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Independent Investment Strategy

Positioning In A Late-Cycle Environment

August 2023



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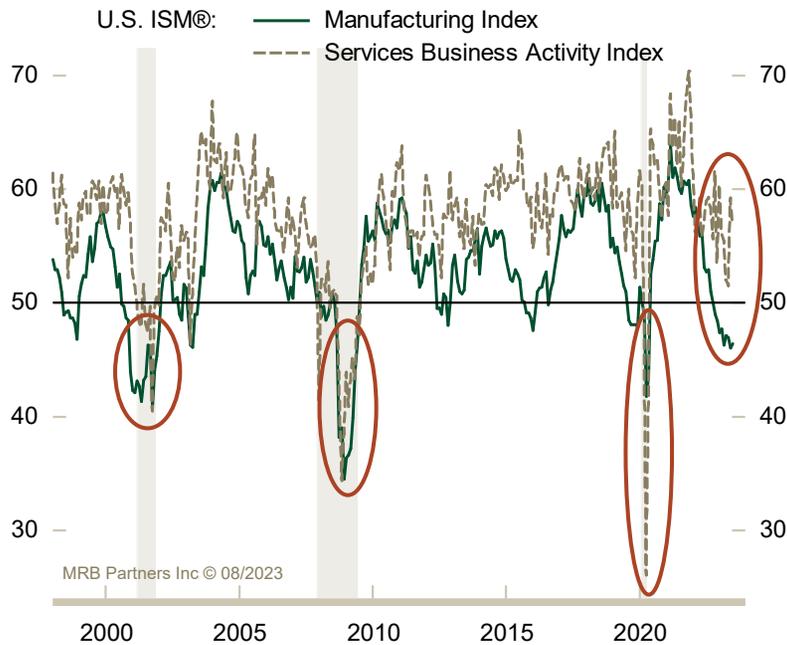
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Main Highlights

- 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.

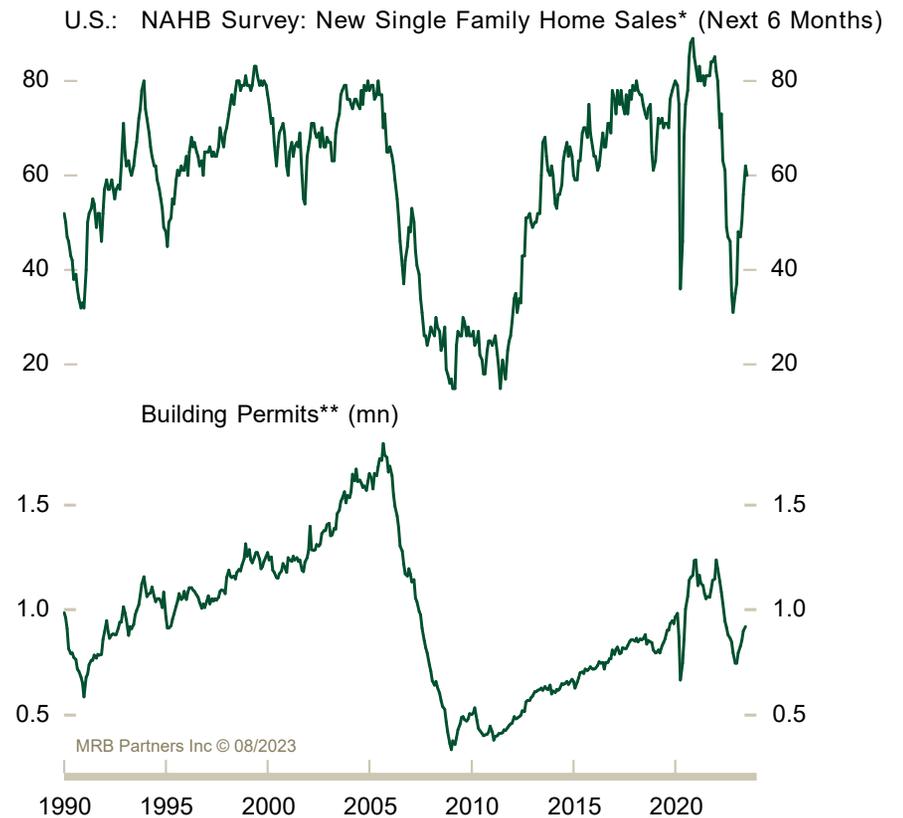
U.S. Economic Growth Has Been Resilient

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



* Source: Institute for Supply Management®
 Note: Shaded for NBER-designated U.S. recessions

- Housing activity has bottomed out



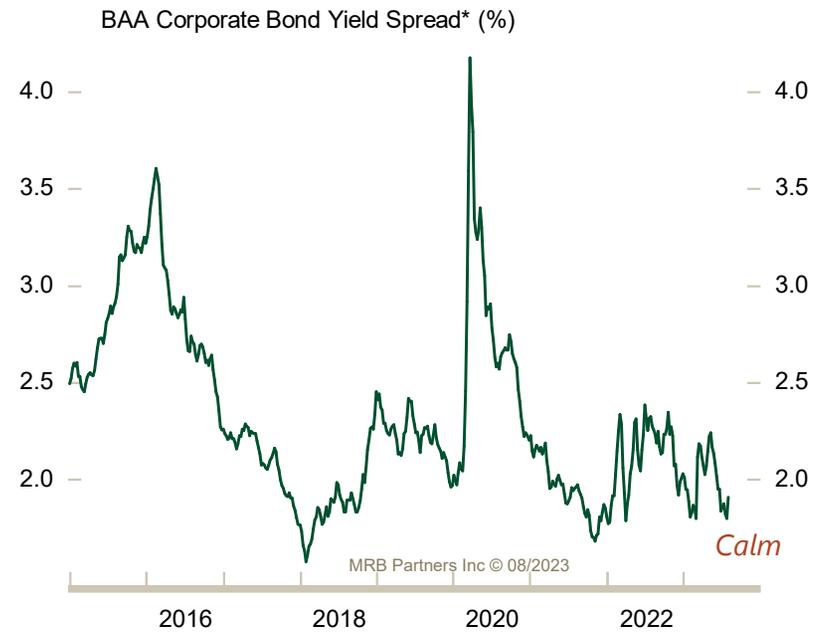
* Source: National Association Of Home Builders
 ** Source: U.S. Census Bureau

High Frequency Indicators Signal That The Economic Expansion Is Continuing

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



* Source: Federal Reserve Bank Of New York
 Note: - - - 13-week moving average

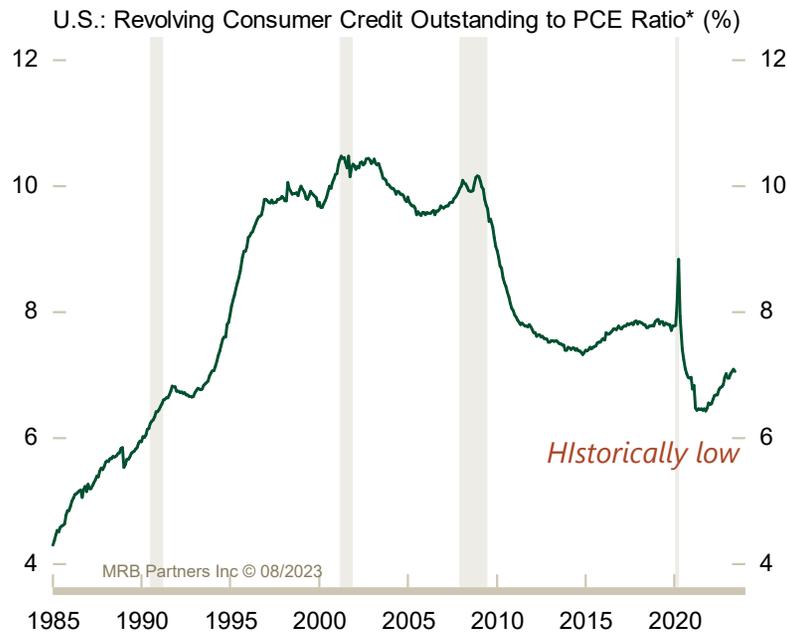


* Source: Federal Reserve Bank of St. Louis

Calm

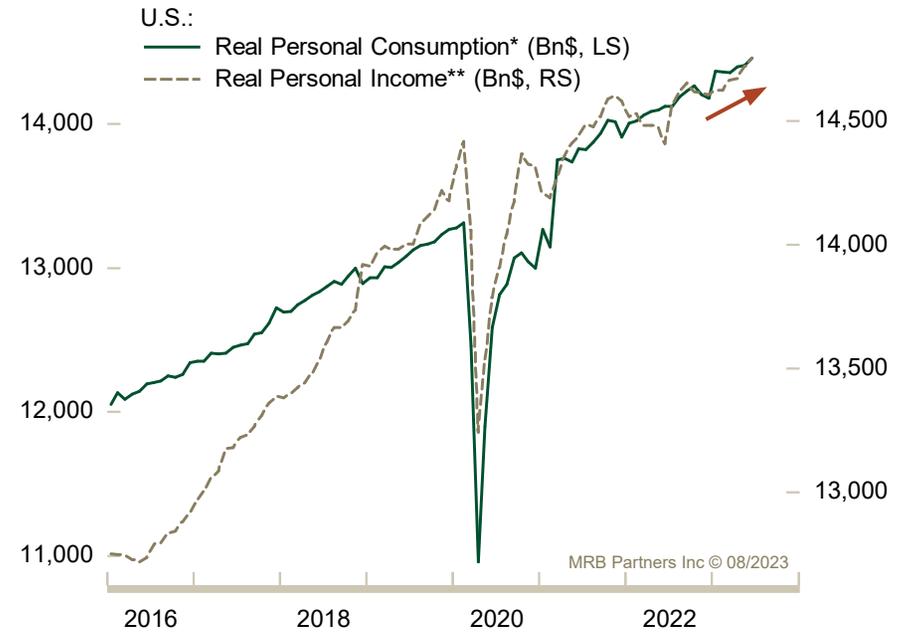
The Prospects For Consumption Remain Solid

- Loan balances-to-spending are historically low



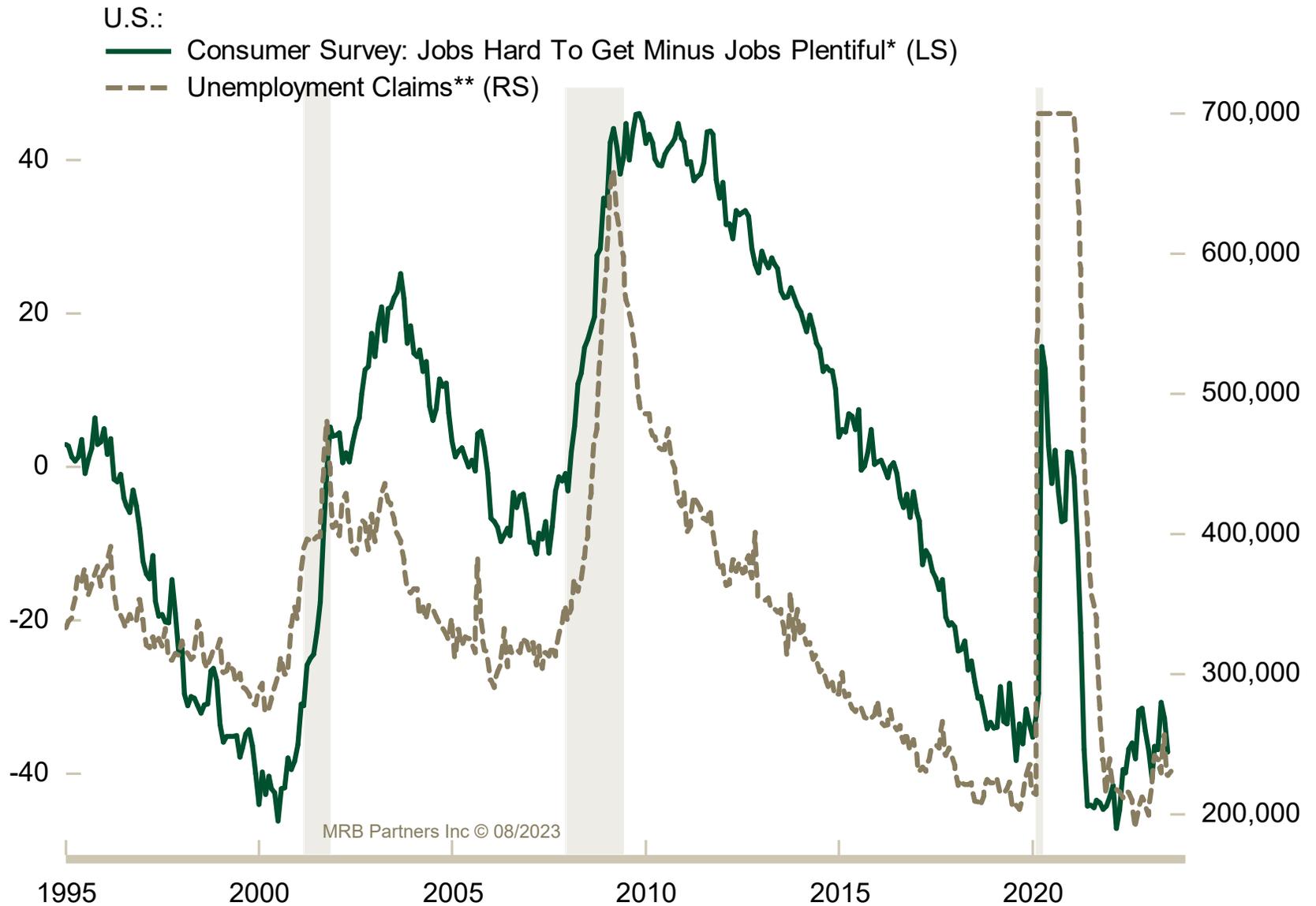
* Source: Federal Reserve & U.S. Bureau of Economic Analysis
 Note: Shaded for NBER-designated U.S. recessions

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



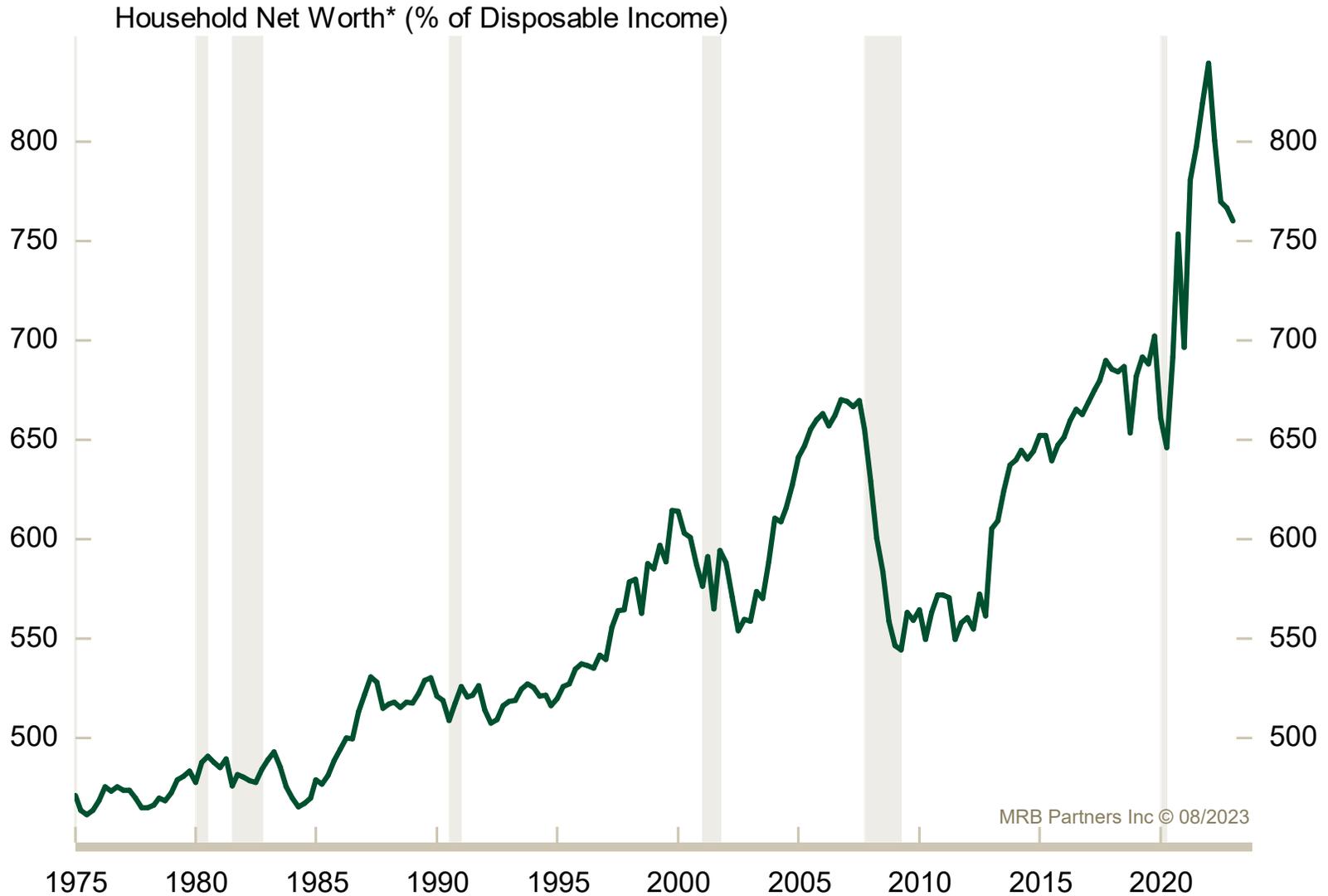
* Source: U.S. Bureau of Economic Analysis
 ** Excluding current transfer receipts; source: U.S. Bureau of Economic Analysis

