Global Research & Investment Strategy

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Early Look At A Mid-Cycle Transition

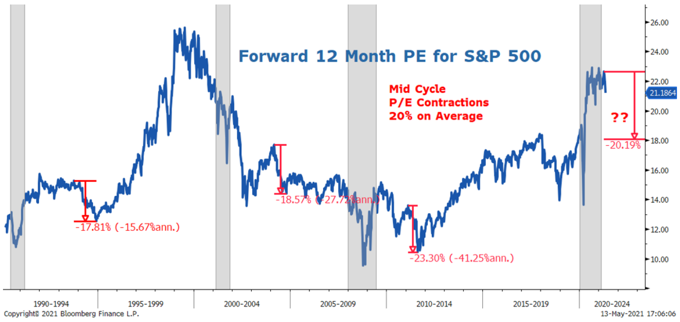
The pandemic-induced recession and recovery is unique for a number of reasons, not the least of which is its velocity both down and up. While we believe the re-opening phase is still ongoing, the market is gradually transitioning to a mid-cycle with internals already beginning to reflect the shift - correction in high growth, small caps, low quality, and early cycle sectors.

Admittedly, we are a little early in our call for a mid-cycle transition. However, our premise is based on a series of converging factors. Early to mid cycle transitions begin in earnest with the peak rate of change in economic growth and monetary policy. Manufacturing PMI and both M1 and M2 growth peak are in for the cycle. Earnings revision breadth and year-on-year earnings growth peaked along with fiscal stimulus to consumer in the March $1.9tn bill. The transition is happening much sooner than normal, hence why it is not yet fully appreciated. Many of the leadership changes one could expect are starting to occur. Speculative stocks are underperforming, early cycle sectors (autos, home builders/improvers, semis, retail, transport) are rolling over, small caps briefly underperformed, and the quality factor is doing better.

However, so far, there is one missing piece to the mid-cycle transition: lower valuations. One of the most important outcomes of the mid cycle transition is the de-rating and thus far it has been concentrated in the extreme portion of the market like unprofitable growth companies that are more vulnerable to higher rates, hence small caps underperformance. The broader market may avoid its typical de-rating this time around with the Fed's slower reaction function (e.g., average inflation target). While the Fed is more dovish than it typically is, waiting longer to start the tightening cycle simply means it will have to move faster later on. We believe the market is forward looking enough to price in higher long-term rates well before they arrive.

As it takes longer for long-term rates to adjust, we believe the repricing in risk assets will first come from the equity risk premium ("ERP") channel. The nonlinear move in back-end rates we were expecting this year played out in February and already had an outsized effect on more expensive and speculative parts of the market. Although the S&P 500 P/E multiple fell 5% YTD, it has been much more sever in expensive parts of the market. In many ways, the de-rating of the most expensive and small cap stocks is just a leading indicator for what to expect in the broader market. Such transitions commonly see valuation contractions of 10-20% **(Chart 1)**. Excitement around the recovery compressed ERP but eventually higher rates, positioning resets, and a slowing rate of change in growth offset this sentiment and sends multiples lower.

Chart 1. Mid-Cycle Transitions Tend Lead to P/E Contraction

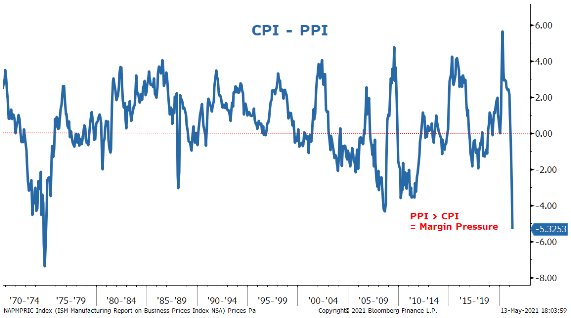


Source. Bloomberg

Earnings growth in a strong economy mitigates downside risk, but rising costs and higher corporate tax rates also limit the upside. The net effect is a tug-of-war between earnings and valuations, tepid returns over a 12-month period, and a likely 10% correction between here and there.

