CHIEF INVESTMENT OFFICE

Equity Spotlight

Timing and Positioning for a Second Half Recession

June 2023

All data, projections and opinions are as of the date of this report and subject to change.

SUMMARY

A recession is likely around the corner given the persistent inversion of the yield curve. That said, we suggest targeting Equity sector exposure that is relatively high quality, reasonably valued, and focused on capital return and helps long-term investors navigate the market while preserving and growing wealth.

The risk of a recession this year has been top of mind for market participants for quite some time. As the tumultuous but "recession free" first half of the year winds down, long-term investors look cautiously ahead to 2023's second act. Predicting the exact timing of a recession can be somewhat challenging but history has given us good guideposts that strongly suggest a second-half downturn in the economy. We see opportunities for long-term investors to preserve and grow wealth as they calibrate their Equity exposure to sectors we view as high quality, reasonably valued, and adept at creating shareholder value.

There are several indicators when a potential recession looms for the economy—a slowdown in manufacturing, including new vehicles; an increase in unemployment; a slowdown in consumer spending. One of the more reliable recession indicators has been the inversion of the yield curve, notably the spread between the 2-year and 10-year treasury yield (2s/10s). In past cycles, the U.S. economy has typically dipped into recession about 15-months after the initial inversion (Exhibit 1). This time around, the initial inversion of the 2s/10s spread occurred in March 2022, putting us at or near the 15 month mark at the time of this publication. It would not be inconsistent with history if a recession did not fully materialize for several more months, but the writing is on the wall. Since the yield curve inverted over a year ago, it has been a countdown to recession in the economy.

Exhibit 1: Time From 2s/10s Initial Inversion to Start of Recession.

2s/10s Initial Inversion	NBER* Recession Start Date	# Months from Initial Inversion to Recession
Mar. 22	—	—
Aug. 19	Feb. 20	6
Dec. 05	Dec. 07	24
Feb. 00	Mar. 01	13
Jan. 89	Jul. 90	18
Sep. 80	Jul. 81	10
Aug. 78	Jan. 80	17
Average		**15**

Sources: Bloomberg; *National Bureau of Economic Research (NBER). Monthly data referenced. May 31, 2023.

CIO ASSET CLASS VIEWS

Asset Class	CIO View				
	Underweight		Neutral	Overweight	
Global Equities	•	•	🟡	•	•
U.S. Large-cap Growth	•	•	🟡	•	•
U.S. Large-cap Value	•	•	•	🟢	•
U.S. Small-cap Growth	•	•	🟡	•	•
U.S. Small-cap Value	•	•	🟡	•	•
International Developed	•	🟠	•	•	•
Emerging Markets	•	•	🟡	•	•

Source: Chief Investment Office as of June 1, 2023.
CIO asset class views are relative to the CIO Strategic Asset Allocation (SAA) of a multi-asset portfolio.

CIO EQUITY SECTOR VIEWS

Sector	CIO View				
	Underweight		Neutral	Overweight	
Healthcare	•	•	•	•	🟢
Energy	•	•	•	🟢	•
Utilities	•	•	•	🟢	•
Consumer Staples	•	•	🟡	•	•
Information Technology	•	•	🟡	•	•
Communication Services	•	•	🟡	•	•
Industrials	•	•	🟡	•	•
Financials	•	•	🟡	•	•
Materials	•	🟠	•	•	•
Real Estate	•	🟠	•	•	•
Consumer Discretionary	🔴	•	•	•	•

Source: Chief Investment Office as of June 1, 2023. All sector and asset allocation recommendations must be considered in the context of an individual investor's goals, time horizon, liquidity needs and risk tolerance. Not all recommendations will be in the best interest of all investors.

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With the Federal Reserve at or near the end of an abrupt but sizable series of rate hikes, we head into the summer months with an Equity portfolio strategy that emphasizes quality, capital return and GARP (growth at a reasonable price) for long-term investors. Accordingly, we see opportunities to deploy capital in the Healthcare sector, which looks relatively attractive trading with a forward price-to-earnings (P/E) ratio discount to the broader market (currently about 16.9x vs. 18.6x for the S&P 500),[1] and near a cyclical trough valuation given a historical range of 16-19x P/E over the past decade. Earnings durability in the Healthcare Supplies, Medical Devices and Medical Equipment subsectors should exceed that of the broader market in an economic downturn. We also see select high-quality names in large Pharma and Managed Care that have lagged year-to-date (YTD) but we are comfortable holding through the cycle.