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



* Source: Federal Reserve

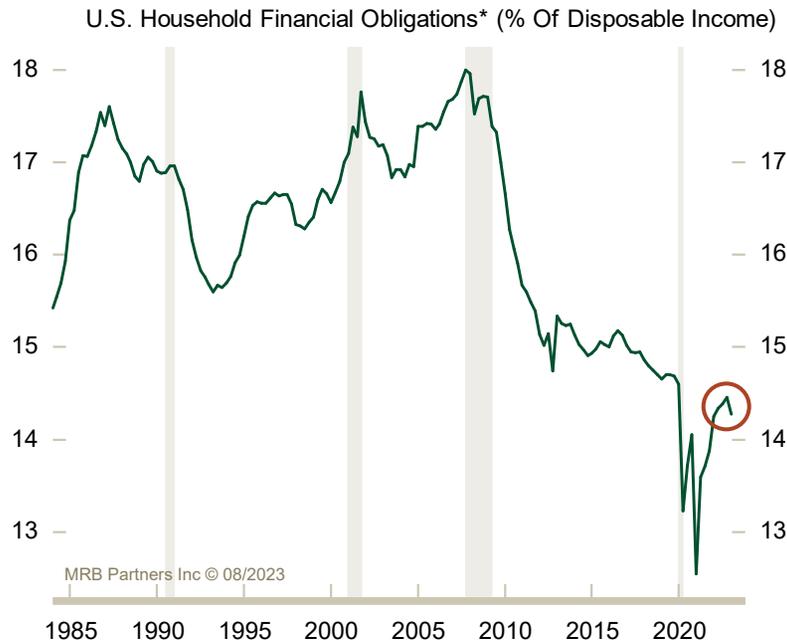
Note: Shaded for NBER-designated U.S. recessions

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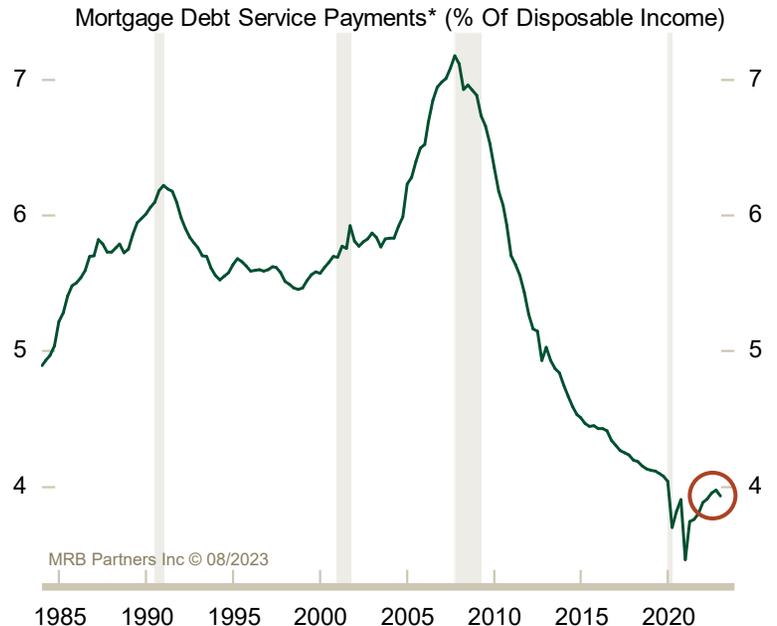
The Fed Is Not Crimping Households

- Debt service burdens are still low by historical standards

- Mortgage debt service payments are manageable

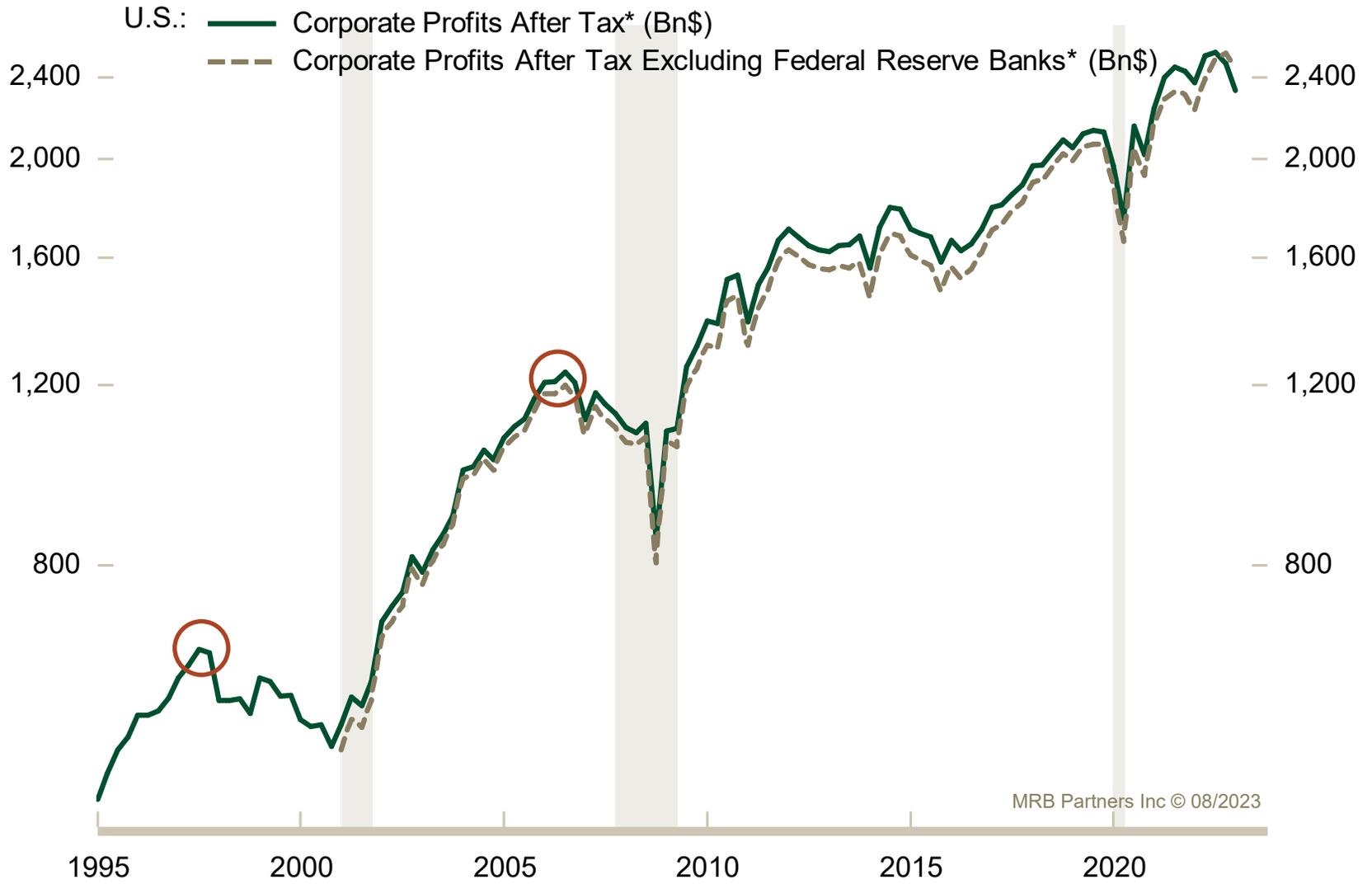


* Source: The Federal Reserve
 Note: Shaded for NBER-designated U.S. recessions



* Source: The Federal Reserve System
 Note: Shaded for NBER-designated U.S. recessions

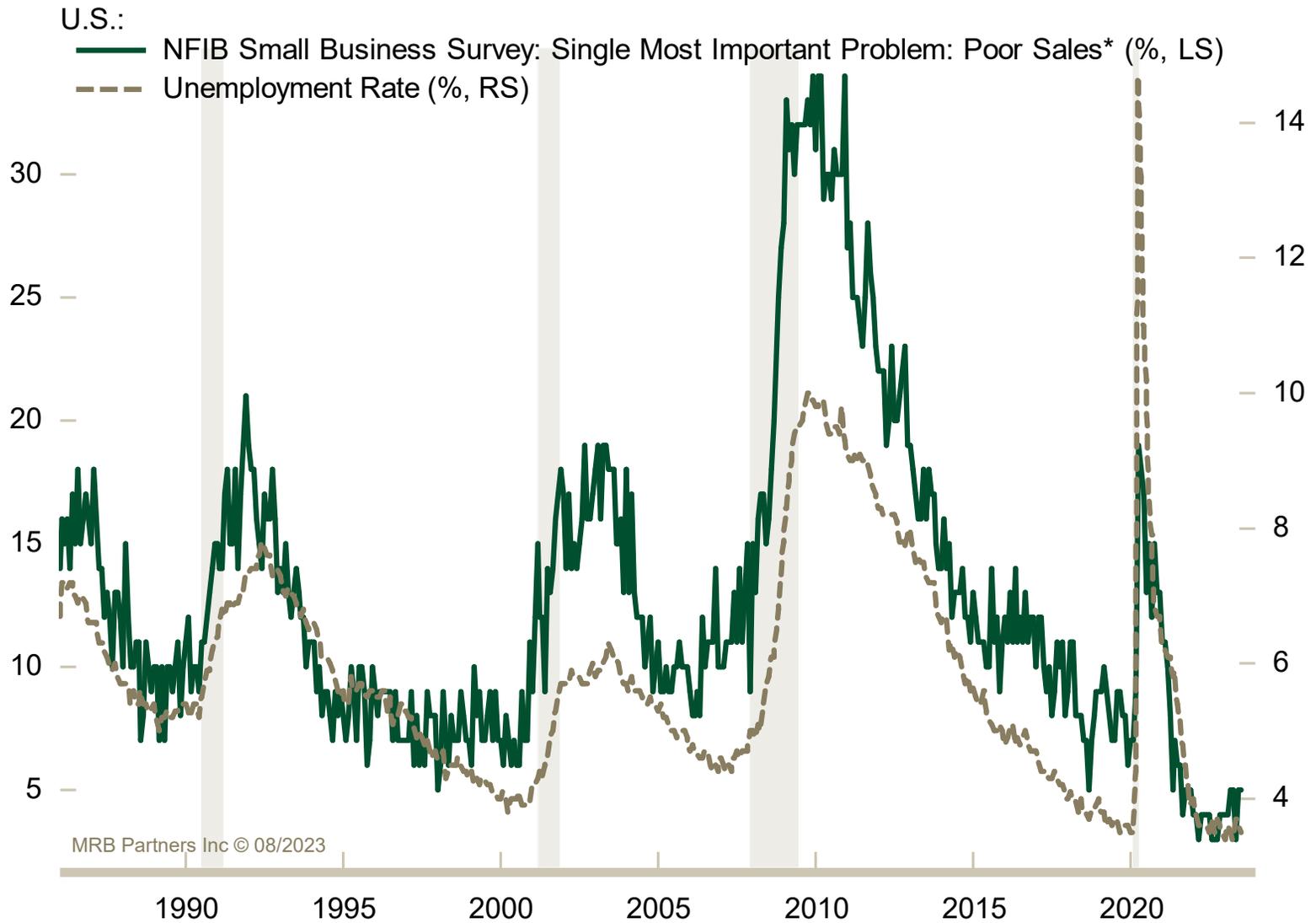
Corporate Profits Are Showing Tentative Signs Of Rolling Over



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

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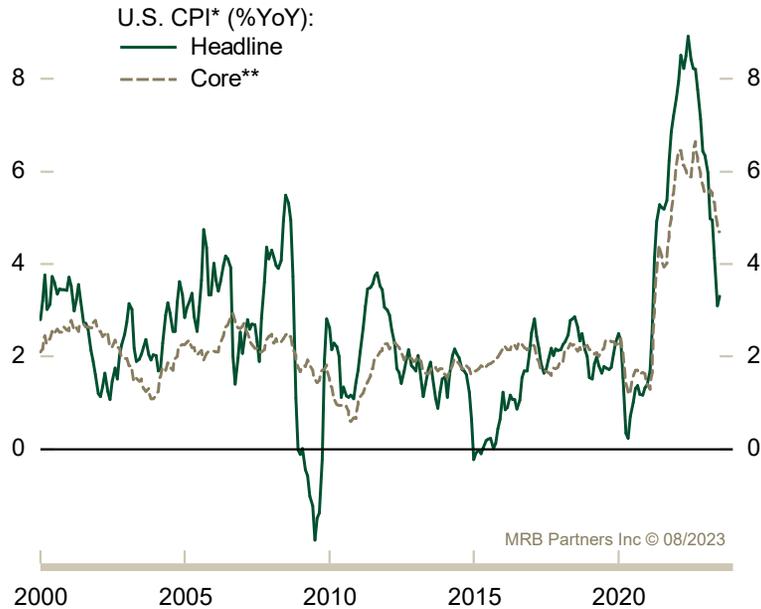
Companies Usually Do Not Cut Costs Unless Their Sales Prospects Deteriorate



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

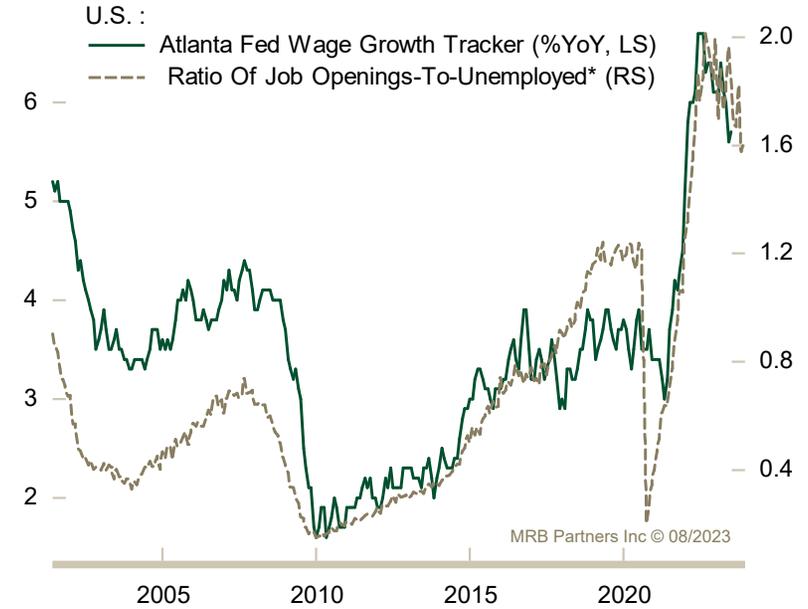
The Fed Will Have To Hold The Policy Rate Higher For Longer

- Headline and core inflation have moderated



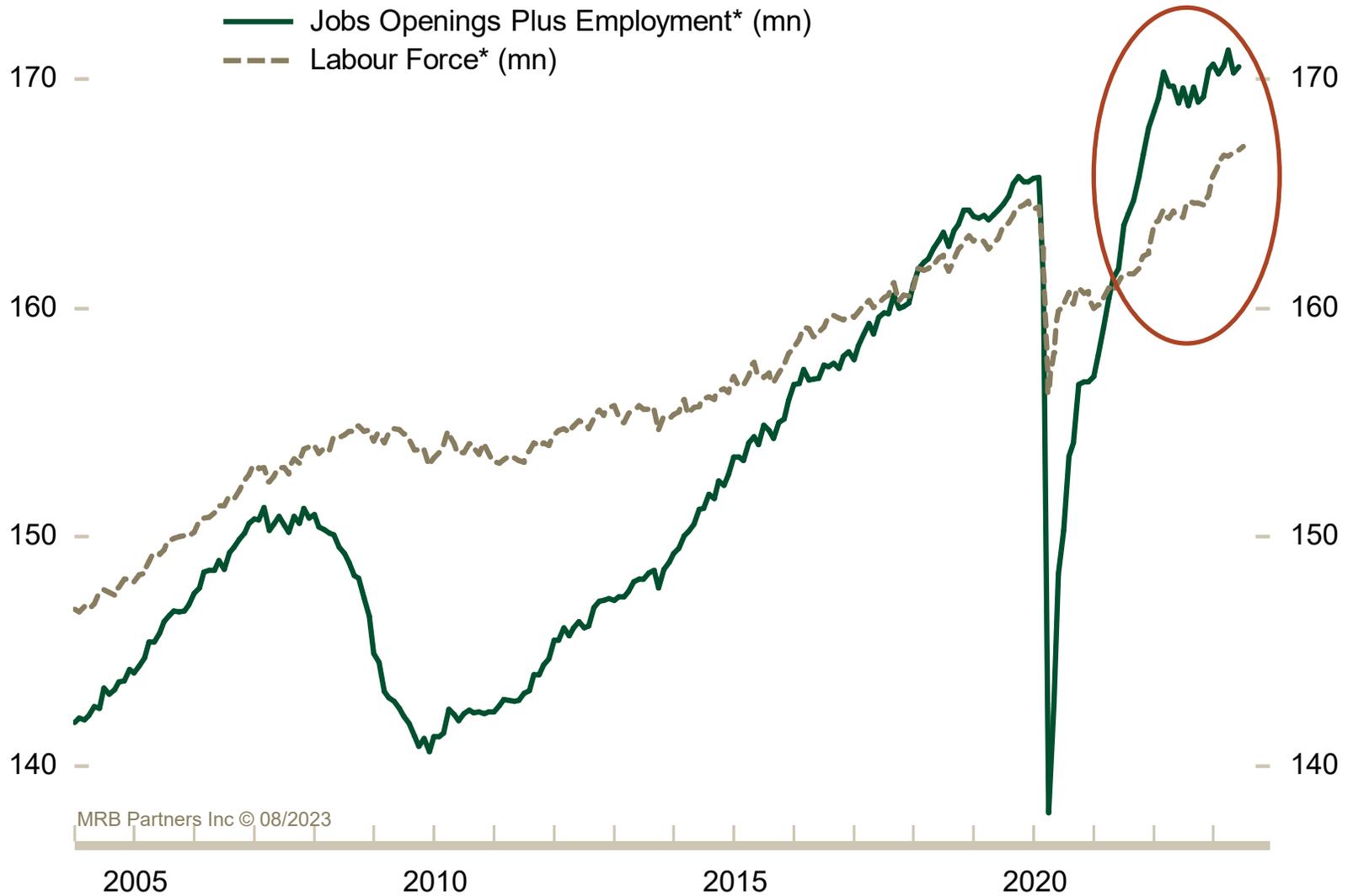
* Source: U.S. Bureau of Labor Statistics
 ** Excluding food and energy

