SPECIAL REPORT

PERSPECTIVES ON THE US EQUITY MARKET

by **Robert F. DeLucia, CFA**
Consulting Economist

While it is impossible to predict the ultimate length and depth of the current correction in equity prices, there are certain concrete observations that can be made. The most important conclusion is that the weakness in stock prices appears to be internal to the equity market rather than a manifestation of economic weakness. The fundamental underpinnings of the equity market and the credit markets are solid. The domestic economy is healthy in virtually all respects and is expected to grow at an above-trend pace during the final three quarters of this year.

The abrupt shift in equity market sentiment that began in early January has been a shock to many investors and has contributed to the lowest level of consumer confidence in ten years. There remains considerable misunderstanding among investors, partially a result of widespread misinformation from the media and from Wall Street. This Special Report provides some perspective on the current period of extreme volatility.

- While it is impossible to predict the ultimate length and depth of the current equity market consolidation, there are certain concrete observations that can be made. *The most important conclusion is that the weakness in stock prices appears to be internal to the equity market rather than a manifestation of economic weakness*. The fundamental underpinnings of the equity market are solid.

- *The domestic economy is healthy in virtually all respects and is expected to grow at an above-trend pace during the final three quarters of this year*. First quarter GDP will be negatively affected by the surge in coronavirus infections during December and January, but cases are already beginning to decline.

- *Most importantly, none of the typical early signs of recession are evident*. A reliable guide to risks in the underlying economy is the corporate bond market, where option-adjusted spreads (OAS) have remained stable. Underlying credit conditions are excellent.

- The sudden market sell-off can be best explained as an abrupt shift in investor psychology regarding liquidity conditions, which have been the primary driver of the bull market since the onset of the pandemic in early 2020. *In principle, excess liquidity always leads to speculative excesses in financial markets*.

- Speculation has been evident not only in the equity market but also in the IPO (initial public offerings) market along with the private equity and venture capital markets. Strong rallies in the shares of companies without earnings is also a clear sign of widespread speculation, as is the sharp increase in trading in cryptocurrencies. Perhaps the poster child for this speculative wave was the surge in investor funds flowing into special purpose acquisition companies (SPACs).

- Excess liquidity also results in investor complacency and a belief that the stock market can only go up. *Through yearend 2021, the S&P 500 Index rose for 61 consecutive weeks without experiencing a 6% correction*. History shows that this trend was abnormal and ultimately unsustainable.

- *In a normal year, the equity market typically experiences at least one 10% correction, and several corrections of greater than 5%*. The S&P 500 Index declined by more than 5% on three occasions during 2019; by 20%, 10%, and 7% in 2018; by 10%, 6%, and 5% in 2016; and by 12% and 6% during 2015.

- The peak-to-trough decline in the S&P 500 Index has been roughly 10%, while the NASDAQ has slumped by nearly 17%. The severity of the sell-off in stocks can be better understood by looking beneath the surface, as many individual stocks have plunged by more than 50%. More than 40% of the 3000 stocks in the NASDAQ have suffered cumulative declines of greater than 50%.

- *The current market sell-off can also be understood as a belated reaction to overvaluation in the equity market over the past two years*. The biggest individual stock declines have been concentrated in the shares of companies with the highest price-to-earnings (P/E) ratios. The cumulative decline in growth stocks (-16%) has far exceeded the decline in value stocks (-6%). The overall P/E for the S&P 500 has declined from a peak of 24x last year to 20x currently.

- Unusually high volatility can be explained by the dominance of hedge funds, exchange-traded funds (ETFs), day traders, and computer-driven trading by large institutions. Recent growth in the role of individual investors — a large percentage of whom with limited experience — has also contributed to increased volatility. *In general, investors are rattled by wild swings in the market and lack conviction regarding the economic outlook, all of which creates a negative feedback loop in terms of volatility*.

- The catalyst for the sudden market drawdown was the perception that the Federal Reserve had adopted a more aggressive mindset with respect to the process of normalizing interest rates. Analysts have steadily revised upward their expectations with respect to the timing and magnitude of rate hikes. I continue to expect the Fed to tighten policy at a measured pace in order to extend the life of the expansion.

- I expect the Fed to begin raising rates at its March 16 meeting, and project a 1% federal funds rate at the end of this year. I expect another four rate hikes in 2023 with short-term rates reaching 2% by yearend. *My assumption is that these rate increases will not begin to affect the real economy until next year*, for two reasons: (1) Even 2% is a very low cost of capital in absolute historical terms; and (2) With inflation of 3% or higher, the *real cost of capital* would be exceptionally low.