We are also placing an emphasis on exposure to the Energy sector, which has also lagged YTD. The Energy sector is trading near cycle lows (around 10.5x P/E) and offers compelling capital return to shareholders, with dividend yields, including special dividends the industry has regularly utilized. We see relative value and the opportunity to deploy capital in Oil Field Services and select Refiners that have posted double-digit YTD stock declines despite what we view as a fairly healthy backdrop for energy prices and a durable business model. We also see an opportunity for clients to lean into Utilities and Consumer Staples to position their portfolios more defensively—these two sectors have historically outperformed the broader market in recessions (Exhibit 2). Thematic investment opportunities in Industrials, especially Aerospace & Defense, and high-quality Technology that captures the long-term trend of continued digitalization of the economy should also be a part of the Equity portfolio strategy.

Exhibit 2: S&P 500 Sector Performance During Historical Recessions.

NBER Recession Dates	S&P 500 Peak Date	S&P 500 Trough Date	S&P 500 Index	Communication Services	Consumer Discretionary	Consumer Staples	Energy	Financials	Health care	Industrials	Information Technology	Materials	Real Estate	Utilities
Feb. 20 – April. 20	12/27/2019	3/23/2020	-31%	-25%	-28%	-23%	-60%	-43%	-27%	-40%	-23%	-37%	-34%	-30%
Dec. 07 – Jun. 09	10/9/2007	3/9/2009	-57%	-51%	-58%	-31%	-47%	-83%	-40%	-65%	-53%	-60%	-75%	-46%
Mar. 01 – Nov. 01	3/24/2000	10/9/2002	-49%	-74%	-41%	24%	-18%	-25%	-7%	-38%	-82%	-25%	-26%	-48%
Jul. 90 – Mar. 91	7/16/1990	10/11/1990	-20%	-9%	-32%	-14%	-5%	-33%	-13%	-28%	-31%	-23%	—	-3%
Average			-39%	-40%	-40%	-11%	-33%	-46%	-22%	-43%	-47%	-36%	-45%	-32%

Source: Bloomberg as of June 2, 2023. S&P 500 Index peak-to-trough dates referenced for all S&P 500 Global Industry Classification Standard (GICS®) Level 1 sectors. **Past performance is no guarantee of future results.** Please refer to index definitions at the end of this report.

Conversely, we are far less sanguine about the Consumer Discretionary sector, which has significantly lagged Staples in past recessions, as consumers tighten their belts and reduce spending. Exposure to the Materials and Real Estate sectors should also be destressed given a relatively poor earnings growth outlook for next year versus the broader market, which will likely pressure valuation. Prospects for the Financial sector will ultimately improve under a “higher for longer” interest rate regime, but near-term challenges such as unrealized losses in bond portfolios, which pressure capital, increased regulation in the wake of the regional bank troubles this year, and rising credit costs driven by commercial real estate (CRE) charge-offs will be an overhang on shares for some time. Regional Banks have been in the crosshairs of regulators and should be deemphasized in client portfolios in favor of the larger Diversified Banks, in our view.

A recession is likely around the corner given the persistent inversion of the yield curve. That said, we suggestion targeting Equity-sector exposure that is relatively high-quality, reasonably valued, and focused on capital return and helps long-term investors navigate the market while preserving and growing wealth. We give emphasis to exposure to the Healthcare, Energy, Utilities and Consumer Staples sectors and note thematic investment opportunities in Aerospace & Defense and high-quality Technology.

[1] Bloomberg as of June 5, 2023.

Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Indexes are all based in U.S. dollars.

S&P 500 Index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market.

S&P 500 Sector Index constitute a method of sorting publicly traded companies into 11 sectors-Information Technology, Health Care, Financials, Consumer Discretionary, Communication Services, Industrials, Consumer Staples, Energy, Utilities, Real Estate (REITs), and Materials. Also known as the Global Industry Classification Standard (GICS) sorts companies into sectors based on their primary business activity.

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