



# A CIO perspective and market outlook

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# Are we there yet?

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A market's evolution from a valuation story to a profit story

# Four pillars of the equity market



Earnings



Interest rates



Liquidity



Valuation

Source: Fidelity Investments Canada ULC.

# Executive summary

1

Price movement of risk assets in 2022 was precipitated by rapidly rising inflation expectations, the subsequent rise in interest rates, receding financial system liquidity, rising oil prices and a stronger USD.

2

Price movement of risk assets in 2023 will be predominantly governed by corporate profits. Pay attention to **global nominal GDP, global PMIs, housing, wages and employment, and credit spreads.**

3

Equity markets have never bottomed before the onset of an economic contraction coupled with an inverted yield curve and shrinking monetary base. **Focus on leadership, not “the market.”**

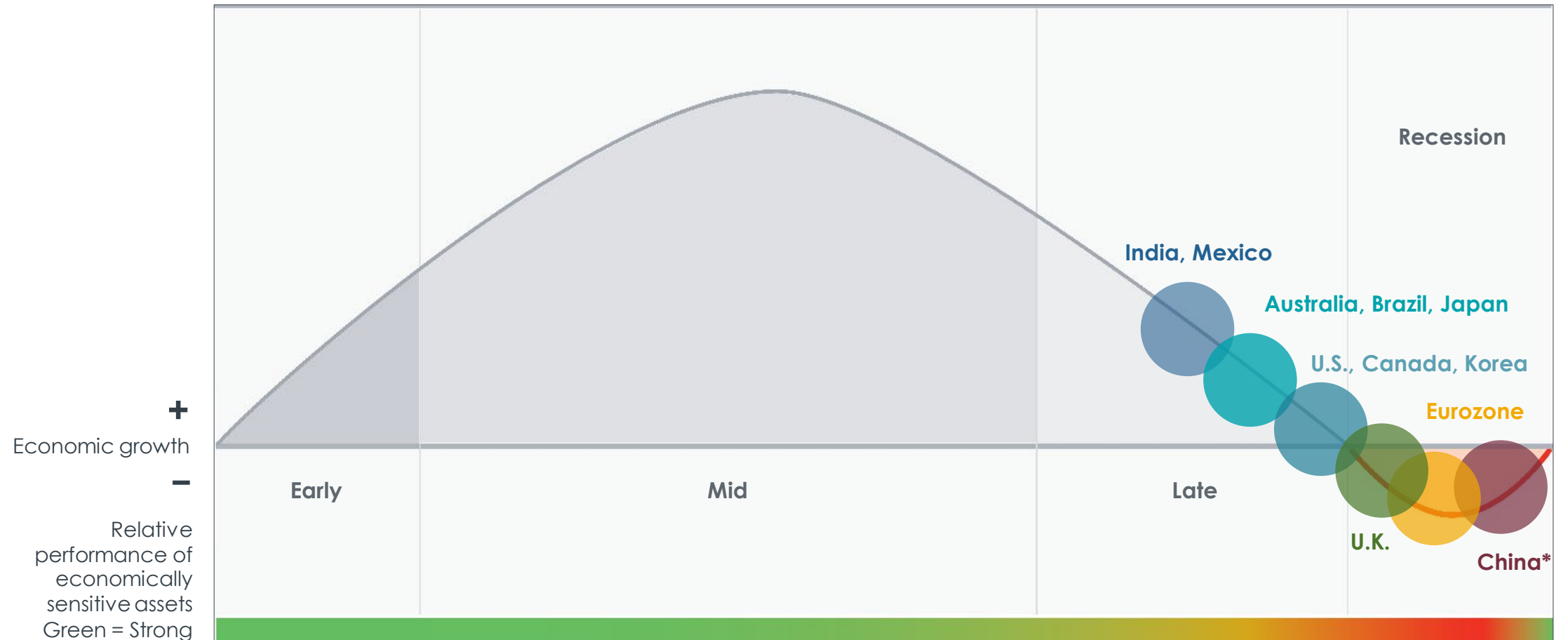
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Quality factors dominated market performance in 2022 irrespective of sector and style; selectively look for opportunities to add risk governed by deeply discounted valuation. **Think three to five years, not 12 months.**

