MORNING BRIEFING
January 31, 2023

Market Dynamics

Check out the accompanying chart collection.

Executive Summary: Old-fashioned stock picking may be coming back into fashion as momentum investing stumbles. The breadth of stocks participating in the recent rally is improving, which could even the playing field for active versus passive equity managers and give the former a shot at outperforming the latter. … We recommend overweighting four S&P 500 sectors this year (Energy, Financials, Industrials, and Materials), market-weighting two (Tech and Health Care), and underweighting the remaining five. Our choices reflect our soft-landing expectations for the US and global economies in 2023 (with better growth in 2024). … Also: The latest Fed business surveys depict a slowing US economy and lower inflation.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

Strategy I: A Market of Stocks. Now that the MegaCap-8 stocks (i.e., Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, NVIDIA, and Tesla) have lost some of their mega and allure, the breadth of the stock market has improved. From approximately 2017 through 2021, it was mostly a market of these eight stocks that were driven higher by the momentum investment style.

Now stock picking is back in fashion, in our opinion, because more stocks are participating in the market's action. More importantly, that action is no longer dominated by the MegaCap-8 stocks. In other words, active equity managers may finally have a chance of outperforming passive equity managers. Mutual fund managers might have a shot at beating the performance of ETFs. Consider the following:

(1) *Market capitalization.* The MegaCap-8 benefitted from the pandemic. Their combined market capitalization soared from $5.3 trillion at the start of 2020 to peak at a record $12.3 trillion on December 27, 2021 (*Fig. 1*). Over this period, their share of the S&P 500's market capitalization rose from 16.8% to 25.7% (*Fig. 2*).

Since their peak, the MegaCap-8's collective market cap has dropped $4.2 trillion to $8.1 trillion during the January 27 week, and together they now account for 21.0% of the S&P 500's capitalization.

(2) *Active vs passive styles.* The outperformance of the MegaCap-8 during 2020 and 2021 can partly be explained by the massive net inflows into equity ETFs and net outflows from mutual funds during this period. Active equity managers tend to diversify their portfolios. Very few are likely to concentrate 25% of their portfolios in a handful of stocks. ETFs, on the other hand, will do so automatically since they are mandated to track specific stock price indexes without any diversification restrictions.

In other words, the ETFs that are indexed to the S&P 500 will beat portfolios benchmarked to the index if the former are outperforming. That's because a handful of stocks are dominating the market-cap share of the S&P 500 in a way that active managers can't pursue if they have explicit or self-imposed limits on the percentage of their assets that can be invested in any one stock.

(3) *Equity ETFs vs mutual funds.* On a 12-month basis, equity mutual funds experienced a record net outflow of $575.6 billion through February 2021 (*Fig. 3*). On the other hand, equity ETFs had record net inflows of $730.7 billion through December 2021, also on a 12-month basis.

The latest data through December 2022 show that equity mutual fund net outflows were down to $316.3 billion, while ETF net inflows were $418.4 billion. Yes, this suggests that passive investing still has an advantage over managed equity money, but less so than in 2020 and 2021, as long as a handful of stocks don't dominate the market.

(4) *Breadth.* Measures of breadth suggest that more stocks are participating in the stock market's action as stock picking comes back into fashion. The ratio of the S&P 500's equal-weighted to market-cap-weighted indexes is the highest that it has been since before the pandemic (*Fig. 4* and *Fig. 5*). Since the S&P 500 bottomed last year on October 12 through Friday's close, the former is up 17.7%, while the latter is up 13.8%.

The NYSE advance/decline lines for all securities and based on volume were both in downward trends since early 2021 (*Fig. 6* and *Fig. 7*). Both are showing signs of reversing that trend in recent weeks.

(5) *Growth vs Value.* You might have noticed that the ratio of the forward P/Es of the Growth to Value indexes of the S&P 500 tumbled at the end of last year (*Fig. 8*). The ratio peaked at 1.9 at the end of 2021 (just before the bear market). It was around 1.4 most of last year but plunged at the end of last year to only 1.1 during the January 19 week, the lowest reading since December 2009.

There has been a big 29% jump in the forward P/E of Value from 13.0 on September 30 last year to 16.8 last Friday (*Fig. 9*). Over this same period, Growth's forward P/E rose just 2% from 18.9 to 19.2.

