January 2023
Market Commentary

First Affirmative
FINANCIAL NETWORK
Invest for a Sustainable Future

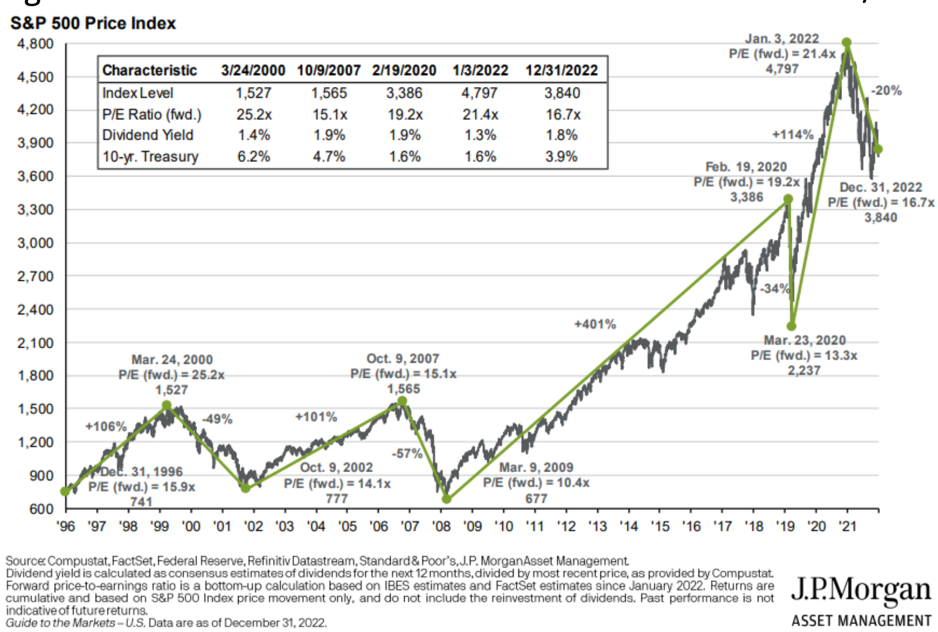
Corporate profits to decline: Priced in or "the other shoe"?

By Theresa Gusman
January 23, 2023

Overview

Inflation's surge to a 40-year high in 2022 led the Fed to an unprecedented series of interest-rate increases, cratering the bond market and sending stocks tumbling. Following a 24.9% decline in the first three quarters 0f 2022, the S&P 500 advanced 7.6% in the fourth quarter, trimming full year losses to 18.1% (see Figure 1, below). As we enter 2023, equity valuations are more attractive (see Figure 2, page 2), inflation is decelerating, China is reopening following a long COVID hiatus, and a relatively warm winter has allowed Europe to side-step energy Armageddon. However, the US and European economies are slowing and could slip into recession and corporate profits are set to decline – possibly significantly. Ultimately, maybe as soon as early 2024, we anticipate interest rate stability and a return to trendline economic and profit growth, which points toward a choppy rebound in equity markets as the year progresses.

Figure 1. S&P 500 at Inflection Points – Bull and Bear Markets, 1996 to Date



Source: J.P. Morgan Asset Management Guide to the Markets – U.S. Data are as of December 31, 2022

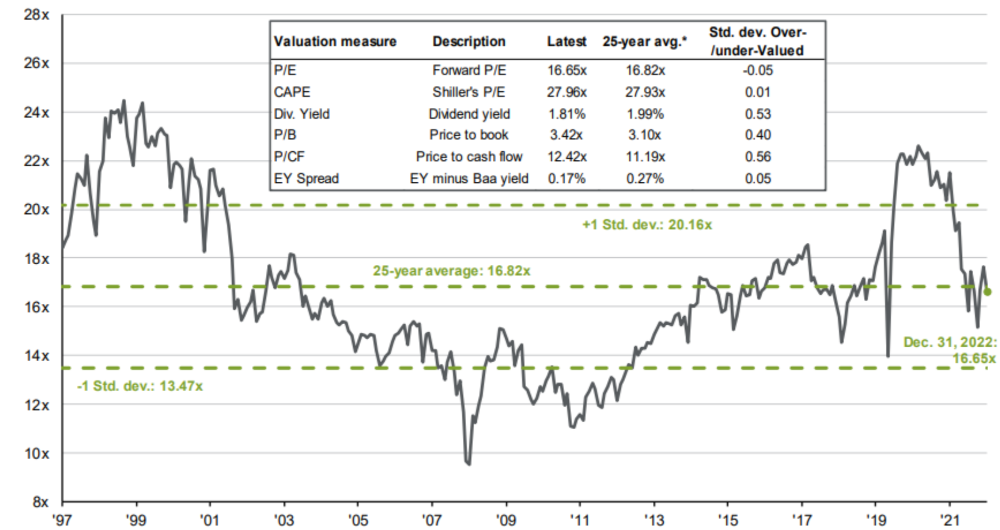
Corporate Profits – The key to equity market performance in 2023