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



* Source: U.S. Bureau Of Labor Statistics

Labor Demand Exceeds Labor Supply

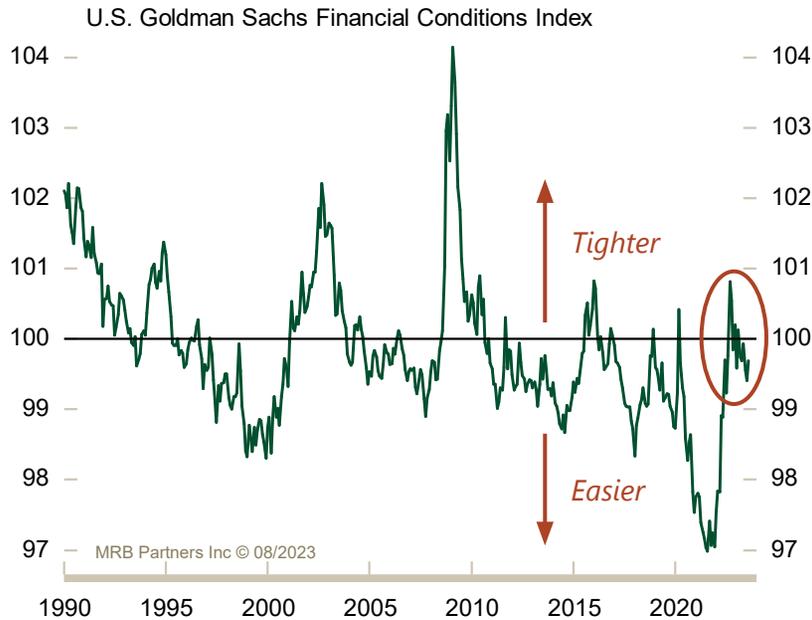


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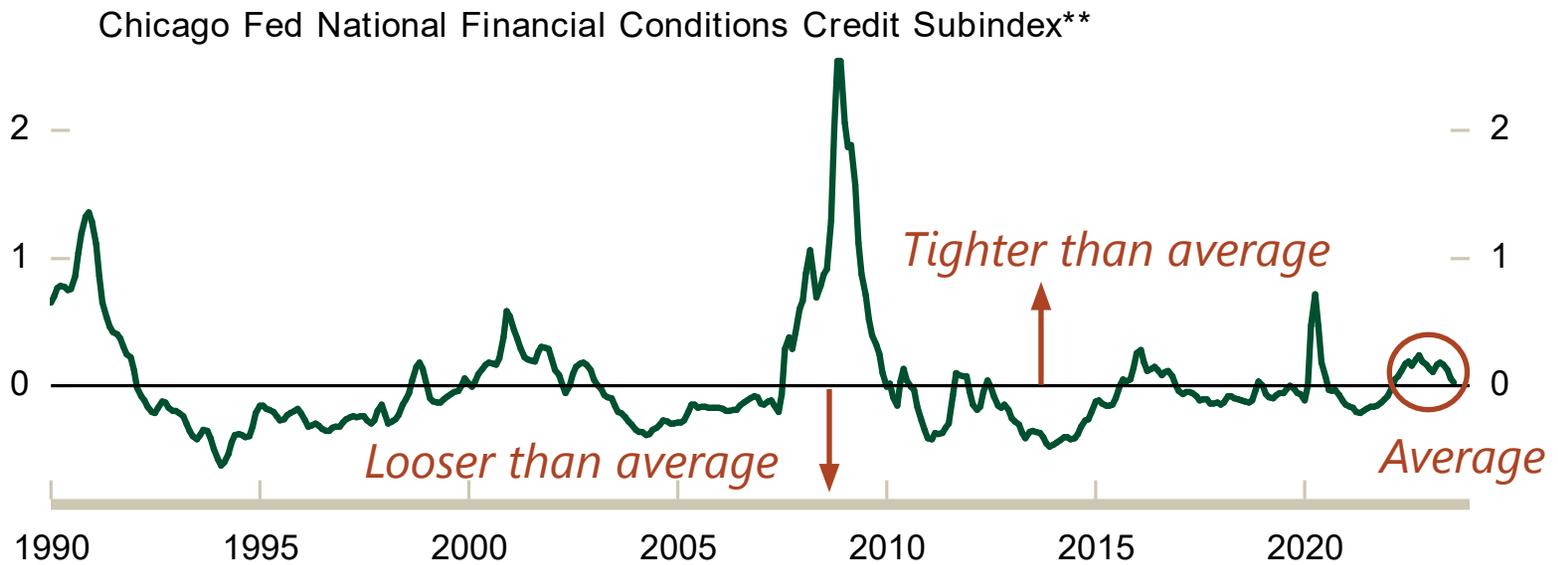
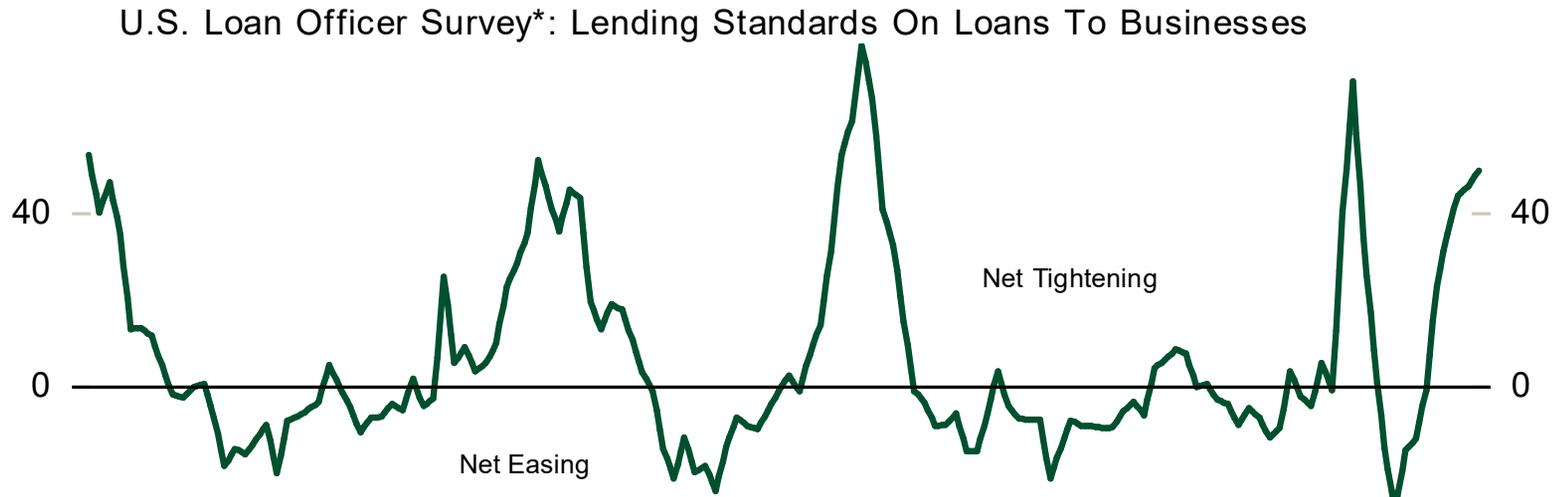
* Source: U.S. Bureau of Labor Statistics

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

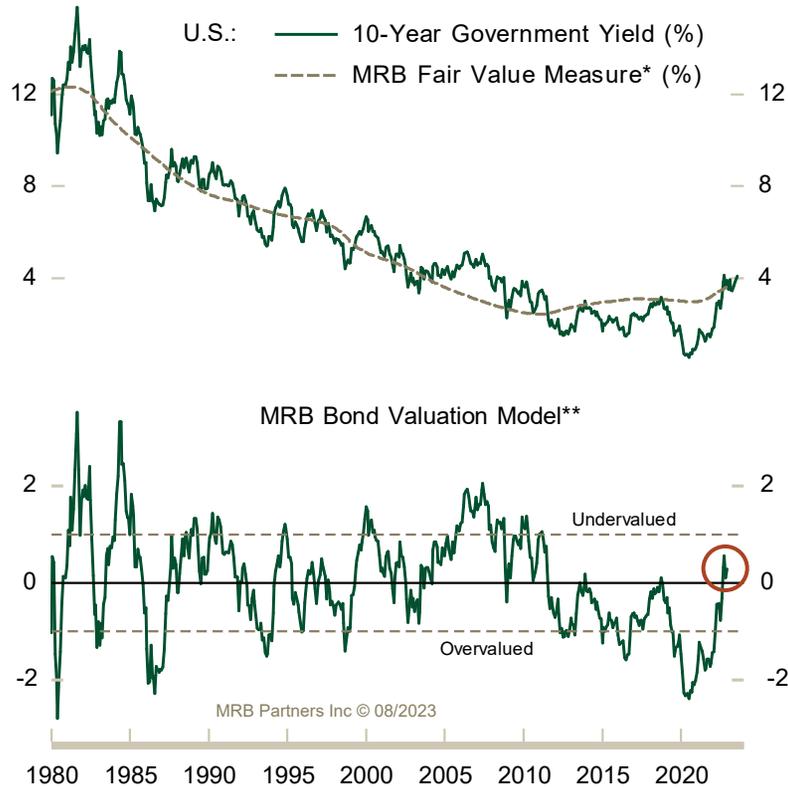


* Source: Federal Reserve

** Source: Federal Reserve Bank of Chicago

Bond Valuations Are Not Compelling

- Bonds have only returned to roughly fair value



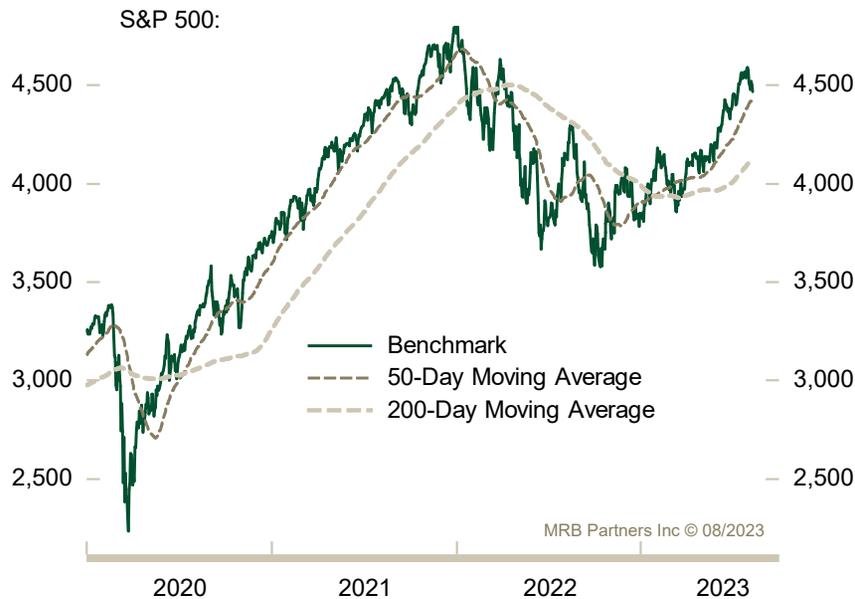
* Includes long-term economic growth and inflation measures
 ** 10-year government bond yield minus MRB Fair Value Measure

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



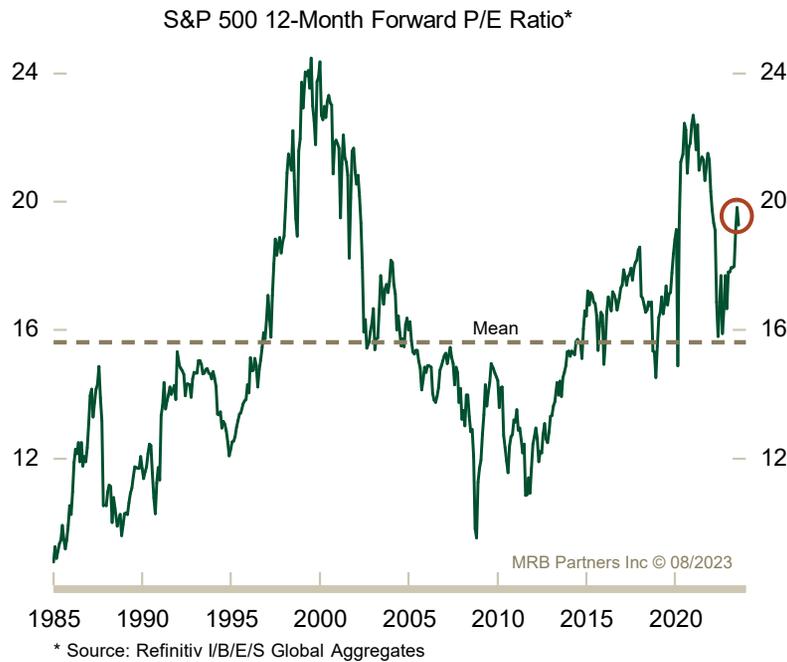
The Technical Picture For Stocks Is Positive

- 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

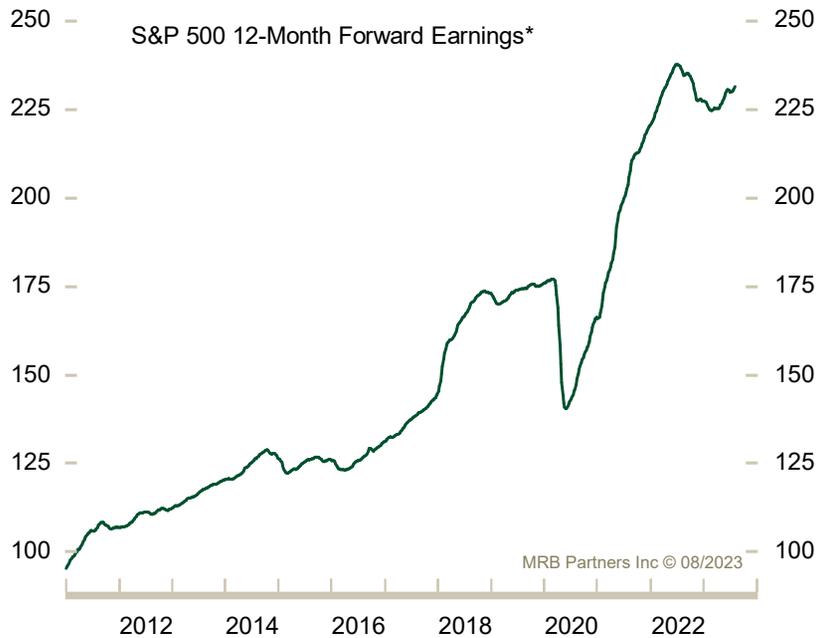


- Valuations have recently diverged from interest rates



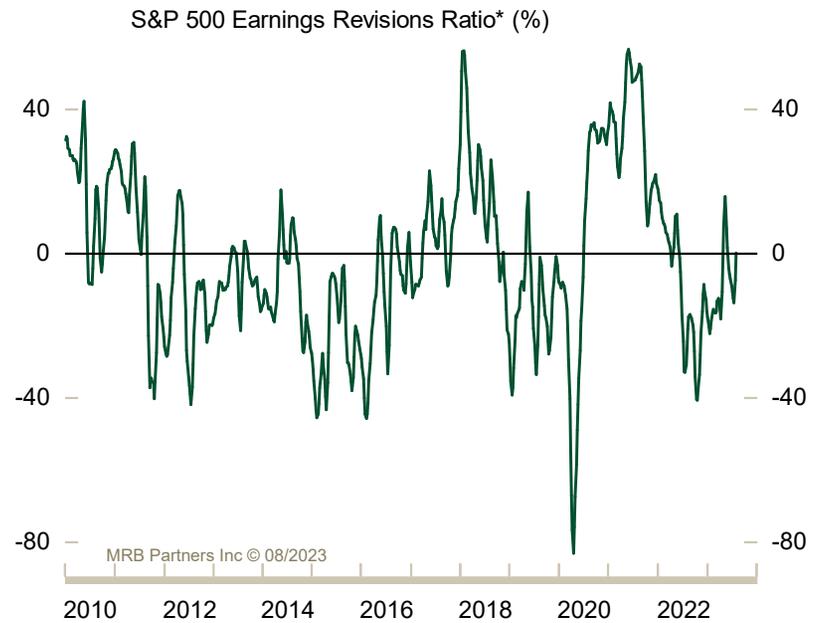
Earnings Have Shown Some Minor Green Shoots

- 12-Month forward earnings have recently hooked up



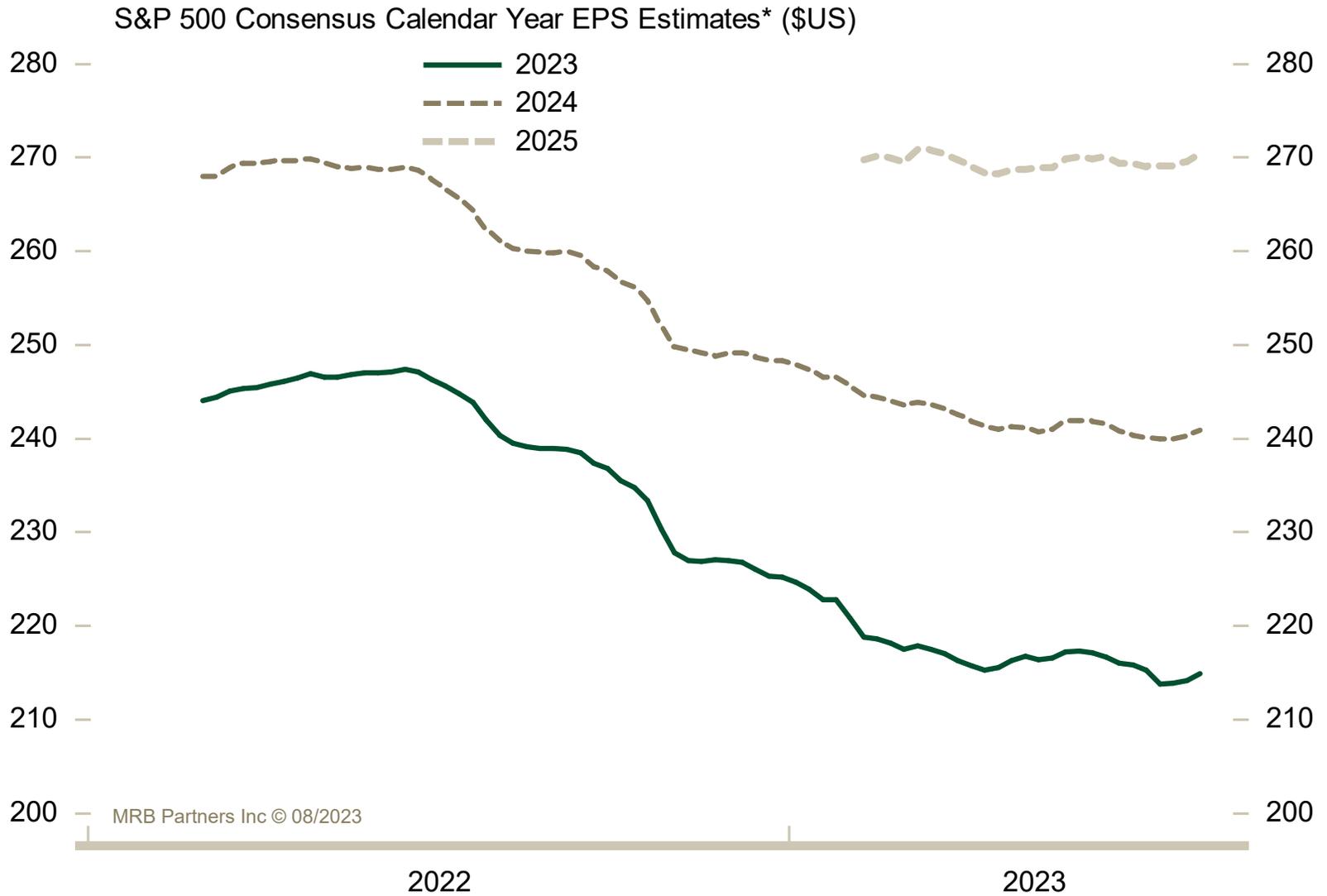
* Source: Refinitiv I/B/E/S Global Aggregates

