Investment Strategy Update #142

US – Still our most preferred global equity market exposure

- Defying negative expectations, US equities (+10.8%) have led the rally in global markets since the start of the year, climbing a ‘wall of worry’ that has included sticky inflation, fears of ever higher policy rates, debt ceiling concerns and a slowing economy.

- Despite this resilience, we remain cautious on the near-term risk-reward outlook for equities. Although economic growth has held up better than expected, we think the slowdown is broadening and investors should be wary of an imminent policy pivot to support markets as we head into 2H.

- While the US is at the heart of a global slowdown, among major equity markets we still believe it will outperform its more cyclically sensitive peers (Europe, Japan, Emerging Markets) on a relative basis given its weighting to areas such as technology and health care.

- This relatively defensive/growth sector mix is supporting the market as breadth of performance has narrowed and should also provide solid earnings support as other more cyclically exposed sectors come under downside pressure. In addition, US equities should also benefit in common currency terms as the global economy weakens given the US Dollar rallies during this ‘risk-off’ environment.

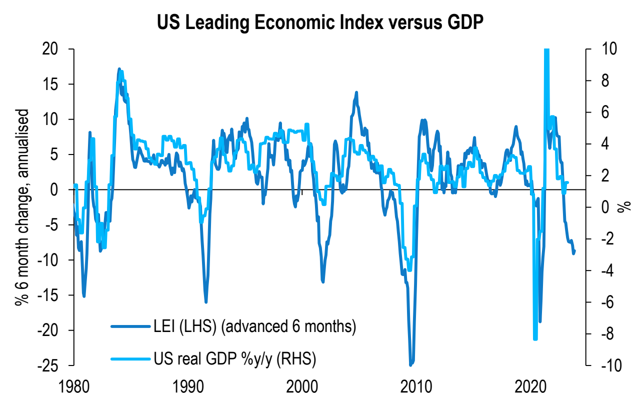
- As recession risks rise, we think investors should remain cautious on equities but with a preference for the US within a global portfolio. It will not remain immune to a broad risk-off period, but we think it has enough support to ensure that it is the ‘best in a bad neighbourhood’ should equities take a turn down, as we expect.

- On a more positive note, we started the year expecting equities to go through a recession induced correction, but that there was no need for markets to set new lows (seen in October 2022 when inflation and rate fears were at peak) and that by year end they would be back in positive territory. We maintain this view and see any bouts of weakness as opportunities to raise an underweight equity allocation back up to neutral.

A weakening economic outlook…

Macquarie’s central case remains a (developed world) recession starting in 2H23 with 3Q23 the first quarter of U.S. contraction. Macquarie’s baseline is for this to last three quarters and for it to involve a peak to trough decline in real GDP of -1.6%. This is more severe than the consensus forecast for a “softish landing” with only a -0.2% peak to trough decline.

Leading indicators suggest economic weakening ahead

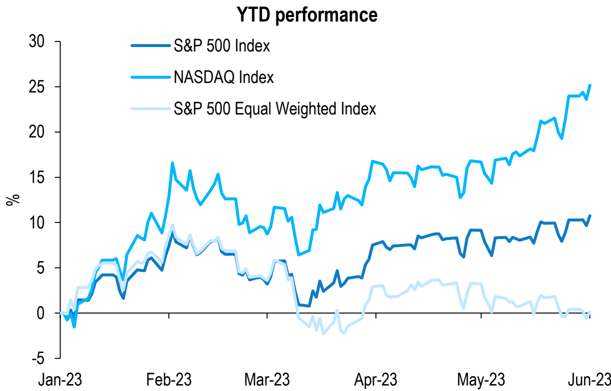


Source: Factset, MWM Research, May 2023

…leads us to be cautious on equities

While equities have bounced off their early March lows, we think this signals a shift away from pricing in a worst-case scenario arising from the US regional banking crisis, a slower than expected decline in activity (more resilient growth) and expectations of an imminent policy pivot. Additionally, measures of breadth in equities have been deteriorating (i.e., the proportion of stocks going up is very low), with the rally having been led by a handful of large technology-related names, spurred on by excitement of AI advances (such as NVIDIA Corporation, up 172% YTD). The S&P 500 Equal-Weighted Index (which is not as impacted by breadth) is up only 0.1% this year versus +10.8% for the S&P 500 (cap-weighted) Index.

S&P 500 return driven by a handful of tech stocks



Source: Factset, MWM Research, May 2023

We don't think the macroeconomic outlook has fundamentally improved to a level that now requires adding risk either via equities or other risk proxies, even though the calm that has enveloped markets is drawing some to that conclusion.

While we think markets will still follow growth momentum lower, our view remains intact that we have seen the lows. However, we also think upside is limited in the absence of more evidence that we are closer to a policy pivot, and this appears premature.

