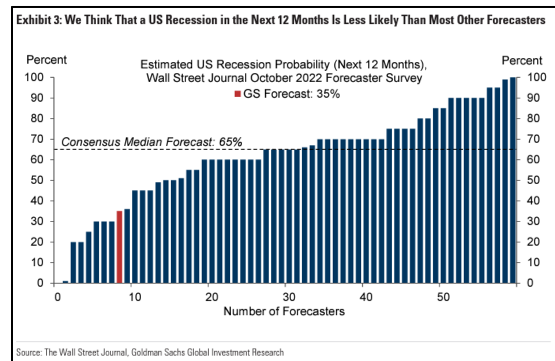
Historic rate moves drive down valuations

2022 was a difficult year for investors across most asset classes and styles. At the end of 2022, the S&P 500, NASDAQ, and the US Agg Bond Index were down -19.44%, -33.10%, and -13.01%. These negative returns are primarily attributed to the rising rate environment caused by efforts to tame inflation. The Federal Reserve raised the lower end of its target range from 0% to 4.25% and as a result, the 10-year US treasury yield rose from 1.63% to 3.88%.

Recession fears for 2023, overdone?



In the Wall Street Journal's survey of economists, the median forecasted probability of recession over the next year is 65%, which if correct, makes it one of the most predicted recessions in modern history. John Maynard Keynes once said, "The expected never happens; it is the unexpected that always happens." 2022 was a phenomenal example of this, with inflation, central bank policies, and global conflicts impacting markets throughout the year. In 2023, while the risk of a recession is certainly above average, we believe that the market is overestimating the depth of a potential recession. Beginning with the invasion of Ukraine, the unexpected events throughout 2022 have resulted in many businesses shifting to more cautious and defensive positions for almost a year. Recessions, in the classic, fear-inducing sense of the term, are self-fueling events that result in negative economic ripples impacting all corners of the economy. The reason for these widespread effects is the rapid repositioning of businesses to recalibrate to lower demand levels, resulting in layoffs to reduce headcount and decreased investment. These shifts flow down the value chain as higher unemployment decreases discretionary spending and lower investment impacts other business-to-business companies. In the current environment, businesses are not overextended; to the contrary, many have been shifting to a more defensive position for most of the year. Furthermore, the persistent labor shortage has made it such that even companies aggressively pursuing growth have struggled to increase their headcounts. As a result, if economic growth does slow, or even mildly contract, the majority of defensive recalibration has already occurred. Because of this, we expect that any recession that does occur during 2023 will be mild. Additionally, the health of the financial sector is stronger than previous recessions due to the extensive stress testing and regulation of banks since the Global Financial Crisis. As a result, banks are well capitalized and capable of absorbing losses without causing a credit crunch.

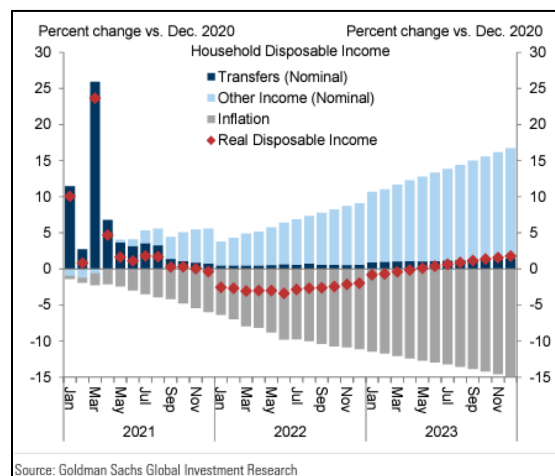
In terms of equity investing, two factors drive price performance: earnings and multiples. With forward multiples now at reasonable levels following the market decline in 2022, investors are primarily concerned with an earnings slowdown from reduced business activity in response to the Federal Reserve's aggressive rate hikes. It is our view that this earnings slowdown has been largely priced in already (see graph). This is not to say that equities have already reached their definitive bottom for this market cycle or that there won't be an earnings slowdown, however we expect that any deceleration in earnings growth and margins will be moderate for high quality companies. Businesses with pricing power and secular tailwinds will be able to protect their earnings and margins better than peers.