- Negative revisions have eased



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

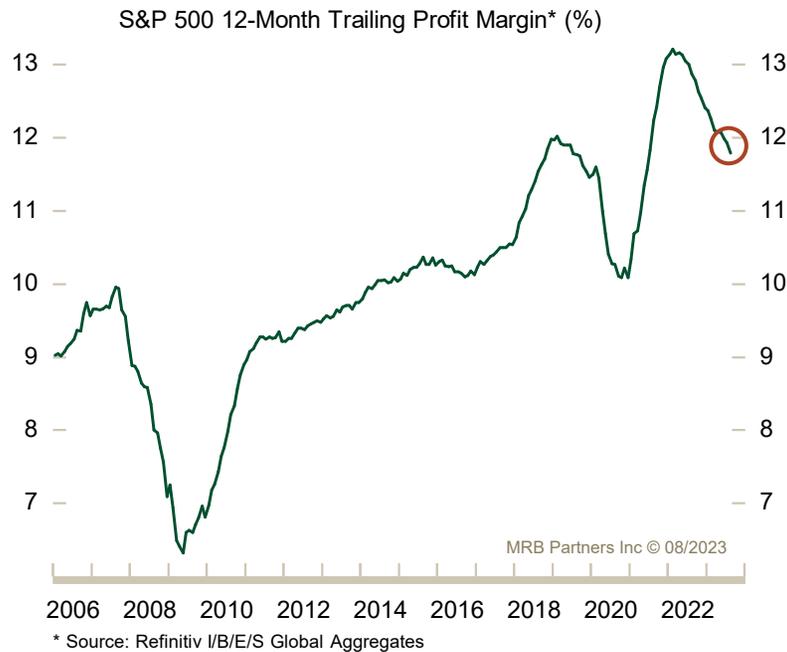
Full-Year Earnings Estimates Are Not Being Upwardly Revised



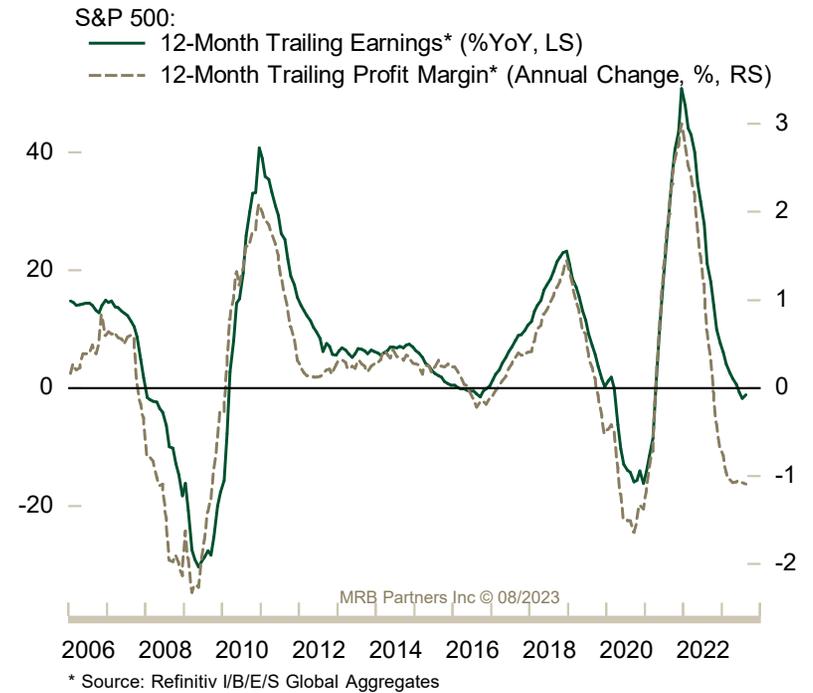
* Source: Refinitiv I/B/E/S Global Aggregates

Profit Margins Are Critical To The Earnings Outlook

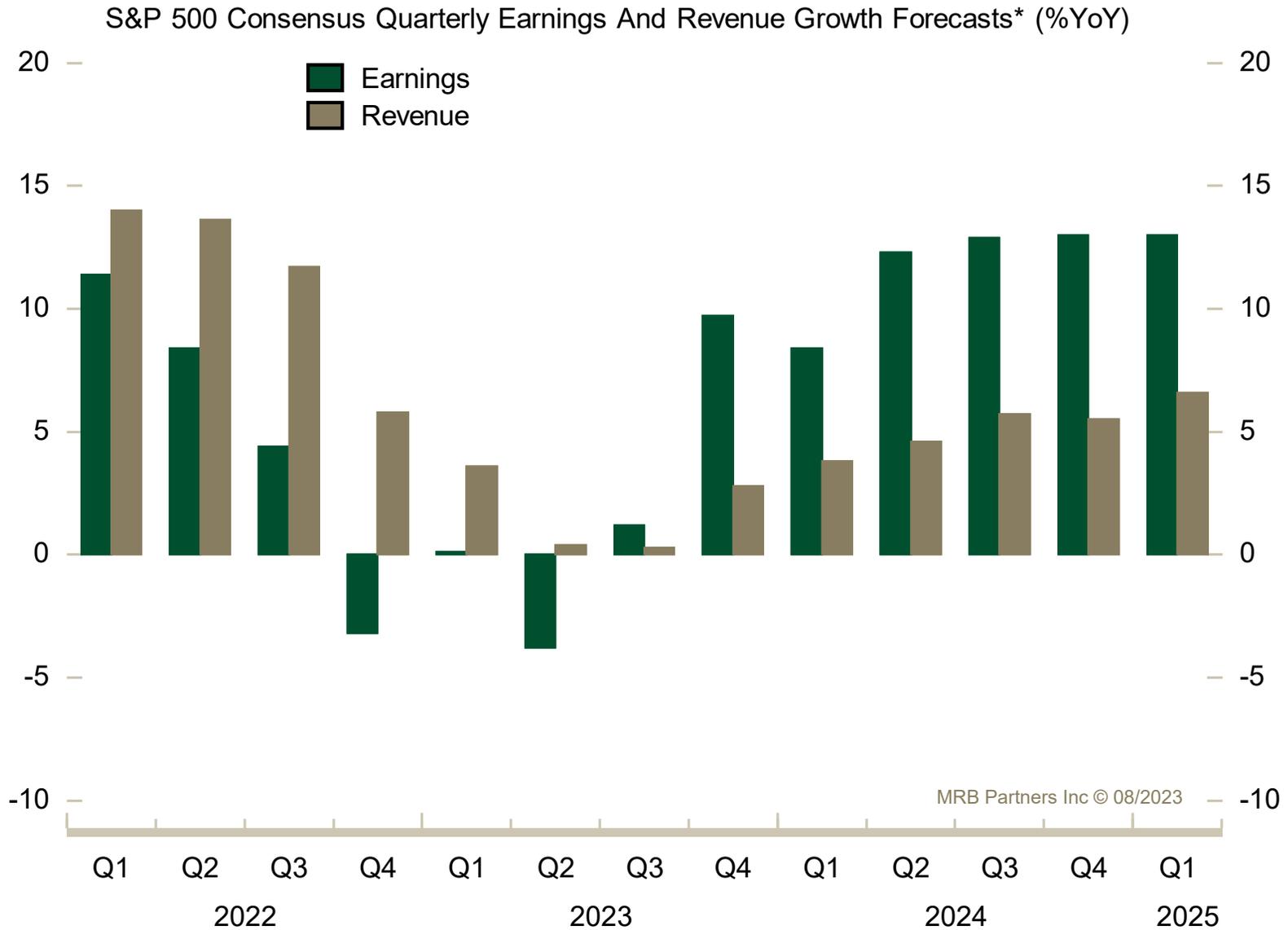
- Profit margins have declined from their highs, but remain at historically elevated levels



- 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	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Communication Services	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Consumer Staples	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Energy	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Financials	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Health Care	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Industrials	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Information Technology	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Materials	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Real Estate	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Utilities	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>

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* 6-12 month horizon

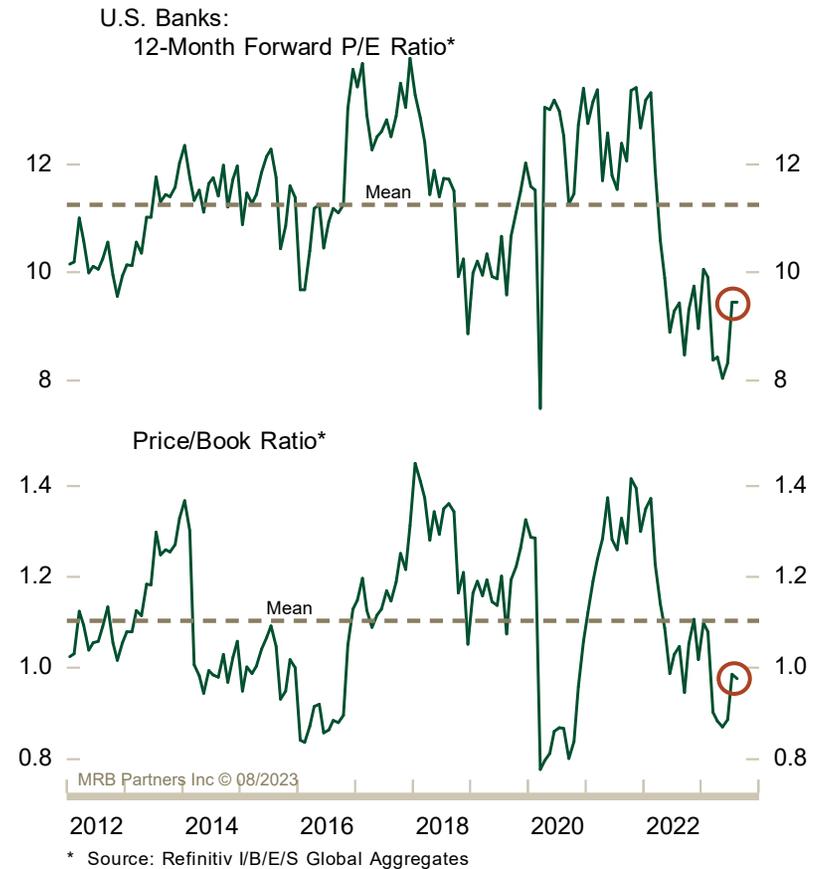
Note: + = overweight, N = neutral, - = underweight

Financials: Bank Stocks Have Been Overly Punished

- Bank stocks have discounted a massive decline in their underlying earnings

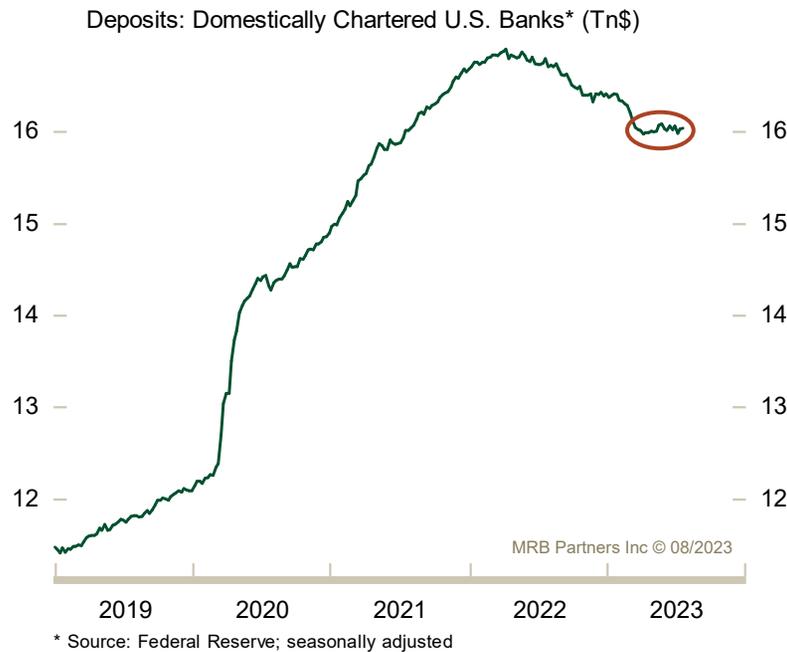


- Valuations are not far removed from their post-GFC lows

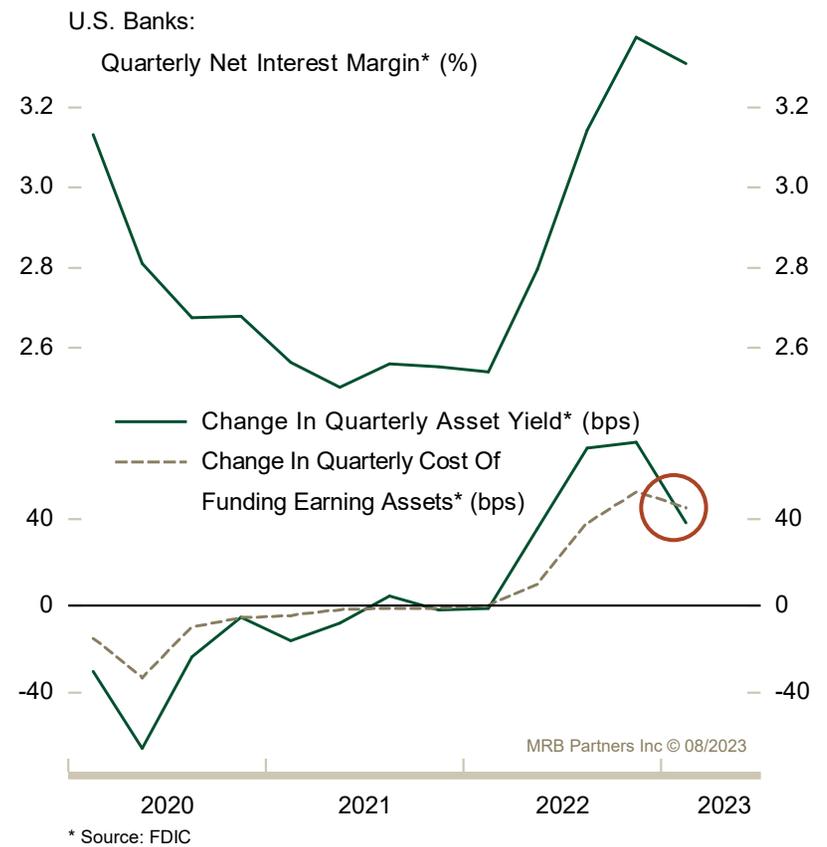


Financials: The Worst-Case Scenario For Banks Is Not Playing Out

- 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

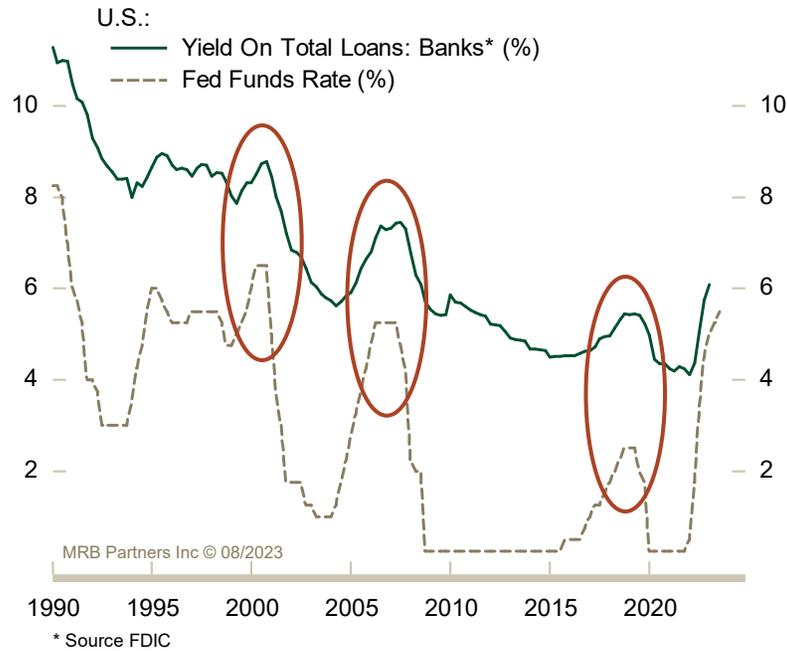
- Earnings estimates for diversified banks have been improving

