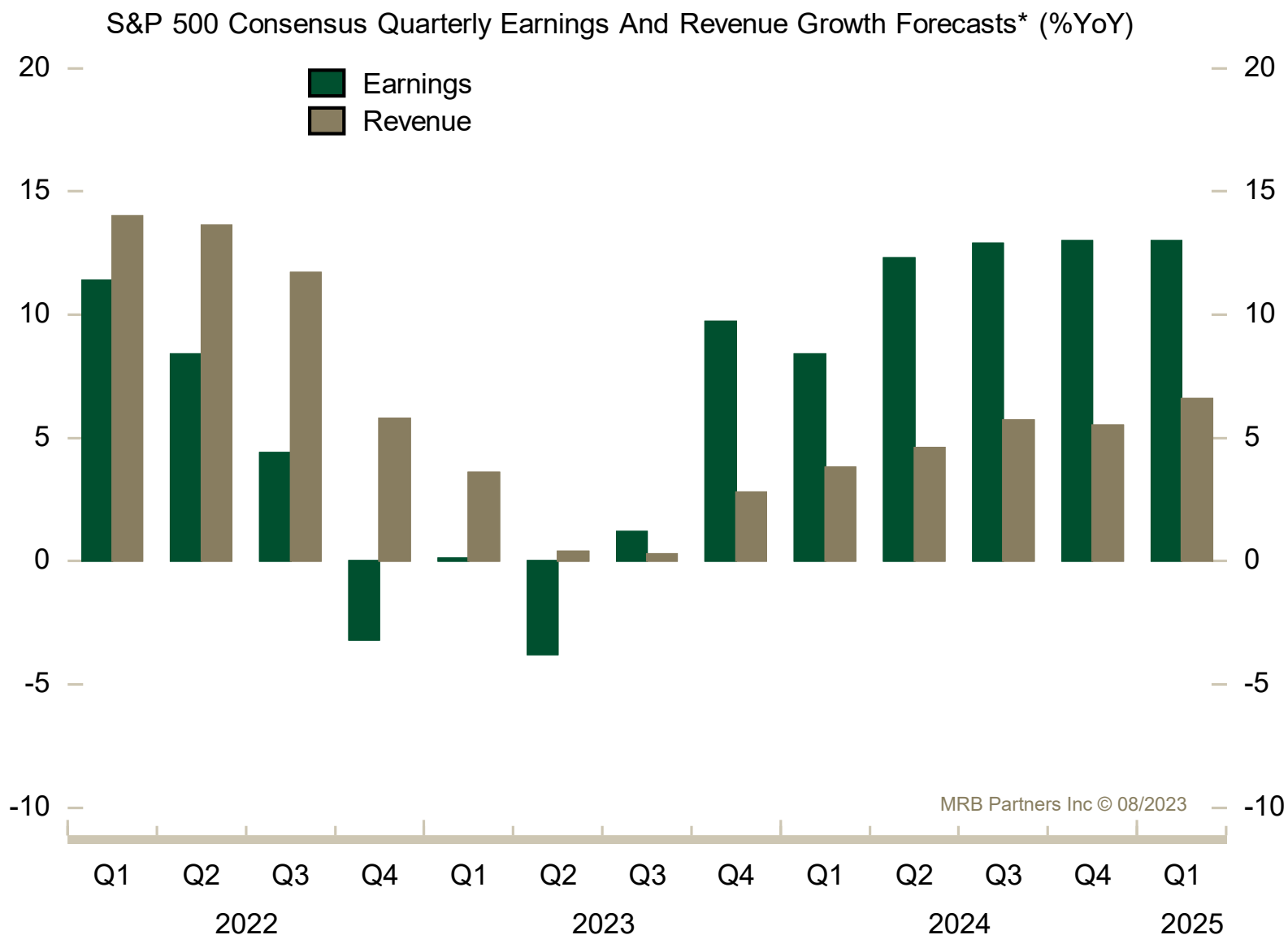
- Profit margins have declined from their highs, but remain at historically elevated levels



- Profit margins are the biggest driver of earnings growth



# Expectations For A V-Shaped Recovery In Earnings Look Too Optimistic



\* Source: Refinitiv I/B/E/S Global Aggregates

# De-Synchronized Earnings Growth Across Sectors Creates Opportunities For Stock-Picking


































Sector	Earnings Growth (%YoY)			
	2021(Act.)	2022 (Act.)	2023 (Est.)	2024 (Est.)
Communication Services	34.5	-21.7	22.6	18.3
Consumer Discretionary	73.8	1.3	29.5	16.1
Consumer Staples	11.2	2.3	2.0	8.5
Energy	n.c.	153.1	-28.8	1.8
Financials	65.9	-13.2	9.9	9.2
Health Care	28.6	5.5	-13.6	13.3
Industrials	92.6	30.0	16.2	12.8
Information Technology	37.5	8.6	-1.7	14.5
Materials	87.1	9.0	-19.3	5.9
Real Estate	43.8	3.4	-14.2	5.3
Utilities	3.5	2.0	6.1	8.9
S&P 500	50.5	7.2	0.1	11.8

Source: Refinitiv I/B/E/S Global Aggregates; n/c = noncalculable due to negative earnings in 2020

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# MRB's U.S. Sector Recommendations

## MRB U.S. Equity Sectors Allocation\*

	–	N	+
Consumer Discretionary			
Communication Services			
Consumer Staples			
Energy			
Financials			
Health Care			
Industrials			
Information Technology			
Materials			
Real Estate			
Utilities			

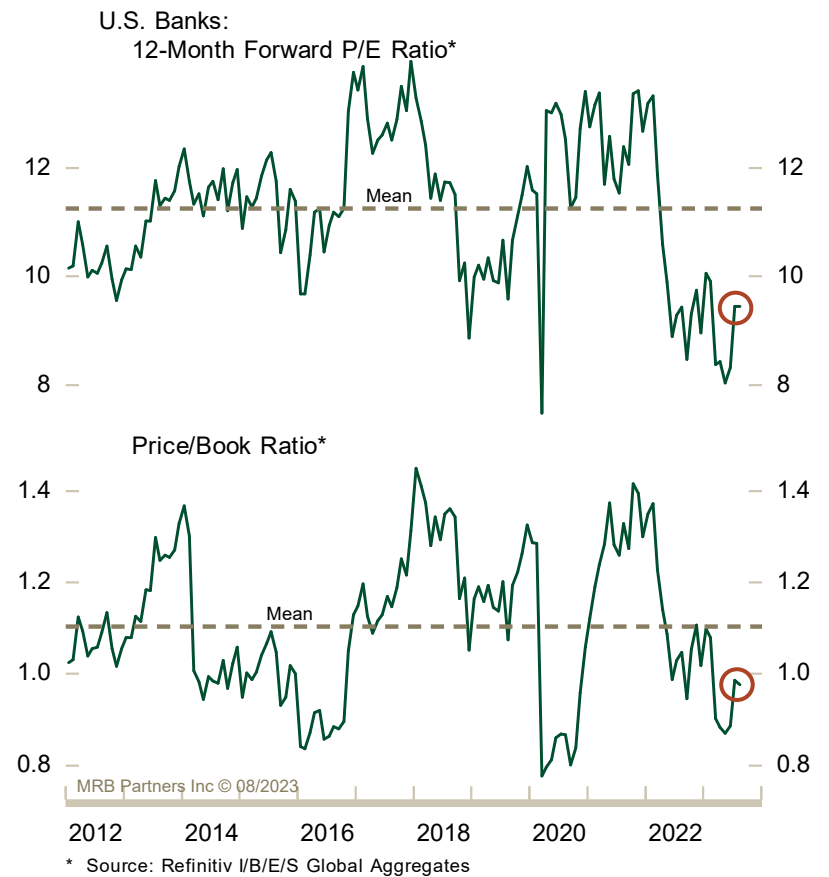
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\* 6-12 month horizon

Note: + = overweight, N = neutral, – = underweight

# Financials: Bank Stocks Have Been Overly Punished

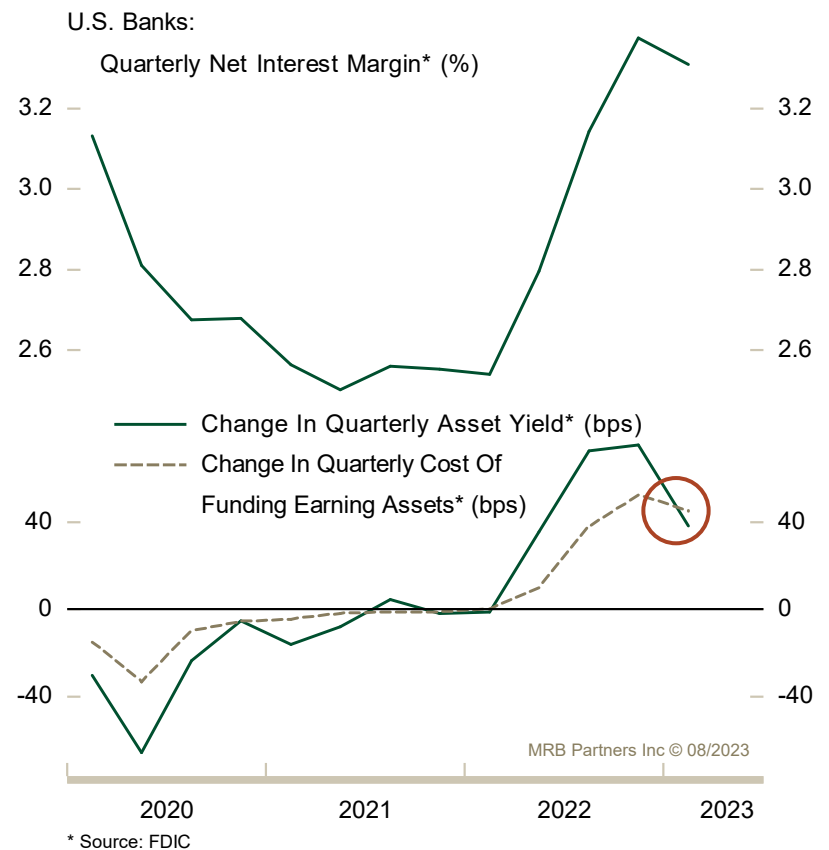
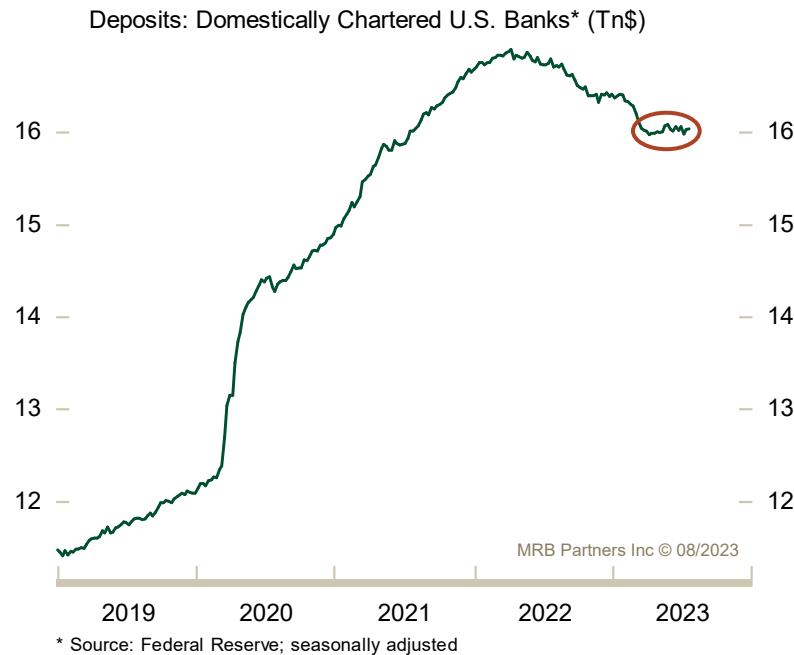
- Bank stocks have discounted a massive decline in their underlying earnings
- Valuations are not far removed from their post-GFC lows