The lightning fast recession and V-shaped recovery resulted in a classic early cycle operating leverage story on steroids and the massive outperformance of early cycle sectors. Given the unusual nature of this recession and recovery, and the extraordinary response to the pandemic, there is a greater than normal risk to margins as we progress through the mid-cycle transition **(Chart 2)**.

Chart 2. PPI > CPI = Lower Margins

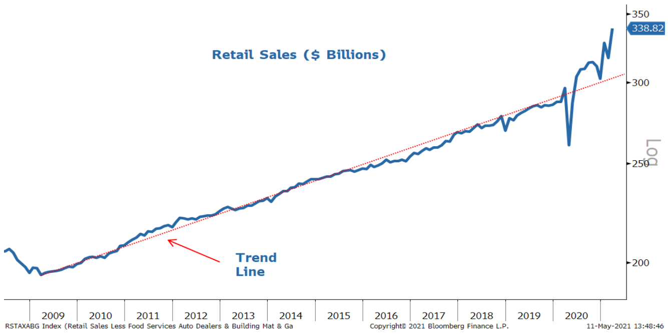


Source. Bloomberg

It is common knowledge there was a material pull forward in the demand for many tech goods last year as people worked from home and companies were forced to push digitization efforts. In many ways, this resembled the surge of demand seen 20 years ago as the world furiously upgraded its tech infrastructure ahead of the new millennium. In fact, today, the surge is even greater (55% above trend vs. 45% in 1999). This speaks to the fact we had a surge in demand for other households items that consume more silicon than then. As a result, we expect a "payback" over the next 12-months with wider implications for the economy and broader market. The semiconductors sector is showing an above trend extension that started breaking down recently, suggesting the surge in demand has peaked and will likely return to trend. The sector is an early cycle group and tends to lead in any recovery.

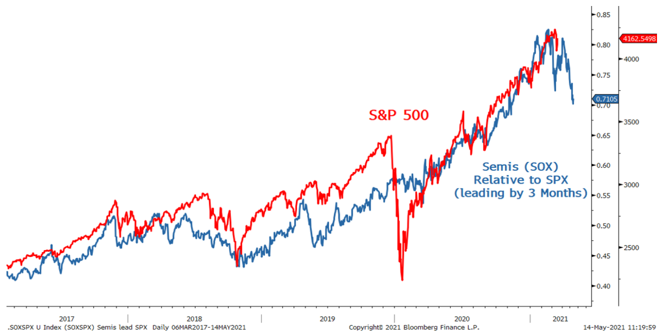
This time around, the very cyclical semiconductor sector did not experience any recession during the pandemic. Instead, sales and shipments surged to all time highs. Could this be representative of other essential business demand that saw the same surge in demand? Retail sales data support such risk **(Chart 3)**. Hence, there may not be as much pent up demand for many items that already saw a surge in growth last year, goods that have nothing to do with technology spending or digitization (i.e., home improvements - appliances, furniture). If consumers decide to get more active with experiences we may see a strong decline in retail sales. In other words, sales and margins expectations may suffer from demand as much as from supply shortages. While it may be out of consensus, it is worth considering given how high earnings expectations are now for this year and next. Even if earnings estimates prove to be achievable, it is very unlikely investors have the earnings upside to offset the multiple contraction we think will come. The relative underperformance of semiconductors in recent weeks could be a great leading indicator of how markets will trade over the next 3-6 months **(Chart 4)**.