- However, they have yet to bottom for regional banks

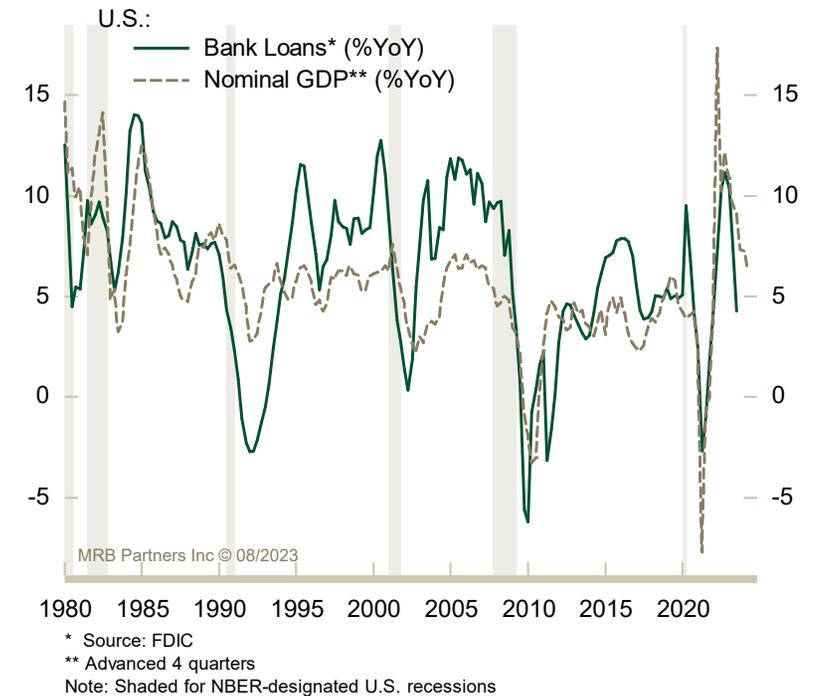


Financials: A Collapse Of Net Interest Income Is Not In The Cards

- Loan yields have room to increase



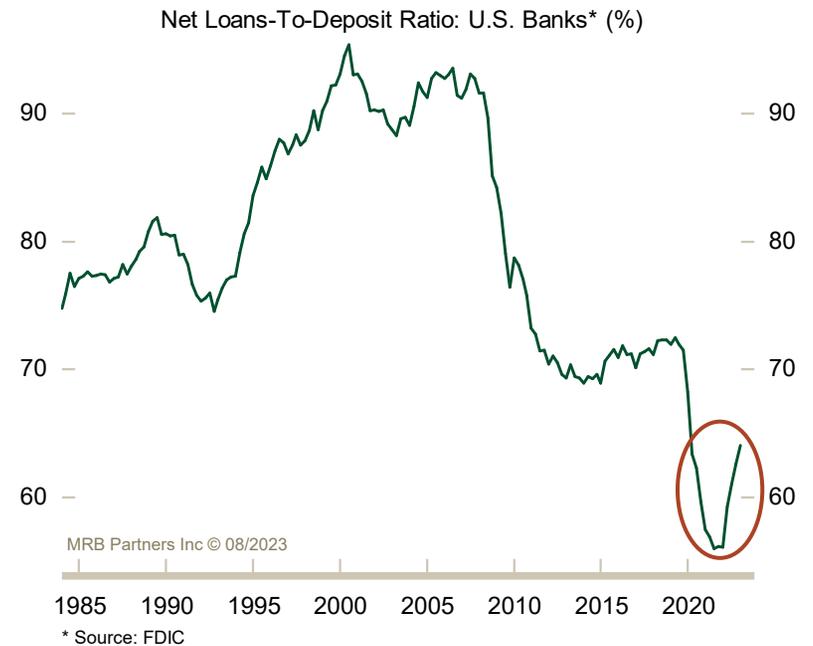
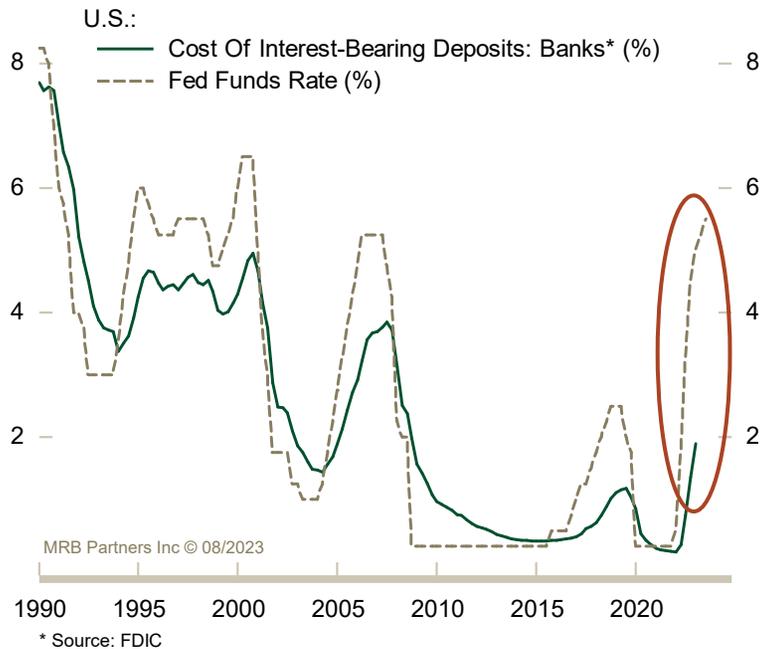
- Loan growth is moderating commensurate with the slowdown in nominal GDP growth



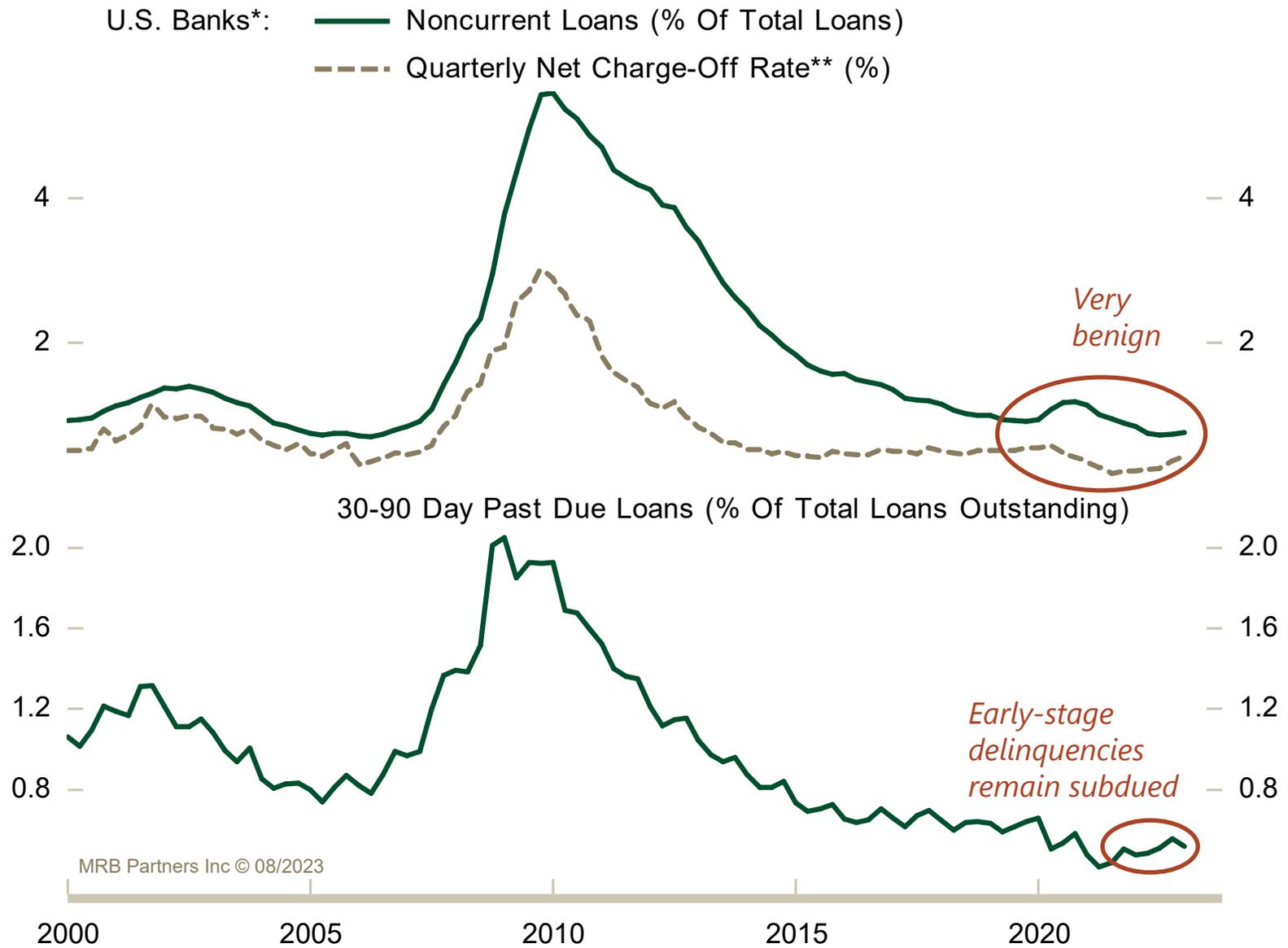
Financials: Funding Costs For Banks Will Continue To Rise, But The Increase Should Be Manageable

- Banks have been slow to increase the interest rate paid on deposits

- Low loan-to-deposit ratios suggest that most banks have excess deposits



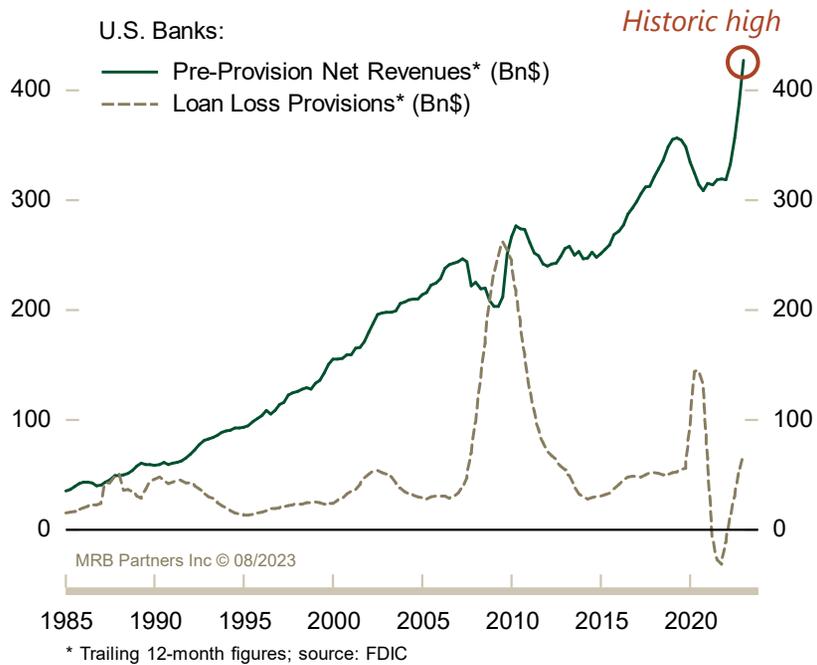
Financials: Credit Quality Remains Exceptionally Strong



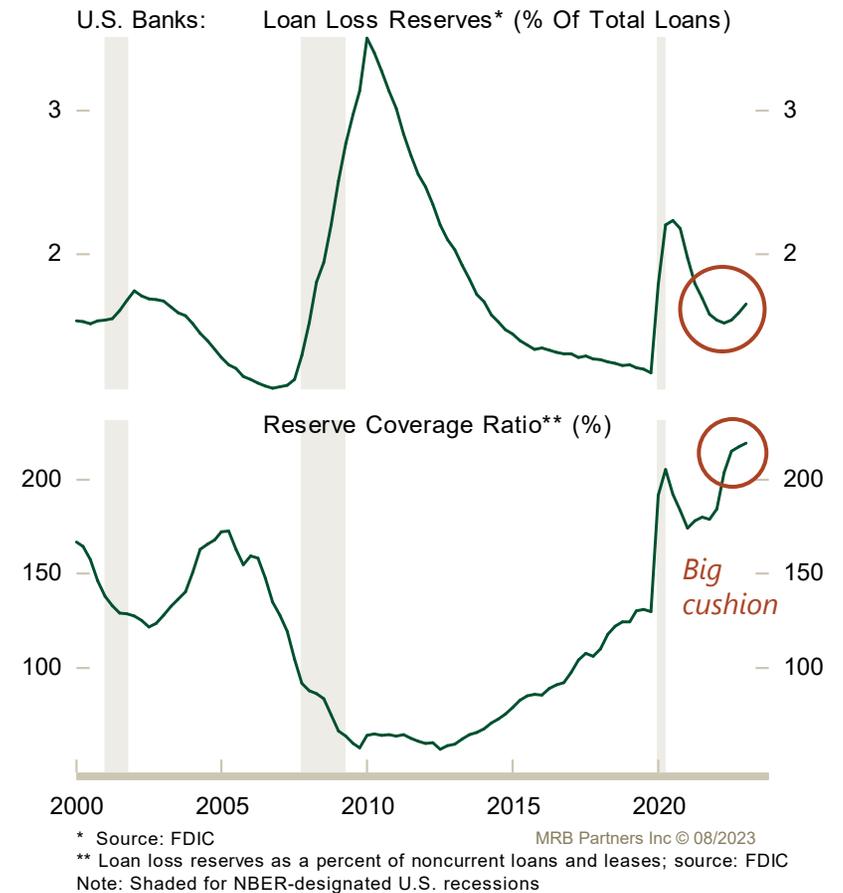
* Source: FDIC
 ** Annualized

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



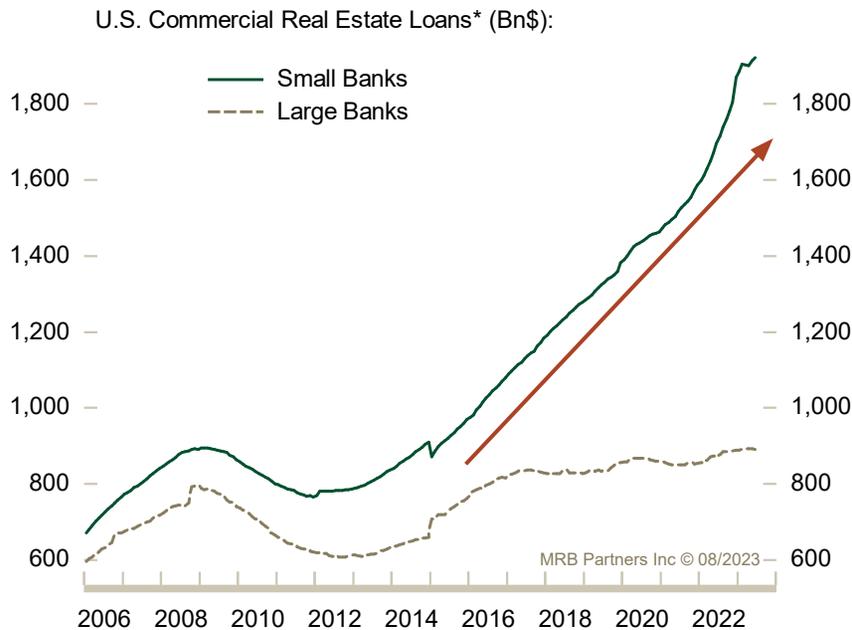
- Reserves against loan losses are higher than at the start of previous recessions



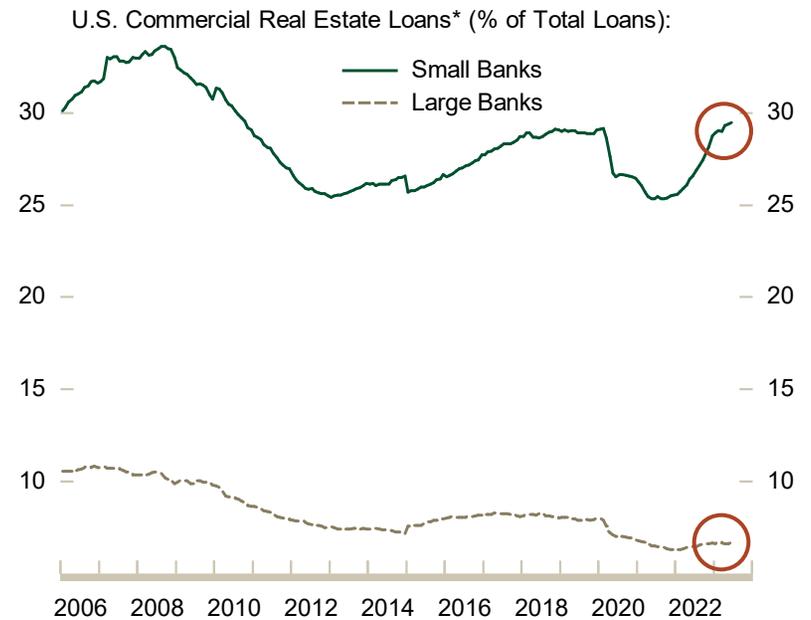
Financials: Concentration Risk In CRE Loans Is An Issue For Small Banks

- CRE lending has risen rapidly for small banks

- Small banks have significantly more exposure to CRE loans



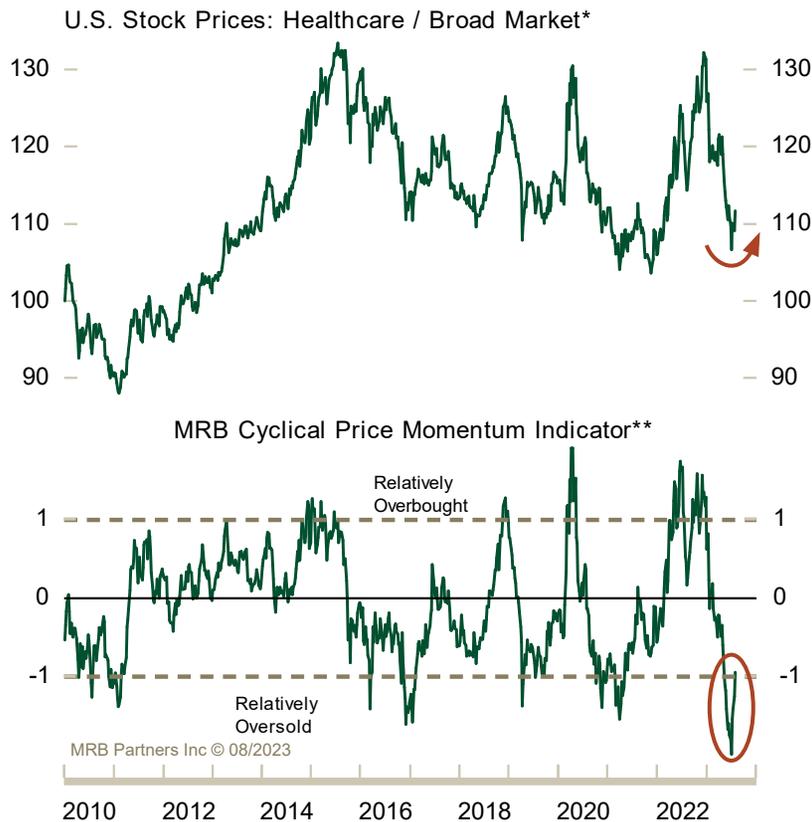
* Source: Federal Reserve
 Note: Large banks are defined as top-25 banks ranked by assets, while small banks are banks not included in the top-25