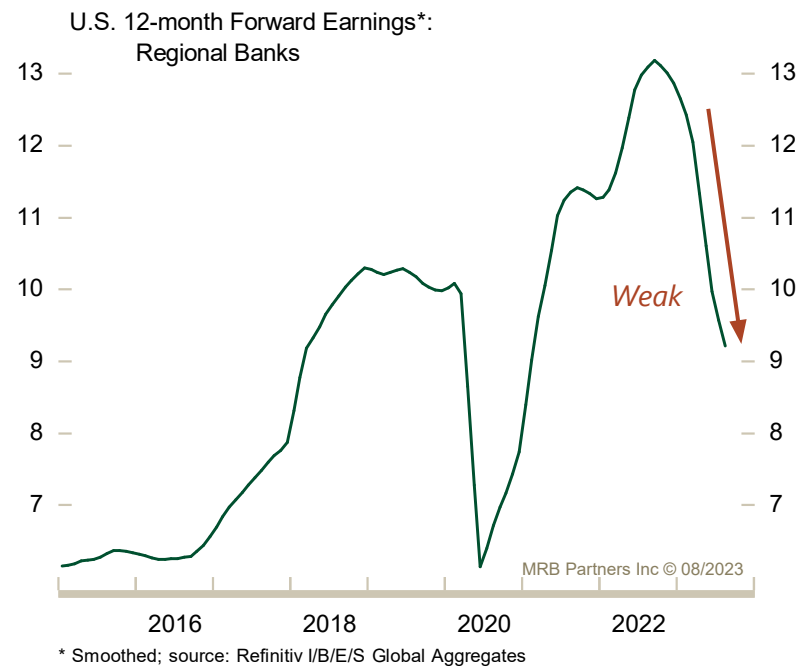
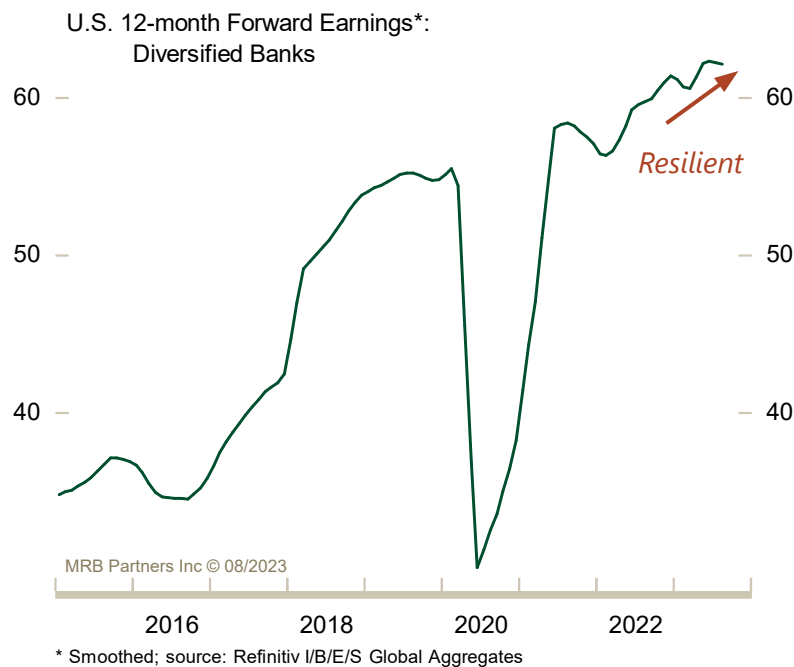
# Financials: The Worst-Case Scenario For Banks Is Not Playing Out

- Deposit outflows have stabilized
- Net interest margins have softened, but not imploded



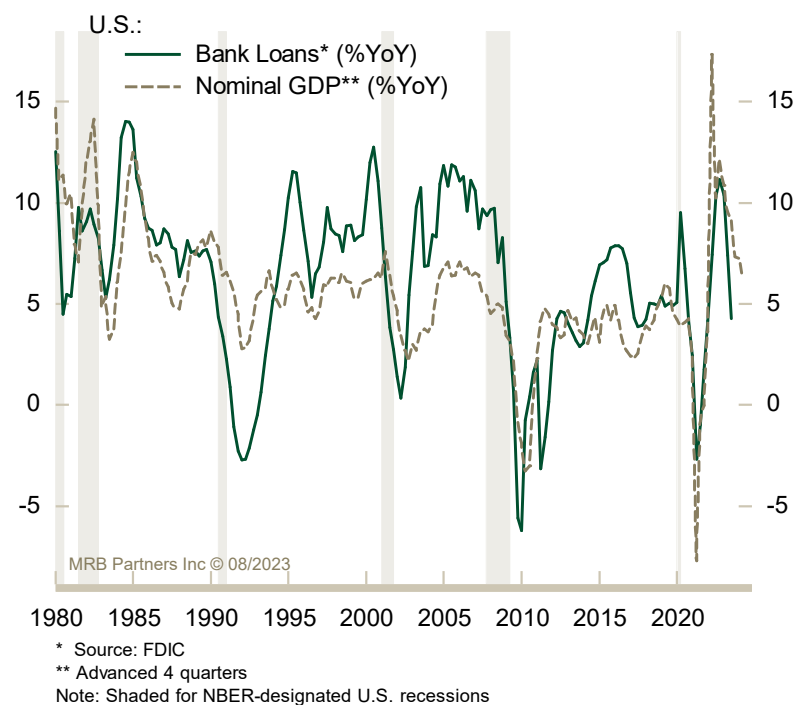
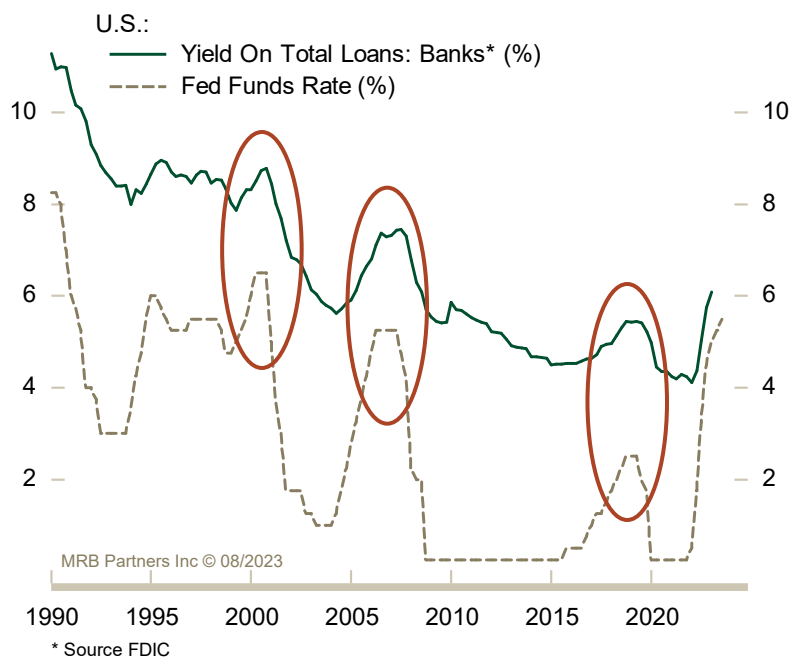
# Financials: The Mega-Cap Banks Have Benefited From The Earlier Turmoil In The Regional Banking Industry

- Earnings estimates for diversified banks have been improving
- However, they have yet to bottom for regional banks



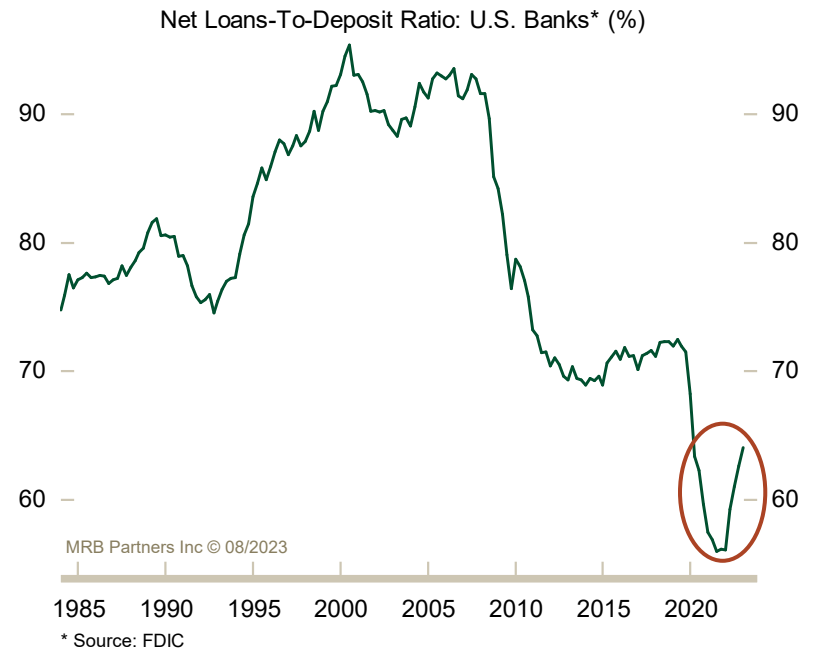
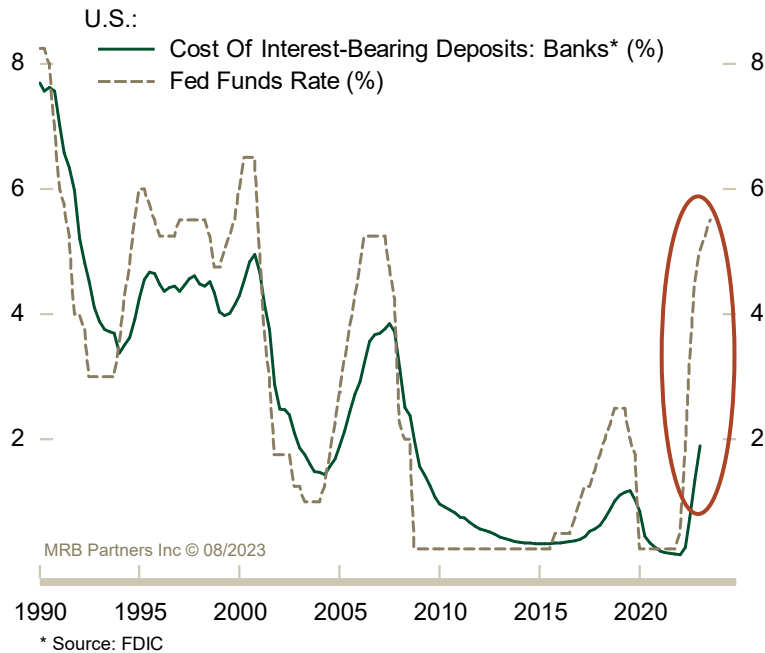
# Financials: A Collapse Of Net Interest Income Is Not In The Cards

- Loan yields have room to increase
- Loan growth is moderating commensurate with the slowdown in nominal GDP growth

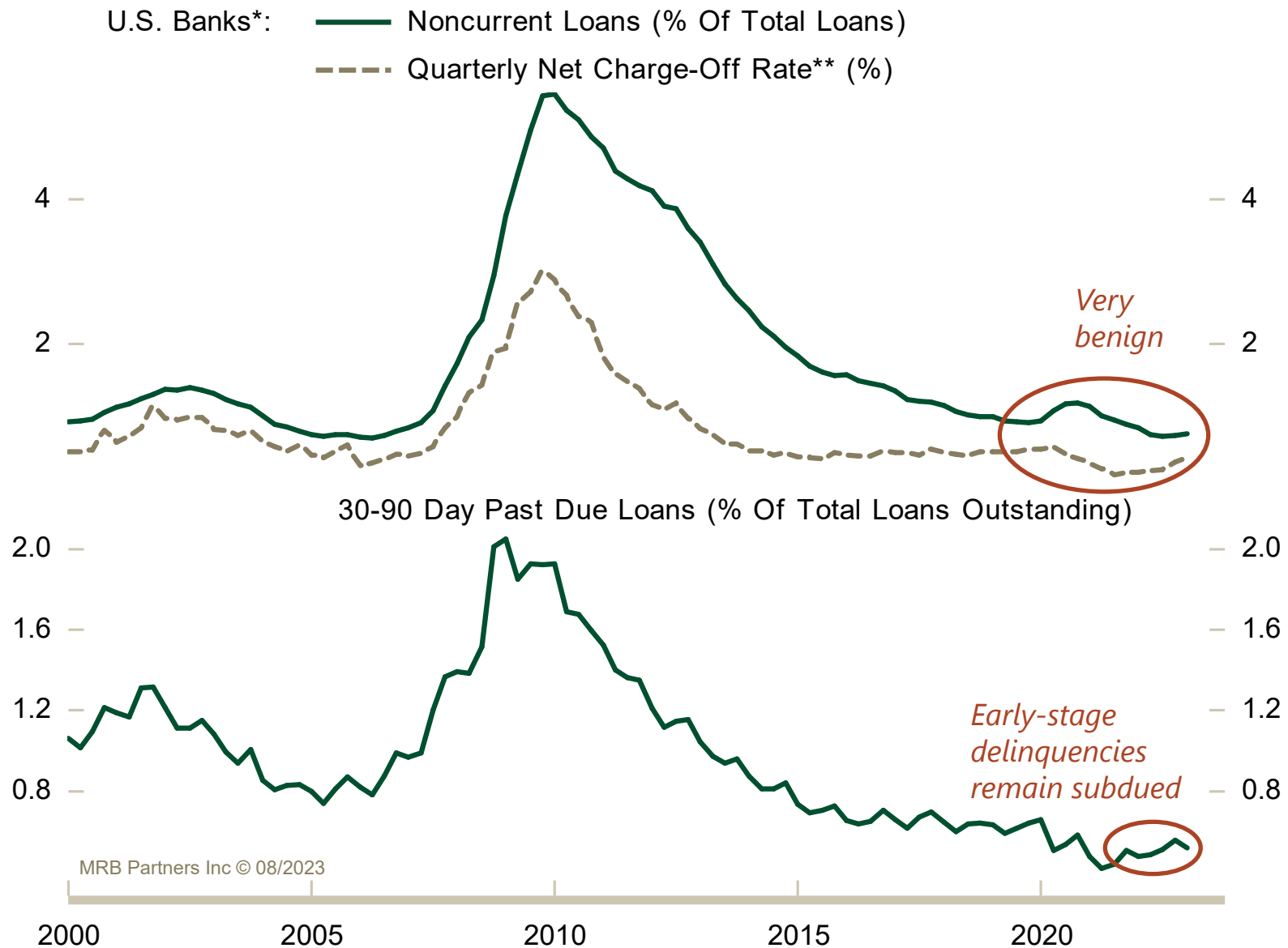


# Financials: Funding Costs For Banks Will Continue To Rise, But The Increase Should Be Manageable

- Banks have been slow to increase the interest rate paid on deposits
- Low loan-to-deposit ratios suggest that most banks have excess deposits