5

Use PMIs below 50, negative earnings revisions and shifts in central bank policy to **selectively add risk** in preparation for a new investment cycle. **Patience is a virtue.**

# Global economic cycle



The diagram above is a hypothetical illustration of the business cycle, the pattern of cyclical fluctuations in an economy over a few years that can influence asset returns over an intermediate-term horizon. There is not always a chronological, linear progression among the phases of the business cycle, and there have been cycles when the economy has skipped a phase or retraced an earlier one.

\* A growth recession is a significant decline in activity relative to a country's long-term economic potential.

Source: Fidelity Investments (AART), as at December 31, 2022.

# Earnings

## Outlook

Quarter	# of weeks to quarter-end	EPS growth est. (actual for past quarters)	# of weeks to quarter-end	EPS growth est. (actual for past quarters)
Q1/22	–	–	–	9.2%
Q2/22	–	–	–	8.0%
Q3/22	–	–	–	6.0%
Q4/22	39	+10%	0	-2.0%
Q1/23	39	+10%	15	-1.1%
Q2/23	39	+5%	27	-1.4%

Source: Bloomberg. As at January 4, 2023.

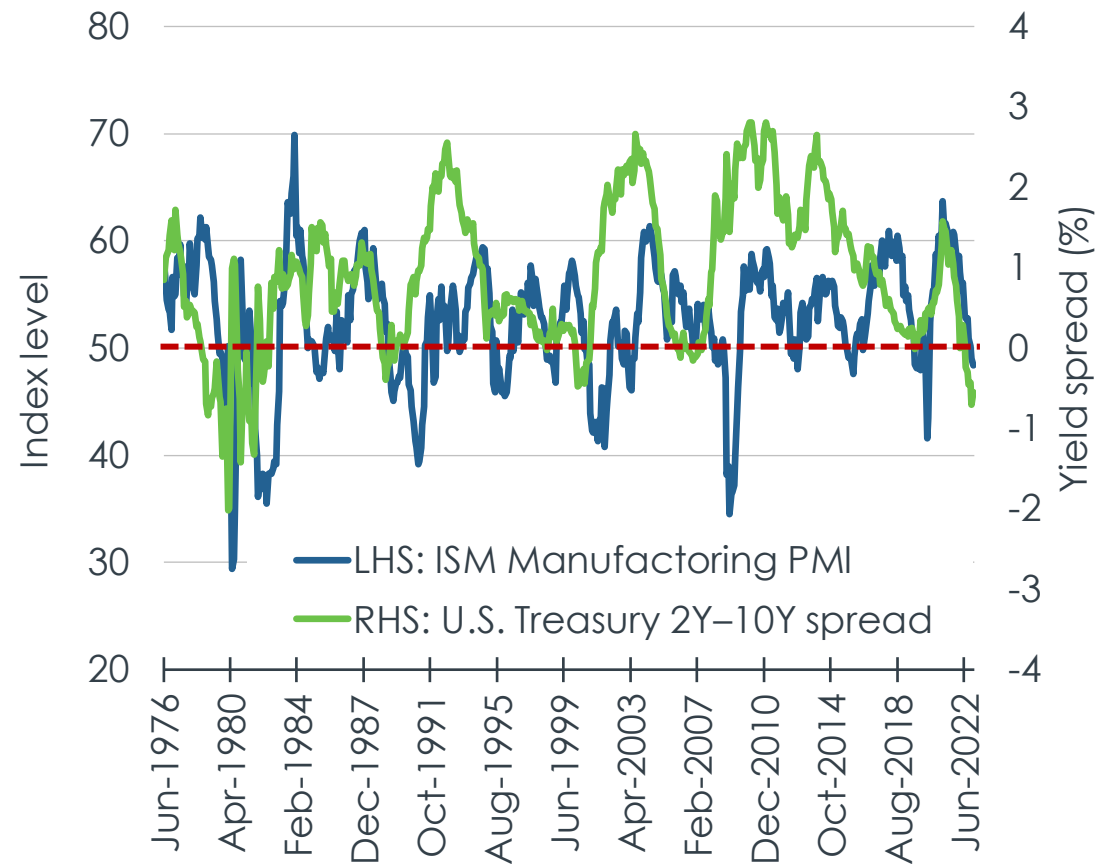
## Breadth: % of S&P 500 constituents with positive three month change in annual EPS estimates