Source: MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Earnings are 12-month forward earnings expectations. Past performance is not a reliable indicator of current and future results. Data as of 31 October 2022.

Labor market tightness temper inflation concerns

During 2022, one of the most notable market drivers has been central bank policy. As mentioned in our prior market outlook published at the end of Q3, recent Fed policy decisions have been, and will continue to be, driven by the labor market. In the FOMC's December meeting, the committee unanimously voted for a 50 basis point rate increase, a downshift from the last four 75 bps hikes, bringing the Federal Funds target range to 4.25% – 4.50%. While the 50 bps hike was in-line with market expectations, the market wasn't expecting the increase in the projected 2023 terminal rate to 5.1% in the updated SEP (Summary of Economic Projections). In the post-meeting press conference, Chair Powell emphasized that the current level of wage growth is not consistent with the committee's longer run inflation target. The concern is that persistently elevated wage growth will result in increasing labor costs within the service sector that are then passed on via price increases, starting a wage-price spiral. In November, real wages increased 0.5% versus the prior month (0.6% increase in nominal wages, 0.1% increase in CPI).

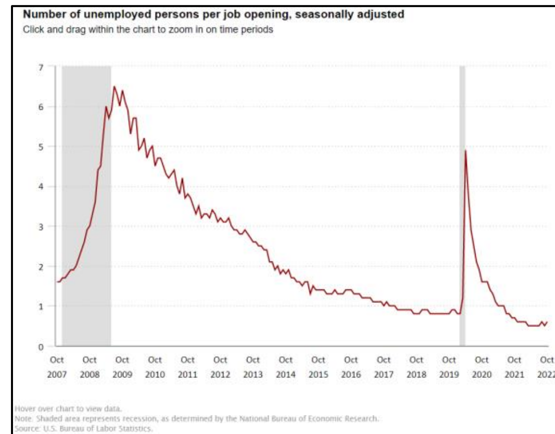
The FOMC has increased the Federal Funds Rate by a total of 4.25% since the start of 2022, however, there has been minimal impact on labor market tightness (which is best assessed via unemployment rate and job openings). We attribute this to few things. Firstly, monetary policy has lags in its impact and influences the economy and labor market via effects on demand. Broad consumer demand has remained robust throughout the year with observable impacts only recently starting to show; it will take at least another couple months for aggressively positioned companies, which we believe are the minority of cases, to reach new headcount targets recalibrated for shifting demand. Secondly, the labor force participation rate has yet to recover to pre-COVID levels and likely never will. In past economic cycles, weakening consumer financial conditions typically drove an increase in participation rate. Prime age worker participation has recovered to pre-COVID levels and



Source: Goldman Sachs Global Investment Research

therefore, the current differential versus pre-COVID levels is almost entirely driven by early retirements. These are unlikely to be reversed. Additionally, over the past couple months, there has been some anecdotal evidence that suggests a relatively novel trend of labor hoarding is emerging.

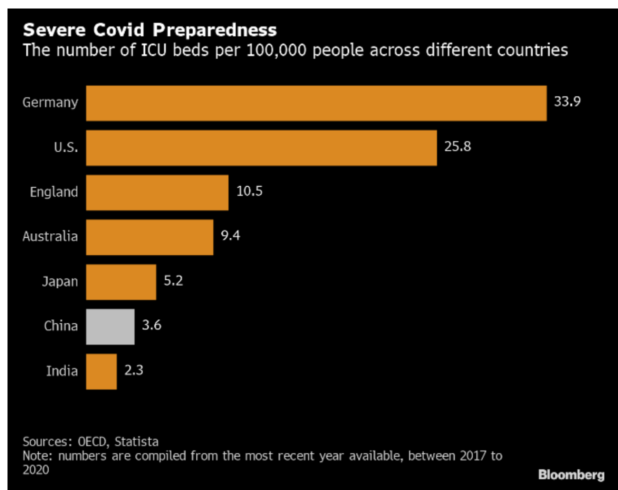
Moving into 2023, the US continues to experience a severe labor shortage. As is shown in the chart on the right, the ratio of unemployed person to job opening is currently at just 0.6, the lowest level in several years. At the current level, there are nearly two jobs available for every unemployed person seeking work. Following the FOMC's December meeting, Powell acknowledged that the pace of rate hikes is "not so important" now, indicating that the final level of rates can now take priority over the pace of their implementation. We expect a couple of 25 basis point hikes during the FOMC's first few meetings of 2023. From there, we expect rates to remain at elevated levels through the remainder of 2023 as the elevated levels of high-persistence inflation drivers prevent inflation from nearing the committee's longer run target during the year.