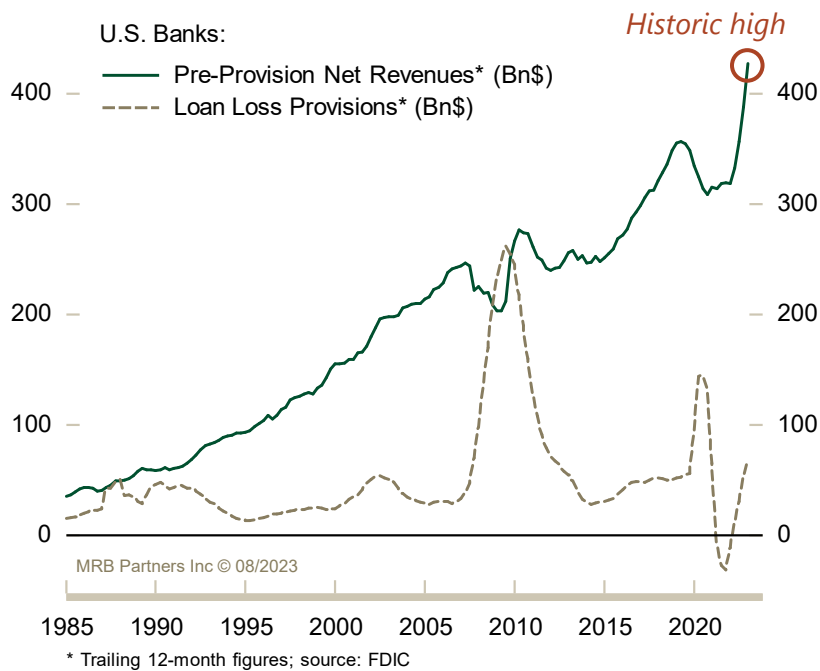
# Financials: Credit Quality Remains Exceptionally Strong



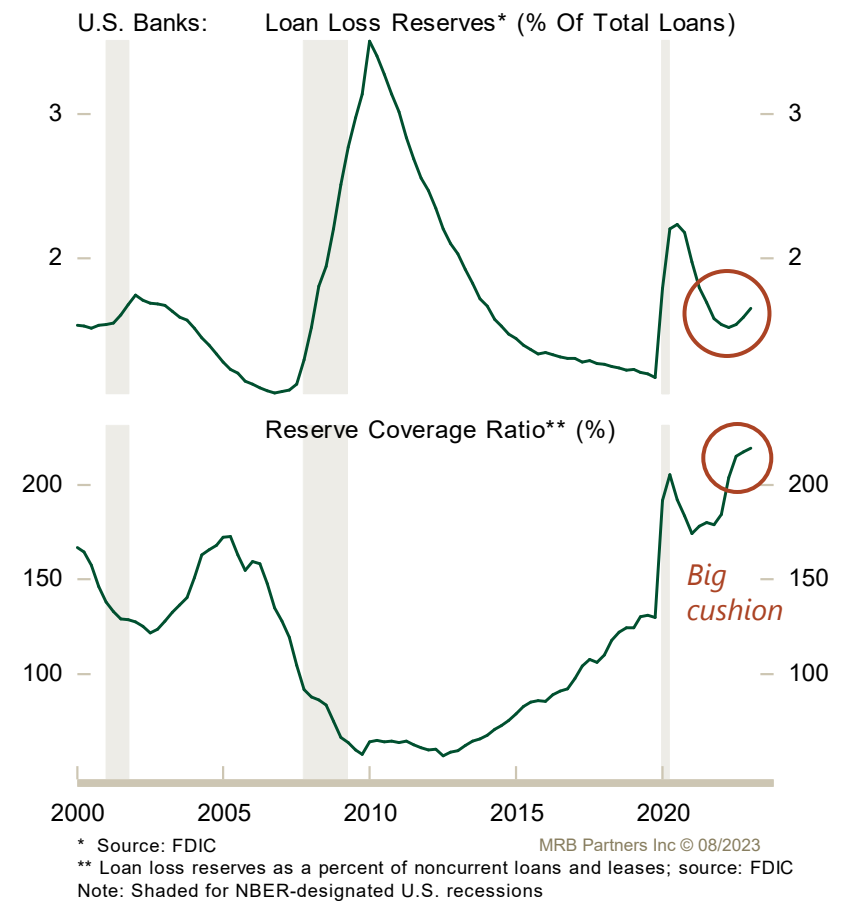
\* Source: FDIC  
 \*\* Annualized

# Financials: Banks Are Prepared For A Normalization Of Credit Losses

- Pre-provision net revenues provide a big cushion to absorb an increase in credit losses



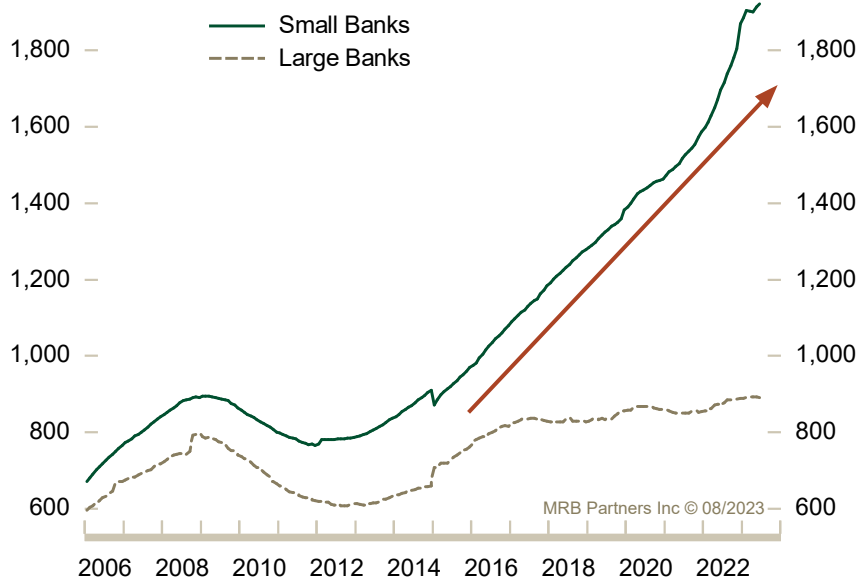
- Reserves against loan losses are higher than at the start of previous recessions



# Financials: Concentration Risk In CRE Loans Is An Issue For Small Banks

- CRE lending has risen rapidly for small banks
- Small banks have significantly more exposure to CRE loans

U.S. Commercial Real Estate Loans\* (Bn\$):

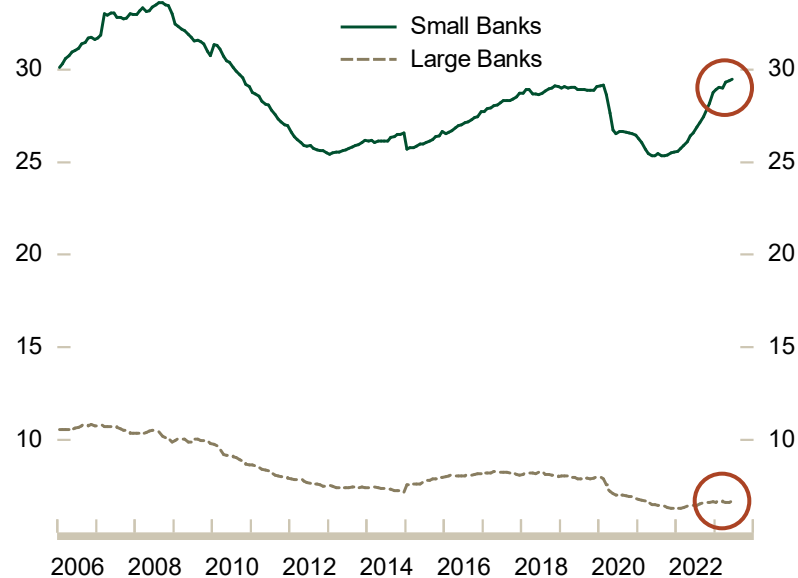


\* Source: Federal Reserve

Note: Large banks are defined as top-25 banks ranked by assets, while small banks are banks not included in the top-25

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U.S. Commercial Real Estate Loans\* (% of Total Loans):



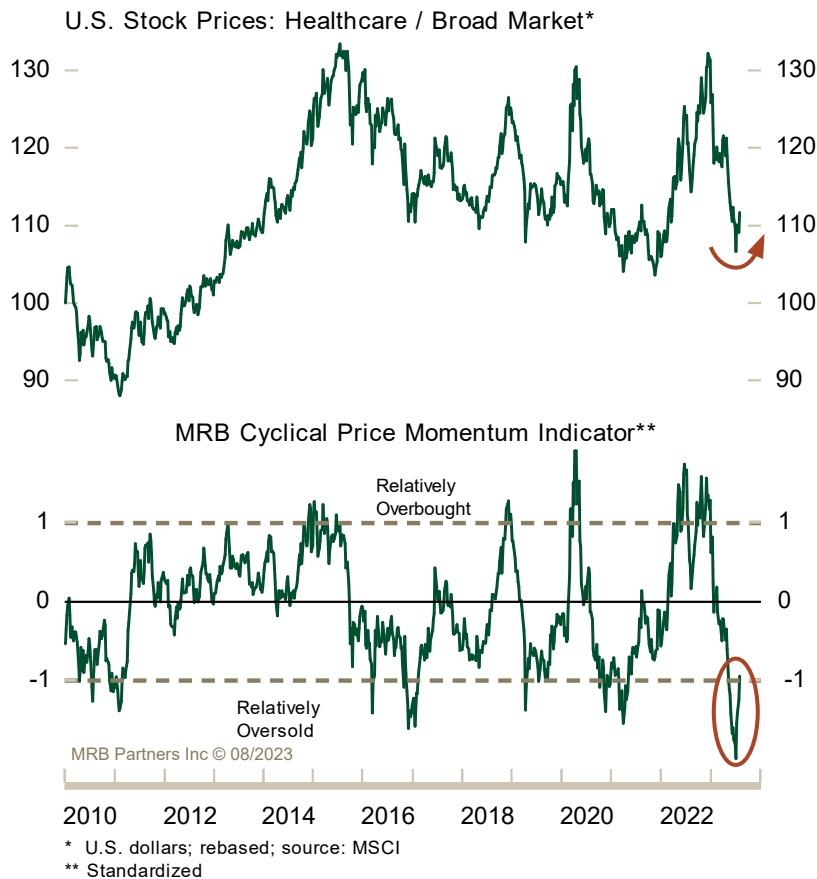
\* Source: Federal Reserve

Note: Large banks are defined as top-25 banks ranked by assets, while small banks are banks not included in the top-25

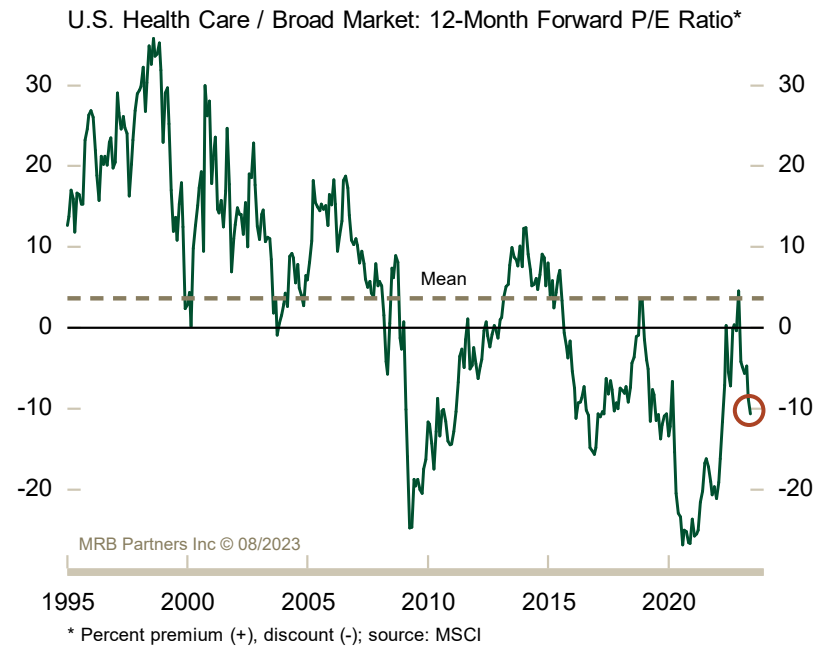
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# Health Care: Remains Our Most-Preferred Defensive Play

