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Equity Outlook


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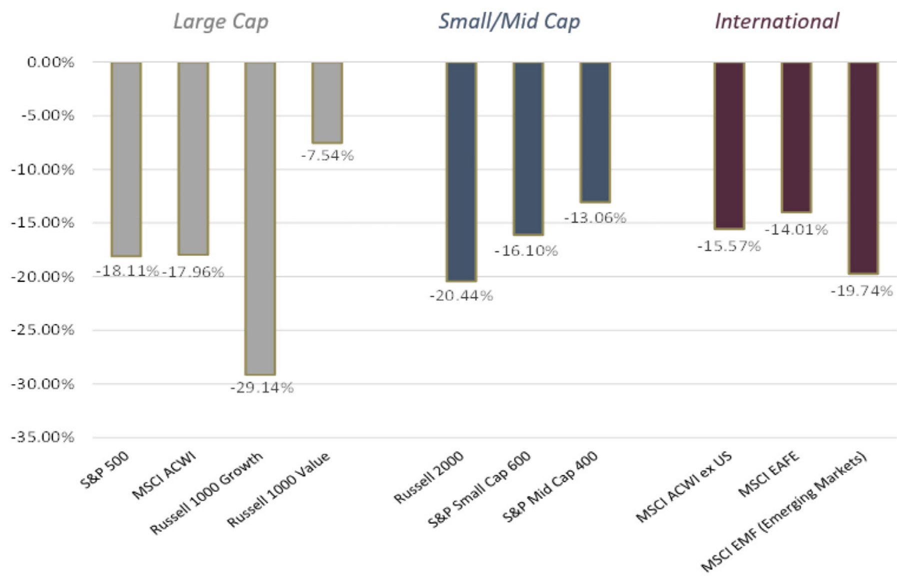
As we turn to equities, stocks struggled under the weight of decades-high inflation, surging interest rates, and geopolitical conflicts, all which culminated into fears of an impending recession. The S&P 500 recorded a loss of -18.1% in 2022, the benchmark's worst performance since 2008 and the fourth worst calendar year decline since the end of World War II. Large cap stocks remain in the "bear market" that began on June 13. Smaller U.S. stocks also struggled during 2022; the mid-cap S&P 400 index fell -13.1% and the small-cap Russell 2000 index lost -20.4%. Thanks to a strong fourth quarter, international developed stocks outperformed most domestic counterparts, as the MSCI ACWI ex-U.S. index dropped -15.6% during the year. Finally, the MSCI Emerging Markets Index fell -19.7%, driven lower by poor stock performance in China and South Korea.

Higher interest rates and forward discount rates pummeled the high growth names (specifically the technology and communication services sectors) that have benefited most client's portfolio's three and five year returns. The communications sector declined -39.8%, followed by a -37% decline in the consumer discretionary sector and a -28% decline in technology. Real Estate was also one of the four worst performing sectors posting a decline of -26% for the year. The only significant bright spot was the energy sectors, which posted a +65.7 % return for the year.

Despite the significant drawdown in equities, actual corporate profitability remained particularly resilient. S&P 500 EPS estimates for 2022 are still forecast to come in at +5.9% over 2021. While this growth rate is projected to slow to +5% or even closer to 2% to 3% for 2023, equity markets in 2022 were driven downward by valuation compression and the expectation of significant earnings slowdowns in 2023, driven by global recession and a weakening consumer. At the beginning of 2022, the P/E multiple on the forecasted twelve months of S&P 500 earnings was approximately 21.2x; that statistic is much more favorable entering 2023 and now stands at 17.1x versus a 25-year average of 16.8x.