Spiking China COVID, minimal impact to supply chain?

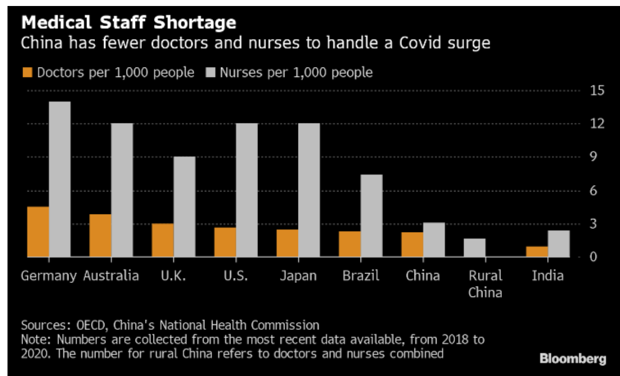
While China's relaxation of "zero COVID" policies is a step required for the county's complete post-pandemic economic recovery, the timing and situation under which these policy changes are being implemented will likely result in several more quarters of volatility as the country attempts to transition. China's narrow focus on lockdowns and published case counts since the start of the pandemic has resulted in deficiencies in other COVID preparations, such as vaccinations and hospital upgrades/investments, and therefore the country is not adequately prepared for the transition to post-COVID.

Due to its stringent lockdown measures over the past 3 years and the lack of persistently elevated case counts, herd immunity in China is extremely low relative to the rest of the world. Additionally, China has thus far insisted on only using vaccines developed within the country. Of the currently approved vaccines in China, the two most prevalent are the Sinovac and Sinopharm vaccines. These vaccines have significantly lower efficacy than the globally adopted Pfizer-BioNTech and Moderna vaccines. The Pfizer-BioNTech and Moderna vaccines are both more than 90% effective at preventing severe disease (exact efficacy can vary from mid-nineties to nearly 100% based on trial and dominant variant). While data on the Sinovac and Sinopharm vaccines is far less prevalent and accessible, available data suggests efficacy of ~60% and 67%-79%, respectively. On the note of data availability, we would caution on selection of data sources;



published efficacy numbers on China-based media and the WHO website vary significantly versus numerous real-world studies conducted in other countries and published by other sources.

In China, only 69% of people above 60 and 40% of people above 80 have received booster shots. This low vaccination rate and the efficacy shortfall are especially pertinent when viewed in the context of China's healthcare system. On a per capita basis, China has significantly fewer doctors, nurses, and ICU beds versus other countries. As a result, we project a high probability that the country's healthcare system becomes quickly overwhelmed with severe COVID cases.



We expect that in this situation, demand would be more negatively impacted than supply. Due to the CCP's focus on public perception and the recent lockdown protests, the reimplementation of large-scale lockdowns is unlikely. We believe that the CCP will view the reimplementation of lockdowns so soon after relaxation of COVID policies as admitting fault and therefore, will be unwilling to do so. As a result, supply chains should continue to function smoothly. Regarding demand, surging case counts combined with overflowing hospitals and the government's pernicious framing of COVID for the past few years will likely result in decreased consumption as the Chinese people exert caution with their finances and activities. Evidence of this non-mandated shift in activity has been demonstrated in multiple other countries where mobility tracking data declined as case counts surged despite no reimplementation of government mandates. The most impacted areas of consumption would likely be in services, gasoline, and discretionary categories.