- Technical conditions are relatively oversold



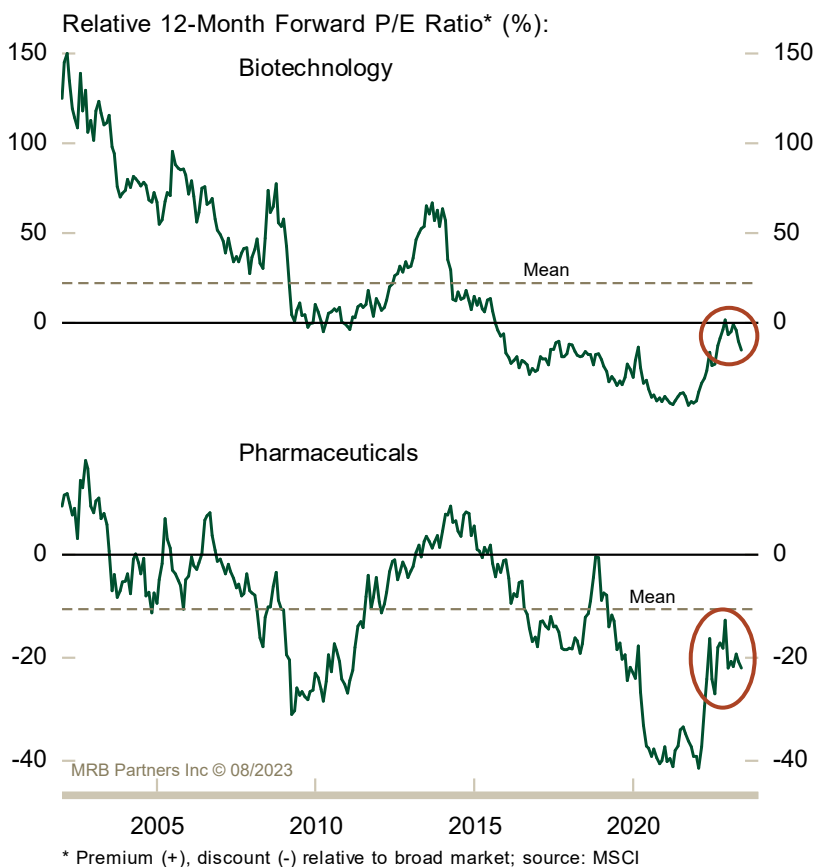
- Relative valuations are reasonable



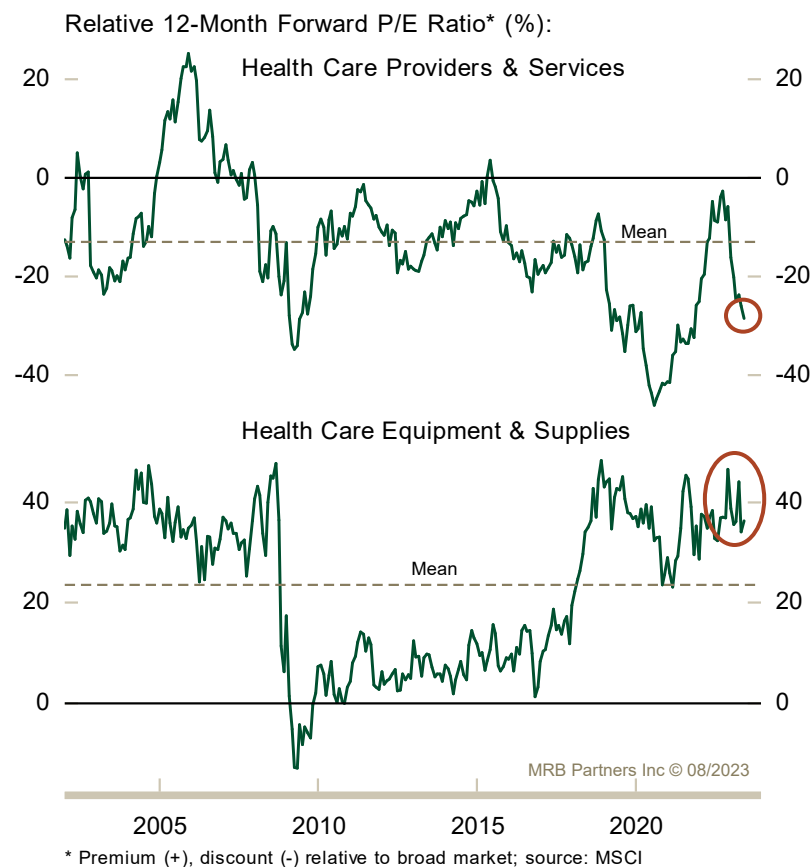


# Health Care: Most Sub-Groups Trade At Attractive Relative Valuations

- Drug stocks have room to further re-rate as innovation drives value creation

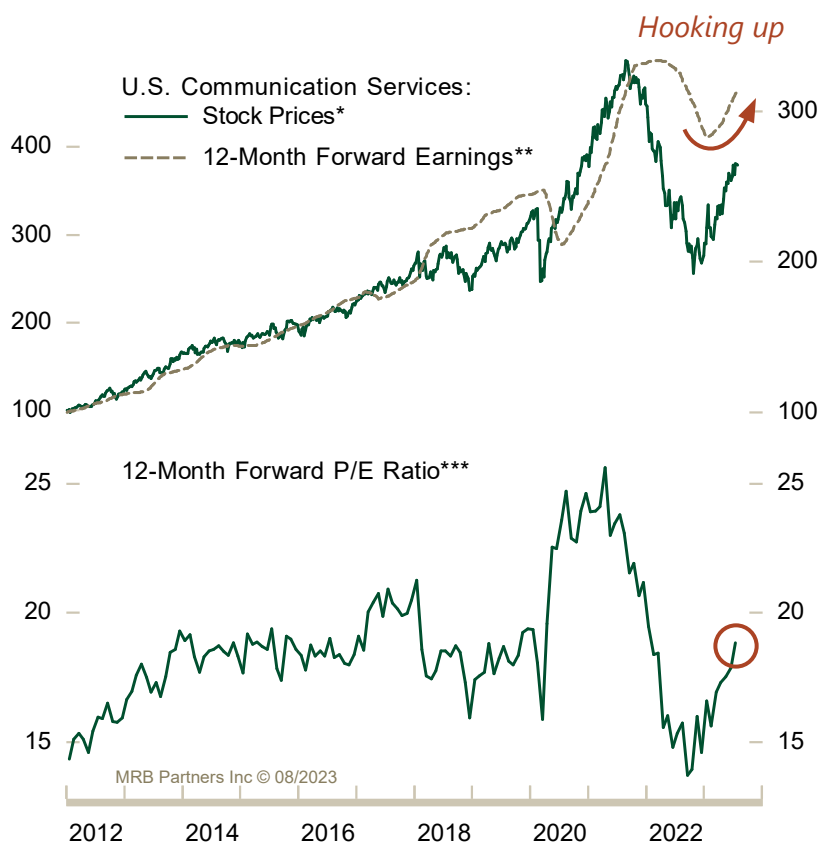


- Equipment & supply stocks are the most expensive segment of the health care sector



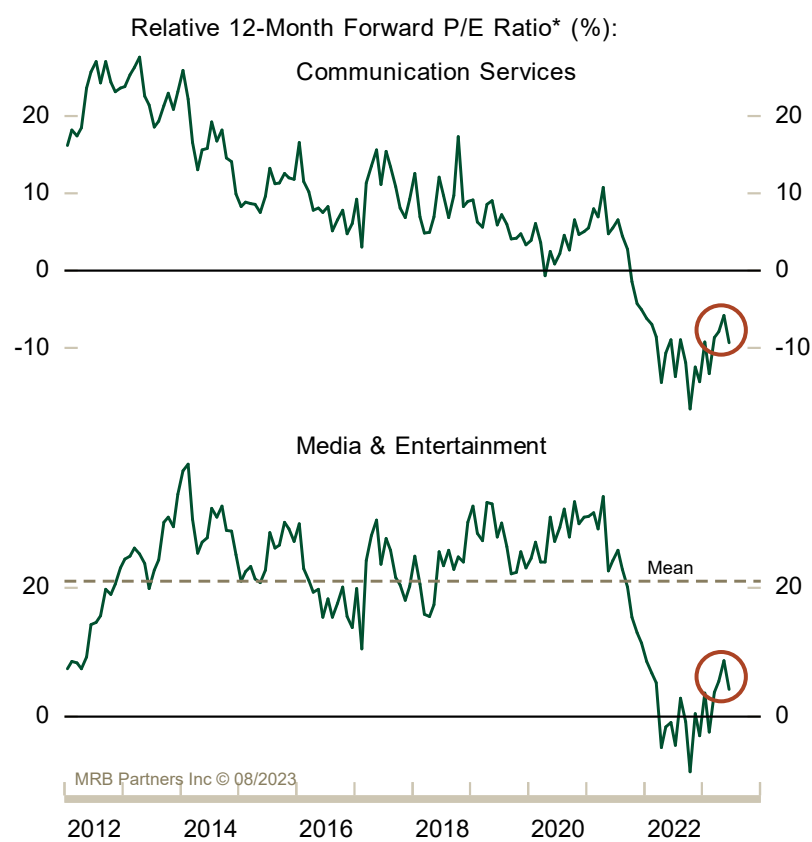
# Communication Services: There Is More Relative Upside As Relative Earnings Improve And Valuations Continue To Normalize

- Share prices and valuations undershot underlying fundamentals in 2022



\* Rebased; source: MSCI  
 \*\* Smoothed; source: MSCI  
 \*\*\* Source: MSCI

- Relative valuations are still attractive relative to their history

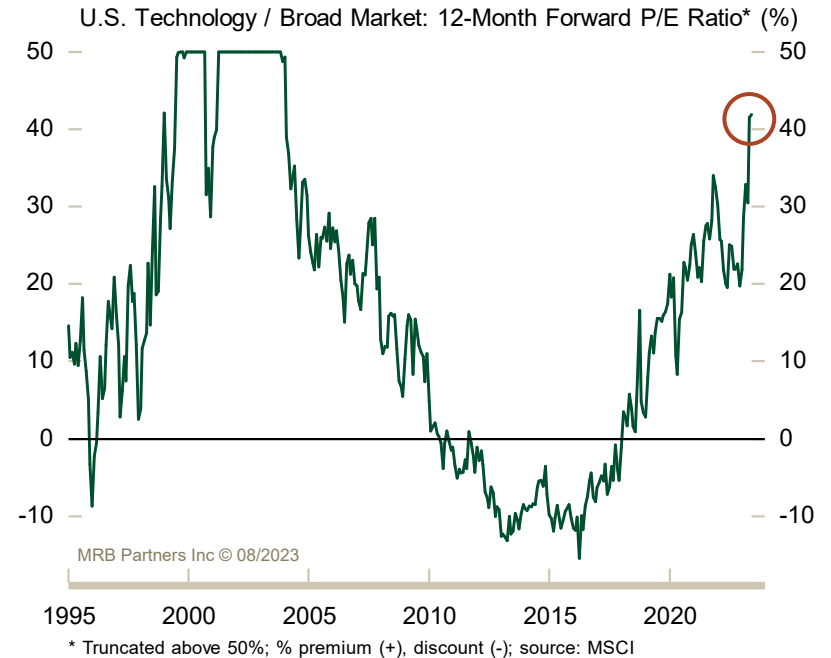
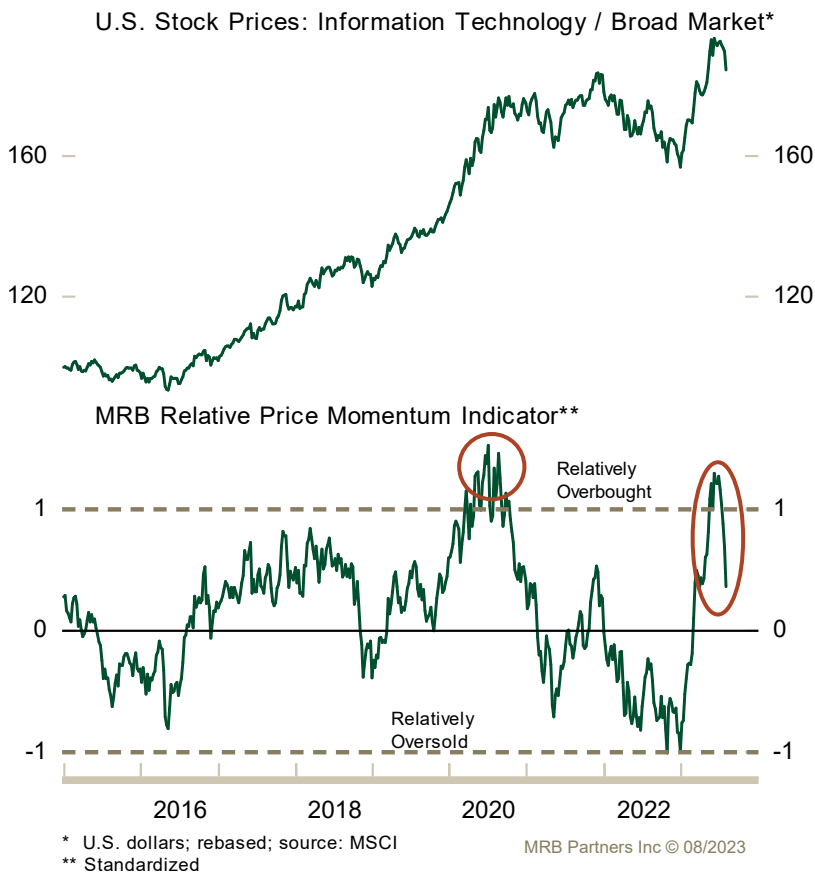