	Jul 2021	Dec 2022
Breadth	77%	24%
Yield curve	+140bps	-70bps

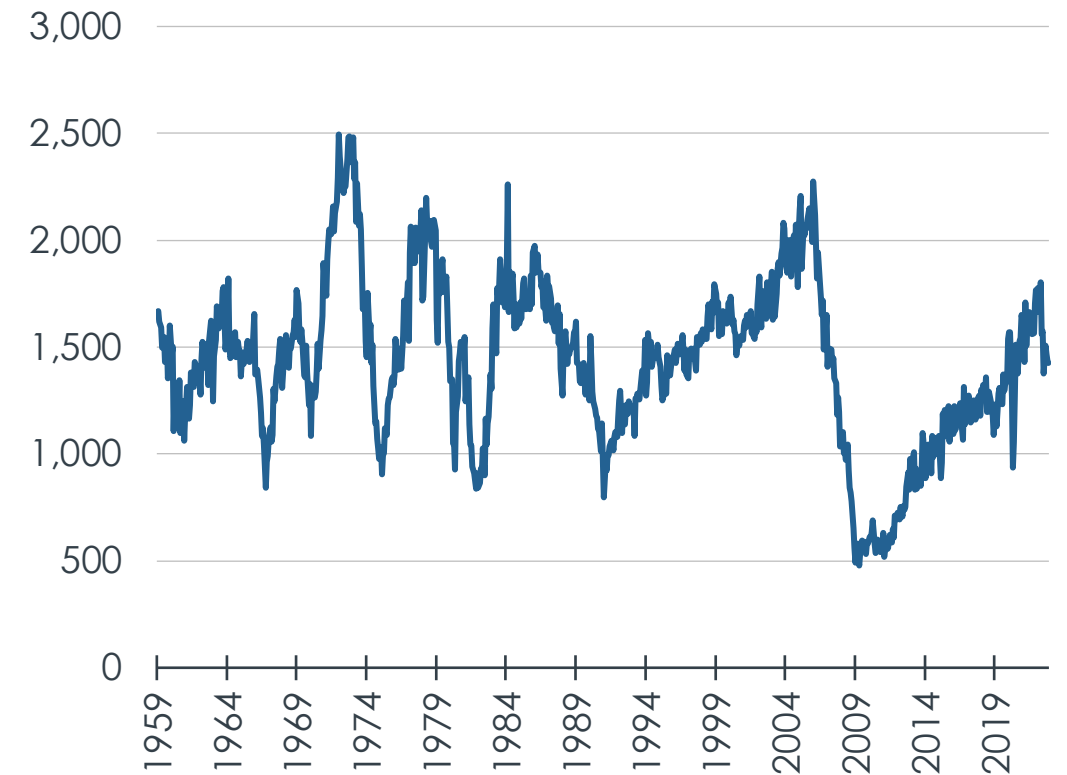
	2023 (E)	2024 (E)
Annual EPS forecast	4.6%	9.8%

Source: Bloomberg and S&P 500.

