

# 2023: Our U.S. Teams Weigh In

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Tightening monetary policy drove rising 10-year Treasury bond yields and pressured equity valuations in 2022. While impossible to predict what 2023 has in store—especially because interest-rate changes can have a lagged effect on corporate earnings—we asked our U.S. equity teams to weigh in.

## Changing Dynamics

Interest rates will drive the market environment, to some extent, according to our U.S. growth and core equity and U.S. value equity teams.

“We imagine 2023 will look very different from the turbulence experienced in 2022,” says Greg Czarnecki, a portfolio specialist on our U.S. value equity team. “At a high level, we began 2022 with high valuation multiples, rising inflation, and moderate growth coming out of the global pandemic. We envision 2023 starting with competing forces: reasonable valuation multiples, falling inflation, and slowing growth due to a higher rate environment.”

Investors expect interest rates to continue to rise, albeit at a slower pace than 2022, assuming inflation continues to moderate, says our U.S. growth and core equity team. “We believe the majority of multiple compression from rising interest rates should already be largely embedded in stocks,” says Rob Lanphier, partner, a portfolio specialist on our U.S. growth and core equity team.

But according to Czarnecki, the stock market could stabilize when it becomes clear that the U.S. Federal Reserve is near the end of its current rate-hiking regime. “Our best estimate is that we are closer to the end of this rate-hiking cycle than the beginning. Investors are now focused on whether the Fed will be forced to hold rates higher for longer than the bond market is predicting” he says.

### **The Effects of Rate Increases**

Given the lagged impact, the effects of interest rate increases will likely have a more meaningful impact on the U.S. economy in 2023, according to our U.S. growth and core equity team.

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“A slowing economy and generally weaker demand relative to this past year may necessitate costs come into equilibrium with slower revenue growth,” says Lanphier. “This implies risk to corporate earnings. Moreover, as an era of near-zero rates ends, capital sources for more speculative equities are likely to diminish, focusing more on near-term fundamentals.”

### **A Quality Focus Is Key**

Given this cautionary outlook, we believe market performance in 2023 will likely be tied more closely to fundamentals than valuation difference. Looking forward to 2023, both teams believe there are indications that higher-quality investments should fare better in the coming year.

According to Lanphier, quality companies, which have the financial independence to continue to invest in their operations and the business model flexibility to quickly adjust in a dynamic environment, have become increasingly attractive investment opportunities against this backdrop. “Pricing flexibility, for example, will be critical if inflationary pressures from labor and materials persist and overall demand weakens,” he says. “This scenario would likely cause pressure on margins and earnings disappointments for the average company.”

Lanphier and his team believe companies with strong management teams, superior business models, and solid financials would be in a better position to navigate such headwinds. “In addition, higher-quality investments did not materially outperform during the sell-off in 2022, resulting in compelling valuations for these businesses as we look ahead.”

As for our U.S. value equity team, Czarnecki stated that “our approach to navigating the uncertain markets of 2023 remains consistent with our time-tested philosophy and process that we have leveraged for the last three decades in managing small- to mid-cap value strategies: employing an acute focus on the intersection of value and quality.”

### Valuations Remain Important

Valuations continue to remain in focus. “Over the course of 2022, we have used the market’s weakness to upgrade the quality of the U.S. value equity portfolios’ holdings, whose future earnings either may be more resilient than the market expects or are already pricing in a moderate to severe recession,” says Czarnecki. “In particular, our team has increasingly focused on balance sheet strength and avoiding significant leverage. During this period of economic uncertainty, we are comforted by the historically low valuation of our strategies’ holdings, which trade below long-term historical averages.”

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