Chart 3. Retail Sales Suggest Cycle Is Far Along



Source. Bloomberg

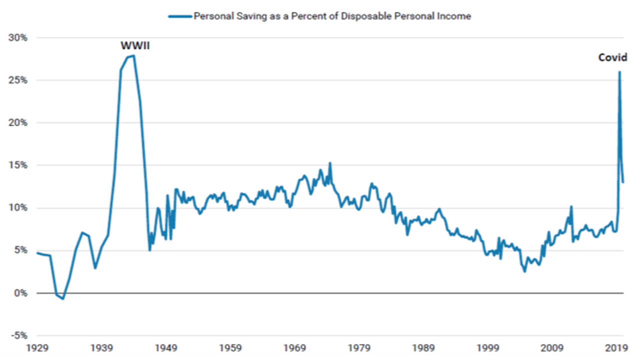
Chart 4. Semiconductors Stocks Lead S&P 500



Source. Bloomberg

We have been reading and hearing a lot of references to the Roaring 20s as an analogy to the post-pandemic environment. While similarities to the Spanish Flu are quite noticeable, the comparison falls apart from an economic and policy regime standpoint. We believe the post-World War II period where similarities - shift to fiscal policy dominance, excess savings, pent-up demand, constrained supply drive higher inflation - are much stronger. First, the war and pandemic created a huge increase in excess savings unlike any other time in observable history **(Chart 5)**, coinciding with an economy shut which precluded the consumption of many items.

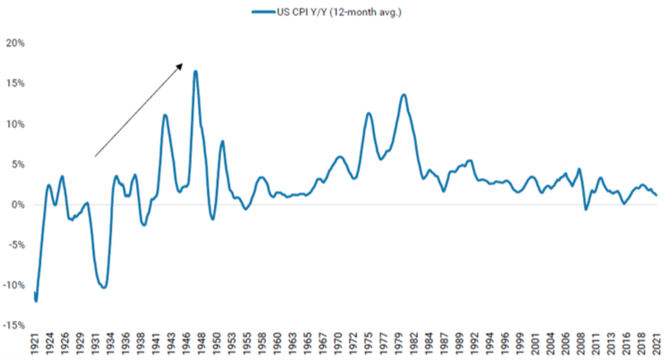
Chart 5. Savings Rate Spike Looks More Like 1940s



Source. Haver Analytics, MS Research

Second, as the economy reopened in the post-war, demand surged and led to inflation that proved to be more than transient **(Chart 6)**. Through the Spanish Flu, lockdowns were non-existent, businesses continued to normally operate, and no meaningful destruction of supply chains was reported. Although labour pools were hurt from the death toll on the younger population, survivors were eager to work without unemployment benefits safety net and other extraordinary fiscal stimulus. Given the lack of government support, there was little pent up savings during that period.

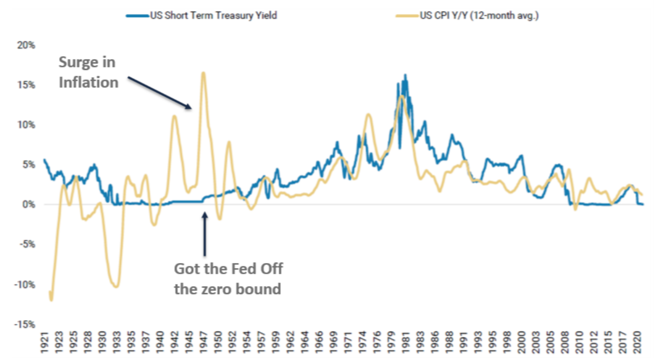
Chart 6. Surge in Demand and Supply Distribution Inflationary



Source. Haver Analytics, MS Research

Third, the Fed was engaged in financial repression through WWII and the years preceding it due to the Great Depression. This is very similar to the current period and the ten years post-Great Financial Crisis. It is the only other time in history where Fed Funds were stuck at the zero bound for any length of time. The surge in demand post-war, much of which was driven by the government (e.g., GI Bill, Marshall Plan, etc.) is what finally forced and allowed the Fed to get off the zero bound and it never looked back **(Chart 7)**. The sharp rise in back end yields earlier this year is a clue the Fed will be moving off the zero bound earlier than it/most think. It might well be the most important similarity providing clues on the policy regime going forward. It is import to embrace new leadership in value sectors and other investments levered to higher nominal GDP growth, inflation, and interest rates.