Last week, Joe reported that Standard & Poor's moved four of the MegaCap-8 stocks from Pure Growth to Growth and Value. He wrote: "Recall that the S&P 500 Growth and Value indexes are … analyzed to determine which companies exhibit scoring characteristics of both Growth and Value and are weighted in each of those indexes by their scores. Meeting the criteria to appear in both indexes were 135 of the S&P 500 companies, including half of the MegaCap-8 stocks: Alphabet, Amazon, Meta, and Microsoft."

Prior to this change, these four (along with the other four MegaCap-8) were classified as Pure Growth by S&P. As a result, the MegaCap-8's market-cap share of the Growth index dropped from 41.4% just before the change late last year to 36.8%. It was back up to 39.4% during the January 20 week (*Fig. 10*). The change also boosted the forward earnings of Growth and depressed the forward earnings of Value (*Fig. 11*).

Strategy II: Relative Sector Momentum. While stock picking may be back in style and momentum investing is running out of momentum, Joe and I are still keeping track of the relative performance of the 11 S&P 500 sectors to one another and to the overall index (*Fig. 12*).

Our four favorite sector picks for this year are Energy, Financials, Industrials, and Materials. These are our overweight recommendations. We would market-weight Information Technology and Health Care. We would underweight the remaining sectors.

The following sectors have been showing upward momentum relative to the S&P 500 in recent weeks: Energy, Industrials, and Health Care. Downward momentum has been displayed by Communication Services, Consumer Discretionary, Information Technology, Real Estate, and Utilities.

Our sector choices reflect our view that the global economy will continue to grow in 2023 and that the US economy will do the same. There won't be any hard landings here or abroad.

US Economy: Less Growth & Inflation. We now have in hand all five business surveys for January conducted by the Federal Reserve district banks in Dallas, Kansas City, New York, Philadelphia, and Richmond (*Fig. 13*). Collectively and individually, they show less economic growth and lower inflation than in recent months.

The average of their general business indexes dropped further into negative territory this month, suggesting that the M-PMI also fell further below 50.0 this month. The averages of the regional prices-paid and prices-received indexes continued to fall in January, though they remained elevated (*Fig. 14*). The average prices-paid index is highly correlated with the PPI for final demand and suggests that this measure of inflation should continue to fall (*Fig. 15*).

January's M-PMI will be out on Wednesday, February 1, in time to have some influence over the FOMC's policymakers during the second day of their two-day meeting. We are expecting a 25bps hike in the federal funds rate.

Calendars

US: **Tues:** Consumer Confidence 109.0; Employment Cost Index 1.1%; S&P/CS HPI Composite 20 cities -0.5%m/m/6.9%y/y; Chicago PMI 44.9; API Weekly Crude Oil Stock. **Wed:** Job Openings 10.23m; Crude Oil Inventories & Gasoline Production; ADP Nonfarm Employment 170k; ISM M-PMI & Price Index 49.5/39.5; Construction Spending -0.1%; MBA Mortgage Applications; Fed Interest Rate Decision 4.75%; OPEC Meeting. (Bloomberg estimates)

Global: **Tues:** Eurozone GDP -0.1%q/q/2.2%y/y; Germany CPI 1.0%m/m/9.2%y/y; Germany Import Prices -2.2%m/m/11.6%y/y; Germany Retail Sales 0.4%; Germany Unemployment Rate 5.5%; France GDP 0.1% q/q; France CPI 0.5% m/m; Italy GDP -0.1%q/q/2.0%y/y Italy Unemployment Rate 7.8%; Japan Household Confidence 30.6; Canada GDP 0.1%m/m/3.5%y/y; China Caixin M-PMI 48.9; ECB Bank Lending Survey. **Wed:** Eurozone Headline & Core CPI -0.3%mm/9.0%y/y & -0.2%m/m/5.4%y/y; Eurozone Unemployment Rate 6.5%; Eurozone, Germany, France, Italy, and Spain M-PMIs 48.8/47.0/50.8/49.6/48; UK Nationwide HPI -0.3%m/m/1.9%y/y. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell for a third straight week for all three of these indexes as analysts' revision activity began to accelerate with the release of Q4 results. LargeCap's dropped to a 50-week low and is down in 12 of the past 17 weeks. MidCap's fell to a 48-week low and has dropped in 17 of the past 19 weeks. SmallCap's was down to a 62-week low and is down in 15 of the past 17 weeks. For a 31st straight week, none of these three indexes had forward earnings at a record high. However, forward earnings remains on a modest downtrend for these three indexes compared to their deep declines during the Great Virus Crisis and the Great Financial Crisis. LargeCap's is 5.0% below its record high at the end of June; MidCap's is 7.4% below its record high in early June; and SmallCap's is 9.8% below its mid-June record. Forward earnings momentum remains near two-year lows. The yearly rate of change in LargeCap's forward earnings was down to a 23-month low of 1.1% y/y; that compares to a record-high 42.2% at the end of July 2021 and is up from -19.3% in May 2020, which was the lowest since October 2009. MidCap's rate of 2.8% y/y is at a 23-month low, down from a record high of 78.8% in May 2021, and compares to a record low of -32.7% in May 2020. SmallCap's rate of -1.6% y/y is at a 26-month low, down from a record high of 124.2% in June 2021. It had been at a record low of -41.5% in June 2020. Analysts' consensus earnings forecasts for 2023 have been heading lower since June. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (5.3%, 3.2%), MidCap (15.2, -5.5), and SmallCap (4.9, 2.5).