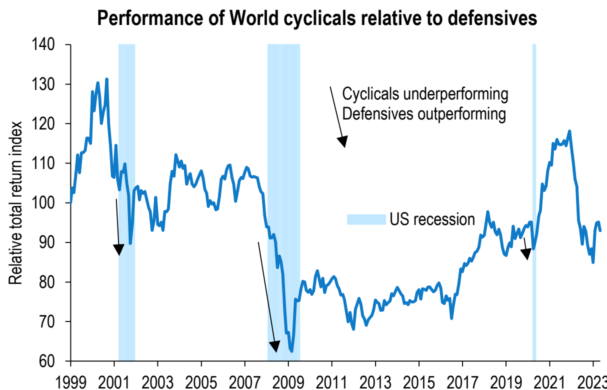
… but with US equities as our top pick

Among international equity markets, we prefer the US over Europe, Japan and Emerging Markets for the following reasons:

#1 The US is a high 'quality' market

Cyclical equity markets tend to do worse in recessions than more growth/defensive orientated markets. This is because stocks more leveraged to the business cycle will see their earnings impacted more by an economic slowdown.

Cyclicals underperform during recessions



Source: Factset, MWM Research, May 2023

The US is a more defensive/growth-oriented equity market relative to major peers, with a heavy overweight in sectors such as IT, Communication Services and Health Care, whose earnings are likely to be relatively resilient during a downturn. The US underweight in economically sensitive cyclical sectors should help it weather the EPS recession that is coming. Of note is the US underweight in Financials given recent stresses in the global banking system.

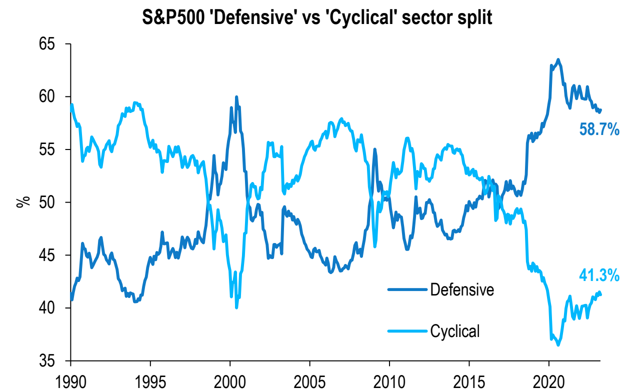
US overweight defensive/growth sectors

	S&P500	MSCI World ex US	Relative
Defensive sectors			
IT	25.8%	8.0%	+17.8%
Communication Services	8.3%	4.2%	+4.0%
Health Care	14.4%	12.1%	+2.3%
Utilities	2.9%	3.5%	-0.6%
Consumer Staples	7.4%	10.1%	-2.7%
Total for defensive sectors	**58.7%**	**38.0%**	**+20.8%**
Cyclical sectors			
Industrials	8.4%	15.2%	-6.8%
Financials	13.1%	19.6%	-6.5%
Materials	2.6%	7.9%	-5.3%
Energy	4.7%	6.0%	-1.3%
Consumer Discretionary	9.9%	11.1%	-1.2%
Real Estate	2.5%	2.2%	+0.3%
Total for cyclical sectors	**41.3%**	**62.0%**	**-20.8%**

Source: Factset, MWM Research, May 2023

The US market's 'defensive/growth' tilt is a relatively recent phenomenon, having been boosted by the rise of technology (& technology-related) mega-cap names. While the US market had a very high defensive/growth tilt in the early 2000's we note that only occurred briefly as a result of a massive inflation in IT stock valuations (which subsequently was erased with the 'Tech Wreck' bear market that immediately followed). The more recent increase in the defensive/growth weighting, on the other hand, has been years in the making and reflects more than just valuation increase given high P/E valuations have already taken a major hit in 2022.

US 'defensive/growth' overweight has spiked recently

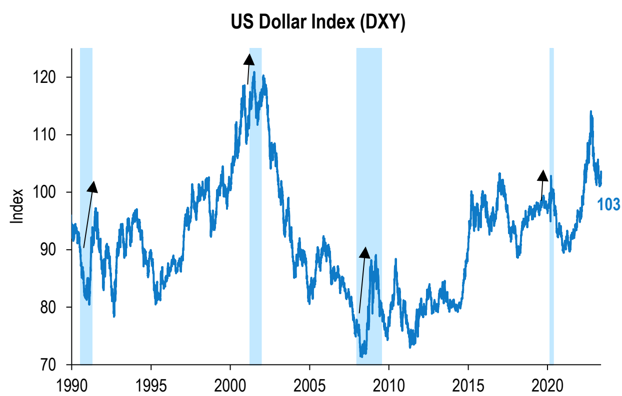


Source: Factset, MWM Research, May 2023

#2 The US market will benefit from a stronger US Dollar

US equities will also benefit in common currency terms from a rising U.S. Dollar. The U.S. Dollar has traditionally risen at the beginning of a recession because the beginning of a recession is a ‘risk-off’ environment during which investors flock to perceived ‘safe-haven’ assets, such as bonds and the U.S. Dollar.

US Dollar has tended to spike as recessions begin



Source: Factset, MWM Research, May 2023

Investment Strategy Update #142 finalised on 2 June 2023.

Recommendation definitions (Macquarie Australia/New Zealand)
Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

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