Macro factors – particularly the surges in inflation and interest rates, the war in Ukraine, and China's "Zero COVID" policy -- drove global equity markets lower in 2022. This year, the focus will shift to corporate profits. The massive downdraft in the equity market, in general, and growth-oriented sectors (Communication Services -39.9%, Consumer Discretionary -37.0%, Technology -28.2%), in particular, have resulted in more attractive valuations at both the market and sector levels (see Figure 3, page 2). Given current valuations, the scope for earnings shortfalls is not huge.

To determine the market trajectory in 2023, we will monitor two factors closely:

- Earnings estimates. Analysts are notoriously bad at forecasting earnings declines. As shown in Figure 4, page 3, analysts are forecasting a rebound in earnings this year following last year's marginal pull-back. We believe a decline is more likely.
- Profit margins. As shown in Figure 5, page 3, respondents to the most recent NFIB Small Business Economic Survey expect price increases to moderate, sales growth to slow, and compensation to rise. This combination suggests a decline in profit margins and lower earnings in 2023.

Figure 2. S&P 500 Valuation Measures, 1997 to Date



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	16.65x	16.82x	-0.05
CAPE	Shiller's P/E	27.96x	27.93x	0.01
Div. Yield	Dividend yield	1.81%	1.99%	0.53
P/B	Price to book	3.42x	3.10x	0.40
P/CF	Price to cash flow	12.42x	11.19x	0.56
EY Spread	EY minus Baa yield	0.17%	0.27%	0.05

Source: FactSet, FRB, Refinitiv Datastream, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.
Price-to-earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since December 1997 and by FactSet since January 2022. Current next 12-months consensus earnings estimates are $231. Average P/E and standard deviations are calculated using 25 years of history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-months consensus dividend divided by most recent price. Price-to-book ratio is the price divided by book value per share. Price-to-cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure. *P/CF is a 20-year average due to cash flow availability.
Guide to the Markets – U.S. Data are as of December 31, 2022.

J.P.Morgan ASSET MANAGEMENT

Figure 3. Returns and Valuations by Sector, December 31, 2022

		Energy	Materials	Financials	Industrials	Cons. Disc.	Tech.	Comm. Services*	Real Estate	Health Care	Cons. Staples	Utilities	S&P 500 Index
Weight	**S&P weight**	5.2%	2.7%	11.7%	8.7%	9.8%	25.7%	7.3%	2.7%	15.8%	7.2%	3.2%	100.0%
	Russell Growth weight	1.7%	1.5%	3.3%	8.1%	14.2%	43.2%	6.8%	1.6%	13.5%	6.1%	0.1%	100.0%
	Russell Value weight	8.4%	4.3%	20.1%	10.5%	6.0%	8.3%	7.3%	4.5%	17.4%	7.4%	5.8%	100.0%
	Russell 2000 weight	6.8%	4.3%	17.2%	15.6%	10.4%	12.7%	2.6%	6.4%	16.9%	3.6%	3.5%	100.0%
Return (%)	**4Q22**	22.8	15.0	13.6	19.2	-10.2	4.7	-1.4	3.8	12.8	12.7	8.6	7.6
	2022	65.7	-12.3	-10.5	-5.5	-37.0	-28.2	-39.9	-26.1	-2.0	-0.6	1.6	-18.1
	Since market peak (February 2020)	86.6	36.9	17.4	23.1	-1.8	24.0	-15.2	-0.9	37.4	27.3	10.6	18.8
	Since market low (March 2020)	323.4	114.1	105.7	111.2	43.8	80.1	18.8	59.1	90.6	67.6	71.8	79.4
β	**Beta to S&P 500**	1.3	1.1	1.1	1.1	1.2	1.1	1.0*	0.8	0.8	0.6	0.5	1.0
ρ	Correl. to Treas. yields	0.1	-0.4	-0.3	-0.4	-0.5	-0.7	-0.6	-0.5	-0.4	-0.3	-0.4	-0.5
%	Foreign % of sales	37.8	55.2	21.3	32.3	34.4	57.6	42.8	15.5	36.1	43.1	2.0	39.6
EPS	NTM earnings growth	-13.2%	-11.2%	14.1%	14.5%	30.4%	3.9%	7.8%	2.5%	-3.6%	3.5%	7.4%	4.6%
	20-yr avg.	101.0%	16.4%	20.9%	14.0%	16.7%	13.6%	10.2%*	6.7%	8.4%	7.7%	4.2%	11.2%
P/E	Forward P/E ratio	9.7x	15.8x	12.1x	18.1x	20.8x	20.2x	14.1x	16.6x	17.5x	21.0x	19.0x	16.7x
	20-yr avg.	13.8x	14.7x	12.4x	16.2x	19.2x	18.0x	19.0x*	16.7x	15.1x	17.3x	15.4x	15.5x
Bbk	Buyback yield	2.8%	3.2%	3.1%	2.5%	2.5%	2.7%	5.0%	-1.7%	1.7%	1.4%	-1.1%	2.5%
	20-yr avg.	1.6%	0.9%	0.3%	2.2%	2.4%	2.9%	1.5%	-1.3%	1.9%	1.8%	-1.0%	1.7%
Div	Dividend yield	3.2%	2.1%	2.3%	1.8%	1.1%	1.2%	1.2%	3.7%	1.7%	2.7%	3.1%	1.8%
	20-yr avg.	2.8%	2.4%	2.3%	2.2%	1.4%	1.1%	0.0%	3.9%	1.9%	2.8%	3.9%	2.1%