- The lesson of previous rate-tightening cycles beginning in the 1970s is clear: *Stock prices tend to rise simultaneously with interest rates in a sustained uptrend during a large portion of the tightening cycle*. Dating back to the 1970s, the S&P 500 has risen by an average 28% as the Fed was tightening monetary conditions. In the words of Mark Twain, "history does not repeat itself, but it often rhymes."

- The previous two tightening cycles are instructive. The Fed raised the federal funds rate 17 times from 1% to 5.25% beginning in June 2004 and ending in June 2006. The Fed also raised its policy rate eight times from 0.5% to 2.5% from 2016 through most of 2018. *The S&P 500 rose by a cumulative 35% from 2004 to 2006, and by 42% from 2016 through 2018*.

- *An important caveat is that the increase in both short-term and long-term rates is accompanied by a rising trend in corporate earnings per share (EPS)*. The current earnings cycle is expected to remain positive throughout this year and much of 2023. More than 55% of companies in the S&P 500 have issued Q4 financial reports, and 78% have reported EPS above analyst expectations. The average EPS gain in the fourth quarter is 27%, with full-year growth of 45%. My forecast assumes EPS growth of 8-10% for 2022.

- *The major risk to the outlook is inflation*. While underlying inflationary pressures should gradually build over the next several years, monthly government data on consumer inflation could begin to moderate as this year unfolds. Improving public health conditions will likely alleviate supply pressures that have triggered the rapid rise in material costs, wages, and selling prices. A normalization of consumer spending should also ease supply-chain pressures, as household spending shifts from durable goods to services.

- *It seems unlikely that the current corrective phase has fully run its course, implying further stock price weakness in future weeks*. Sentiment measures are mixed: Both hedge funds and traditional institutional money managers have reduced their equity exposure, but retail investors continue to pour money into the market. Investor sentiment could decline further, suggesting that it could take a number of weeks for a durable equity bottom to form.

- *The equity market is entering a new phase consistent with a maturing business expansion cycle*. This new phase will be characterized by a reduced emphasis on momentum trading, theme investing, and speculative bets, and a greater focus on individual stock selection and valuation. It should also be characterized by greater up-and-down volatility and more moderate rates of return.

- *I expect the equity market to post a positive rate of return for the full year, albeit with occasional brief corrections along the way*. Investors should not expect large gains this year but rather total returns in the single digits. Market corrections are often accompanied by changes in leadership. I continue to believe value managers will outperform growth managers and that international equity returns will surpass those of the US.

Robert F. DeLucia, CFA, was formerly Senior Economist and Portfolio Manager for Prudential Retirement. Prior to that role, he spent 25 years at CIGNA Investment Management, most recently serving as Chief Economist and Senior Portfolio Manager. He currently serves as the Consulting Economist for Prudential Retirement. Bob has 45 years of investment experience.

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Bloomberg US Aggregate Bond Index: is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States. Investors frequently use the index as a stand-in for measuring the performance of the US bond market.

Dow Jones Industrial Average: is a stock market index that measures the stock performance of 30 large companies listed on stock exchanges in the United States.

MSCI World Excluding US Equity Index: is a stock market index comprising of non-U.S. stocks from 23 developed markets and 26 emerging markets. The index is calculated with a methodology that focuses on liquidity, investability, and replicability.

NASDAQ: is an American stock exchange at One Liberty Plaza in New York City. It is ranked second on the list of stock exchanges by market capitalization of shares traded, behind the New York Stock.

NYSE FANG+ Index: is an equal-dollar weighted index designed to represent a segment of the technology and consumer discretionary sectors consisting of highly-traded stocks of technology and tech-enabled companies.

Russell 2000 Index: is a small-cap stock market index of the smallest 2,000 stocks in the Russell 3000 Index. It was started by the Frank Russell Company in 1984. The index is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.

Russell 3000 Growth Index: is a market capitalization-weighted index based on the Russell 3000 index. The Russell 3000 Growth Index includes companies that display signs of above-average growth. The index is used to provide a gauge of the performance of growth stocks in the United States.

Russell 3000 Value Index: : is a market-capitalization weighted equity index maintained by the Russell Investment Group and based on the Russell 3000 Index, which measures how U.S. stocks in the equity value segment perform by including only value stocks.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

The Value Line Geometric Composite Index: is the original index released, and launched on June 30, 1961. It is an equally weighted index using a geometric average. Because it is based on a geometric average the daily change is closest to the median stock price change.

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