



After Goldilocks, Which Bear (Market) Will Prevail?

A clearer picture of the U.S. market outlook should emerge over the coming weeks.

November 2022

KEY INSIGHTS

- Amid ongoing market uncertainty, the near-term outlook in the U.S. should begin to reveal itself more clearly by the end of 2022.
- While conditions are expected to remain challenging, we could see three potential bear market scenarios—mild, moderate, or longer lasting.
- If investors gain confidence that the inflation outlook is improving, a more moderate outcome is likely, which could augur well for growth stocks in 2023.



Taymour Tamaddon
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The U.S. economic outlook remains highly uncertain, but we believe the environment will begin to reveal itself more clearly—good, bad, or somewhere in between—by the end of 2022. This does not necessarily mean that markets will be quick to respond, and discount appropriately, but we should gain a reasonable idea about how the dust is settling in the U.S. reasonably soon. With the next Federal Reserve (Fed) interest rate-setting meeting on December 14, there is one further inflation print to be released before that time. With the latest U.S. inflation data coming in below expectations, this remaining data point takes on added significance.

As it currently stands, we believe that we could see three possible economic scenarios play out in the U.S. as we move into the new year. To elaborate on these and on other key questions about the U.S. market outlook in 2023, we spoke with Taymour Tamaddon,

portfolio manager of the T. Rowe Price US Large-Cap Growth Equity Strategy.

1. Can you elaborate on the three possible economic scenarios and how you see U.S. equities—particularly growth stocks—faring in each?

 **The mild bear.** The first possible scenario is that the Federal Reserve manages to orchestrate a relatively quick soft landing. This is undoubtedly the best outcome as far as growth investors are concerned. However, at the same time, we think this is the most unlikely outcome, given where we are currently, and the high degree of uncertainty that remains. In this scenario, interest rates do not have to go much higher, inflation recedes quite quickly in response to rate rises, and economic growth remains generally solid, with modest expansion that is ultimately not too hot and not too cold. However, the probability of this scenario being landed appears slim, in our view.

 **The moderate bear.** This second scenario is the one that we believe to be the most likely outcome—is that we experience a mild recession, but where interest rate rises are soon sufficient to gradually slow the economy and tame inflation from current elevated levels. In this scenario, our expectation is for a few quarters of slowing growth, with inflation gradually inching down, before ultimately seeing early signs of a recovery from mid-2023.

In such an environment, growth becomes harder to find, and higher-quality companies with stronger fundamentals, better business operations, and quality management are likely to be rewarded by investors. This is a supportive backdrop for growth investors as individual company quality becomes the principal market driver, rather than being driven by macroeconomic factors or investment momentum. And in a mild recessionary environment, those companies that can continue to grow their earnings,

competitive leadership, and market share in the absence of a strong gross domestic product tailwind tend to be growth-oriented companies, moreso than their value counterparts.

 **The longer lasting bear.** The third possible scenario—and the one that would prove most difficult for investors generally—is an environment in which uncertainty continues to prevail, where the Federal Reserve is unable to gain control of inflation, and it remains unclear how high interest rates will need to go in order to reinstate price stability. In this environment, the market continues to fluctuate, and volatility remains prevalent as investors remain unsure as to whether the Fed has done enough. This high degree of ongoing market uncertainty and fragile sentiment is the least supportive background for growth investors. The lack of clarity regarding the direction of travel will likely see investors gravitate toward defensive market areas and away from more growth-oriented stocks and sectors.

The Magnitude of the Sell-Off

(Fig. 1) Growth-oriented sectors have seen steep declines

Russell 1000 Growth Index Performance (%)	-30.66%
Sector (%)	
Energy	36.51
Utilities	-11.75
Consumer Staples	-13.01
Industrials and Business Services	-21.63
Health Care	-22.17
Financials	-24.08
Real Estate	-28.57
Consumer Discretionary	-31.05
Information Technology	-32.49
Materials	-33.18
Communication Services	-45.49

December 31, 2021–September 30, 2022.

Past performance is not a reliable indicator of future performance.

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“The highly uncertain backdrop has made it very difficult for companies to gauge demand for their products and services, causing many to lower guidance and, in some cases, withdraw it altogether.