Source: FactSet, Refinitiv Datastream, Russell Investment Group, Standard & Poor's, J.P. Morgan Asset Management. All calculations are cumulative total return, not annualized, including dividends for the stated period. Since market peak represents period from February 19, 2020 to December 31, 2022. Since market low represents period from March 23, 2020 to December 31, 2022. Correlation to Treasury yields are trailing 2-year monthly correlations between S&P 500 sector price returns and 10-year Treasury yield movements. Next 12 months (NTM) earnings growth is the percent change in next 12-months earnings estimates compared to last 12-months earnings provided by brokers. Forward P/E ratio is a bottom-up calculation based on the most recent S&P 500 Index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates and J.P. Morgan Asset Management. Buyback yield is net of share issuance and is calculated as last 12-months net buybacks divided by market cap. Dividend yield is calculated as the next 12-months consensus dividend divided by most recent price. Beta calculations are based on 10-years of monthly price returns for the S&P 500 a... its sub-indices. *Communication Services (formerly Telecom) averages and beta are based on 5-years of backtested data by JPMAM. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of December 31, 2022.

Figure 4. Corporate Earnings and Analyst Expectations, 1988-2024E

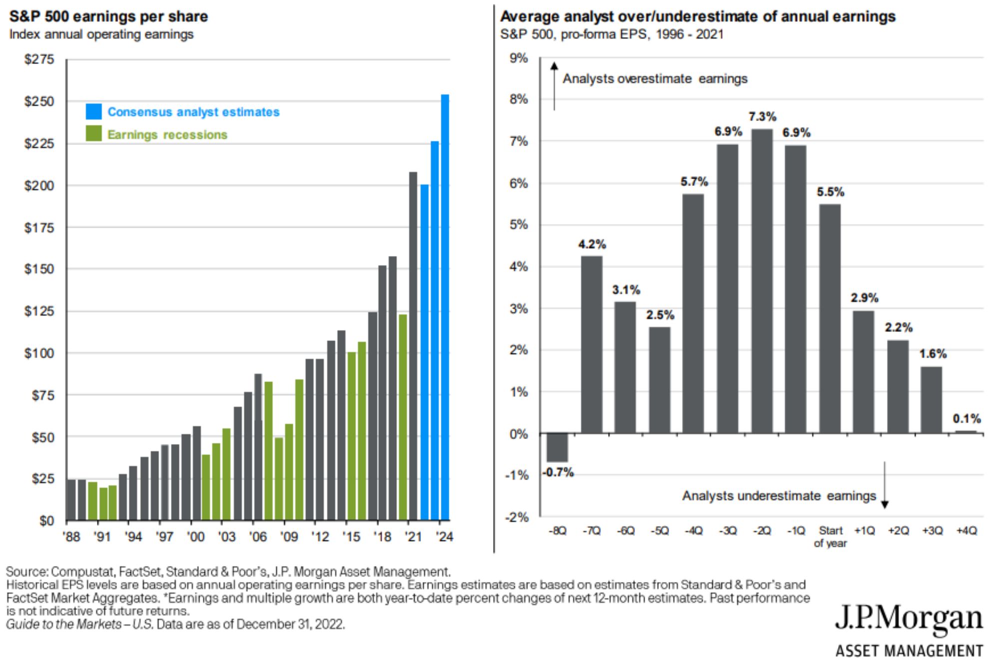
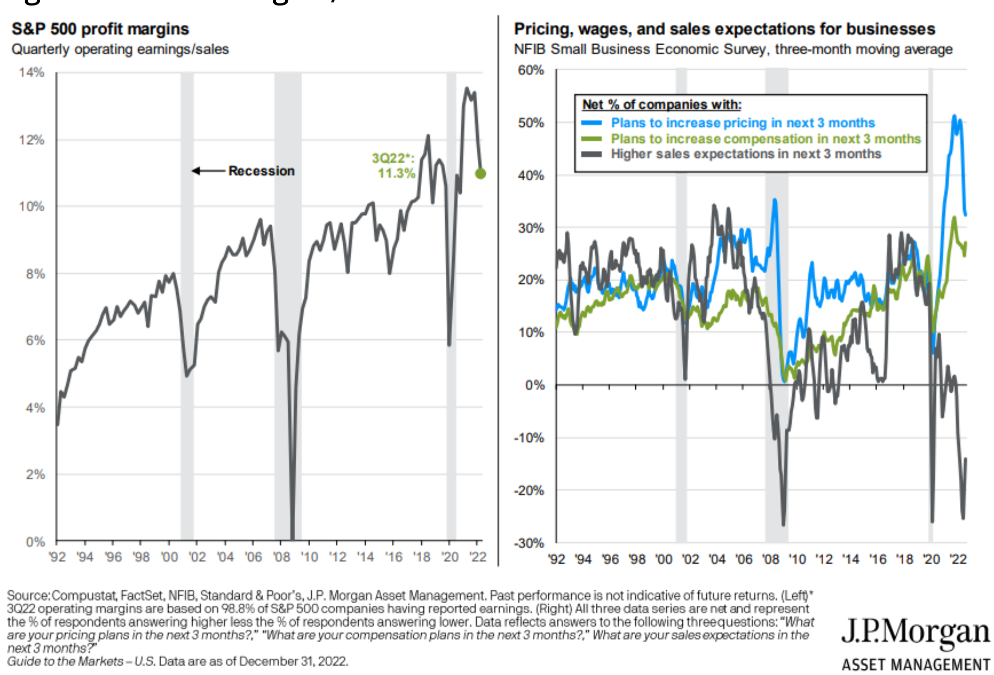


Figure 5. Profit Margins, 1991-2022



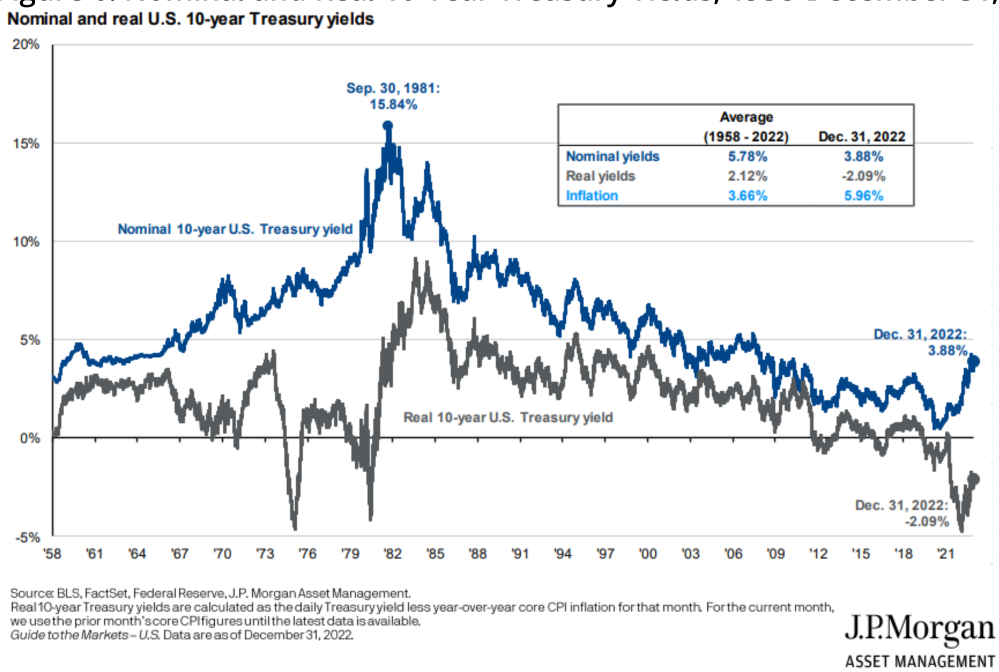
Source: J.P. Morgan Asset Management Guide to the Markets – U.S. Data are as of December 31, 2022