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

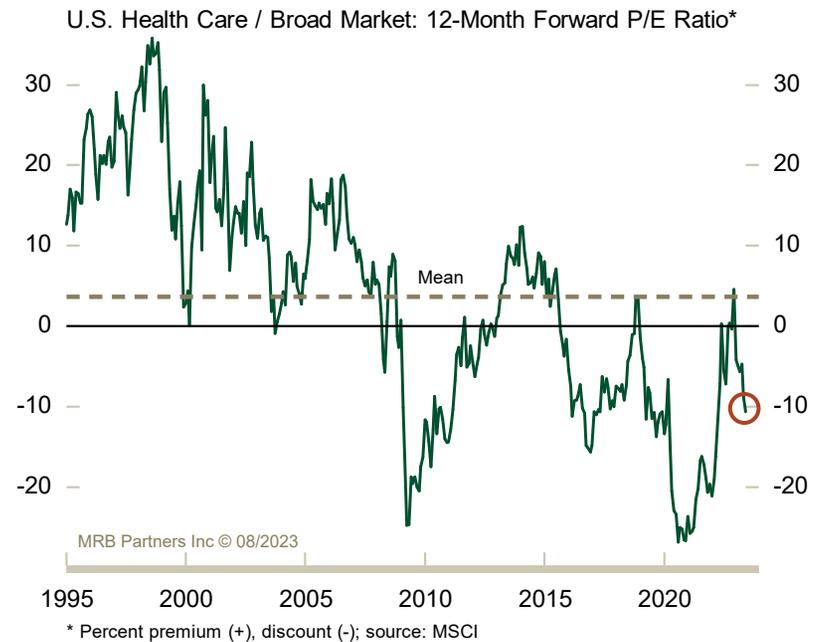
Health Care: Remains Our Most-Preferred Defensive Play

- Technical conditions are relatively oversold



* U.S. dollars; rebased; source: MSCI
 ** Standardized

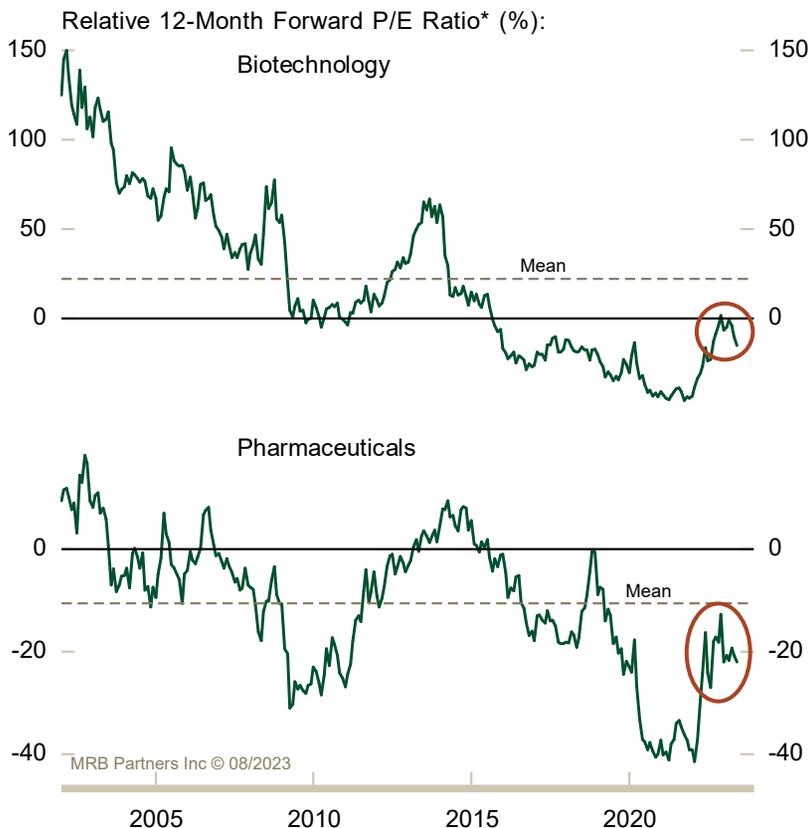
- Relative valuations are reasonable



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

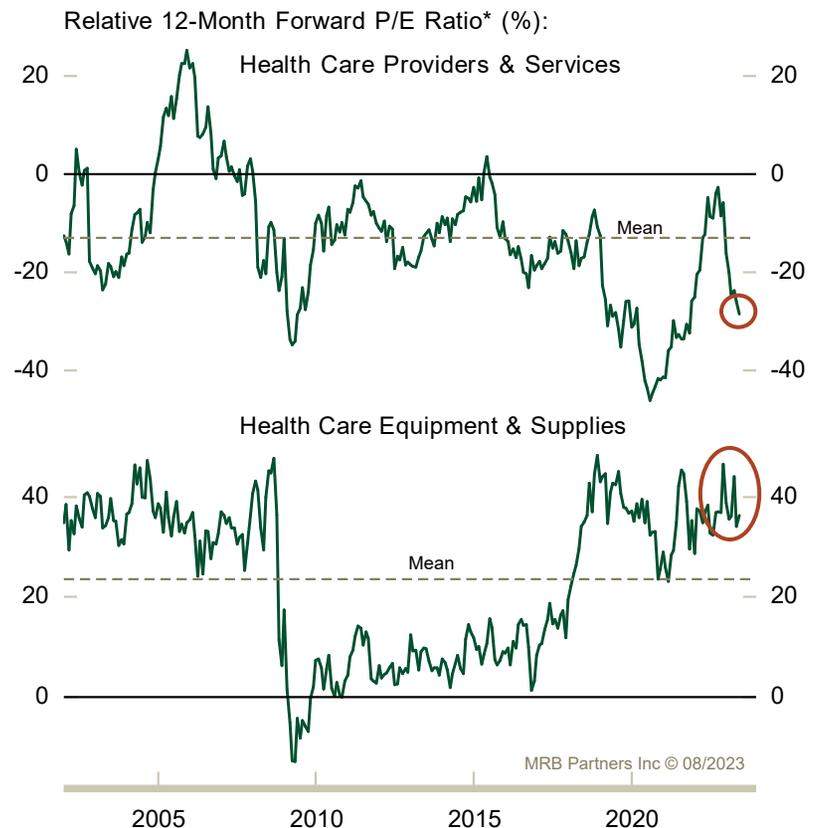
Health Care: Most Sub-Groups Trade At Attractive Relative Valuations

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



* Premium (+), discount (-) relative to broad market; source: MSCI

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



* Premium (+), discount (-) relative to broad market; source: MSCI

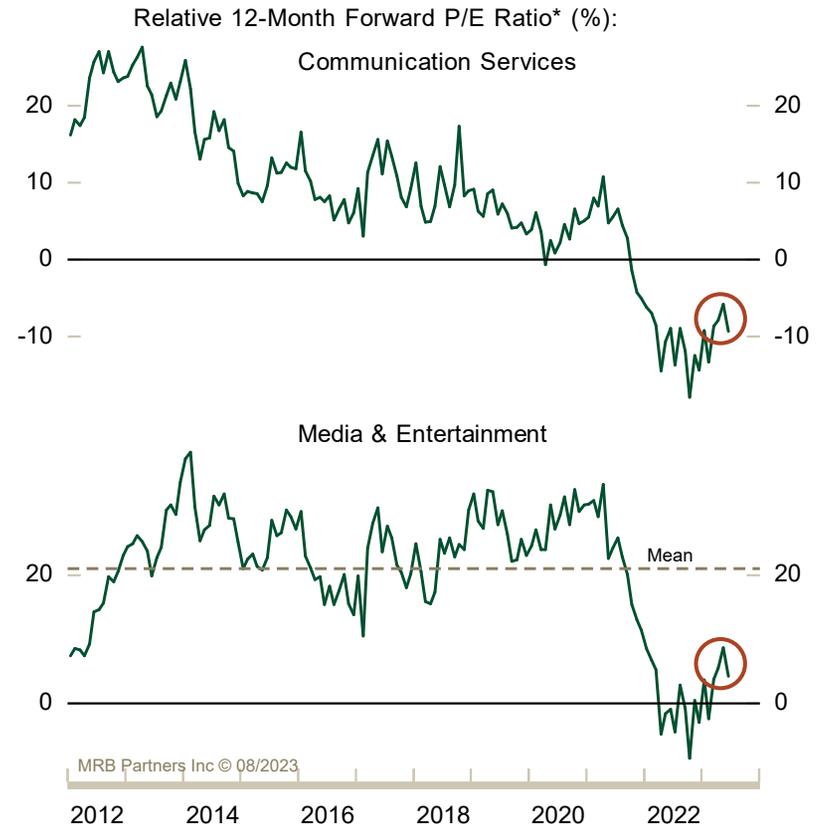
Communication Services: There Is More Relative Upside As Relative Earnings Improve And Valuations Continue To Normalize

- Share prices and valuations undershot underlying fundamentals in 2022



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

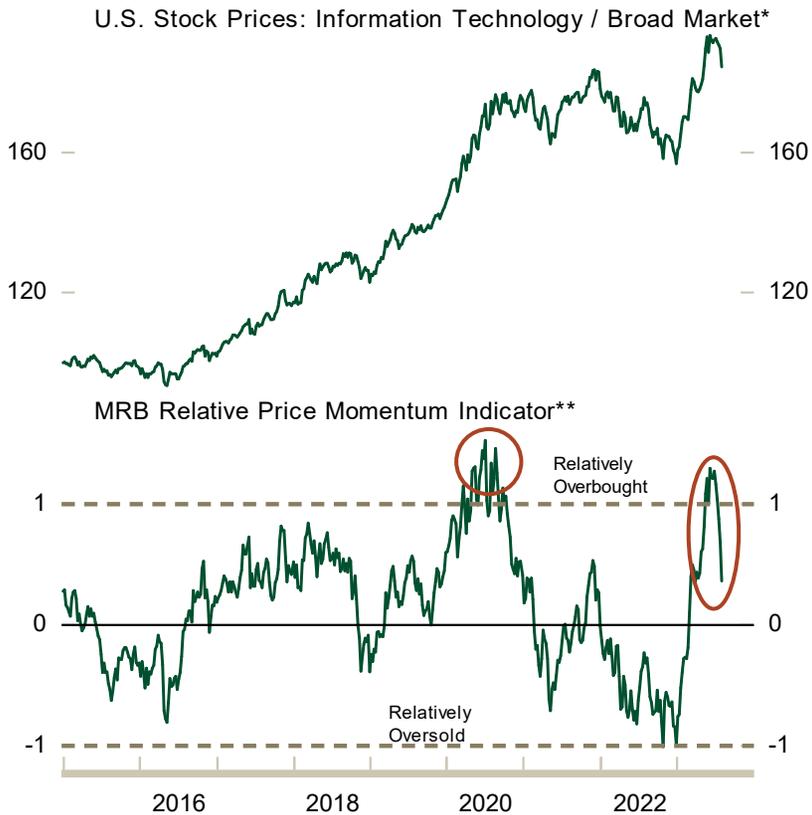
- Relative valuations are still attractive relative to their history



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

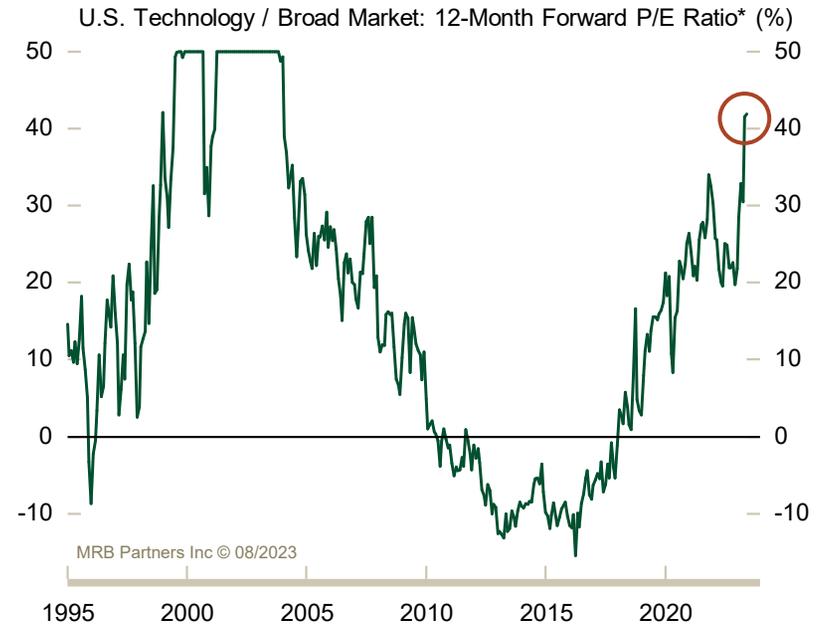
Technology: The Rally Has Been Mostly Driven By Sentiment, Rather Than Fundamentals

- The risk of a reversal in relative share prices is high
- Relative valuations currently exceed their late-2021 highs



* U.S. dollars; rebased; source: MSCI
** Standardized

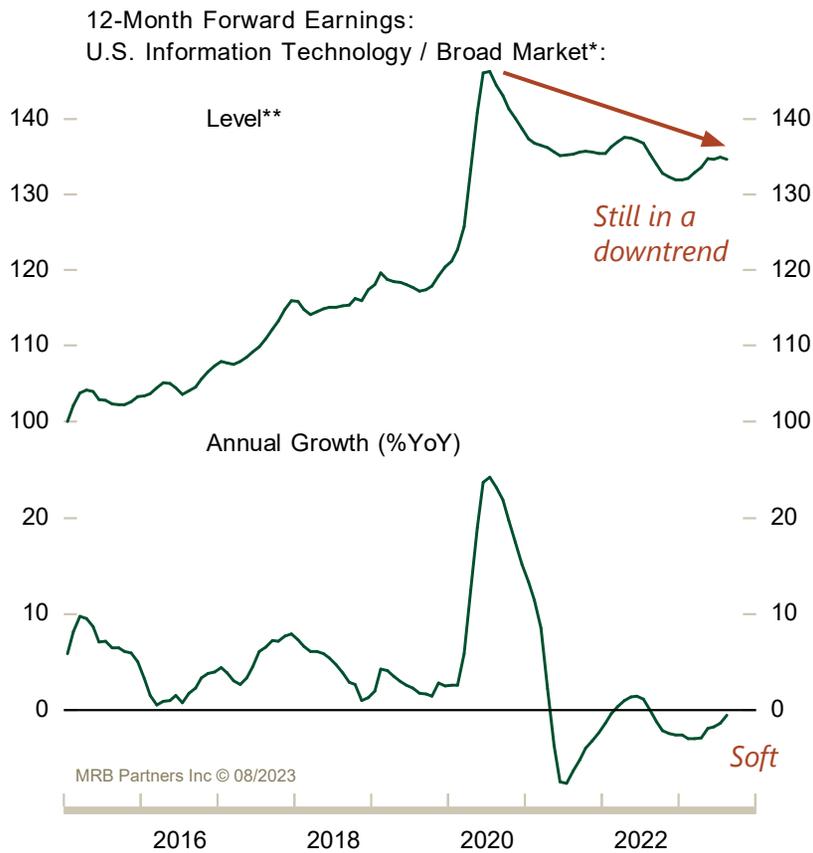
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* Truncated above 50%; % premium (+), discount (-); source: MSCI

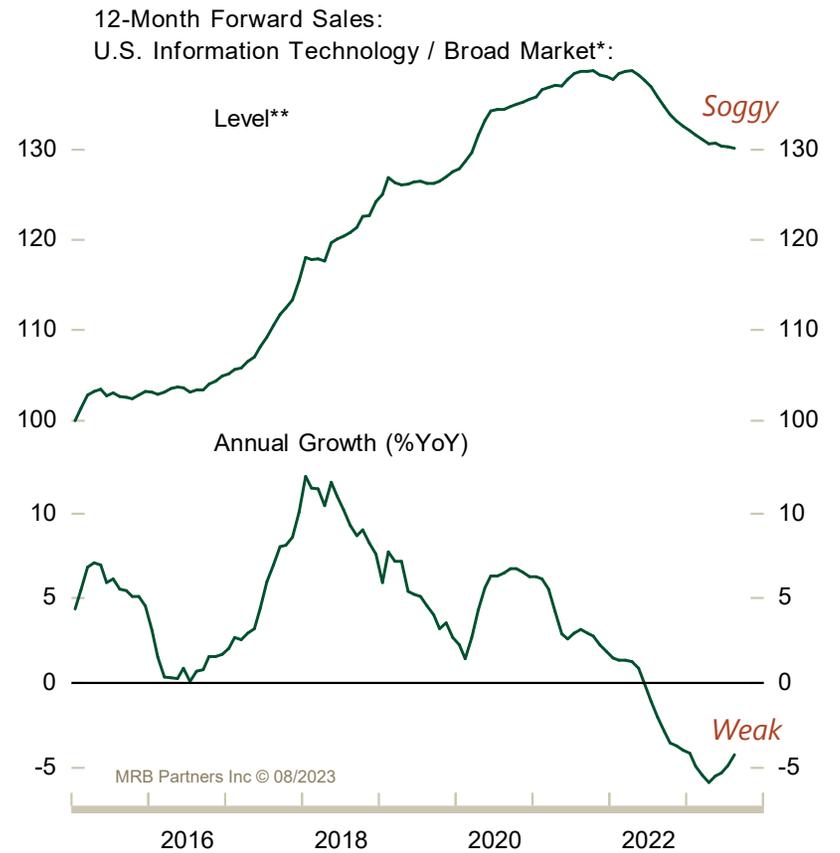
Technology: The Fundamentals Are Uninspiring