\* % Premium (+), discount (-) to the U.S. equity benchmark; source: MSCI

# Technology: The Rally Has Been Mostly Driven By Sentiment, Rather Than Fundamentals

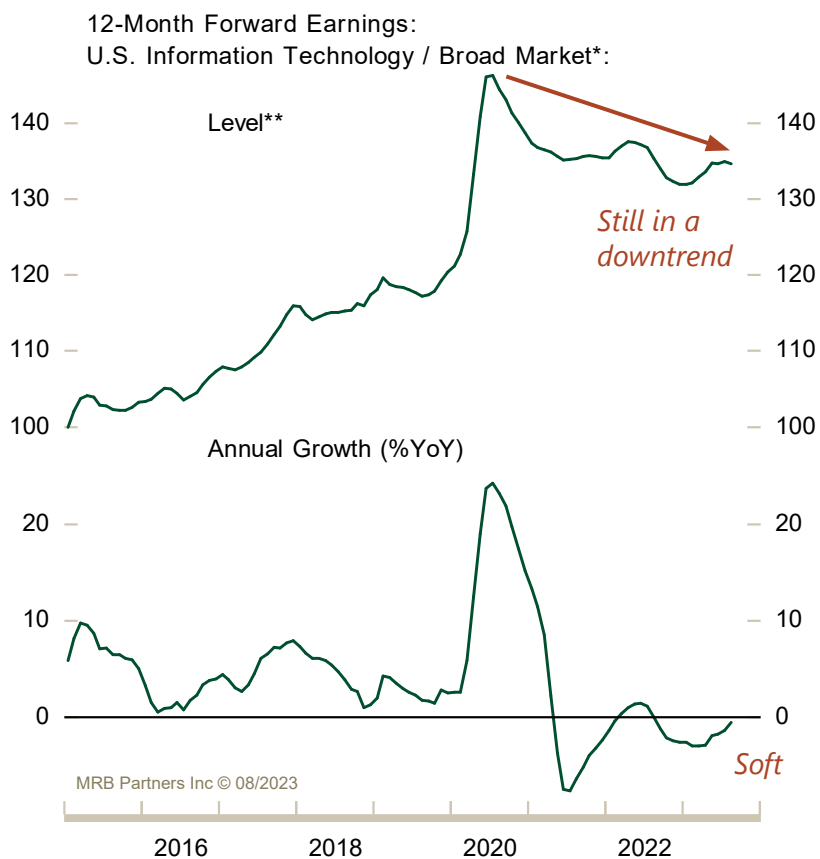
- The risk of a reversal in relative share prices is high

- Relative valuations currently exceed their late-2021 highs



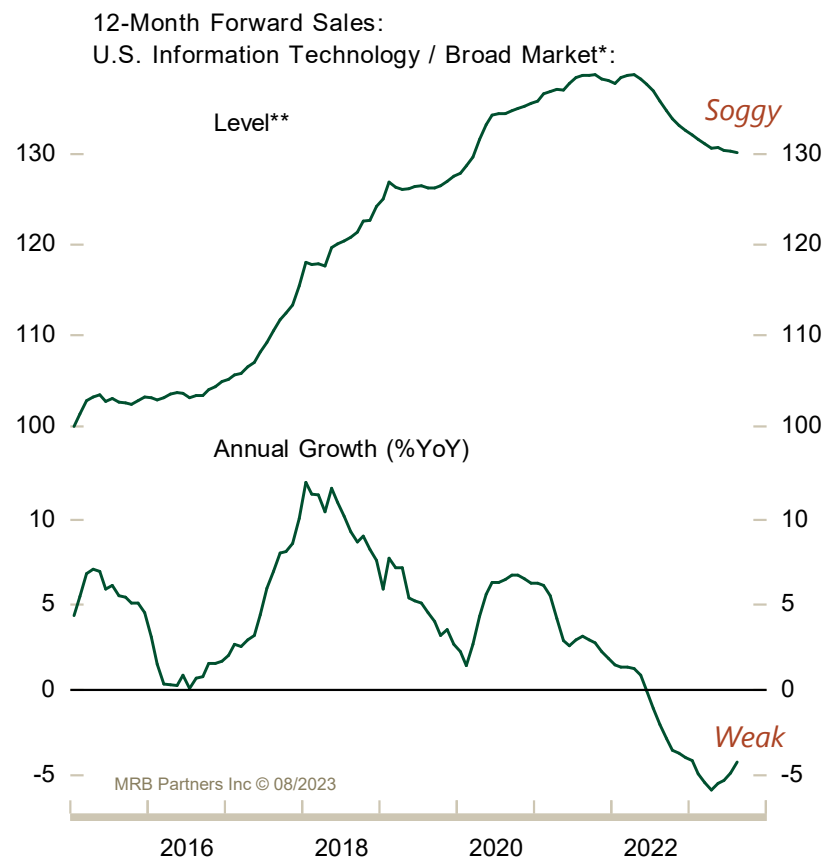
# Technology: The Fundamentals Are Uninspiring

- Lackluster trends in relative earnings



\* Smoothed; source: Refinitiv I/B/E/S Global Aggregates  
\*\* Rebased

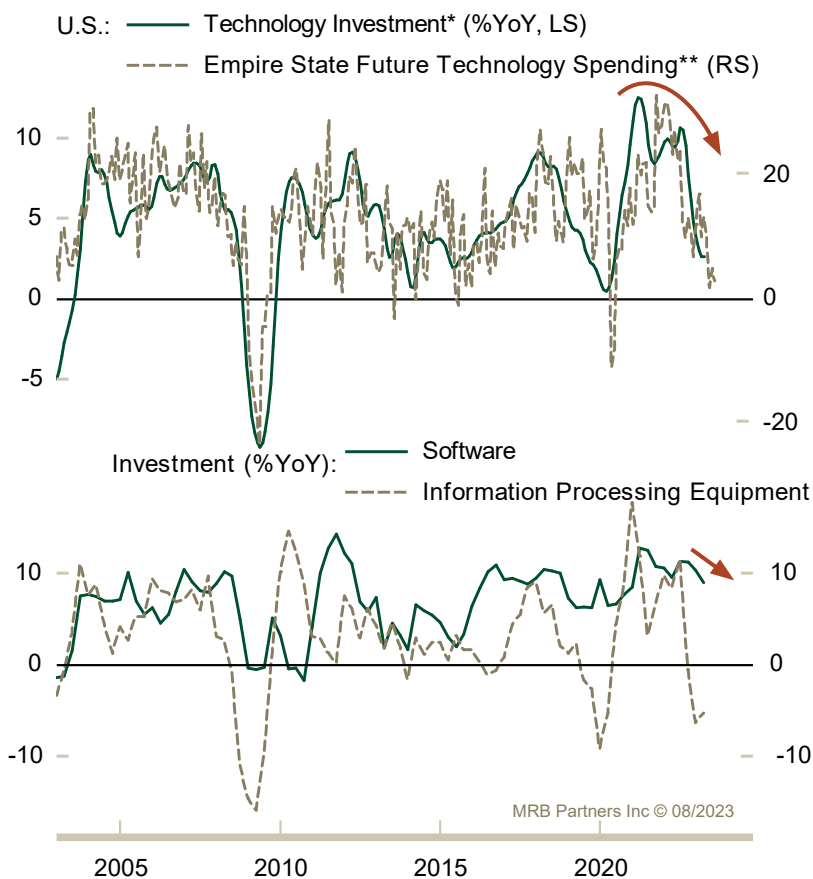
- Tech has lost its revenue growth advantage



\* Smoothed; source: Refinitiv I/B/E/S Global Aggregates  
\*\* Rebased

# Technology: Enterprise Spending Has Room To Weaken

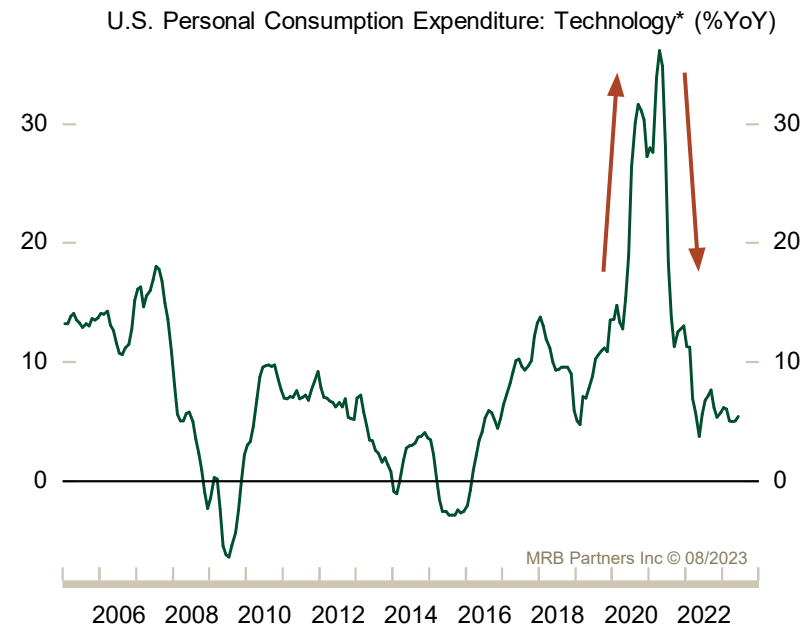
- Tech capex growth is decelerating from elevated levels



\* Private fixed investment information processing equipment and software;  
 source: U.S. Bureau of Economic Analysis

\*\* Advanced 3 months; source: Federal Reserve Bank of New York

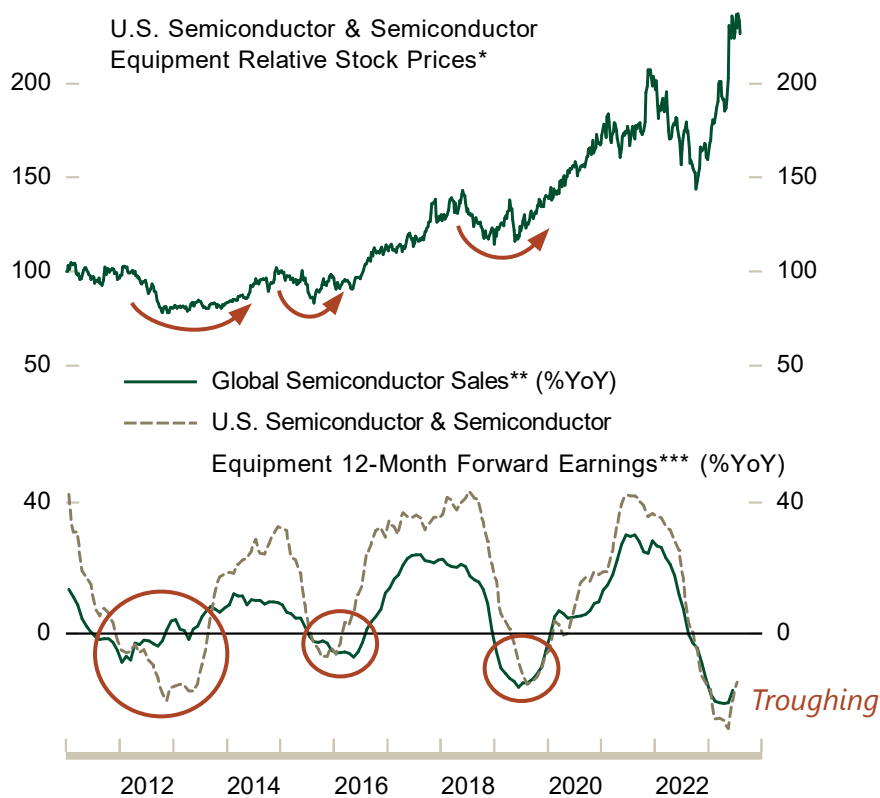
- The pandemic boom in tech consumer spending growth has reversed



\* Includes personal computers/tablets and computer software & accessories;  
 smoothed; source: U.S. Bureau of Economic Analysis

# Technology: Chip Stocks Have Massively Front-Run An Industry Recovery In 2024

- Share prices are too far ahead of underlying fundamentals
- Semiconductor stocks are expensive on next year's earnings