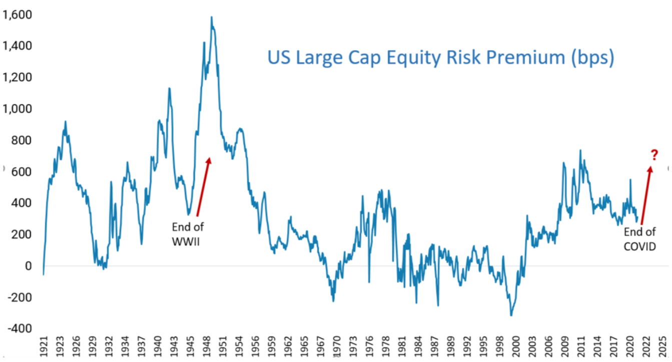
Chart 7. Fed Policy Shifted 1-Yr post-WWII As Inflation Spiked



Source. Haver Analytics, MS Research

Finally, we looked at the Equity Risk Premium closely during this period. Back then, ERP bottomed simultaneously as the war ended in summer 1945 **(Chart 8)**. ERP low was 325bps (using 20-Yr treasury yield, then official "long bond"). Today, using a 20-year yield, ERP stands at just 243bps, but above its April 13 post-GFC lows of 221bps. In our view, ERP is headed higher as the pandemic officially ends with the reopening of the economy. Similarly to 1945, it has the potential to rise sharply as markets begin to anticipate higher inflation and demand a higher risk premium.

Chart 8. Fed Policy Shifted 1-Yr post-WWII As Inflation Spiked



Source. Bloomberg

While the Fed continues to jawbone long rates lower with guidance and policy intention, equity markets may soon stop "buying it" and instead begin to anticipate the next move, a tightening of some kind. Obviously, this would lead to a sea of changes to investors accustomed to high multiples due to lower nominal and real rates. The most egregiously valued parts of the market have already started this painful de-rating as we mentioned, but this should broaden to the entire market. In the end, we see the next set of de-ratings coming from the ERP channel rather than rates and this could very well be sharp and swift like in the 1940s.

The first quarter marked a strong earnings season. We should expect continued strong year-on-year growth rates heading into the second quarter earnings season. A strong economy and continued increases in top line estimates are sources of support for forwards earnings projections, but we are mindful of a number of factors limiting the direct flow through to earnings. (1) Rising costs and record high margin projections do not mix. The consensus is currently projecting margins 60bps above prior peak this year and 30bps next year. In our view, the reopening is likely to bring higher costs and capacity constrains: supply chain bottlenecks, supply double sourcing (already seen in Semiconductors), freight cost, labor availability/cost, and commodity costs among other things. Supply will adjust to lower input prices in many instances but it takes time and will likely come as top line decelerates. To date, easy comps and the initial stage of reopening have mitigated these issues, but they will become more prevalent starting in the second half. (2) Mix shift favors lower margin businesses. We think the economic reopening and wallet share shift back to lower margin parts of the market is one more dynamic to consider. (3) Taxes are going up.

We have argued the market is entering in a mid-cycle phase of the economic recovery. The skew for multiples is lower due to skews in the direction of travel in the underlying drivers of the multiple, rates, and equity risk premium. As part of our analysis, we built a simple valuation framework calculating a 12-month forward earnings yield (EPS/Price) by adding a forecast for the US 10-Year and an equity risk premium. With growth expectations largely fairly priced, we firmly believe the skew for both of these is higher. (1) Treasury yields are likely to rise to 2% (+40bps) as a function of better growth, inflation, and higher deficit spending. (2) ERP does not have much left to give. ERP post-GFC traditionally moved in a wide but stable band with 300bps a sustainable low and 435bps a high **(Chart 9)**. Several factors benefited risk appetite and equity flows. The economic recovery, ample fiscal/monetary support adding liquidity to markets, and the poor risk-reward seen in bonds. While a strong growth environment can keep ERP lower for longer, the skew of potential outcomes tilts higher as high expectations, tapering, and a slowing rate of change on growth all fall within our study horizon.