Looking Forward to 2023 – Equity Market

In 2022, the Russell 1000 Value outperformed the Russell 1000 Growth by 21.6%. Despite their poor performance in 2022, growth stocks are still overvalued by historical standards and value names are relatively undervalued. Value oriented securities like Dividend-orientated equities provide a good option for investors in the event of an earnings slowdown because, historically, dividends decline at a lesser rate than earnings during recessionary periods. Additionally, during times of market volatility, the lower risk nature of dividends becomes increasingly attractive to investors, resulting in more capital inflows than other equities. The expectation that rates stabilize at a higher level bodes well for "value" stocks but another factor beyond just "value" vs "growth" that investors should consider is a company's earnings resiliency. Investing in companies with true pricing power is crucial because their earnings should be relatively resilient compared to the overall market. High-quality companies will be better able to maintain their margins due to market power and/or product differentiation.

Disclosures

This letter may contain "forward-looking statements" which are based on Brookmont's beliefs, as well as on a number of assumptions concerning future events, based on information currently available to Brookmont. Current and prospective clients are cautioned not to put undue reliance on such forward-looking statements, which are not a guarantee of future performance, and are subject to a number of uncertainties and other factors, many of which are outside Brookmont's control, and which could cause actual results to differ materially from such statements. All expressions of opinions are subject to change without notice.

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Brookmont Capital is defined as an independent investment management firm that is not affiliated with any parent organizations.

A complete description of Brookmont's performance calculation methodology, including a complete list of each security that contributed to the performance of this Brookmont portfolio is available upon request.

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The Brookmont Dividend Growth Strategy returns are based on an asset-weighted composite of discretionary accounts that include 100% of the recommended holdings. Individual accounts will have varying returns, including those invested in the Strategy. The reasons for this include, 1) the period of time in which the accounts are active, 2) the timing of contributions and withdrawals, 3) the account size, and 4) holding other securities that are not included in the Strategy. Dividends and capital gains are not reinvested. The Strategy does not utilize leverage or derivatives. Returns are based in U.S. dollars. The inception of the Strategy is January 1, 2008.

The Brookmont Dividend Growth Strategy Composite contains fully discretionary accounts with similar value equity investment strategies and objectives. For comparison purposes, the Dividend Growth Strategy Composite is measured against the Russell 1000 Value Index. The Russell 1000 Value Index measures the performance of the large-cap segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values. The Russell 1000 Value Index is constructed to provide a comprehensive and unbaised barometer for the large-cap value segment. There is no representation that this index is an appropriate benchmark for such comparison. You cannot invest directly in an index, which also does not take into account trading commissions and costs. The Volatility of this index may be materially different from the performance of the strategy.

The firm maintains a complete list and description of composites, which is available upon request. Results are based on fully discretionary accounts under management, included those accounts no longer with the firm. Composite policy requires the temporary removal of any portfolio incurring a client initiated significant cash inflow or outflow of at least 15% of portfolio assets. The temporary removal of such account occurs at the beginning of the month in which the significant cash flow occurs and the account re-enters the composite at the beginning of the month which follows the cash flow by at least 30 days. Additional information regarding the treatment of significant cash flows is available upon request.

Brookmont's returns do include reinvestment of dividends and are shown gross-of-fees. All transaction costs are included. The Russell 1000 Value cumulative return includes reinvestment of dividends and capital gains. During a rising market, not reinvesting dividend could have a negative effect on cumulative returns. There is no representation that this

index is an appropriate benchmark for such comparison. You cannot invest directly in an index, which also does not take into account trading commissions and costs. The Volatility of this index may be materially different from the performance of the Strategy.

Gross returns will be reduced by investment advisory fees and other expenses that may be incurred in the management of the account. Net-of-fees performance was calculated using actual management fees. Additional information regarding the policies for calculating and reporting returns is available upon request.

Your account returns might vary from the composites returns if you own securities that are not included in the Strategy or if your portfolio dollar-cost averaged into the Strategy during the reporting period.

Brookmont Capital Management claims compliance with the Global Investment Performance Standards (GIPS®). To receive a complete list and description of Brookmont's composites and a presentation that adheres to GIPS standards, please contact Suzie Begando at 214-953-0190 or write Brookmont Capital Management, 5950 Berkshire Lane, Suite 1420, Dallas, TX 75225.

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