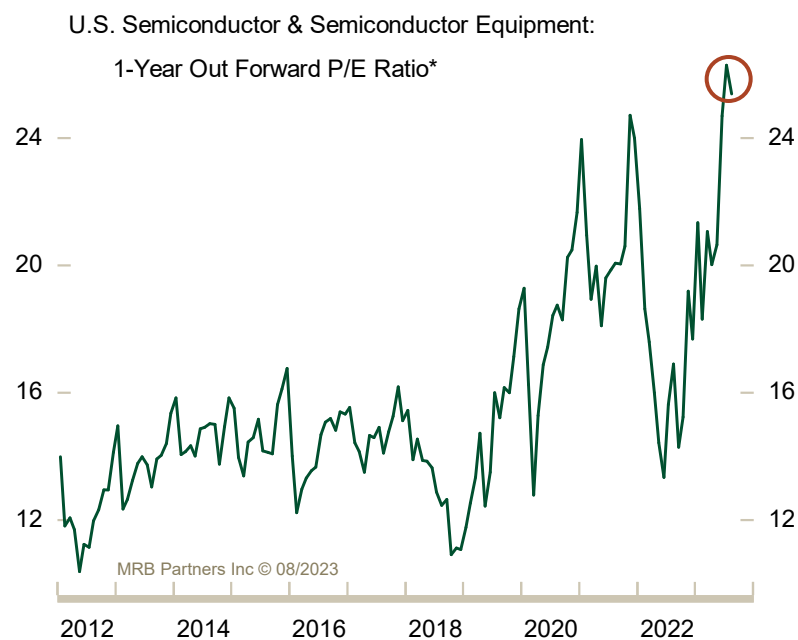


\* Relative to the U.S. broad market; rebased; source: Standard & Poors

\*\* Source: Semiconductor Industry Association

\*\*\* Source: MSCI

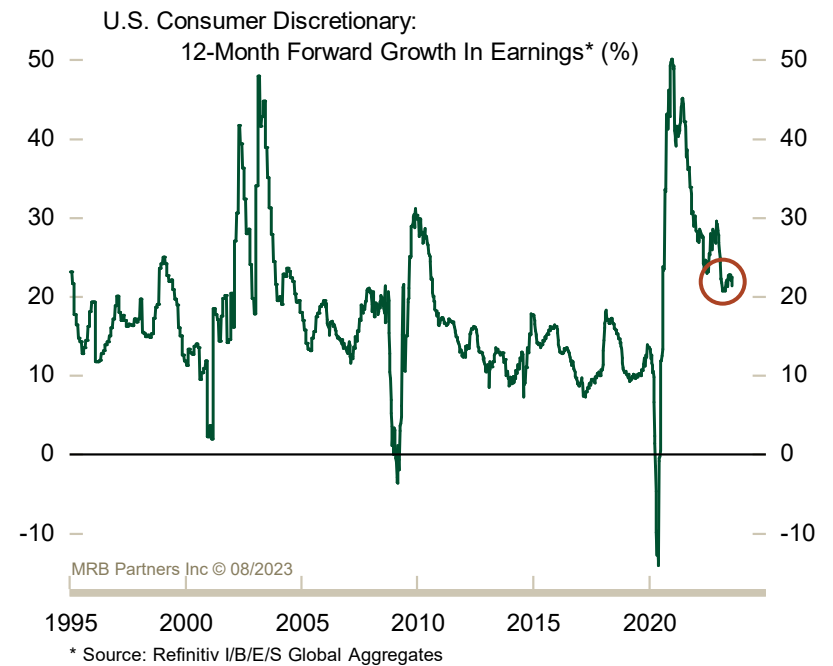
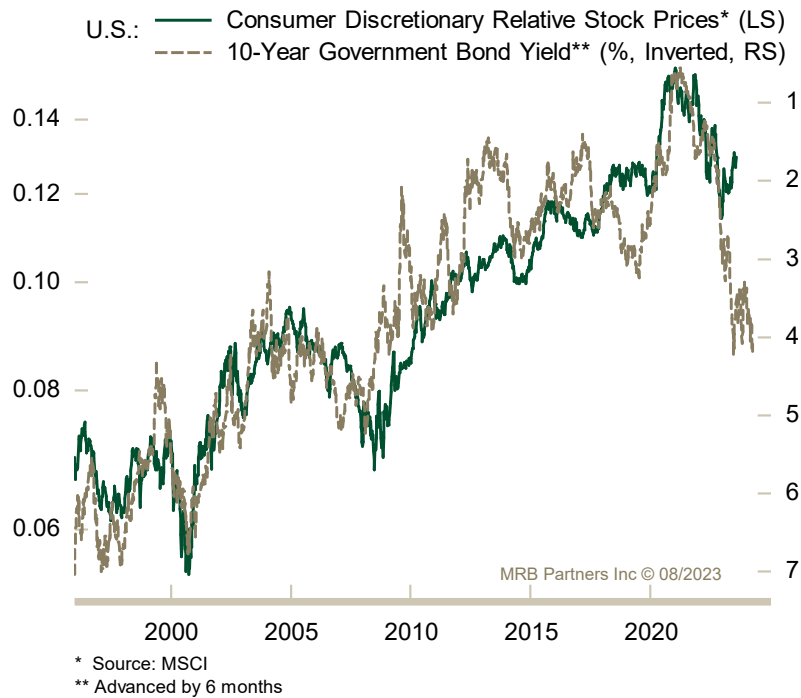
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\* Source: Refinitiv I/B/E/S Global Aggregates

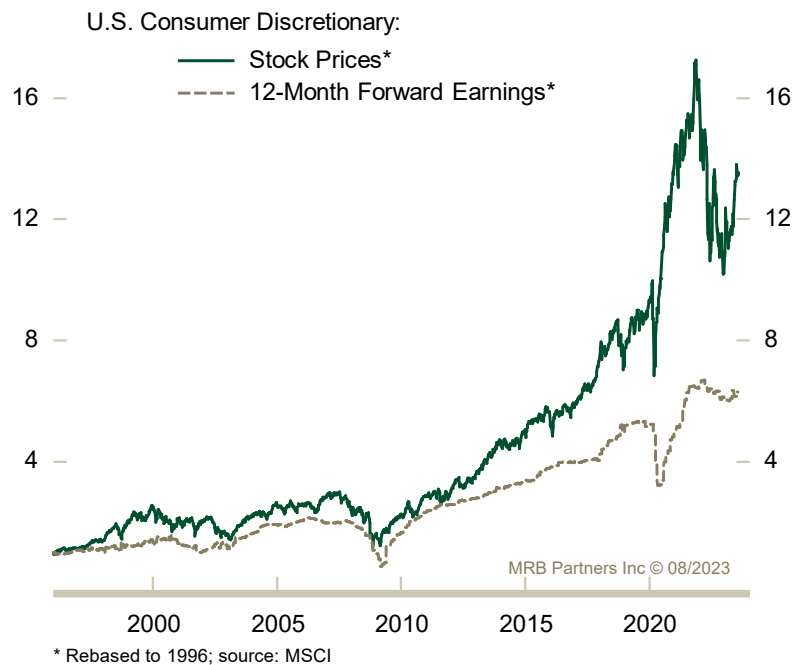
# Consumer Discretionary: Late-Cycle Conditions Keep Us Cautious

- The sector is interest rate sensitive
- Earnings growth expectations are very elevated

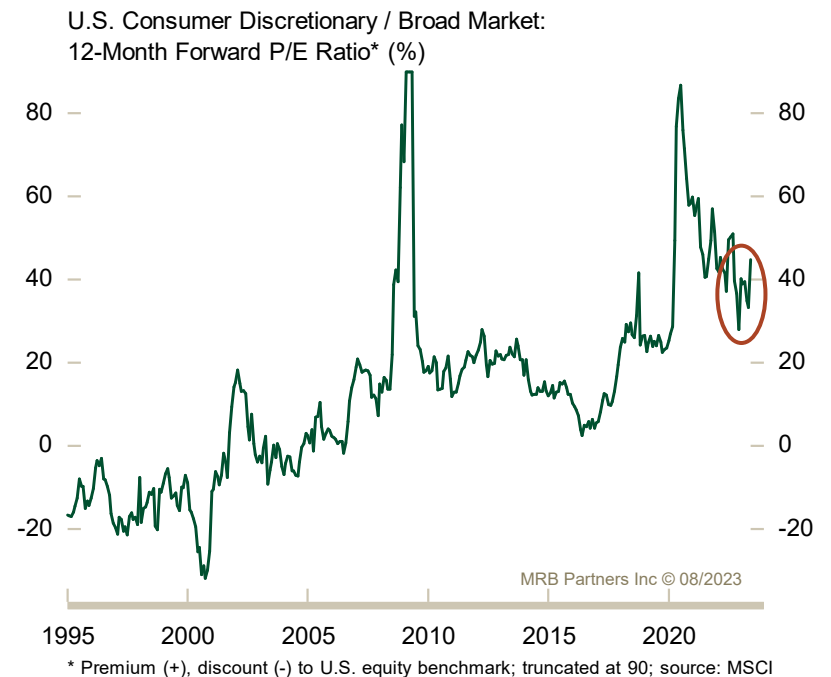


# Consumer Discretionary: Elevated Valuations Provide Little Protection Against Adverse Developments

- Over the past decade, share prices have massively outrun underlying earnings



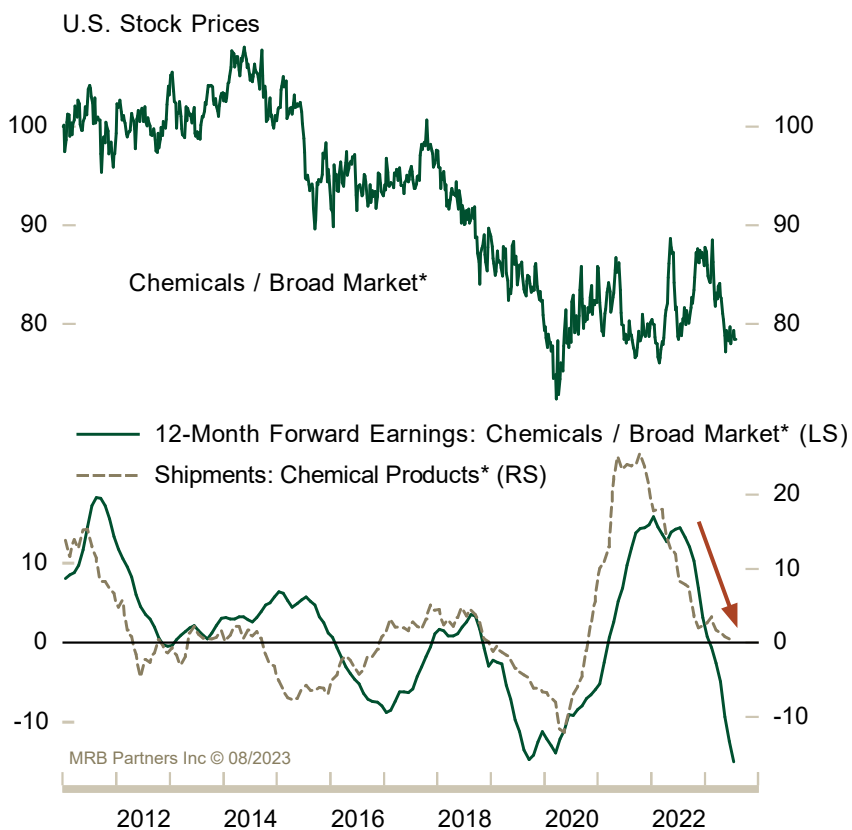
- The sector trades at a hefty premium to the broad equity market





# Materials: The Global Economic Growth Outlook Is Not Strong Enough To Justify Adding To Exposure

- Activity momentum in the chemicals industry is decelerating



\* Rebased; source: MSCI

\*\* Source: U.S. Census Bureau

Note: 12-month forward earnings are smoothed in panel 2

- An uninspiring outlook for metals prices leaves us cautious on metals & mining stocks

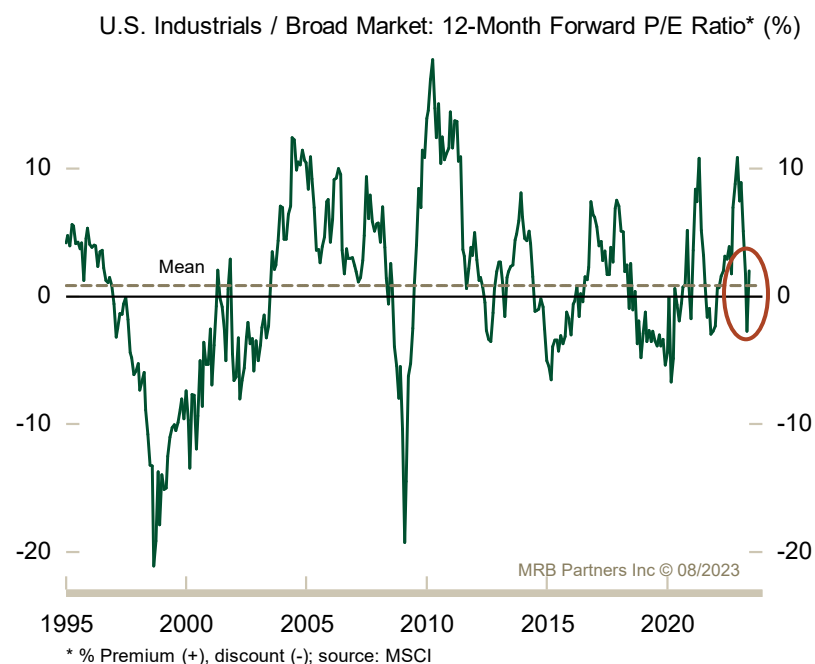
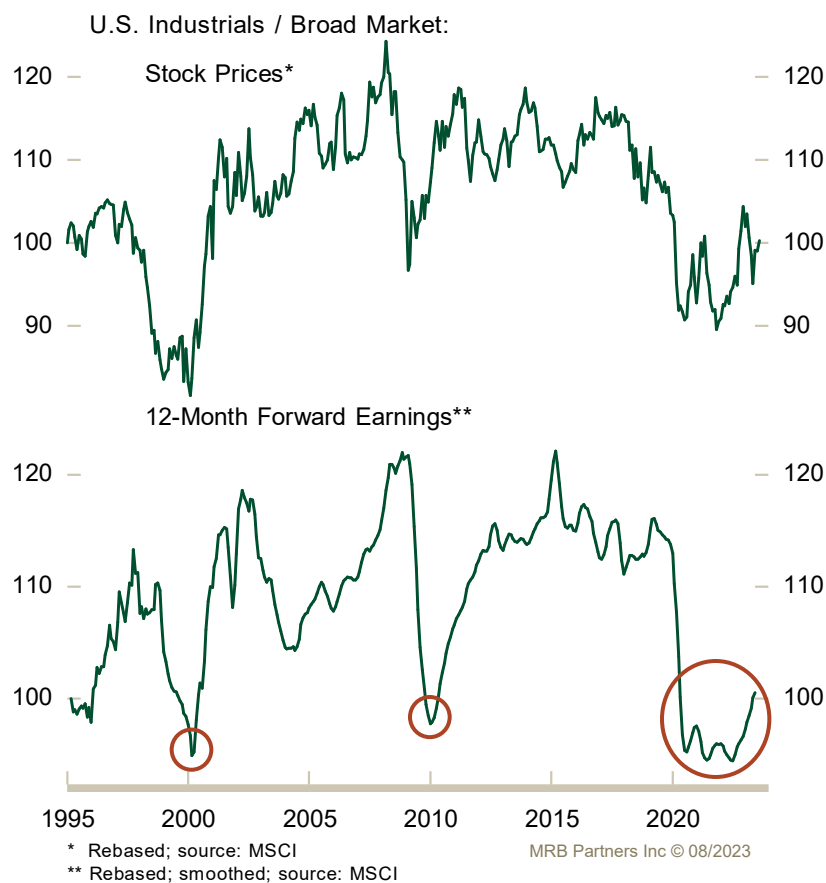


