

US Equity Transitions

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With the New Year underway, investors are undoubtedly wondering what's in store for equities and the economy in 2022. Given the S&P 500 rose a whopping 27% last year, it's fair to wonder if we'll see a repeat performance or something more tempered. The first week of 2022 presented a continued recalibration amongst high-flying speculative growth stocks, and acceleration in some of the more traditional value-based corners of the market. Can we expect more of the same in 2022?

This week, we are presenting a missive from Tan Kai Xian, our partner at Gavekal Research, who outlines four major transitions that he expects to unfold this year. Please enjoy.

Despite huge supply chain disruption, rising inflation and a more-hawkish-than-expected central bank, the S&P 500 index rose a whopping 27% last year and along the way suffered a maximum fall of -5%. Going into 2022, investors may conclude that US equities have hit "escape velocity" and nothing will spoil the rally. I tend to the view that such effortless superiority will be hard to sustain, as four major transitions will probably unfold this year.

1. US equity volatility and market drawdowns will likely be bigger as the profit-seeking private sector again comes to dominate capital allocation instead of government agencies and the central bank. The Federal Reserve is winding down its asset purchases, while the government is no longer making huge emergency transfers. Markets are exposed to this change, as valuations are rich and many retail investors have high leverage. November's spike in the Vix volatility index offered an early warning of this change.
2. Market breadth will probably contract, making it even harder for active managers to outperform. The US economy looks to be deep into its business cycle, which typically sees market leadership narrow to mega-cap stocks (see the left-hand chart below). This is because when the economy runs above potential, higher wage pressure dents profit margins. At such moments, firms operating on thin margins are hurt most, and may turn loss-making. In contrast, fatter-margin firms can keep growing. This trend results in a narrowing rally, causing the market cap-weighted

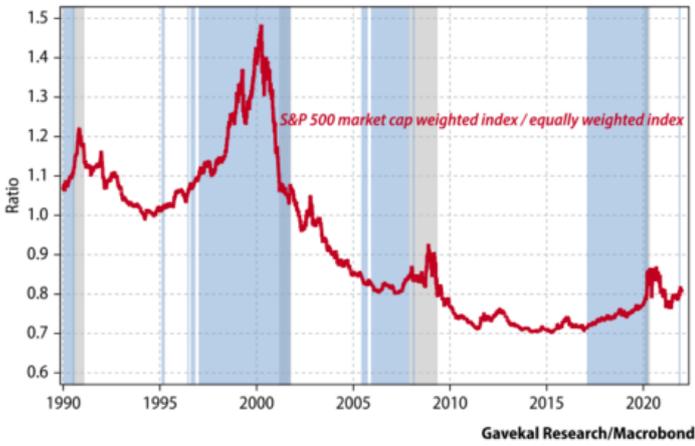
index to outperform.

3. The market should have a less gloomy view of US earnings growth. When the economy slowed in 2H21, sell-side analysts revised down their forward-earnings estimates. This posed a headwind to equities, even though they did well in the period (see right-hand chart below). Looking ahead, the US economy seems to be expanding at a level consistent with its structural growth rate of 2-2.5%. In the near term, any easing of supply bottlenecks and reduced Covid concerns could spur a mild economic rebound, which would aid corporate sales. On the flip side, higher wage costs, which should be confirmed in Friday's payroll report, will dent margins. On a net basis, these two factors look to be a wash, with US corporate earnings growth likely to come in as expected. This will not deliver a boost to equity investors, but at least the drag seen in the last six months should fade.
4. US equity valuations will become stretched if bond yields rise. For most of last year valuations based on national accounts earnings were pretty stable. This was largely down to real yields being range-bound. Looking ahead, the Fed's bond-purchase taper and the Treasury's bulking-up of its cash balance point to a rise in nominal yields. If inflation stays steady or retreats, leading to higher real yields, then equity valuations will start to look stretched versus bonds.

If these four major transitions duly play out, investors are advised to take the following three precautions: (i) avoid holding US equities unhedged and consider Vix futures as a way to protect a portfolio; (ii) be more selective, and overweight mega-cap stocks that are hurt less by late-cycle dynamics; (iii) keep equity duration short by holding value stocks, which benefit more from a stabilization of the earnings outlook and are hurt less by higher real yields. On balance, mega-cap banks check all these boxes.

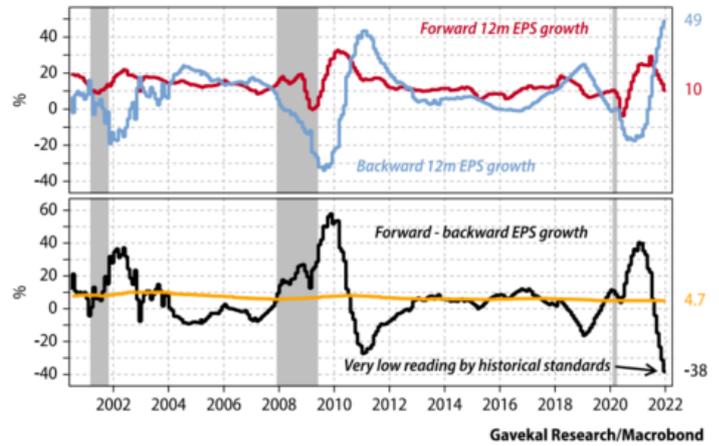
Late stage of US business cycle = narrower market leadership

Shaded grey: US recessions; blue: tight labor market (unemployment rate < NAIRU)



The derating of US equity-earnings estimates is likely ending

MSCI IMI US index; shaded grey: US recessions



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