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Reality Bites: Are Equity Markets Too Upbeat?

While equity-markets investors may be optimistic, the latest rallies may not have a leg to stand on.

Nanette Abuhoff Jacobson
Managing Director and Multi-Asset Strategist at Wellington Management and Global Investment Strategist for Hartford Funds

2022 has been a roller-coaster ride in more ways than one. Case in point: In recent months, US equity-market participants have pounced on any signs that the US Federal Reserve (Fed) might be becoming less hawkish, sending the market soaring for brief intervals, only to be disappointed when the Fed pushes back on the notion that its words or actions signal a policy pivot. US stocks just completed a very strong November, but there are two big reasons why I think this latest market rally will disappoint yet again (and, indeed, already has as of the first week of December):

1. The Fed funds[1] futures market is still pricing in Fed interest-rate *cuts* (not hikes) in the latter half of 2023.
2. Corporate earnings estimates haven't come down far enough for me to wave the all-clear sign on US equities.

Wishful Thinking on Rates?

Following Fed Chair Jerome Powell's much-ballyhooed November 30 speech, many investors gleefully focused on the Fed's planned shift to a 50-basis point[2] (bps) rate hike from the outsized 75-bps hikes enacted at the past four Federal Open Market Committee meetings. However, Powell also emphasized that even though there has been some better news recently on core goods inflation, non-housing services inflation—which represents more than 50% of core inflation—has remained high and sticky. Importantly, this is also the area where wages have risen the most.

From where I sit, here's what the equity market seems to have missed: Fed policy likely needs to be held at restrictive levels for "*some time*" before demand and wages slow enough to warrant looser policy. As of December 7, the futures market was pricing in a peak Fed funds rate of 5.0% and then around 50 bps of rate cuts by the end of next year. Given persistent structural issues around labor supply (e.g., a lower workforce participation rate), I think it's optimistic to believe inflation will have cooled sufficiently for the Fed to be able to pivot to policy easing by next year.

Too Rosy on Corporate Earnings?

On the earnings front, the equity market also seems to have a pretty rosy outlook. Earnings expectations for 2023 have fallen quite a bit this year, to 3.8% for S&P 500 Index[3] companies as of early December, from 9% roughly six months ago (according to FactSet). However, **FIGURE 1** shows that analysts' earnings expectations may have to be pared back even further before hitting the recessionary levels seen over the past three decades. (Earnings "breadth" better captures the condition of the overall market, in my view.) Even in a mild recession, one would expect earnings to contract and their breadth to deteriorate, suggesting that the market may be too optimistic regarding the fundamental earnings picture.

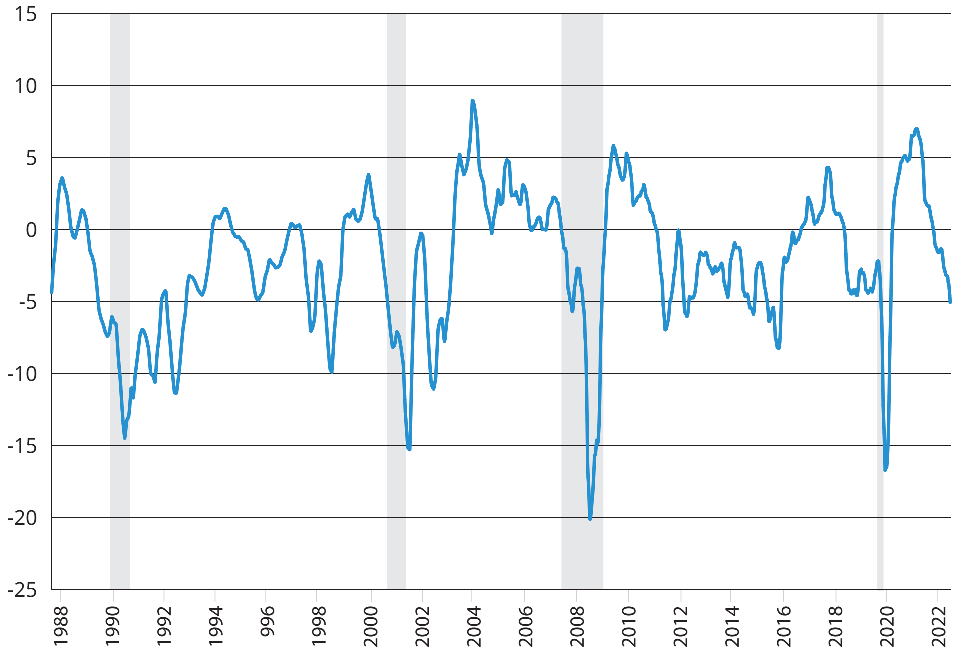
Key Points

- The Fed may be slowing the pace of rate hikes, but policy may need to be held at restrictive levels for "some time" before demand and wages slow enough to warrant looser policy.
- Corporate earnings expectations look pretty rosy now, but they may have to be pared back even further before hitting the recessionary levels seen over the past three decades.
- Investors may want to consider remaining cautious in equities and focusing on high-quality fixed income.

FIGURE 1

Earning Revisions May Have Further Downside

Global Earnings Revisions (1988-2022)



As of 11/29/22. Earnings revisions are (up-down)/total number of earnings estimates. Shaded areas represent US recessionary periods. Source: Datastream.

Investment Implications

Given my assessment that the above factors are apt to weigh on equity markets (particularly the US market) for the foreseeable future, preventing any near-term rallies from gaining real traction, I would recommend that investors consider:

- **Remaining cautious on equities:** With equity markets appearing to be overly sanguine on both Fed policy and corporate earnings, I favor maintaining a moderate portfolio underweight to global-equity risk for the time being.
- **Sticking with quality stocks:** Focus on companies with pricing power, long-term margin stability, and healthy balance sheets that can withstand ongoing inflationary pressures. I currently favor value-oriented sectors such as energy and materials.
- **Dipping back into high-quality fixed income:** There are already tentative signs that tighter financial conditions induced by Fed rate hikes are slowing longer-term growth. With bonds now more competitive vs. equities from a yield perspective, I think this may be a good time to selectively rebuild defensive fixed-income exposure.

Talk to your financial professional about how you should position your portfolio amid market uncertainty.

[1] The federal funds rate is the target interest rate set by the Federal Open Market Committee. This target is the rate at which commercial banks borrow and lend their excess reserves to each other overnight.

[2] A basis point is a unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indices and the yield of a fixed-income security.

[3] S&P 500 Index is a market capitalization-weighted price index composed of 500 widely held common stocks.