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The Benefits of Lower Correlations

Rising Asset Correlations Went into Overdrive In 2022

Correlations across U.S equity, international equity, and fixed income rose in 2022 as global central banks increased policy rates to reduce consumer demand and curb inflation. For fixed income, the worst may have passed as the Federal Reserve (Fed) approaches a terminal rate of about 5%. For international markets, some headwinds have dissipated, while growth expectations in the U.S. have deteriorated slightly. As correlations between asset classes decline, we expect markets to find a balance between growth and value. So far, there have been clear winners and losers on the sector front, evidenced by the severity and breadth of the declines. This disparity could create investment opportunities, but selectivity will be key across asset classes and sectors amid tighter financial conditions.

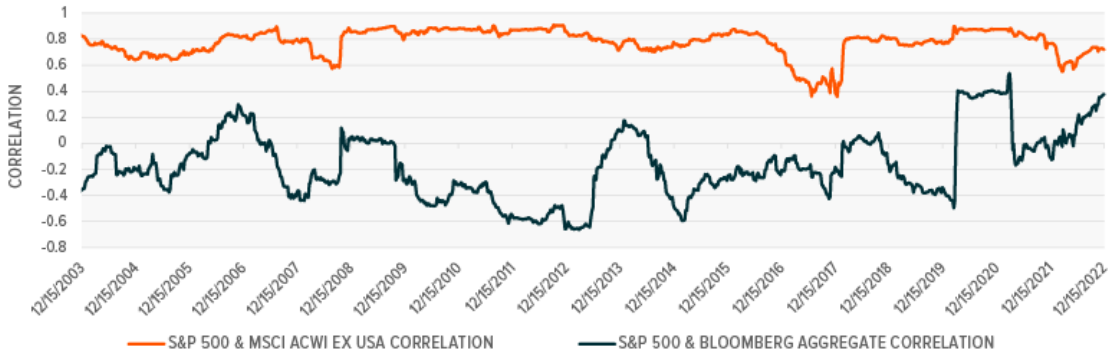
Declining Correlations Could Create Opportunities In 2023

Conditions could be aligning for correlations between U.S. equities and fixed income to decline. The speed of rate increases in 2022 caused aggressive repricing in bonds and U.S. equities simultaneously. As the Fed policy rate nears 5.0%,[1] the pace of rate hikes may subside.

Another factor is the cloudy outlook for U.S. equities in the first half of 2023 with investors expecting earnings contraction. About 55% of S&P 500 companies and 71% of the Nasdaq are trading below their 200-day moving averages (MA).[2] In December, the estimated Q4 year-over-year earnings growth rate for the S&P 500 was revised to -2.8%, well below the 3.7% estimate at the start of the quarter.[3] Weaker earnings growth could occur alongside rising recession risks, evidenced by the Conference Board Leading Economic Index's (LEI) steep decline after peaking in February of 2022.[4] The Conference Board projects a U.S. recession to occur around the beginning of 2023 and last through mid-year. In the meantime, a recession could lead to less restrictive monetary policy, creating investment opportunities.

Asset class correlations ebb and flow, as seen in the chart below, which measures 1-year correlations using weekly rolling data over the past 20 years. To buffer the impact of market downturns on overall investment returns, investors can build diversified portfolios that include assets with low correlations.

HISTORICAL COORELATIONS
Source: Bloomberg data as of December 16, 2022



Improving Global Opportunities

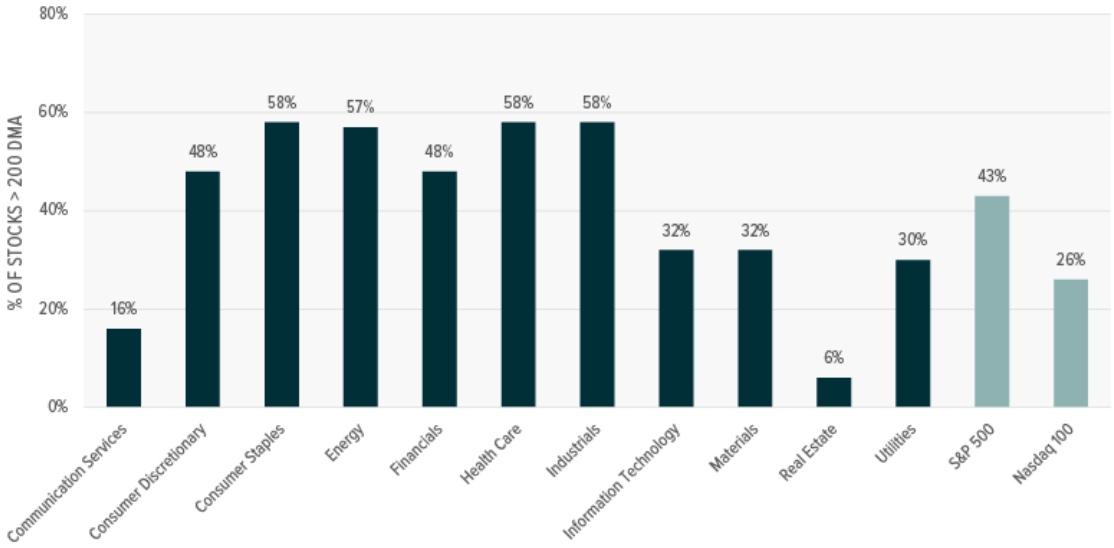
International markets may benefit as peak pessimism fades. European energy shortage fears have dissipated with gas storage adequate for the winter, while China shifting away from their zero-COVID policy reflects an increased prioritization of economic growth. Thematic equity is global in nature and potentially stands to benefit from improving global opportunities. However, with slower global economic growth and restrictive financial conditions, this is an important area to be selective. Clean tech, clean energy, cybersecurity, and robotics are a few themes that we believe continue to have structural tailwinds in the current environment.