Even with fairly generous assumptions around ERP, we still see a 10% de-rating in multiples with the downside skew towards 20% in a bear case scenario **(Table 1)**. Using a fairly strong EPS growth (in line with consensus) to $200, assuming long-term rates remain anchored near 1.70% until year-end, and assuming ERP rises by 15bps to 315bps, we see the S&P 500 Index ending closer to $4,125 by year-end, relatively where we are at today. As such, investors should expect the broader market to move sideways in the near future along some volatility as rotations occurs underneath the surface.

While fundamentally there is little upside to be gained from valuations, we are not calling for a longer correction just yet. The environment is still supportive of earnings growth. In our view, the events to watch out for in terms of trigger for a bigger correction are a Biden tax hike and increased talks of Fed taper; both of which we expect in 2022.

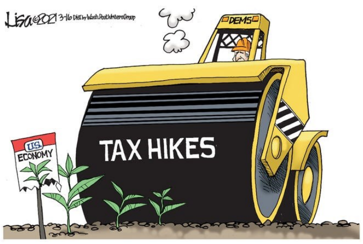
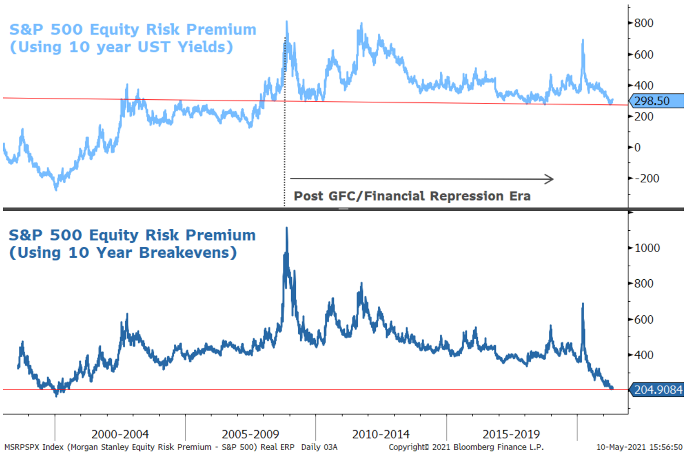


Chart 9. Equity Risk Premium Looks Stretched



Source. Bloomberg, MS Research

Table 1. Equity Risk Premium vs. Rates Matrix on S&P 500 P/E

NTM S&P P/E Sensitivity - ERP & 10Y Yield

10Y Yield (%)	Equity Risk Premium (bps) 285	300	315	330	345	360	375
1.40	23.5x	22.7x	22.0x	21.3x	20.6x	20.0x	19.4x
1.55	22.7x	22.0x	21.3x	20.6x	20.0x	19.4x	18.9x
1.70	22.0x	21.3x	20.6x	20.0x	19.4x	18.9x	18.3x
1.85	21.3x	20.6x	**20.0x**	19.4x	18.9x	18.3x	17.9x
2.00	20.6x	20.0x	19.4x	18.9x	18.3x	17.9x	17.4x
2.15	20.0x	19.4x	18.9x	18.3x	17.9x	17.4x	16.9x
2.30	19.4x	18.9x	18.3x	17.9x	17.4x	16.9x	16.5x
2.45	18.9x	18.3x	17.9x	17.4x	16.9x	16.5x	16.1x

Current Range (22x current) | Target Range (Avg. ? 20x)