- Lackluster trends in relative earnings



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

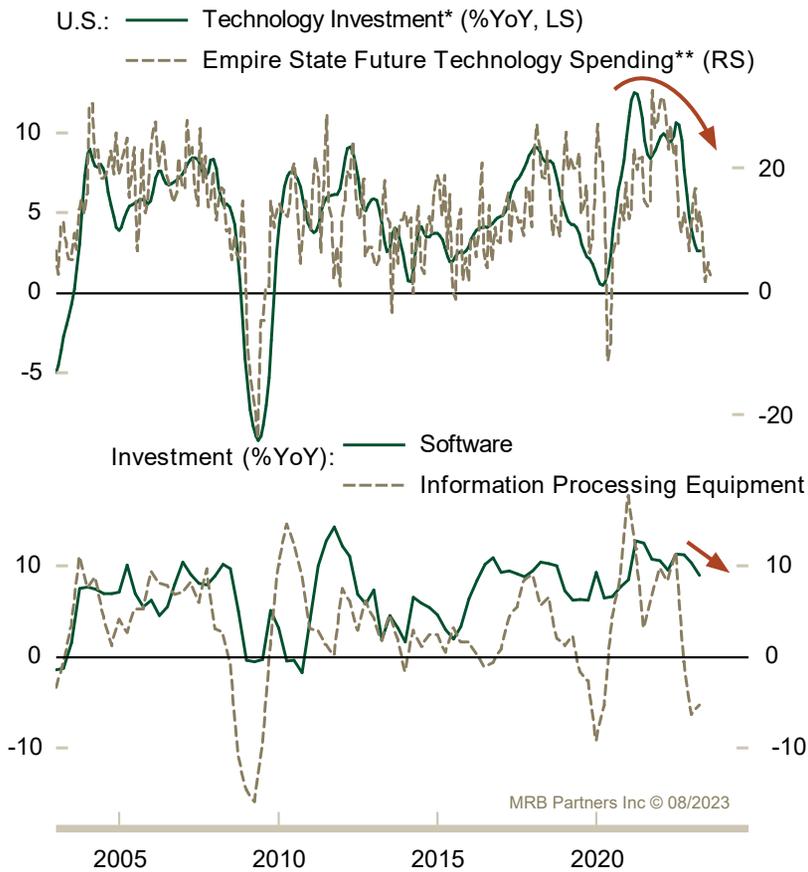
- Tech has lost its revenue growth advantage



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

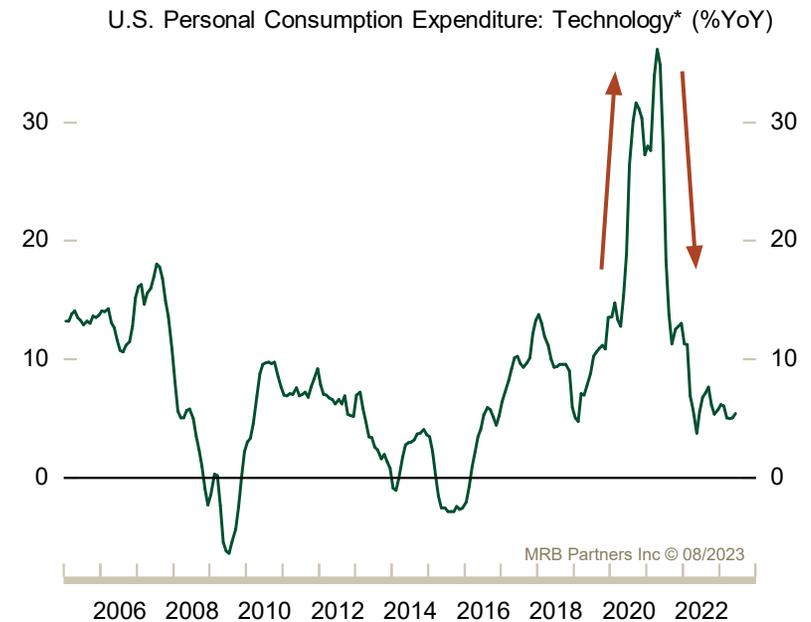
Technology: Enterprise Spending Has Room To Weaken

- 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

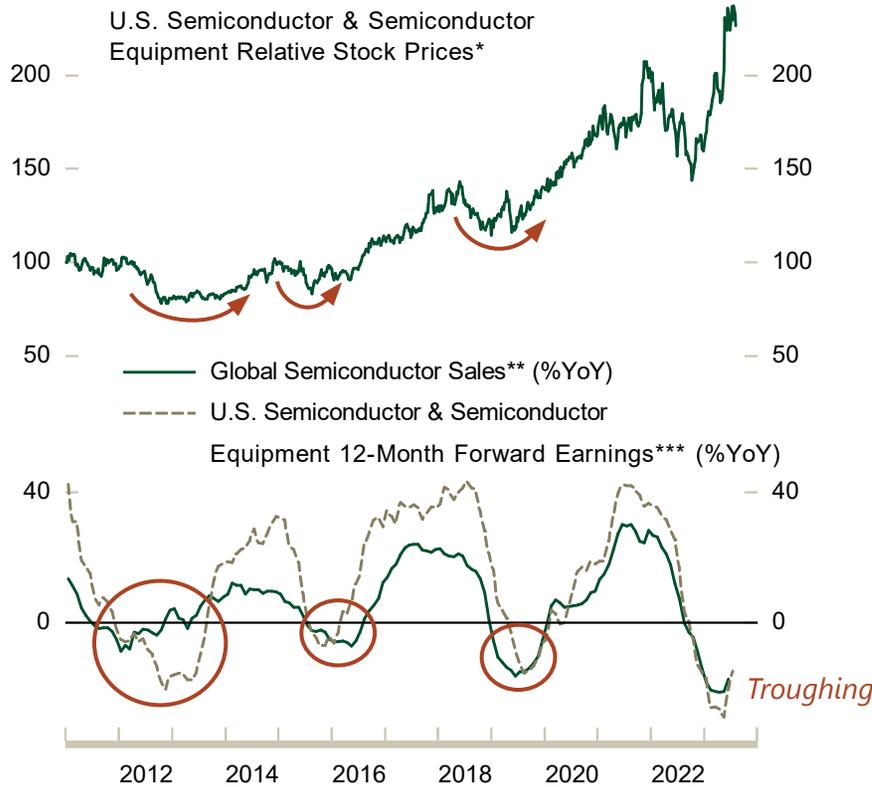


* Includes personal computers/tablets and computer software & accessories; smoothed; source: U.S. Bureau of Economic Analysis

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

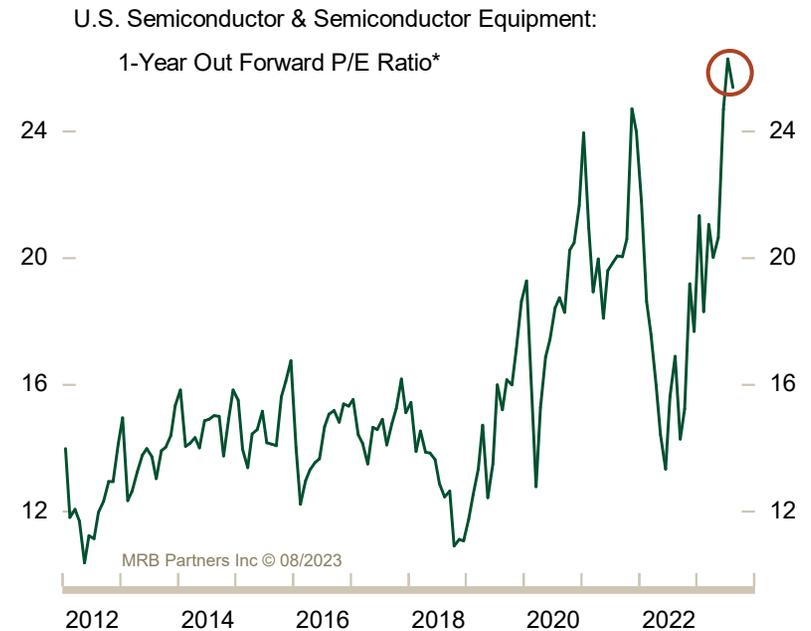
- Share prices are too far ahead of underlying fundamentals

- 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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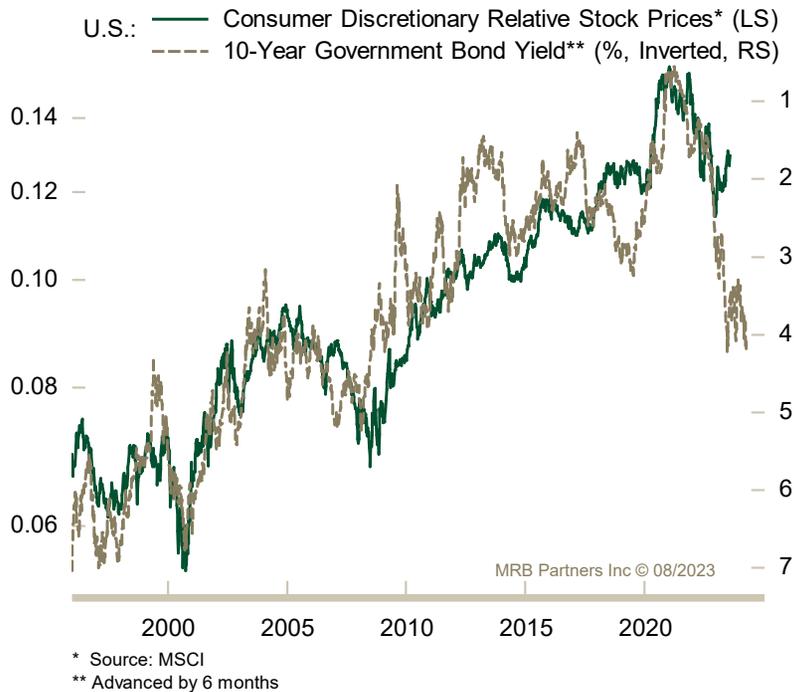


* Source: Refinitiv I/B/E/S Global Aggregates

Consumer Discretionary: Late-Cycle Conditions Keep Us Cautious

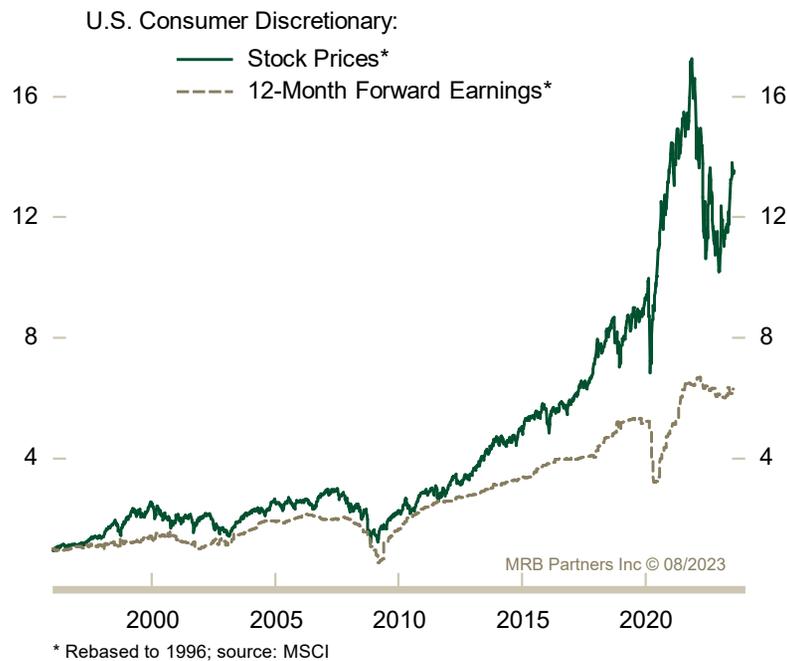
- The sector is interest rate sensitive

- Earnings growth expectations are very elevated

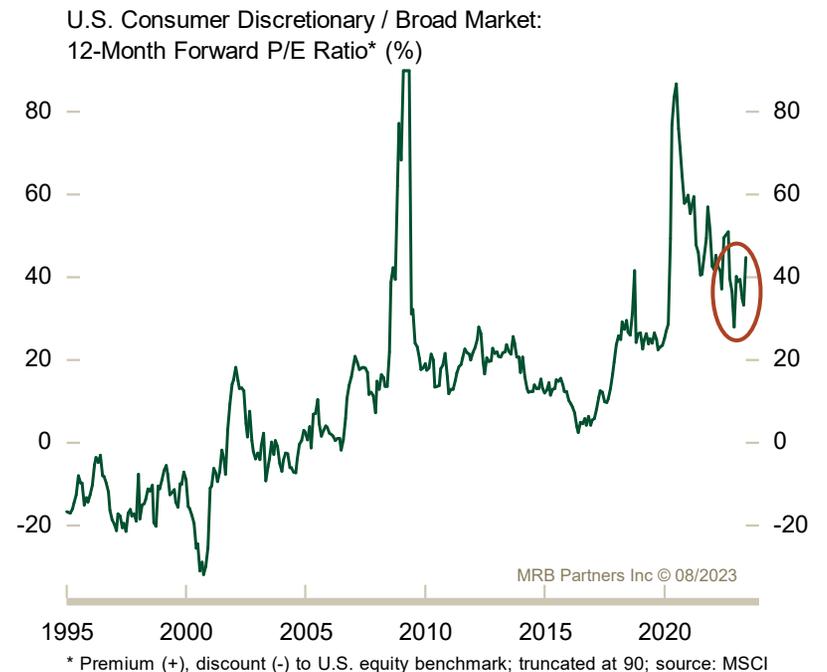


Consumer Discretionary: Elevated Valuations Provide Little Protection Against Adverse Developments

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

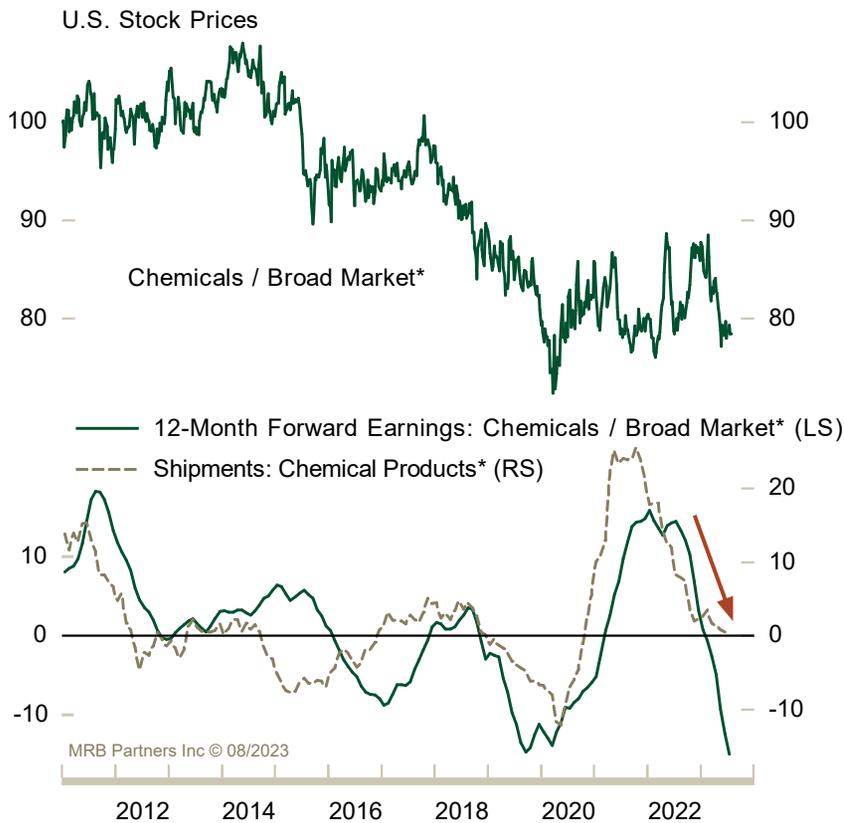


- The sector trades at a hefty premium to the broad equity market



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

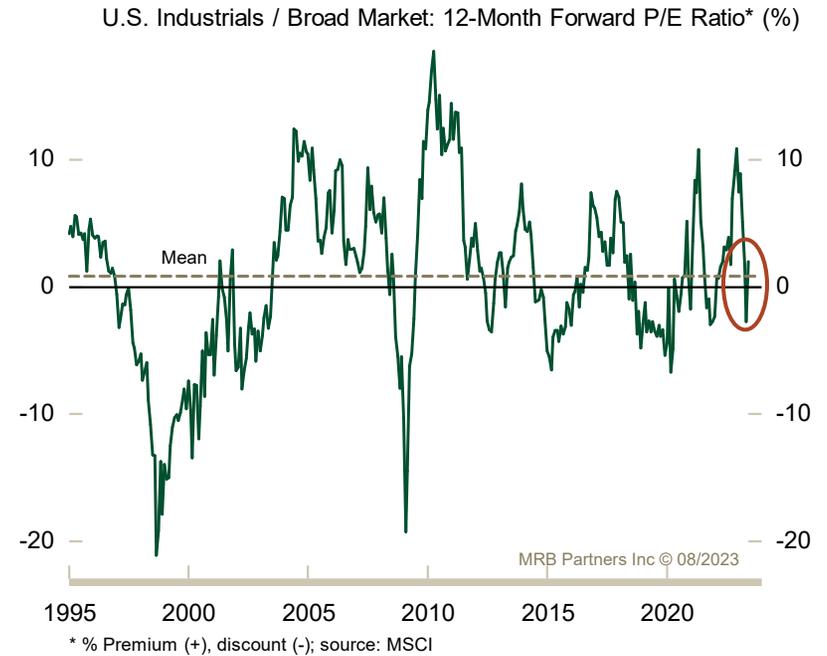


* Rebased; source: MSCI
 ** Source: Bloomberg

Industrials: Mixed Prospects Within The Sector Keep Us Neutral

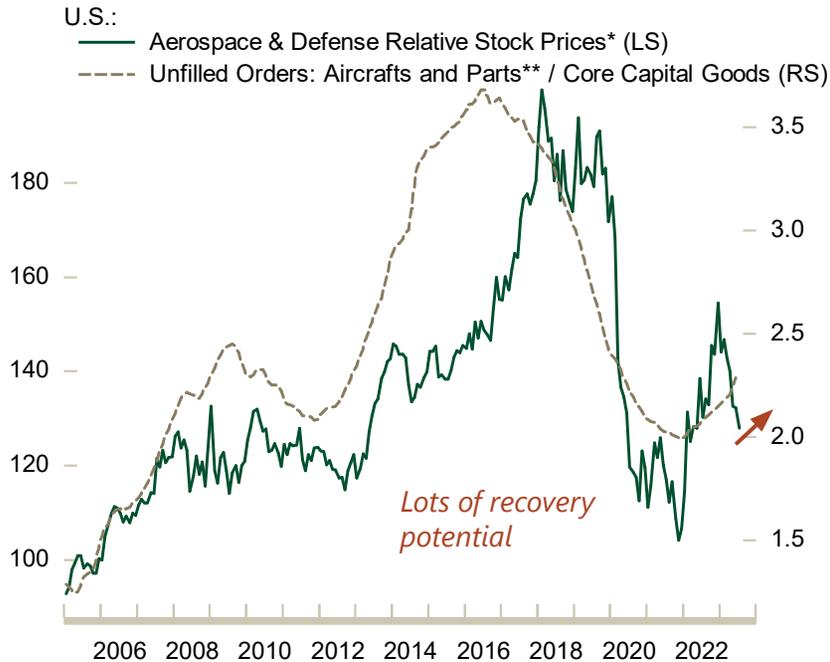
- Depressed relative earnings should put a floor under relative performance