As we anticipated early last year, volatility picked up. We saw the market officially cross into bear market territory in June, followed by bear market rallies, retest lows in October, and show modest recovery in the fourth quarter. **The volatility of the second half of the year, in our view, is indicative of a bottoming process, which turns our view to 2023.**

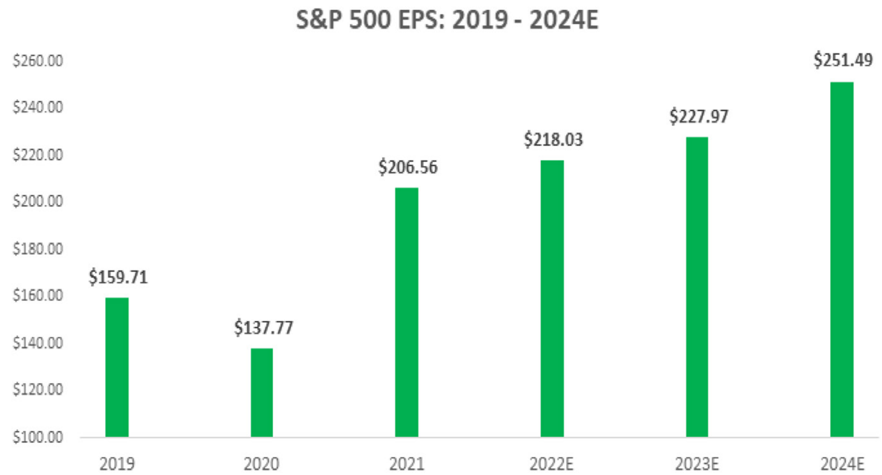


Source: FactSet 12.31.2022

WHAT TO EXPECT MOVING FORWARD

Perhaps the most common question among clients has been "how much additional pain remains?" For 2023, our base case includes an economic backdrop of slowing economic growth with the rising potential of a shallow recession. However, we also believe that much of this has already been considered by equity markets, and that we are in the bottoming process of the cycle. As part of the bottoming process, we look for corp. fundamentals (estimates for 2023) to be revised downward as we go through the earnings season over the next few weeks. We discussed this in our last quarterly outlook that downward revisions will help accelerate the bottoming process. In the first quarter, we expect 2023 earnings estimates for the S&P 500 will be revised down from the current $227 level to below $220 a share. In our view, this is not new news and is highly anticipated at this point – however, has yet to occur.

We expect near-term volatility as the market digests the downward revisions. We estimate the downside range for the market (S&P 500 index) would be limited to a re-test of the October low of 3577 – or approximately -10% from today's price. If this occurs, we would aggressively buy select holdings and use any weakness to continue to upgrade portfolios.



However, given our outlook for a mild recession, we are more enthusiastic about the upside potential of the market over the next 12-24 months as it begins to look forward and price in a recovery in the back half of 2023 and into 2024. Adjustments to EPS estimates will reverse and move higher ***again along with expanding P/E multiples*** especially as we begin to focus on 2024 earnings growth to assess market valuation. Calendar 2024 consensus EPS estimates for the S&P 500 are approximately $251 a share, which implies a +6 to +14% return from current levels based on P/E multiples of 17x to 18x.

One might ask, what would cause downside to this scenario? Our primary fears include reaccelerating inflation that extends the Federal Reserve's rate hiking cycle longer and to a higher than anticipated level. We believe the Fed and other global central banks will likely lean on overtightening and be slow to step in and provide policy support as was common since 2008 and the Great Financial Crisis.

Other catalysts for additional downside could be an unforeseen Covid variant or misstep, or expanded geopolitical tensions, the most severe of which could be a China/Taiwan conflict.

Additionally, we ask ourselves, what could drive an Upside Case? A consistent, faster than expected deceleration of inflation measures, including goods, services, and labor. These conditions may enable the Fed to conclude its policy tightening more quickly, and provide support to both consumers and businesses. In tandem with a resilient underlying economy, we would anticipate a significant upside response from risk assets.

Equities - Outlook

- 2022 earnings growth has been solid; 2022 equity decline driven by valuation compression and the expectation for earnings to be re-set lower in 2023.
- Our base case of a mild recession implies current 2023 S&P 500 EPS est. of $229 is too high. Expect new range below $220 a share – flat with 2022 forecasts. A re-set will accelerate the bottoming process.
- While the near-term dynamics remain challenged, equity valuations, in our view provide a large margin of safety. We are enthusiastic about upside potential as investors begin to look beyond a recession and price in a recovery starting in the second half of 2023.
- Equities are leading, not lagging indicators. Stocks bottom prior to economic data improving.
- We continue to favor domestic stocks over international due to greater U.S. economic visibility.
- In internally managed portfolios, we recommend a balance of growth and income to take advantage of compelling valuations across the economic landscape.