- **Clean Energy and Clean Tech**: The war in Ukraine highlighted the need to expand clean energy infrastructure and clean tech investment in Europe and beyond. Beyond the focus on renewable solutions, this conflict highlighted the importance of energy independence.
- **Cybersecurity**: Heightened cybersecurity risks are a tailwind for topline growth. In the near term, we expect cybersecurity revenue to grow faster than the economy or the broad market.
- **Robotics & Artificial Intelligence**: Broad structural forces are increasing the need for improved efficiency, driving increased demand for automation.

Sector Selectivity Will Be Key

Dispersion in sector price trends could narrow in 2023 as growth headwinds subside. The chart below shows the percentage of stocks in each sector trading above their 200-day moving average. Consumer Staples, Energy, Health Care, and Industrials have maintained their respective uptrends, especially relative to the S&P 500. However, Real Estate, Materials, Industrials, and Communication Services have significantly lower breadth readings. The weaker economy weighed on cyclical sectors, while rising interest rates adversely impacted high valuation growth sectors.

SECTOR BREADTH SHOWS DISPERSION IN TREND
Percent of stocks above 200 day moving average by sector.
Source: Bloomberg data as of December 22, 2022



Breadth can also be a measure of overbought or oversold conditions. Stocks tend to revert to the mean after trading well above or below their 200-day moving averages. Investors may expect a catalyst to balance the scale between growth and value. A slower pace of rate hikes could benefit long duration assets, while improved global growth prospects may positively impact cyclical growth sectors relative to defensives. For now, there is still room for earnings expectations to decline, which could present downside risks in H1 2023.

Lower Earnings Expectations Closer To Reality

The S&P 500's expected year-over-year earnings growth rate for 2022 is 5.1% (-1.8% excluding Energy), compared with estimates of 9.1% in June and 6.9% in September for the same period at different times.[5] Lower expectations from 2022 will likely feed into 2023 alongside a decline in Buy ratings.

Energy, Communication Services, and Information Technology have the highest percentages of analyst Buy ratings, while Consumer Staples and Utilities have the lowest. The concentration of Buy ratings is essentially an inverse of the breadth chart above. December 2021 had a similar makeup of Buy, Hold, and Sell ratings, although sector performance outside of Energy greatly disappointed consensus ratings in 2022.[6]

Despite bearish earnings expectations, investors can still find opportunities. Positioning between sectors will be an important consideration for portfolio diversification in 2023. Declining earnings expectations and the normalizing correlations between stocks and bonds could cause a shift in the relative volatility between equities and bonds. Therefore, a tilt toward defensive and quality sectors could mitigate downside risk. However, as global growth conditions improve, growth sectors could gain, creating opportunities for thematic equities. Some of our high-conviction themes include Cybersecurity, Infrastructure, and Clean Energy, with each benefiting from improving demand.

Our sector views table below provides more detail on sector positioning and the current tailwinds and headwinds for each sector.