NTM S&P Price Matrix Using Current MAM NTM EPS - $200.00

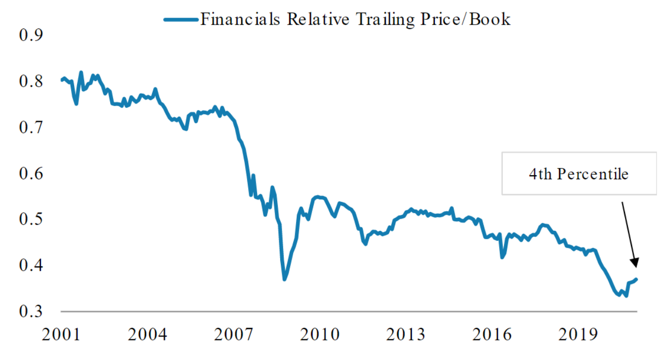
10Y Yield (%)	Equity Risk Premium (bps) 285	300	315	330	345	360	375
1.40	4,706	4,545	4,396	4,255	4,124	4,000	3,883
1.55	4,545	4,396	4,255	4,124	4,000	3,883	3,774
1.70	4,396	4,255	4,124	4,000	3,883	3,774	3,670
1.85	4,255	4,124	**4,000**	3,883	3,774	3,670	3,571
2.00	4,124	4,000	3,883	3,774	3,670	3,571	3,478
2.15	4,000	3,883	3,774	3,670	3,571	3,478	3,390
2.30	3,883	3,774	3,670	3,571	3,478	3,390	3,306
2.45	3,774	3,670	3,571	3,478	3,390	3,306	3,226

Source. Bloomberg, MAM Research

What works well in a mid-cycle transition? Broadly speaking, moving up the quality curve is a good idea and the quality factor is already starting to outperform.

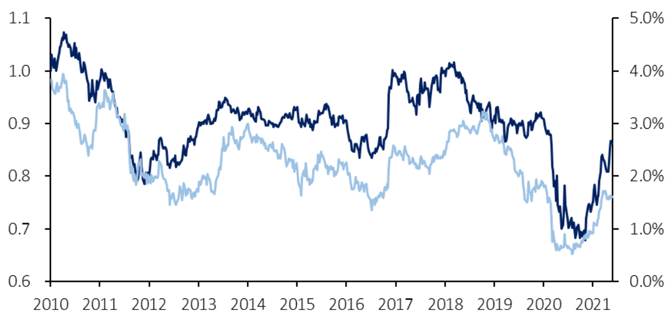
Given the historically depressed relative valuations **(Chart 10)**, improving macro conditions and loans growth, and the potential for higher nominal yields, financials and banks continue to be a sector to own and be overweighted to. Financials are a highly cyclical sector benefiting from improving macro condition. One of the key reasons why financials lagged accelerating macro indicators and earnings revisions is interest rates have remained depressed until recently. The sector's performance is highly correlated to the 10-Year treasury yield in the US **(Chart 11)**. The 6-month composition of the momentum does a good job at leading the 12-month composition and the signal is clear: momentum is moving towards value **(Chart 12)**. We should expect it to turn even more pro-value styles, potentially drawing additional supportive flows throughout the rest of the year.

Chart 10. Financials Relative P/B Ratio



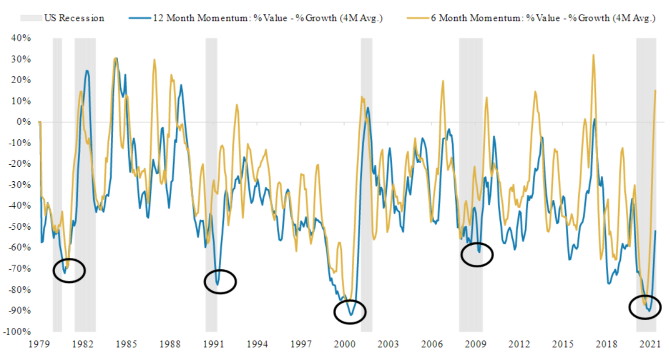
Source. FactSet

Chart 11. Financials Closely Tracking US 10-Year Yields



Source. Bloomberg, MAM Research

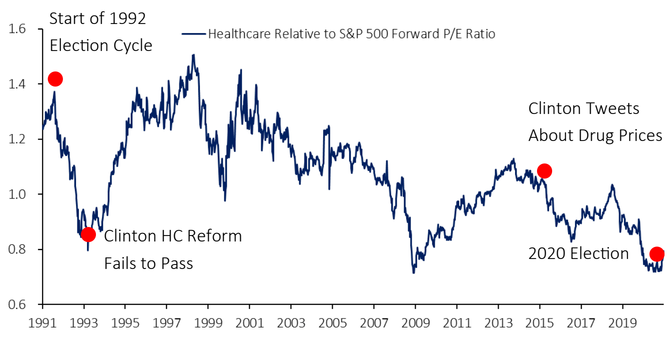
Chart 12. Value's Weight in Momentum Bucket Moving Higher