\* Rebased; source: MSCI

\*\* Source: Bloomberg

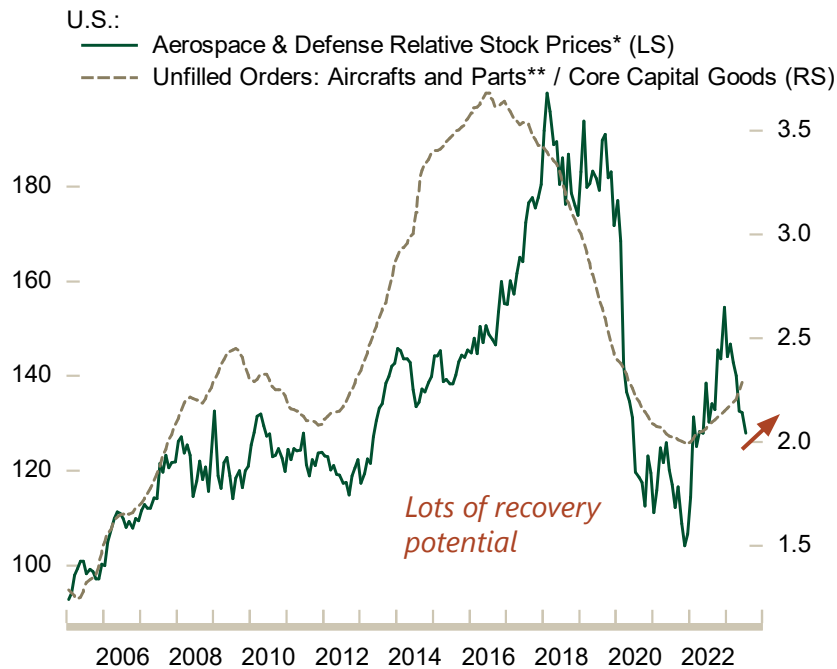
# Industrials: Mixed Prospects Within The Sector Keep Us Neutral

- Depressed relative earnings should put a floor under relative performance
- Relative valuations are at their historical norms



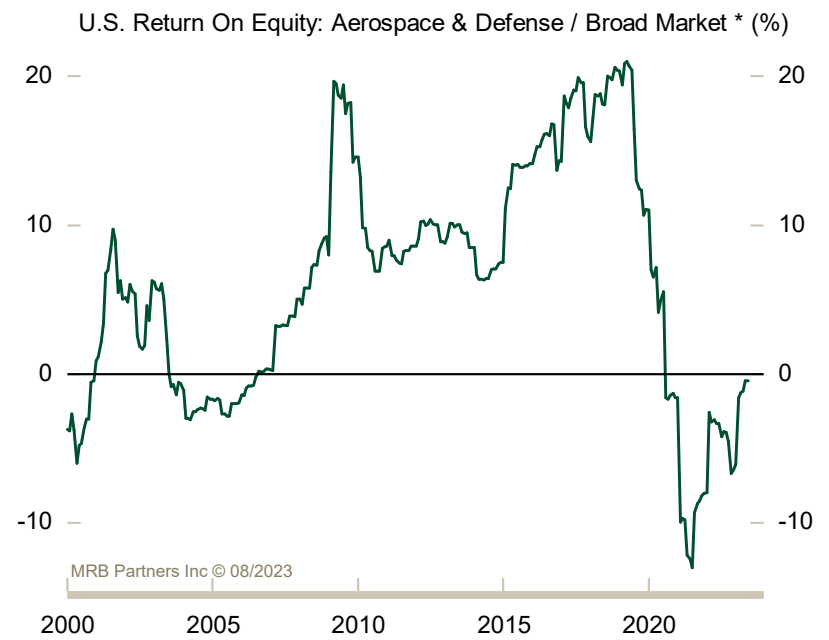
# Industrials: Aerospace & Defense Is Our Favorite Industrial Sub-Group

- Relative orders for aircraft and parts are in the early innings of a recovery
- Relative ROE has a lot of room to improve



\* Relative to the U.S. equity benchmark; rebased; source: MSCI  
 \*\* Includes defense and nondefense; source: U.S. Census Bureau

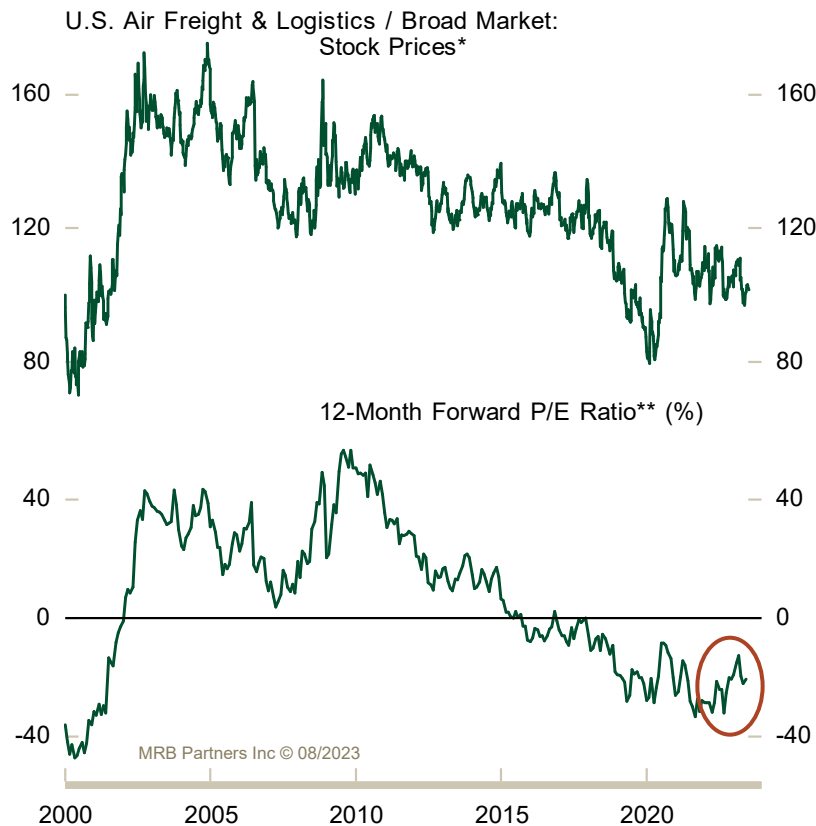
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\* Source: MSCI

# Industrials: Other Areas Of Opportunity

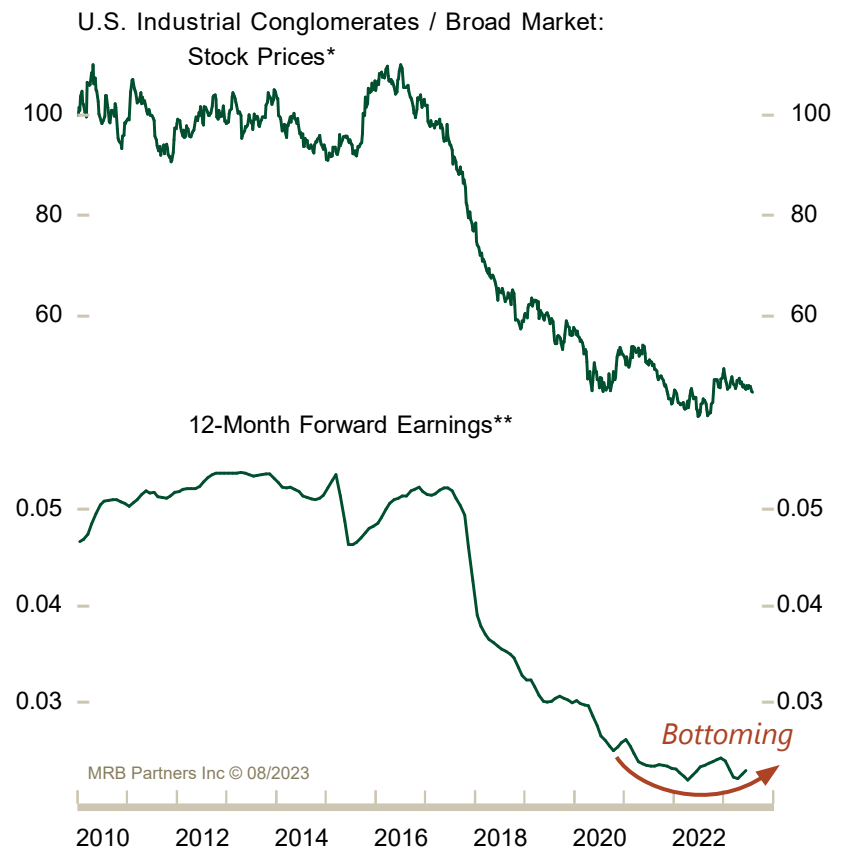
- Air freight stocks have over-discounted cyclical headwinds



\* Rebased; source: Bloomberg

\*\* Percent premium (+), discount (-); source: MSCI

- Industrial conglomerates have been left for dead, but have exposure to attractive end-markets

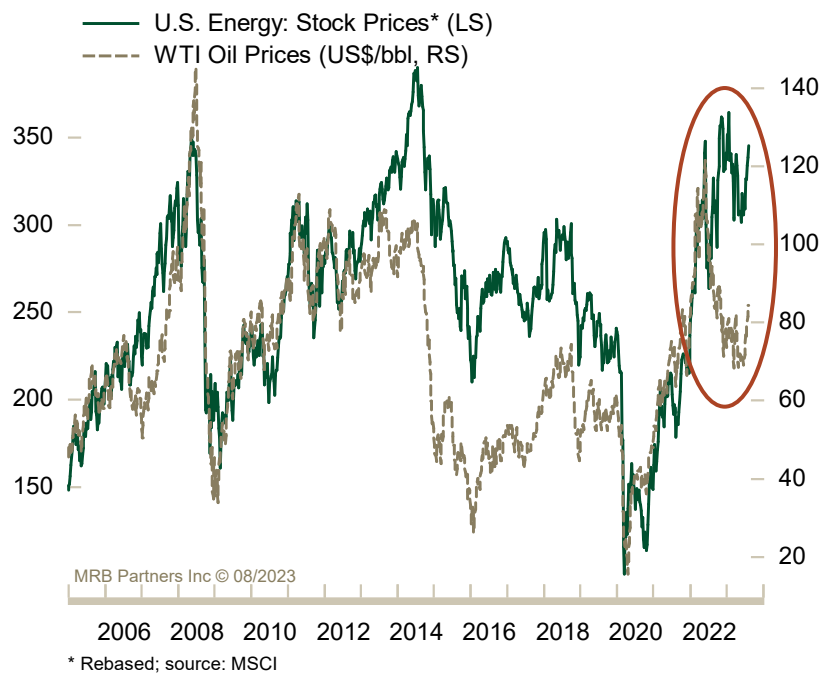


\* Source: Bloomberg

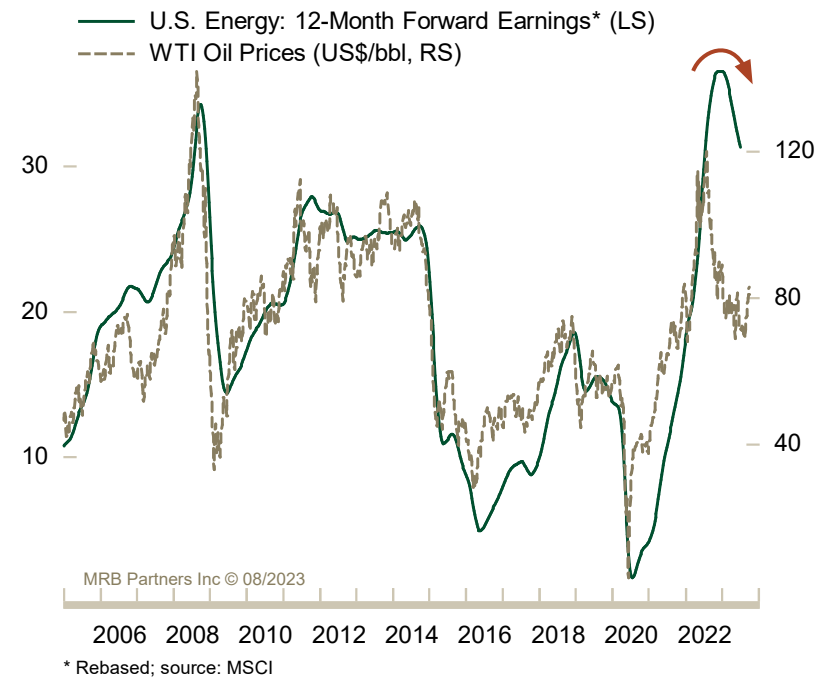
\*\* Rebased; smoothed; source: MSCI

# Energy: A Neutral Stance Is Appropriate Despite Upside Risks To Oil Prices

- Energy stocks look vulnerable if oil prices decline



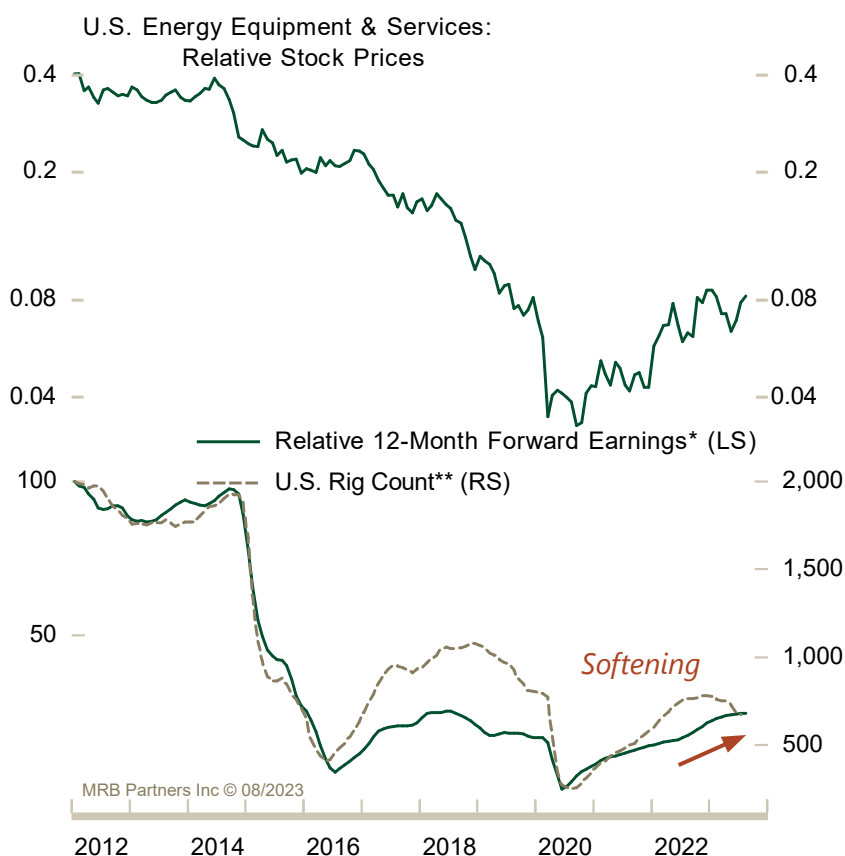
- Forward earnings are facing some mean reversion



