Settling in for the Long Haul

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As we settle into the second quarter of 2023, we reassess our projections for the remainder of the year and analyze how these implications will affect our outlook for recession risk, central banks' pivoting away from restrictive monetary policy sooner than expected, and corporate earnings expectations.

Instability in the Financial Sector Continues

The collapse of Silicon Valley Bank and demise of Credit Suisse exposed some of the risks related to the severity of central banks' monetary tightening.

U.S. regional banks still face headwinds, and signs of stress in the system have not fully subsided. However, we do not believe that full contagion across the banking sector is a likely outcome. That said, we are monitoring the private debt and commercial real-estate markets for signs of systemic risk.

Recession Risks Increase

Banking stress is unambiguously negative for the economy because it creates difficulties for small and midsize companies, which tend to utilize smaller banks due to the ease of access to credit they provide.

In the current environment, the balance sheets of many regional banks are suffering from a mismatch of assets and liabilities. As long as this mismatch persists, we can expect to see a curtailing of lending and other forms of credit activity, which will likely dampen growth of regional and local economies.

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As a result, we are likely to see a deceleration in economic activity—approximately 1% of gross domestic product (GDP) growth. In this tighter economic environment, the likelihood of recession is increasing.

Will the Fed Change Course?

Despite the instability in the financial sector, the U.S. Federal Reserve and global central banks remain vigilant in their fight against inflation, as evidenced by the European Central Bank's (ECB's) and Fed's further rate increases in March.

We believe the Fed will be reluctant to move back on its monetary policy setting by lowering interest rates; however, that does not mean it will not provide liquidity, which we have seen over the past several weeks.

Pressure on Corporate Earnings Likely

This slowdown in economic growth should put downward pressure on corporate earnings. Our previous base case assumed a deceleration in corporate earnings through the third quarter, and we now expect additional downward pressure—but how far it extends toward the end of the year is still too early to tell. Consensus for 2023 corporate profit growth expectations now stands at a touch below +2%, down from about +10% one year ago.

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Despite lowering expectations of economic and corporate profit growth, earnings multiples for the most part have expanded this year. This is a bit of a surprise to us, and likely due to the assumption that real rates and inflation have peaked. We do not expect valuations to further rerate materially until there is some confidence in the level at which growth is likely to trough.

A Word About China

We also think it is relevant to highlight China given its earlier-than-expected reopening during the first quarter.

While the country's reopening brought renewed optimism and the beginning phases of recovery, the pace of growth could be slow in the near term given the time needed to repair consumer confidence, which dropped to a 20-year low in late December.

The government continues to deliver supportive yet measured initiatives on both fiscal and monetary fronts to stimulate the economy, including stabilizing the property market (which fell 30% to 40% last year) while remaining considerate of persistent structural issues.

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China is also keen to support consumption and fight youth unemployment, which rose substantially last year (20% versus 5% to 6% for the general population) due to COVID lockdowns and internet industry regulations.

Recent messaging has also indicated a boost in supportive measures in the private sectors and the platform economy (signaling that regulatory measures are easing and stabilizing) and a continued push for technology advancement and energy transition.

Additionally, we believe the excess savings in China over the past two to three years should support the recovery of consumption, the property market, and investment.

While U.S.-China relations and geopolitical risks have not abated and continue to weigh on market valuation, several factors—including policy support, a stabilizing regulatory environment, and the potential for earnings recovery due to the reopening—could provide support for investors in 2023.

Broad Market Leadership?

As previously discussed, inflation and rates have shifted upward, and the forces that caused this may be beyond just this current pandemic-influenced economic cycle. We believe the environment has changed enough that market leadership will be broader in the coming years as compared to the pre-pandemic era. Our focus remains to identify a diversity of mis-priced value-creating companies across the wide array of our opportunity set.

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