2. What insights can be derived from the sharp bear market rally in July, particularly for growth investors?

As far as U.S. bear market rallies go, the length of the July rally—approximately four weeks in duration—was not unusual. What was unusual, however, were some of the significant movements with some stocks registering gains of more than 100% in the short time that the rally lasted. This was noteworthy as it provided perhaps the first indication since the end of 2021 of just how compressed valuation multiples have become in certain areas. Amid a backdrop of intense market pressure and steep declines, particularly in growth-oriented sectors (Fig. 1), we had an indication that things might be improving after July’s consumer price index reading came in at 8.5%, down from 9.1% in June. While this ultimately proved short-lived, the brief window of optimism provided an insight into what could happen if the market was to gain confidence that inflation was under control and that the economic cycle might be improving.

3. What do you think needs to happen before U.S. inflation begins to ease from its current high levels?

For current high U.S. inflation levels to moderate, we think that consumer spending needs to slow noticeably. Unless consumers start to rein in spending, it will be very difficult to see a demonstrable reduction in inflation. This obviously has much to do with personal consumption but also how secure people feel about their overall wealth, which is closely linked to how comfortable they feel about the value of their biggest asset, i.e., their home. I think we also need to see some evidence of U.S. house prices coming down to help lower inflation.

Looking at the balance sheet of the U.S. consumer currently, it is generally in pretty good shape following the coronavirus pandemic, with stimulus checks coming through during the period, while, at the same time, opportunities for spending became more limited. So, the average U.S. household savings rate is reasonably healthy right now. This is great from a consumer perspective, but it makes things more difficult to predict in terms of the market outlook, as consumers have more confidence, and a bit more time, in our view, to continue spending.

4. What impact has the current uncertainty had on U.S. company earnings, and growth company earnings, in particular?

While we have various significant macro influences playing out currently, there are also idiosyncratic influences impacting many companies. The highly uncertain backdrop has made it very difficult for companies to gauge demand for their products and services, causing many to lower guidance and, in some cases, withdraw it altogether.

There are likely to be further surprises from U.S. companies that have been impacted by supply issues or that have mis-forecast the demand environment. This is being reflected in prices—we have already seen significant compression in valuation multiples this year, particularly among growth stocks. The big question now: Has the market appropriately discounted the valuations of these businesses, depending on what the earnings profiles look like moving forward? This is a very imprecise science, and it places a huge importance on companies delivering earnings in an environment where multiples have already been significantly compressed.

5. As a U.S. portfolio manager, is now the time to be increasing one's risk profile, adding exposure to companies likely to perform well in the early stages of a new economic cycle?

We are not looking to increase the risk profile of our portfolio. While U.S. large-cap growth companies have suffered over the past year, we are not trying to play catch-up by changing our risk profile now that the market has come down significantly. We continue to simply look for good-quality growth ideas where we think there is good potential for the company to deliver earnings and decent growth. For example, we currently like certain health insurance stocks, which is an industry that we think offers

durable growth, as well as select information technology stocks. These are companies that we think can do well in the current environment, but, at the same time, we do not feel the need to significantly increase our positions in these names, upping the risk to potentially capture big rewards.

As we gain confidence that the environment is improving and that these businesses are growing earnings, we may look to scale them up within the portfolio. We are trying to maintain a consistent level of risk within the portfolio until we feel a lot more confident about the environment and the general market outlook, at which point we may look to further increase some of our highest-conviction ideas.

Risks

The following risks are materially relevant to the portfolio.

Style—Style risk may impact performance as different investment styles go in and out of favor depending on market conditions and investor sentiment.

General Portfolio Risks

Equity—Equities can lose value rapidly for a variety of reasons and can remain at low prices indefinitely.

ESG and Sustainability—ESG and sustainability risk may result in a material negative impact on the value of an investment and performance of the portfolio.

Geographic Concentration—Geographic concentration risk may result in performance being more strongly affected by any social, political, economic, environmental or market conditions affecting those countries or regions in which the portfolio's assets are concentrated.

Hedging—Hedging measures involve costs and may work imperfectly, may not be feasible at times, or may fail completely.

Investment Portfolio—Investing in portfolios involves certain risks an investor would not face if investing in markets directly.

Management—Management risk may result in potential conflicts of interest relating to the obligations of the investment manager.

Market—Market risk may subject the portfolio to experience losses caused by unexpected changes in a wide variety of factors.

Operational—Operational risk may cause losses as a result of incidents caused by people, systems, and/or processes.

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