# Economic activity versus yield curve







# U.S. housing

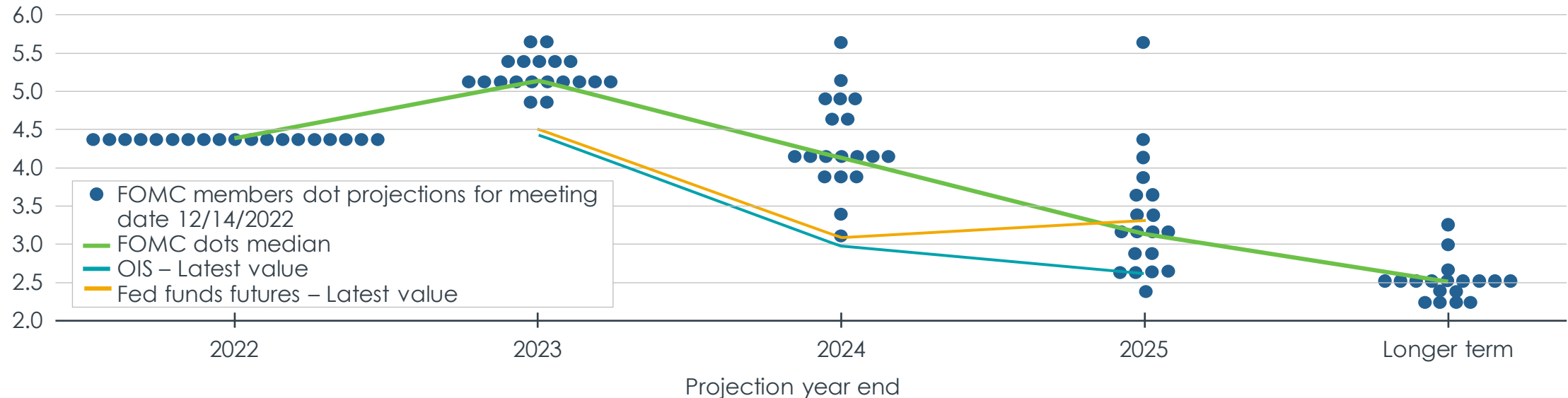


Source: Bloomberg, monthly periods between June 1976 and December 2022. The ISM Manufacturing PMI tracks the general state of the economy as it relates to businesses. It can include broad economy-wide conditions or specific economic conditions of a particular industry. An index value over 50 indicates expansion in activity, and below 50 signals contraction. The U.S. Treasury 2Y-10Y spread represents the difference between the yields of U.S. ten-year Treasury Note and U.S. two-year Treasury Note. The U.S. Housing Index represents the U.S. new privately owned housing, which tracks the new housing units that have been started during the period.

# Market implied policy rates

Country/region	Policy rate		Implied policy rate			
	Jan 3, 2022	Jan 4, 2023	6-month	1-year	2-year	3-year
<b>U.S.</b> 	0.13%	4.38%	5.01%	4.57%	3.23%	2.99%
<b>Canada</b> 	0.25%	4.25%	4.58%	4.19%	3.02%	2.66%
<b>Eurozone</b> 	-0.50%	2.00%	3.32%	3.35%	2.68%	2.44%
<b>China</b> 	2.20%	2.00%	2.43%	2.69%	3.02%	3.24%