# Energy: Energy Equipment & Services Stocks Have Durable Tailwinds

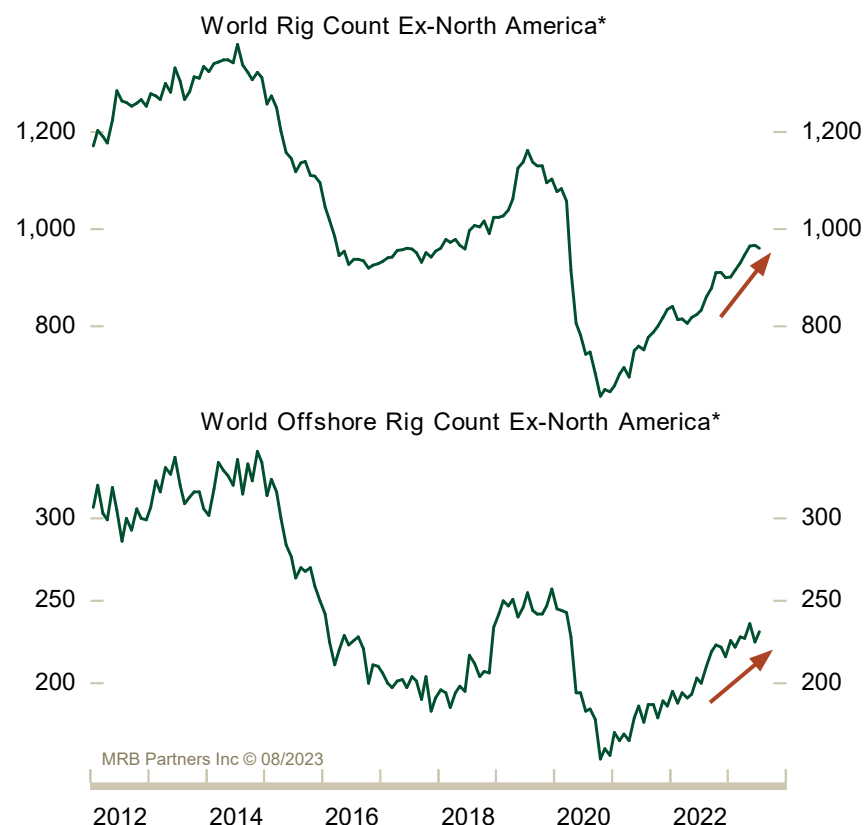
- Softening drilling activity in the U.S...

- ...More than offset by strength in international markets



\* Source: Refinitiv I/B/E/S Global Aggregates; smoothed

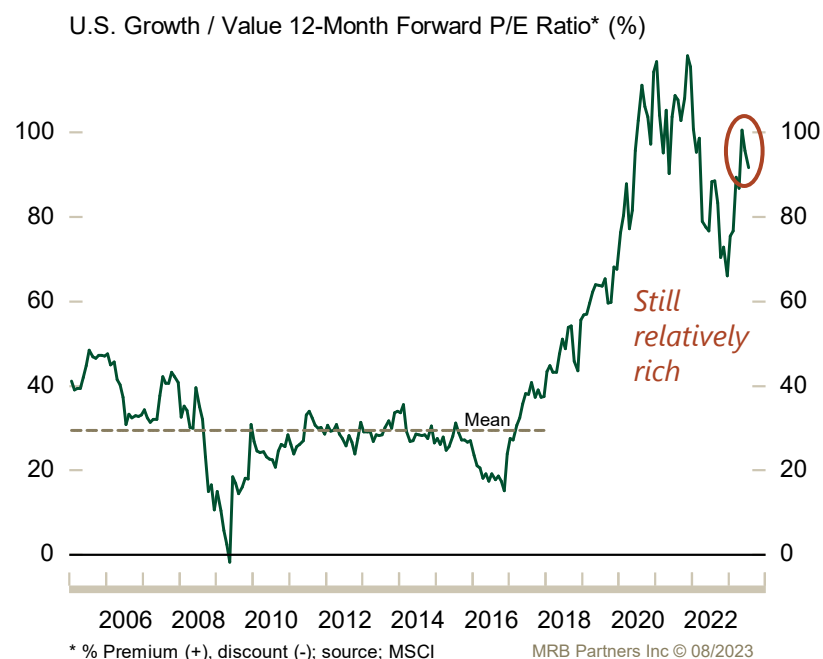
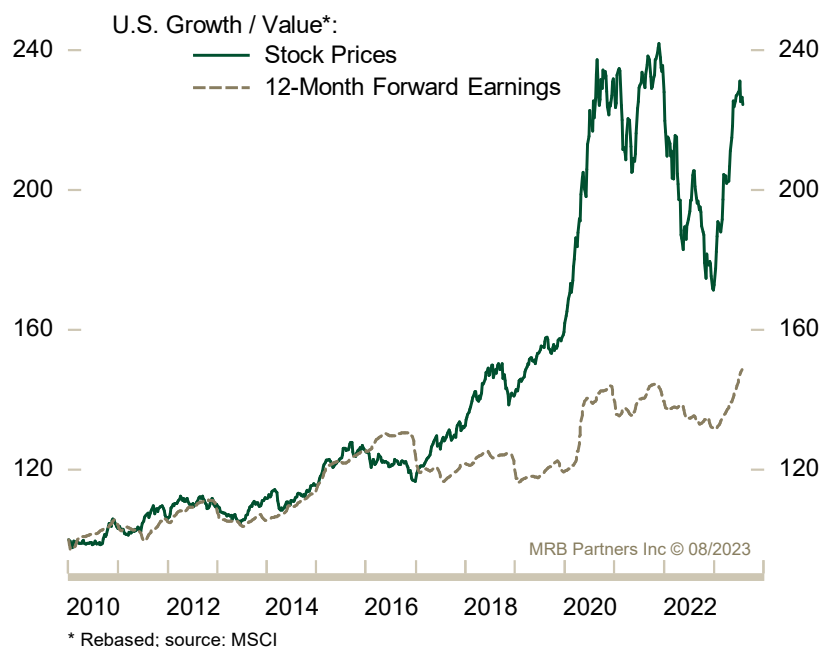
\*\* Source: Baker Hughes



\* Source: Baker Hughes

# Style: Investors Have Placed Lofty Expectations Upon Growth Stocks

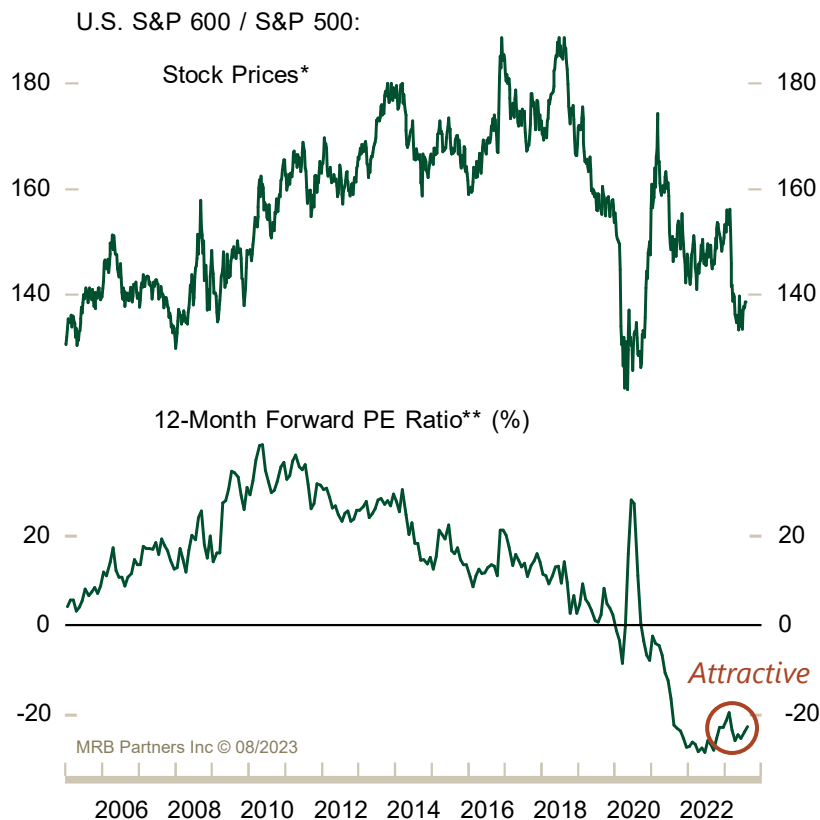
- Relative earnings have not validated the 2018-2021 run-up in relative share prices
- The valuation gap between growth and value remains large by historical standards



# Size: Small Caps Have Offsetting Positive And Negative Factors

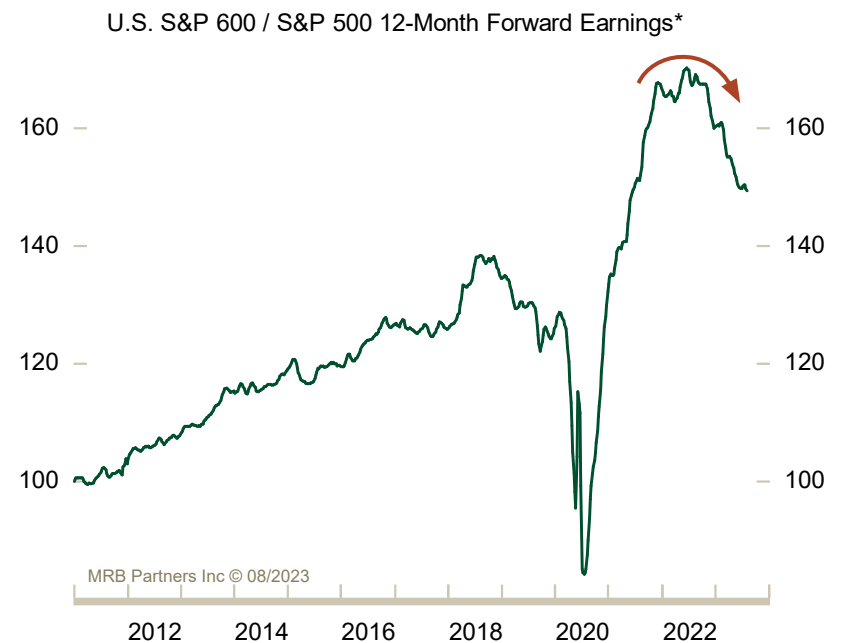
- Small-cap valuations offer attractive long-term value

- However, the relative forward earnings picture is not supportive



\* Rebased; source: Bloomberg












\*\* Percent premium (+), discount (-); source: Refinitiv I/B/E/S Global Aggregates



\* Rebased; smoothed; source: Refinitiv I/B/E/S Global Aggregates



# MRB U.S. Equity Sector And Industry Sub-Group Recommendations

Sector	Industry Ratings*		
	- N +	Underweight	Neutral
Consumer Discretionary		Automobiles Consumer Discretionary Retail Household Durables	Auto Components Hotels, Restaurants & Leisure Textile, Apparel & Luxury Goods
Communication Services			Media & Entertainment Telecom Services
Consumer Staples		Tobacco	Beverages Consumer Staples Retail Food Products Household & Personal Products
Energy			Oil, Gas & Consumable Fuels
Financials			Capital Markets Consumer Finance Insurance
Health Care			Health Care Equipment & Supplies
Industrials		Machinery Road & Rail	Electrical Equipment
Information Technology		Semiconductor & Semi-Equipment Technology Hardware & Equipment	Software IT Services
Materials		Chemicals Metals & Mining	
Real Estate			Real Estate
Utilities			Utilities

\* 6-12 month horizon; relative to the U.S. equity benchmark  
Note: + = overweight, N = neutral, - = underweight

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