S&P 500/400/600 Valuation (*link*): Valuations rose w/w for these three indexes. LargeCap's forward P/E gained 0.5pt to a six-month high of 17.9. It's up 2.8pts from its 30-month low of 15.1 at the end of September, which compares to a four-month high of 18.1 in early August and an 11-year low of 11.1 during March 2020. MidCap's forward P/E rose 0.4pt to a 10-month high of 14.2. That's up 3.1pts from a 30-month low of 11.1 at the end of September and compares to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E was up 0.3pt w/w to a 10-month high of 13.5. That's 2.9pts above its 14-year low of 10.6 at the end of September and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's current 21% discount to LargeCap is near its biggest since September 2000. SmallCap's current 24% reading is near its biggest discount since February 2001. SmallCap's P/E had been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for an 85th straight week; the current 5% discount is an improvement from its 9% discount in December 2021 but remains near its lows during 2000-01.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Following the Q3-2020 earnings season when the US economy emerged from the Covid shutdown, analysts began raising their consensus forecasts for future quarters instead of lowering them as is the historical norm. That six-quarter streak of positive revisions throughout the quarter ended during Q1-2022, and the declines began to accelerate considerably beginning with Q3-2022. Analysts expect the S&P 500's earnings growth rate to weaken q/q in Q4 to -1.5% y/y from 4.0% in Q3 on a frozen actual basis and to -2.9% from 4.4% on a pro forma basis. Just four sectors are expected record positive y/y percentage earnings growth in Q1-2023 and Q4-2022, down from five sectors doing so in Q3. Here are the S&P 500 sectors' latest expected earnings growth rates for Q1-2023 versus their blended Q4-2022 growth rates: Consumer Discretionary (34.3% in Q1-2023 versus -15.6% in Q4-2022), Industrials (22.9, 39.3), Energy (19.7, 59.6), Financials (5.9, -10.9), Consumer Staples (-0.6, -2.1), Real Estate (-4.4, 7.3), Communication Services (-8.5, -21.0), Information Technology (-9.0, -8.7), Utilities (-9.3, 1.7), Health Care (-12.9, -5.8), Materials (-25.7, -20.6).

S&P 500 Q4 Earnings Season Monitor (*link*): The Q4-2022 earnings season is off to a poor start, assessed by the four surprise metrics we measure for both earnings and revenues. Revenue and earnings surprises are deteriorating q/q due to the slowing economy, higher costs, and currency translation. With nearly 29% of S&P 500 companies finished reporting for Q4, revenues are ahead of the consensus forecast by just 0.6%, and earnings have exceeded estimates by 1.6%. That's the weakest earnings surprise since Q4-2008 and the smallest revenue surprise since Q1-2020. At the same point during the Q3 season, revenues were 1.4% above forecast and earnings had beaten estimates by 6.0%. For the 144 companies that have reported Q4 earnings through mid-day Monday, the aggregate y/y revenue and earnings growth rates have slowed considerably from their readings of Q2-2021 to Q3-2022. The collective y/y revenue gain for the 144 reporters so far has slowed from double-digit percentage gains in the prior seven quarters to 6.1%, and earnings have declined 0.4% y/y as higher costs and increased loan loss provisions continue to pressure profit margins. Just 65% of the Q4 reporters so far has reported a positive revenue surprise, and 67% has beaten earnings forecasts. Furthermore, significantly fewer companies have reported positive y/y earnings growth in Q4 (60%) than positive y/y revenue growth (74%). These figures will change markedly as more Q4-2022 results are reported in the coming weeks, particularly from non-financial firms with greater exposure to the strong dollar. While we expect y/y revenue growth rates to remain positive in Q4, earnings are expected to decline for the first time since Q2-2020.