We believe Franklin Street's asset allocation process stands ready to respond to these differing outcomes. Our Asset Allocation Committee is all in our Chapel Hill headquarters and meets often to weigh the constantly evolving investment environment.

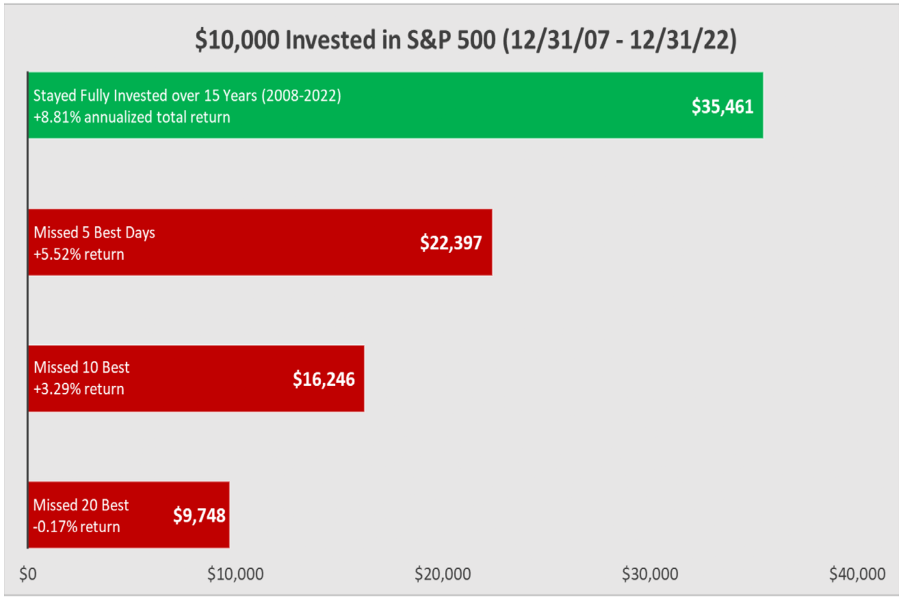
As a reminder, we have maintained a more conservative posture for some time now – we primarily manage to 3 differing risk models, with our Moderate allocation targeting 51% equities, 41% fixed income, and 8% alternative assets of the beginning of 2023 relative to the traditional 60/40 portfolio commonly discussed in financial media. Further, we remain strong advocates in active management and think the higher rate environment supports that confidence. Entering 2023, we believe we have attractive active management opportunities at a number of different points – at the security level, at the asset class level, and at the overall asset allocation level.

BENEFITS OF INVESTING FOR THE LONG TERM

We have often discussed the benefits of remaining invested, of time in markets and not timing markets themselves. Between the end of 2019 and the end of 2022, we've experienced the first global pandemic in over a century, the highest level of inflation since the early 1980s, two bear markets in the S&P 500, the largest one-year increase in the Fed Funds rate since 1985, the highest level of 30-year fixed mortgage rates since 2002, the highest level in WTI crude since 2008, and the first year EVER in which both the S&P 500 total return and the Bloomberg Aggregate indices were both negative. Despite all of that, over the 3 year period encompassing 2020, 2021, and 2022, the S&P 500 delivered a total return of +24.7%, or +7.6% annualized.

While veteran FSP clients understand well the power of longer-term investing and compounding returns, specific illustrations can be helpful over time. For example – in the fifteen-year period between 2008 and 2022 (3,778 trading days), an investor achieved an annualized return of +8.8% by staying fully invested over the entire period. This compares quite favorably to an investor who missed only the best ten days of S&P 500 performance over the entire period and achieved an annualized return of +3.3%. Over that same 2008-2022 stretch, nine of the ten best days occurred within two weeks of the ten worst days.

Importantly, the 2008-2022 span covered bear markets including the Great Financial Crisis (-56.8% peak to trough) and the 2020 Covid-19 pandemic (-35.4%). In fact, the fifteen-year period included two of the four worst (2008 and 2022) calendar year performances since the end of World War II.



