Authored by:

Michelle Cluver, CFA
Jon Maier

Date: October 7, 2022
Topic: Macroeconomic, Outlook

Q4 2022 and Year Ahead Outlook: Downturns Offer Opportunities

Reversing the gains from earlier in Q3, September's market rout brought U.S. and global equity indexes back into bear market territory. Uncertainty, volatility, and recession risk are elevated, but investors should keep in mind that innovations and opportunities often emerge from periods of volatility. Recessions are typically the shortest part of the business cycle, but decisions made during periods like these can shape investment outcomes for years to come. We believe investors can use the current environment to reposition portfolios and use this opportunity to harvest losses for tax purposes.

Key Takeaways

- We expect a gradual U.S. economic contraction that is less severe than prior recessions.
- Defensive and quality-focused positions remain relevant due to lower cyclicality of earnings.
- Diversification benefits are most noticeable during market turmoil, and they highlight the value of an investment plan.

We Expect a Gradual U.S. Economic Slowdown

Every recession is challenging, but every recession is different. Recent memories may impact how investors react to this economic slowdown. However, the COVID recession and the Global Financial Crisis are dramatic recent examples of periods of sharply slower economic growth. Both examples included shock factors with numerous negative feedback loops, which make them poor comparisons for the current period, where we expect U.S. economic growth to slow gradually and the scale of this contraction to be smaller.

But fear persists amid questions about how much further economic expectations and the market environment can deteriorate. In the U.S., banks remain well-capitalized, consumer and corporate balance sheets remain healthy, and the labor market is tight.[1] While a persistent contraction is likely to weigh on each of these elements, the current strength in these areas suggest the potential for a shallow U.S. recession.

However, given the strength of the U.S. dollar, markets currently expect U.S. economic growth to outpace key international economies. Dollar strength improves U.S. purchasing power on a global scale, but it could weigh on U.S. exports. In an extended global economic slowdown, reduced global demand for U.S. goods may weigh on U.S. economic activity.

For a more detailed perspective on our economic views, please refer to our House Views.

Overcoming Investor Psychology in Times of Volatility

Economic uncertainty and elevated market volatility has many investors in wait-and-see mode. Anecdotal evidence from our discussions with clients suggests that there is ample cash on the sidelines waiting to be deployed, which provides reason for optimism as uncertainties ease.

Investor sentiment can change quickly, improving as uncertainties diminish. The rebound in the first two days of October reflect how a small decrease in risk off sentiment can have a large impact on risk assets. The market recovery is likely to start prior to the economy moving out of recession, potentially even before the full extent of the economic contraction is reported out in the GDP growth numbers. It's important to remember that markets generally overshoot in both directions: overzealous and overcautious. As Warren Buffet once said, "Be fearful when others are greedy, and greedy when others are fearful."[2]

Positioning for the Recession

Using a simple dividend discount model as a guide, all three key factors that drive the price of a security - dividends, the expected growth in dividends, and long-term interest rates - are adversely impacted by the current environment.

$$\text{Price} = \frac{\text{Expected Dividend}}{\text{Discount Rate - Dividend Growth Rate}}$$

The Fed's rapid interest rate hikes have weighed on value through the discount rate. In our view, the uncertainty will likely persist until there is clarity on when the Fed will end their tightening. Markets are currently pricing in another 125 basis points (bps) of hikes in Q4 2022 and 25 bps for Q1 2023.[3] Some signs point to U.S. inflation having peaked, but the monthly numbers remain stubbornly high. The trajectory of U.S. headline inflation is likely to have a major impact on market sentiment due to the Fed's response. Should U.S. inflation normalize rapidly, markets may reduce rate hiking expectations. The converse is also true.

Earnings are likely to reflect weakness as economic growth slows. During Q3, S&P 500 earnings estimates were revised down -6.6%, a much larger downward revision than the -2.3% average over the last five years.[4] Should the U.S. experience an earnings recession, some companies may be forced to cut their dividends or curtail their dividend growth. The scale of these responses will determine the impact on intrinsic value.

The cyclicality of earnings differs across sectors and industries. As economic growth expectations slow, market segments with greater earnings stability may be rewarded. Currently, we prefer defensive and quality-focused equities. Free cash flow strength remains important.

We also favor U.S. equity exposure over international developed or emerging market exposure. The strong dollar combined with the energy crisis intensifies the impact of dollar strength on the global economy. The U.S. economy is in a stronger relative position, but many U.S. companies are exposed to international markets. The strong dollar weighs on the translation of foreign sales and earnings, and slower economic growth outside the U.S. may detract from corporate earnings reports.

For more detail on this impact, please refer to our Sector Views.

Positioning to Capture Long-Term Trends

Thus far in 2022, the balance between interest rate sensitivity and economic growth sensitivity favored companies with high dividends. However, as the recession takes hold, markets are likely to begin to prioritize areas with stability and those that can grow despite the economy. We expect investors to balance their exposures between companies that are defensively positioned, able to grow despite economic weakness, and are of higher quality with sustainable dividend and strong cash flows.

In our view, key areas with long-term tailwinds materializing include renewable energy, the commodities essential to the energy transition, cybersecurity, and automation and robotics.

- The energy crisis in Europe remains one of the key market risks. Clean energy solutions will not solve the crisis, but they will be part of the longer-term solution to improving energy independence. CleanTech offers innovation, and renewable power distribution provides utility exposure. Investors can combine these exposures based on the level of volatility they are comfortable with.
- Lithium and battery technology are critical to the transition to renewable energy. And while green energy technology scales and battery storage options improve, nuclear power can provide a clean and reliable source of energy to help bridge the gap. In line to benefit from increased use of nuclear power are uranium producers.
- The ongoing digitalization of the global economy increases cybersecurity risks, which raise the importance of companies implementing rigorous cybersecurity protocols. These protocols can create recurring revenue opportunities for companies providing cybersecurity protection.
- The tight labor market and rising wages create incentives for companies to automate their operations, including through increased use of robots. We expect the robotics market to grow as robot costs decrease and deglobalization increases the need for cost-efficient production and manufacturing.

Conclusion: Volatility Increases the Importance of an Investment Plan

Volatility can drive large market moves in both directions, which means the best days in the market typically occur during turbulent periods. However, timing the market is extremely challenging for even the most experienced, and successful, investors. When volatility strikes, having an investment plan that keeps investors focused on their long-term investment goals can be critical, as market opportunities are generally the greatest at peak pessimism.

Bear markets create periods of reset, where investors take advantage of depressed valuations to reposition portfolios as well as tax-loss harvest. While the current environment is frightening, investors can use this opportunity to look for bargains. Nibbling at higher growth opportunities while maintaining a defensive posture can help make short-term volatility more bearable while looking long-term.

Footnotes:

1. Federal Reserve Economic Data and U.S. Bureau of Labor Statistics data as of 29 September 2022
2. Warren Buffet
3. Bloomberg data as of 29 September 2022
4. FactSet, Largest Cuts to EPS Estimates for S&P 500 Companies for Q3 2022 in More than Two Years, 30 September 2022

Definitions

Basis point: A basis point is a hundredth of one percent. It is predominantly used to express differences in interest rates.

S&P 500 Total Return Index: The index includes 500 leading U.S. companies and captures approximately 80% coverage of available market capitalization.

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information is not intended to be individual or personalized investment or tax advice and should not be used for trading purposes. Please consult a financial advisor or tax professional for more information regarding your investment and/or tax situation.

Global X Management Company LLC serves as an advisor to the Global X Funds.