CURRENT VIEWS ON U.S. SECTORS

	Positive Factors	Negative Factors	Overall View
Communication Services	Reasonably positive trends in subscription services, including streaming, benefit the sector. The development of augmented reality and the Metaverse may provide positive benefits in the long run.	The privacy overhang from major hardware providers could impact revenues for interactive media companies. Slower advertising spending remains a drag on social media earnings.	**Underweight**
Consumer Discretionary	Consumers increased their use of online ordering and deliveries over the past two years.	Wage pressure combined with higher input costs in materials are a risk to margins, especially if	**Underweight**

	Greater savings and a tight job market could encourage spending.	companies are unable to increase sales prices. And a deeper economic contraction could weigh on consumer spending. Rising inventories are a negative. Some companies indicated plans to cut sales prices to get rid of excess inventories.	
Consumer Staples	Demand for consumer staples could remain steady, especially in the event of a deeper economic contraction.	Inflation is likely to negatively impact margins for companies that cannot pass through rising materials costs to the end consumer. In our pricing power analysis, Consumer Staples generally scored poorly.	**Overweight**
Energy	Escalated tensions with Russia and greater natural gas demand from Europe could keep energy prices elevated globally. OPEC+ production cuts and a delayed supply response in terms of drilling could keep energy markets tight and prices high. Large, diversified oil and gas companies ramped up buybacks along with record profits and healthy balance sheets.	A global economic contraction could weigh on demand. The rapid reduction in backwardation of the oil price futures curve indicates a less favorable supply/demand balance.[7] COVID-19 lockdowns in China could reduce oil demand and potentially lower earnings expectations.	**Market Weight**
Financials	For a sector that benefits from strong household and corporate balance sheets, consumer spending remains robust, and to a certain extent, rising rates are starting to benefit net interest margins.	A deeper economic contraction could offset the favorable rise in interest rates. A flattening or inversion of the yield curve will likely hurt margins.	**Market Weight**
Health Care	Aging demographics around the world combined with the growing middle class in emerging	Drug pricing pressure remains a risk factor. Senate proposals to grant Medicare powers to	**Overweight**

	markets benefit health care demand. Health Care is a defensive sector that typically outperforms during severe economic downturns. The sector's valuations are attractive on a forward P/E basis and a relative P/E basis.[8]	negotiate prices on certain drugs could limit price increases on medicines.[9]	
Industrials	Rising interest rates, inflation, and possible infrastructure spending are positives for Industrials. Reshoring and a shift toward automation infrastructure spending will likely be a long-term benefit for Robotics & AI. An increase in U.S. public construction spending from fiscal packages will likely boost demand for tools and machinery for the foreseeable future.	Elevated leverage, increasingly expensive valuations, and rising earnings volatility may detract from performance. Rising labor costs could pressure margins, particularly in the transport industry. Companies are issuing more negative than positive earnings guidance.	**Market Weight**
Information Technology	The sector displays quality factors and positive free cash flow growth. The increased adoption of cloud computing, cybersecurity, and cleantech are likely to remain in a post-COVID-19 world as societies adapt to these key disruptive technologies.	Increased regulatory scrutiny is a risk, and there is bipartisan support for increased regulation in this space. Rising interest rates and slowing economic growth could negatively impact long duration growth sectors such as Information Technology.	**Market Weight**
Materials	Increased focus on electric vehicle adoption, alternative energy sources, and energy storage could benefit disruptive materials such as lithium, copper, and battery producers. The sector benefits from rising inflation, leading to higher prices for raw materials.	A deeper economic contraction could be a big headwind. Increased regulations, especially those focused on preventing climate change, is a potential negative.	**Underweight**

Real Estate	The sector can offer inflation-protected yield.	A fast rise in interest rates could increase the cost of financing, and a deeper economic contraction could raise the risk of costs not being passed along to tenants.	**Market Weight**
Utilities	A preferred defensive sector in recessionary environments due to the inelasticity of goods and services. Adoption of renewables could help transform the sector over the long run.	The potential for increased climate-related regulations over time may detract from this sector's appeal. Companies may not be able to pass through higher inflation-related costs due to government regulations. Rising yields could make Utilities less attractive versus bonds.	**Market Weight**

Footnotes

[1] CME Group, FedWatch Tool, December 23, 2022
[2] Bloomberg, Market Breadth Data, December 22, 2022
[3] FactSet, Earnings Insight, December 15, 2022
[4] The Conference Board, LEI for the U.S. Declined Again in November, December 22, 2022
[5] FactSet, S&P 500 CY 2022 Earnings Preview, December 16, 2022
[6] FactSet, Where Are Analysts Most Optimistic on Ratings for S&P 500 Companies Heading Into 2023, December 19, 2022
[7] Bloomberg, U.S. Oil Futures Point to Oversupply for First Time This year, November 18, 2022
[8] Yardeni Research, S&P 500 Industry Briefing: Health Care, November 29, 2022
[9] CNBC, 'Once-in-a-generation' Prescription Drug Pricing Reform Could be Coming, July 29, 2022

Definitions

NASDAQ 100: The NASDAQ 100 index includes 100 of the largest non-financial companies listed on its stock market.

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