Sources: Franklin Street Advisors, Bloomberg, Putnam, Strategas, 12.31.2022

In our opinion, it is crucial for investors to understand that equities are leading, not lagging indicators, and that history has repeatedly illustrated equity markets bottom prior to meaningful improvement in underlying economic and corporate data.

During the Great Financial Crisis, the S&P 500 bottomed in early March 2009 and had gained approximately +37.9% by the NBER's declared recession end in June 2009. Likewise, the S&P 500 hit its pandemic low in March 2020 and gained +30.4% by the end of that brief recession in April 2020. 2022 was yet another period of uncomfortable drawdown and volatility, but we believe the patterns of the past provide strong evidence of the path of an eventual recovery.

FSP ASSET ALLOCATION AND INTERNAL EQUITY STRATEGIES

Within the equity asset class, we have maintained a domestic-heavy bias for many years. In early 2022, we further reduced exposure to European stocks owing to concerns over the Russia/Ukraine war and its various impacts, including concerns over energy supply reliability, trade and supply chain disruptions, and overall consumer confidence in the region. Later in August, we reduced the U.S. large cap exposure and re-allocated the proceeds to U.S. small and mid-cap stocks for a number of reasons – attractive valuation on a historical basis, less revenue exposure to challenging international markets, and less currency translation exposure.

Within FSP, we actively manage five primary large cap equity strategies with a range of return and risk objectives that represent style tilts to the S&P 500 benchmark – Strategic Growth, Partners Advantaged, Equity Income, Growth & Income, and Sustainable, Responsible Equity. Growth & Income uses a barbell approach, combining stocks from our core growth-oriented strategy (Strategic Growth) with our core value conservative strategy (Equity Income); and Sustainable, Responsible strategy is a thematic ESG approach to our Partners strategy.

In the actively managed, internal large cap equity strategies, we continue to focus on companies with distinct advantaged business models and longer-term secular opportunities, making changes in accordance with the style, risk, and reward objectives for each individual strategy. We continue to favor advantaged companies with secular growth opportunities, strong balance sheets, high free cash flow generation, and capital flexibility. Advantaged businesses are uniquely positioned to potentially emerge as stronger competitors over the longer term as well as weather severe economic challenges. We believe 2023 is a year where active management and stock selection are the key elements to navigate this market. Value is still in favor over growth, principally due to the interest rate outlook, but this trend can reverse quickly. Over the intermediate term, we've enhanced downside protection as recession scenarios escalated. There are a few names that we believe may do better than others when financial conditions are weakening.

An example is TJX Companies Inc. (NYSE: TJX), the holding company for several well-known retailers including TJ Maxx, Marshalls, and HomeGoods. TJX's primary advantage is in its difficult-to-replicate sourcing and distribution agility. By accepting incomplete assortments without return privileges, paying promptly, and stocking brands discreetly (preserving labels' conventional-channel pricing power by avoiding the stigma of a consistent discount presence), TJX is a valued partner for more than 21,000 vendors. We believe the current environment could favor TJX, as elevated wholesale inventories in apparel and home goods are allowing the company to access and purchase on-trend merchandise at attractive rates again. In addition, the return to in-person shopping following the Covid-19 pandemic closely aligns with the "treasure hunt" nature of a TJX shopping experience. Finally, shareholders are also rewarded with a 1.9% dividend yield as of the end of the third quarter.

More recently, at the portfolio level, we continue to emphasize maintaining a balance of growth and income to take advantage of compelling valuations, yet provide a visible income stream while we patiently wait for the market to recognize value.

Another example is Starbucks (SBUX), which has sensitivity to the re-opening of China. Starbucks' cachet has allowed the firm to outflank competitors, leveraging its brand to raise prices 7.4% annually in the U.S. over the last five years, healthily in excess of category inflation. Commanding unit economics, with payback periods in the ballpark of two years should pave the way for mid-single-digit unit growth through 2031, in our view, as the firm increases penetration in its core U.S. and Chinese markets and with its license partners in more than 80 other global markets. Starbucks has the leading market share in China and exposure to a growing middle class, which contribute to a compelling growth narrative in that market. The re-opening of China from the Covid lockdowns could provide a significant tailwind to earnings over the next 2 years.

PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS

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