## Implied Fed funds target rate

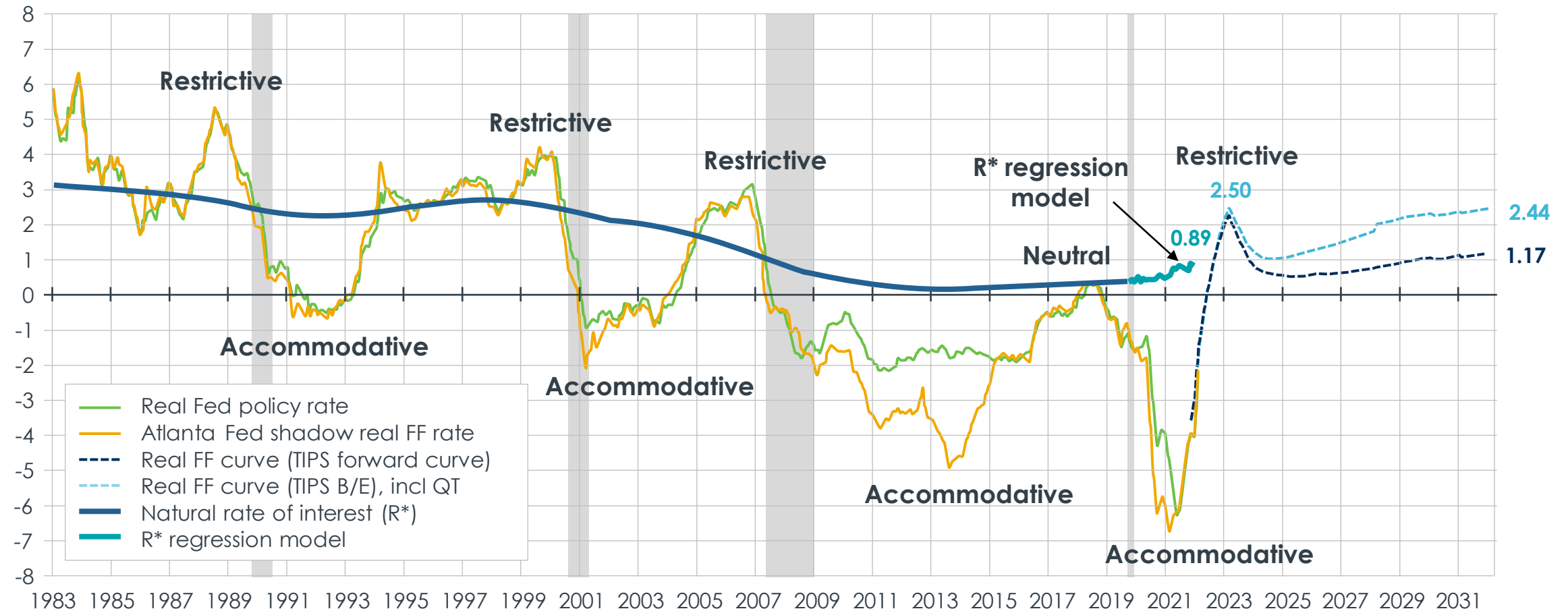


Source: Bloomberg, as at January 4, 2023.



# Are central banks behind the curve?

## U.S. monetary policy



Source: FMRCo and Haver. Data as at January 6, 2023, monthly data.

# Valuation

- S&P 500 ~17x NTM EPS represents a modest premium over historic precedent based on current interest rates, current EPS forecasts and a 3% equity risk premium
- U.S. small-cap securities presently trading at ~12.5x NTM EPS, versus a historic low of 9.5x in April 2020
- Nominal yields meaningfully above long-term inflation expectations as indicated by U.S. ten-year Treasury Inflation-Protected Securities (TIPS) breakeven
  - Positive real rates
  - Implications for fixed income and gold
- Focus on leadership, not market levels
  - Note premium (and potentially widening premium) of defensive versus offensive or late-cycle versus early-cycle stocks

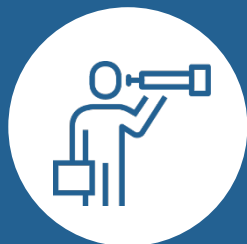
## Best performing versus worst performing factors for the S&P 1500 in 2022 (1<sup>st</sup> quintile versus 5<sup>th</sup> quintile sector neutral)

Factor	Return	Factor	Return
EBITDA/EV	17.5%	One year trailing beta	-19.4%
Dividend yield	15.4%	Long term volatility	-16.5%
EBITDA yield	14.7%	P/E NTM	-13.5%
Cash-flow yield	12.2%	Earnings variance	-8.6%

Source: Bloomberg, as at January 4, 2023. The S&P 1500 is the S&P Composite 1500 Index, which covers approximately 90% of the market capitalization of U.S. stocks.

# Recap

1



2023 will require **discipline, patience and rigor** around profit forecasts and upside/downside scenarios

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2



Equity markets have priced in most of the change in central bank policy or change in liquidity, but have not yet fully priced in earnings compression

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3



Market levels may obscure transition of leadership during the course of 2023

→ **Focus on leadership and opportunities**, not “the market”

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4



**Price moves before earnings:**

→ Understand when the worst fundamentally has been discounted

→ Don't be paralyzed by fear or analysis

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