- Relative valuations are at their historical norms



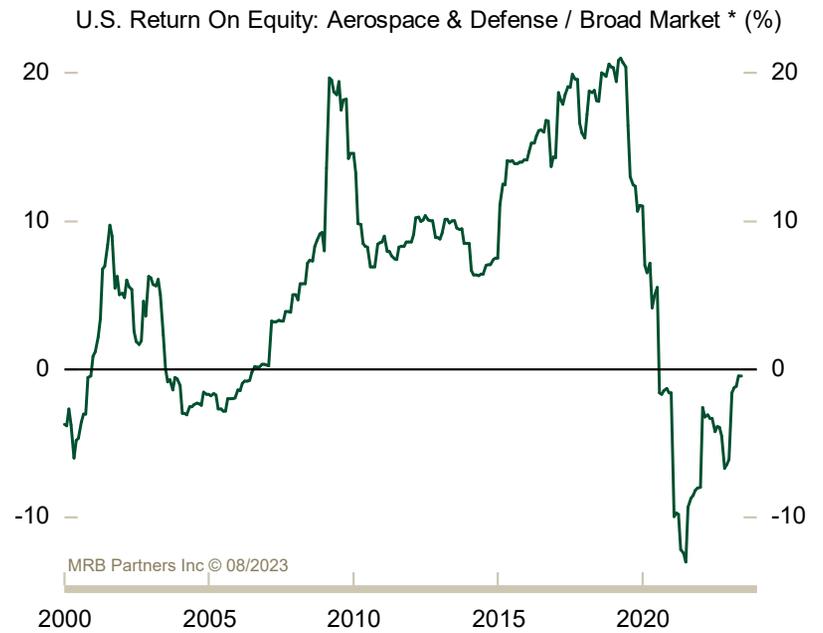
Industrials: Aerospace & Defense Is Our Favorite Industrial Sub-Group

- 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

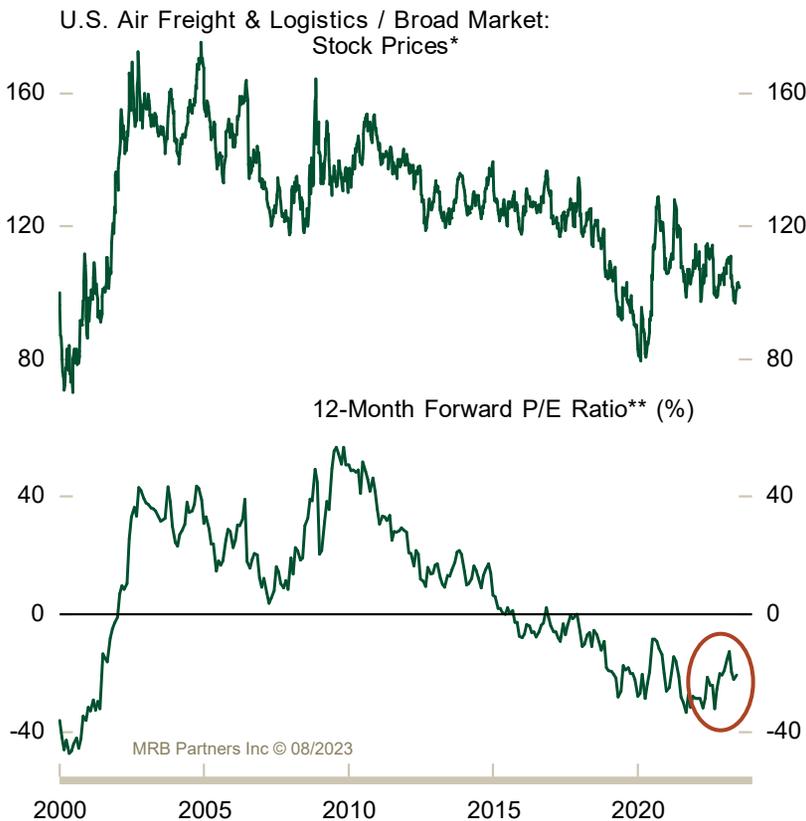
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* Source: MSCI

Industrials: Other Areas Of Opportunity

- Air freight stocks have over-discounted cyclical headwinds



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

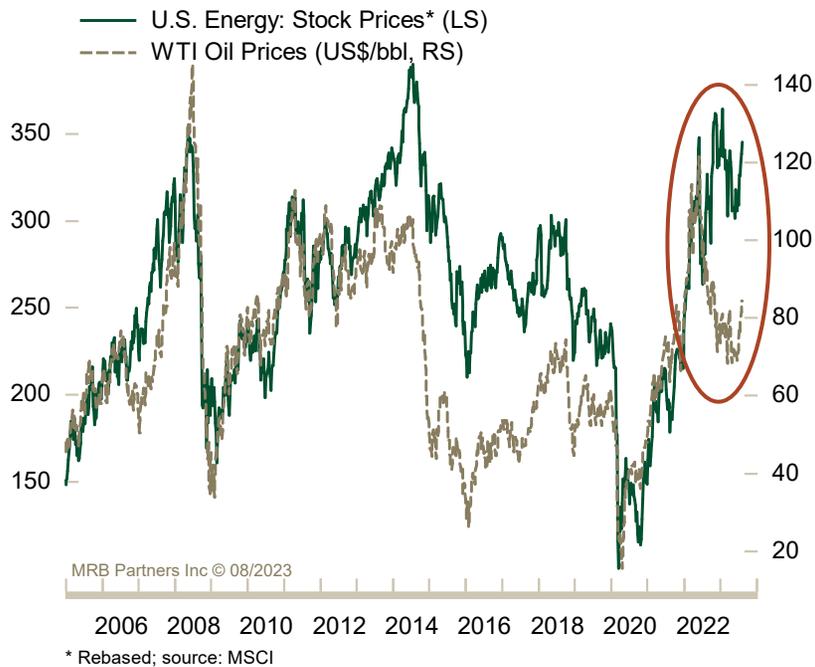
- Industrial conglomerates have been left for dead, but have exposure to attractive end-markets



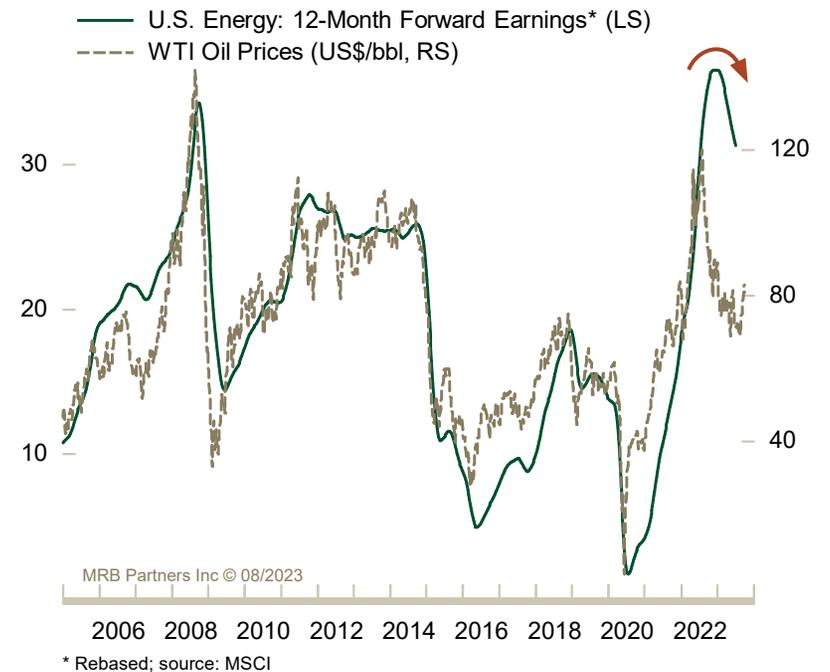
* Source: Bloomberg
 ** Rebased; smoothed; source: MSCI

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

- Energy stocks look vulnerable if oil prices decline

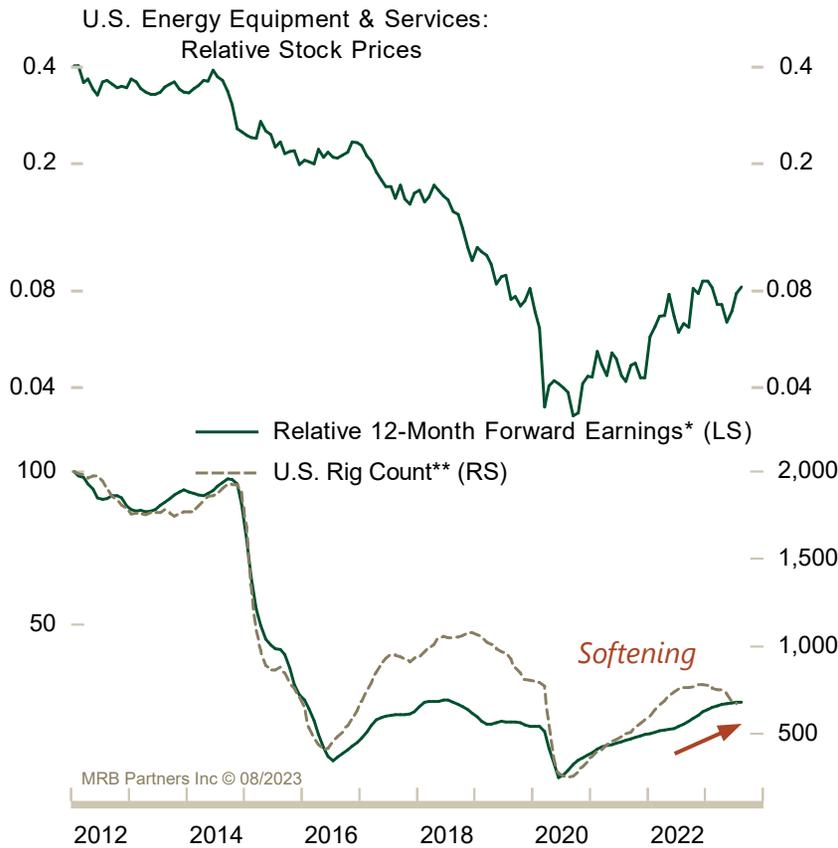


- Forward earnings are facing some mean reversion



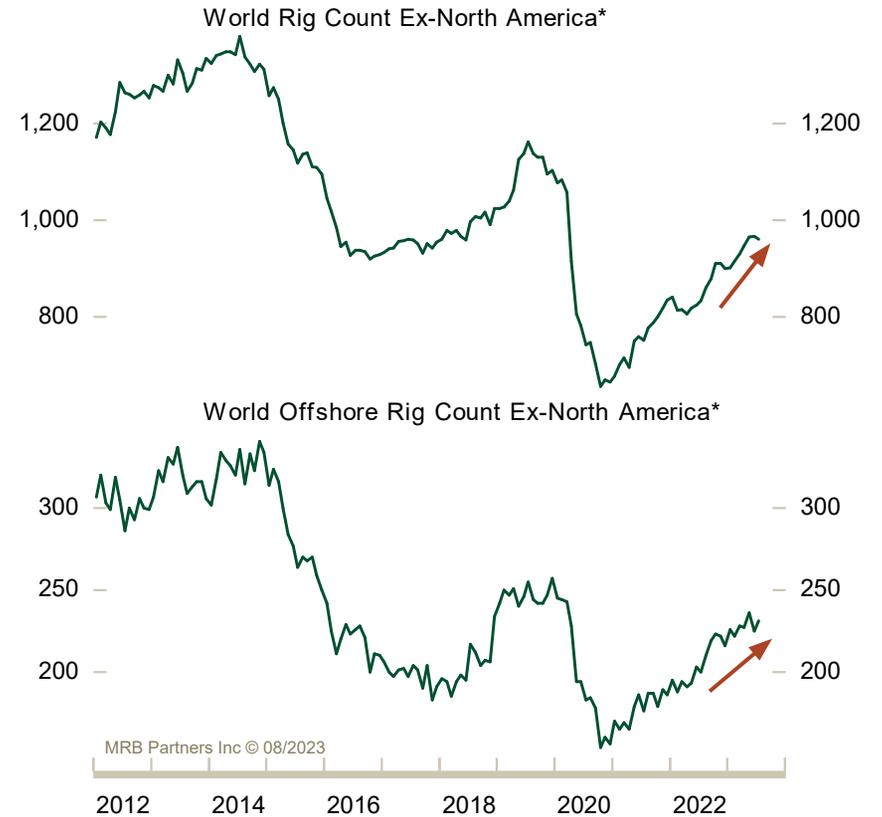
Energy: Energy Equipment & Services Stocks Have Durable Tailwinds

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



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

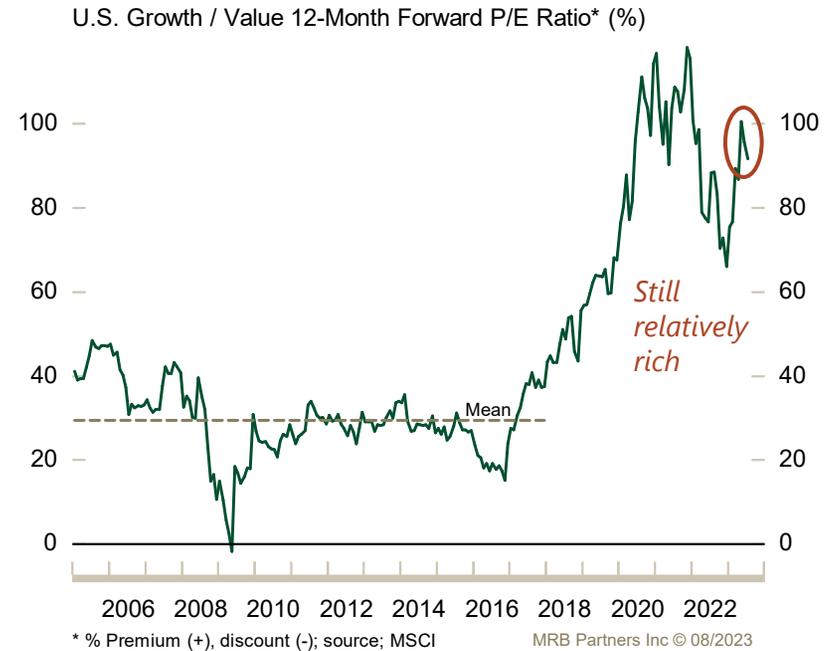
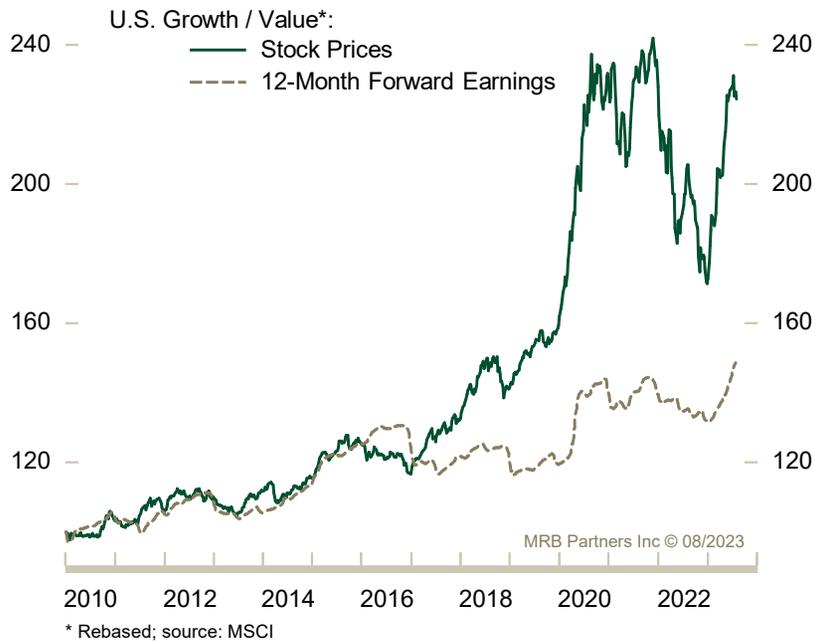
- ...More than offset by strength in international markets



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

* Rebased; source: Bloomberg

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

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

Sector	Industry Ratings*			
	- N +	Underweight	Neutral	Overweight
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	Energy Equipment & Services
Financials			Capital Markets Consumer Finance Insurance	Banks
Health Care			Health Care Equipment & Supplies	Biotechnology Health Care Providers & Services Pharmaceuticals
Industrials		Machinery Road & Rail	Electrical Equipment	Aerospace & Defense Air Freight & Logistics Industrial Conglomerates
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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