On the macro front, we continue to be heartened by the closure of the gap between inflation expectations and reality as evidenced by the recent decline in real interest rates (see Figure 6, page 4). As noted in previous Market Commentaries, either nominal rates must rise to reflect the surge in inflation, inflation will retreat, or we will see some combination of the two (as we expect). The narrowing of the gap continued in the fourth quarter as the Fed raised interest rates, market sentiment shifted, and commodity prices stabilized after retreating ushing in decelerating inflation. Fiscal spending (excluding outlays for the war in

Ukraine) has also moderated following the flood of pandemic-induced spending over the past two years – and this moderation should continue with the mixed election results.

Given the interdependence of global economies and the large non-US components of the earnings of multi-national companies, better news in the US will be tempered as we move through 2023. The surge in the US dollar relative to the euro and Russia's stranglehold on European energy supplies suggest the inflation pain in Europe could far exceed that of the US. Also, the ECB is behind the Fed in its response to inflation. Energy price controls, a mild winter, and supply mitigation efforts so far have softened the blow to European consumers and businesses.

Figure 6. Nominal and Real 10-Year Treasury Yields, 1958-December 31, 2022



Fourth Quarter Market Review

Korea (-28.9%), China (-21.8%), Germany (-21.6%), and the US (-18.1%) were the worst performing markets in USD terms (see Figure 7, page 5) in 2022. Only Brazil was positive for the year in both local and USD terms. Large Cap Funds fell 19.5%, last year, underperforming Small Cap Funds, which declined 17.6%. For the first time in a long time, the MSCI All Country World (ACWI) Ex US index outperformed the US markets in 2022.

Figure 7. Global Equity Markets, December 31, 2023

Returns	2022		2021		15-years	
	Local	USD	Local	USD	Ann.	Beta
Regions						
U.S. (S&P 500)	-	-18.1	-	28.7	8.8	0.90
AC World ex-U.S.	-9.2	-15.6	13.5	8.3	2.0	1.07
EAFE	-6.5	-14.0	19.2	11.8	2.3	1.04
Europe ex-UK	-12.2	-17.3	24.4	16.5	2.4	1.18
Emerging markets	-15.2	-19.7	0.1	-2.2	1.0	1.18
Selected Countries						
United Kingdom	7.2	-4.8	19.6	18.5	1.4	1.02
France	-6.9	-12.7	29.7	20.6	2.8	1.22
Germany	-16.5	-21.6	13.9	5.9	0.9	1.31
Japan	-4.1	-16.3	13.8	2.0	2.5	0.72
China	-20.6	-21.8	-21.6	-21.6	0.6	1.10
India	3.0	-7.5	28.9	26.7	2.4	1.26
Brazil	8.6	14.6	-11.2	-17.2	-2.1	1.50
Korea	-24.4	-28.9	0.8	-7.9	1.6	1.49

Figure 8. Global Equity, Fixed Income, and Real Assets Performance (Percentage Change), 4Q 2022