Source. ClariFi, Bloomberg

In a rotation towards even higher quality areas of the maket, the healthcare sector fits well into that bucket and offers a defensive hedge to our otherwise pro-cyclical overweight (e.g., value, financials, materials, commodities, US Dollar). Its defensiveness means it is not as sensitive to a potential rise in interest rates like several other defensive sectors. Policy risk sure continues to weigh on the sector, but we believe policy priorities look to be elsewhere while relative multiples are already near historical lows and relative earnings revisions look to be bottoming. Relative valuation levels for pharma, healthcare providers and services, biotech and healthcare technology are particularly depressed **(Chart 13)**. All are in the 15th percentile or lower on a relative basis looking back to 2010. Healthcare equipment is the only group appearing expensive on a relative forward P/E (74th percentile since 2010). Additionally, a potential tailwind is consumers are increasingly going in for routine check ups and elective surgeries as the reopening progresses. From a technical standpoint, in Europe notably, the European healthcare subindex has had a tough time in the last year, barely budging while the Stoxx 600 index has risen about 27% **(Chart 14)**. Every time that occurred in the past, it subsequently recovered. Recent signs have been more positive, with the sector slightly outperforming since the end of April as market's extreme cyclical bullishness slowly recedes. The subgroup remains about 5% below pre-pandemic levels. On top of looking attractive on a technical basis, the trade is looking compelling on a fundamental basis with the price-to-book of the European health care sector relative to the broader Euro Stoxx 600 trading over 1SD cheap.

Chart 13. Healthcare Looking Cheap on a Relative Forward P/E



Source. Bloomberg, MAM Research

Chart 14. Stoxx Europe Healthcare Relative to Stoxx 600

Source. Bloomberg, MAM Research

Investment Implications

Considering the risk arising form a potential de-rating in risk assets, it is important to adopt a barbell strategy mixing exposure to reflation and economic growth linked equities (e.g., Financials, Materials, Cheap Industrials), a defensive set of less inflation sensitive equities (e.g., healthcare), and high growth stocks that have already been through the de-rating phase and are trading at relatively cheaper multiples.

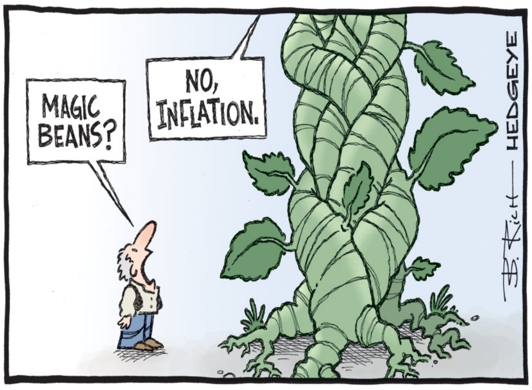
As a result, we would recommend portfolio to maintain a certain degree of exposure to the aforementioned sectors using for instance the following securities.

- *Financials*. Financial Select Sector SPDR Fund, iShares MSCI Europe Financials ETF.
- *Healthcare*. iShares US Healthcare ETF, iShares Stoxx Europe 600 Health Care ETF, Atonra Bionics Strategy (more aggressive).
- *High Growth Stocks*. Providence Public, MAM Best Ideas where there is an active trading of the re-rated names, Atonra Sustainable Strategy.

As always, please feel free to reach out to us should you have any questions regarding this research.

Kind regards,

MAM Investment Team



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