US Economic Indicators

Regional M-PMIs (*link*): Five Fed districts (New York, Philadelphia, Kansas City, Richmond, and Dallas) now have reported on *manufacturing activity* for January. Collectively, they show that activity contracted for the ninth successive month to a 32-month low of -12.4 (from -9.6 in December). Activity in the New York (to -32.9 from -11.2) area deteriorated sharply, while Richmond's (-11.0 from 1.0) swung from positive to negative; those declines were partly offset by a narrowing of declines in the Philadelphia (-8.9 from -13.7), Dallas (-8.4 from -20.0), and Kansas City (-1.0 from -4.0) regions, with the latter looking about to swing positive. *New orders* (-15.6 from -11.2) fell for the eighth month, sliding at its fastest pace since spring 2020, with billings in the New York (-31.1 from -3.6) and Richmond (-24.0 from -4.0) regions plunging, while the Philadelphia (-10.9 from -22.3) and Kansas City (-8.0 from -15.0) measures fell at half of December's pace, while Dallas' (-4.0 from -11.0) moved closer to positive territory. *Employment* (6.5 from 6.7) gains held steady, as hirings in the Philadelphia (10.9 from -0.9) region swung from negative to positive, while the Richmond (-3.0 from 3.0) region saw a swing from positive to negative. New York hirings (2.8 from 14.0) slowed to a near standstill, and Kansas City's was unchanged at 4.0, while Dallas' (17.6 from 13.6) continued to accelerate.

Regional Prices Paid & Received Measures (*link*): We have prices-paid and -received data for January for the five regions—New York, Philadelphia, Richmond, Dallas, and Kansas City. (Note: The New York, Philadelphia, Dallas, and Kansas City measures are diffusion indexes, while Richmond's measures are average annualized inflation rates—which we multiply by 10 for easier comparison to the other regional measures.) The *prices-paid* measure in January slowed to a 26-month low of 35.4, remaining on a steep downtrend from September 2021's record high of 90.2. The New York measure is decelerating again after a brief acceleration, easing to 33.0 this month—its lowest since November 2020—and down sharply from its record-high 86.4 last April, while Richmond's (79.1 from 90.8) is down sharply from its record high of 150.1 last May. Philadelphia's has been on a decelerating trend since reaching its cyclical high of 83.6 in November 2021 (which wasn't far from its record high of 91.1 in the 1970s), easing to a 29-month low of 24.5 this month. Kansas City's (20.0 from 18.0) ticked up, but it's down sharply from its record-high 84.0 in October 2021. Dallas' (20.5 from 21.9) measure held steady; it was at a 84.1 during November 2021. Turning to the *prices-received* measure, it eased for the second month, to a 23-month low of 28.0 in January, after a slight uptick in November to 39.0; it was at a record high of 59.0 in March. New York's prices-received measure eased to 18.8, the lowest since January 2021, after a brief blip up; it was at a record high of 56.1 last March, while Richmond's (65.2 from 76.3) continued to slow from its record-high 103.1 last June. The Philadelphia measure edged up from 28.1 (which was the lowest since March 2021) to 29.9 this month, down from its record high of 65.8 in November 2021, while Kansas City's (16.0 to 15.0) also ticked up but was down sharply from its record high of

60.0 during August 2021. Meanwhile, Dallas' edged down to 9.9 from 10.9.

Global Economic Indicators

Eurozone Economic Sentiment Indicators (*link*): The Economic Sentiment Indexes (ESI) for both the EU and Eurozone increased for the third successive month in January by 5.2 points and 6.2 points, respectively, to 98.0 and 99.9, after an eight-month plunge of 21.0 points and 20.7 points. ESIs among the *six largest EU economies* moved higher in five, with France (+4.4 points to 98.0) posting the largest gain, followed by Spain (+2.7 to 101.5), Germany (+2.5 to 97.9), and Italy (+1.7 to 102.5), while Poland's was unchanged at 89.7. *By sector*, consumer confidence increased for the fourth straight month in January, by a total of 7.6 points to -22.2, after plunging to a record low of -29.8 in September, while retail trade confidence jumped 5.3 points to -1.7. Services confidence climbed for the third consecutive month by 4.4 points to 8.7, to its highest level since last July, while industrial confidence in the EU recovered 2.6 points the past two months to 0.3—moving back into positive territory. Meanwhile, construction confidence dropped 2.2 points in January to -1.5, continuing to bounce around zero.

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