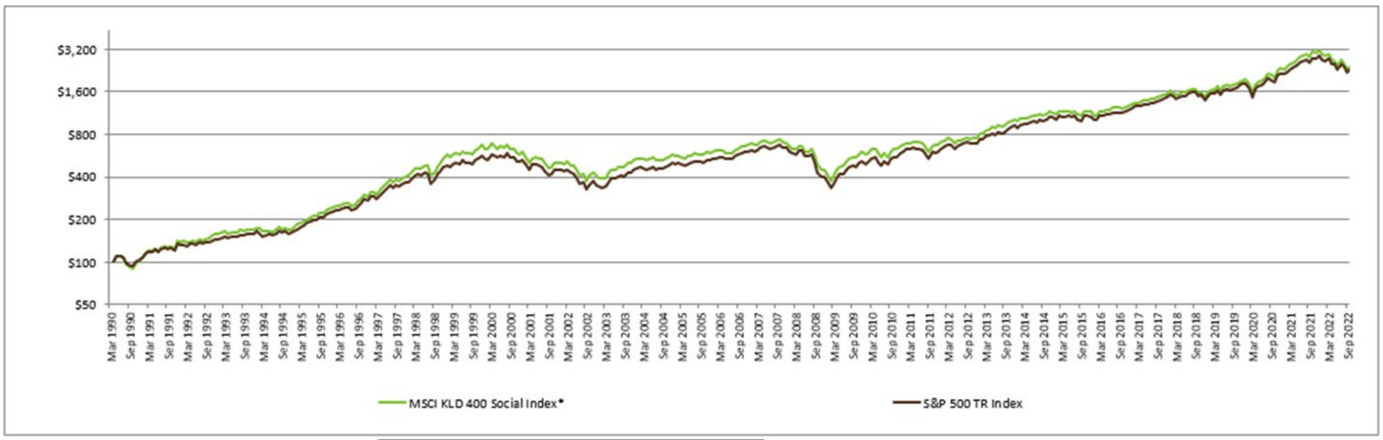
		4Q2022	2022 YTD	Last 12 Months	Last 24 Months Annualized
Equity	**US Equities**	3.85	-19.50	-19.50	0.60
	US Large Cap	3.93	-19.19	-19.19	1.06
	US Mid Cap	5.66	-18.68	-18.68	0.62
	US Small Cap	4.70	-17.56	-17.56	-1.49
	Non-US Equities	14.90	-16.02	-16.02	-5.00
	Non-US Developed Markets	18.14	-14.27	-14.27	-2.35
	Non-US Emerging Markets	9.89	-20.55	-20.55	-12.54
Fixed Income	**US Aggregate**	-1.45	-13.06	-13.06	-7.54
	US Treasuries (Intermediate)	0.98	-10.67	-10.67	-6.70
	Municipals (Intermediate)	4.57	-9.65	-9.65	-4.66
	Investment Grade Corporate	0.02	-15.43	-15.43	-8.64
	US Corporate High Yield	0.89	-11.37	-11.37	-3.94
	Bank Loan	3.28	-1.68	-1.68	0.41
	Emerging Markets	4.99	-18.03	-18.03	-10.58
Real Assets	**Commodities**	3.37	19.29	19.29	30.09
	Energy (Oil/Gas)	8.18	70.10	74.17	79.48
	Energy Pipelines (MLPs)	10.19	30.05	30.05	34.02
	Precious Metals	11.84	-1.76	-1.76	-4.31
	Industrial Metals	5.89	-11.09	-11.09	6.96
	Agriculture	-2.11	2.70	2.70	12.08
	REITs (Real Estate)	1.10	-26.20	-26.20	1.79

Achieving Long-Term Investment and Impact Objectives

The shift into sustainable, responsible, and impact (SRI) investments continues – albeit at a slower pace. Following years of excess performance, as shown in Figure 9, page 6, the MSCI KLD 400 index underperformed the S&P 500 index last year amid surging prices for fossil fuels and other commodities. This setback notwithstanding, the sustained, consistent performance of this standard SRI/ESG benchmark over time supports our view that strategies incorporating environmental, social and governance (ESG) factors – with an eye toward making the world a better place – and mainstream financial returns can be achieved simultaneously.

As always, everything we do at First Affirmative is driven by our dedication to enabling advisors to deliver financial results to clients and belief in the power of capital to bring about lasting environmental and social change. Our new, innovative Values-Aligned Direct Index Solution (VADIS) and Sustainable Managed Mutual Fund and Multi-Manager Investment Solutions are built to enable clients to achieve their financial goals over the long term, along with their individual environmental, social, governance, ethical, and values-based objectives. Each portfolio is carefully constructed to be well diversified across assets, sectors, geographies, securities, and management styles –– and designed to weather periods of uncertainty and volatility.

Figure 9. MSCI KLD 400 vs S&P 500 Indices, December 31, 2022



Annualized Return Since 5/1/90:	MSCI KLD 400 Social Index*	S&P 500 TR Index
	11.18%	10.04%

Source: Morningstar. *Data prior to 9/1/2010 is that of the MSCI KLD 400 Social Index GR, while data since 9/1/2010 is that of the MSCI KLD 400 Social Index NR. Indexes are unmanaged groups of securities. Index performance does not include the impact of cash, fees, or transaction costs. Investors cannot invest directly in indexes but may purchase mutual funds or other investment products designed to track the performance of various indices.

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