EQUITY STRATEGY INSIGHTS

Looking for Value in the New Year

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EXECUTIVE SUMMARY

- As 2023 gets underway, it's a good time to look for ideas for the new year.
- In this commentary, we focus on the valuation component of our investment disciplines (fundamentals and technicals being the others).
- Solely looking at valuations reveals several asset classes and sectors to consider in 2023, including small and midcap stocks, value stocks, international stocks, and the energy and financials sectors.

With 2022 in the rear view mirror, it's a good time to look for ideas for this year. LPL Research uses three investing disciplines to evaluate investments: 1) fundamentals, 2) valuations, and 3) technical analysis. In this edition of *Equity Strategy Insights*, we focus on valuations, which leads us to the following ideas: value stocks, small and mid caps, developed international stocks, and the energy and financials sectors. We recognize that valuations are typically not very good as short-term timing mechanisms, but over periods of a year or more, when combined with fundamentals, technicals, and sentiment (which we view as a subset of technical analysis), we believe they can be a useful piece of a robust process.

High Quality Small Cap Valuations Look Too Low

At first, moving down market cap now might seem counterintuitive. During bear markets—especially those that are accompanied by recession—smaller companies with generally weaker balance sheets would be expected to lag their larger brethren as the cost of credit increases, credit availability diminishes, and merger and acquisition volumes dry up.

But at current valuations, as shown in **Figure 1**, recession appears largely priced in for small caps, particularly for the more profitable companies that make up the S&P 600 Index.

1 Small Cap Valuations Are Low Relative to Large Caps

Source: LPL Research, FactSet data as of 01/03/23
Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

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The small cap S&P 600 is trading at a more than 30% discount to the large cap S&P 500 on a forward price-to-earnings basis.

The S&P 600 is trading at a more than 30% discount to the S&P 500 on a forward P/E basis. The story is similar with the Russell Midcap Index, which trades at an 8% discount to the S&P 500, after trading at a premium valuation for much of the last two decades [Figure 2].

2 Midcap Valuations Are Also Low Compared With Large Caps

Source: LPL Research, FactSet, as of 1/03/23
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Even in a mild, short-lived recession, small caps may be able to put a nice run together in the second of the year on the back of low valuations.

Even a mild, short-lived recession—as likely as any other economic scenario in our view—small caps could put a nice run together in the second half of the year on the back of those low valuations. And we cannot completely dismiss prospects for a soft-ish landing that would boost riskier assets.

Earnings could help, with consensus currently calling for a 15% gain in Russell 2000 earnings per share in 2023. Though earnings for the higher quality S&P 600 Index are not expected to see much of an increase due to a tough comparison against 2022 (consensus is +2%), the Strategic & Tactical Asset Allocation Committee (STAAC) still expects high quality small caps to benefit from an improving U.S. economy, relatively less exposure to Europe, and their sensitivity to broad market performance.

The LPL Research STAAC maintains a slightly positive bias toward small and mid caps relative to large caps.

Value Style Stood Out as Strong Performer in 2022

There were few clear winners in 2022 besides the energy sector (more on that topic below), but value stocks certainly put on a good show. Value held up much better than growth in 2022, as the Russell 1000 Value Index, propelled by energy sector strength, lost 7.3% for the year compared to the Russell 1000 Growth Index's 29% decline.

Despite their strong run last year, value stocks remain attractively valued compared with growth.

Value's strong year is easy to explain by looking at 2022 sector performance. Energy, one of the biggest value sectors, returned 66%, while technology, the biggest growth sector, lost 28%. The other big value sector, financials, lost just 10.5% last year, while the second biggest growth sector, consumer discretionary, tumbled 37%. Looking at it from a more macro perspective, rising interest rates hurt stocks with high valuations, most of which are found in the growth indexes.

Value stocks are, by definition, cheaper than their growth peers. That's how they end up classified as value stocks. However, the size of the valuation discount matters and can make value stocks relatively more or less attractive against growth. As shown in Figure 3, despite the strong run for value last year, value stocks remain attractively valued compared with growth.

3 **Value Stocks Are Attractively Valued Relative to Growth Stocks**

Source: LPL Research, FactSet as of 01/03/23
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The STAAC maintains a slight preference for value stocks over growth, including a positive view of energy and negative views of consumer discretionary and technology.

Dollar Weakness Helps Markets Recognize Value in International

2023 international earnings estimates have been moving nicely higher and may end up being more resilient than U.S. earnings in a slowdown/ recession.

International equities in developed markets, particularly in Europe, have defied the skeptics (count us among them) and performed well in recent months. Much of the MSCI EAFE Index's outperformance compared with the S&P 500 Index during the fourth quarter (+18.1% vs. +7.6%) was driven by a weaker U.S. dollar. However, earnings are earnings and 2023 international earnings estimates have been moving nicely higher and may end up being more resilient than U.S. earnings in a slowdown/recession.

Attractive international valuations are also supportive, as shown in Figure 4. The struggles of the mega-cap technology names in the U.S., and the Committee's preference for value over growth, has narrowed the gap. International equities fall much more in the value bucket than growth, while the U.S. is much more of a growth-leaning market.

4 **Developed International Stocks Are Attractively Valued Relative to U.S. Stocks**

Source: LPL Research, FactSet as of 01/03/23
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The technical analysis picture has also improved with the recent outperformance, while the dollar may be poised for additional weakness in the near-term as the end of the Fed's rate hiking campaign approaches.

Still, we remain concerned about the energy crisis in Europe as the Russia-Ukraine conflict continues. Europe makes up about two-thirds of the MSCI EAFE Index, with Japan only about 22%. However, the economic data has mostly surprised to the upside recently, suggesting the market's worst fears may not be materializing. An economy going from bad to less bad can support attractive investment opportunities, and international has gotten our attention.

The STAAC maintains a slightly negative view of international equities but reduced its underweight position in the recommended tactical asset allocation for January.

Sector Valuation Opportunities: Energy and Financials

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It's easy to think that after a more than 60% rally in 2022 that the energy sector is expensive, but it actually isn't. On a price-to-earnings ratio (P/E) basis, the sector is trading at a more than 40% discount to the S&P 500 P/E, which would have been a 25-year low if it wasn't for the pandemic (remember when oil futures prices went negative in 2020?). On the more widely used price-to-book value measure, the sector trades at a 37% discount to the S&P 500, similar to valuations during the oil downturn in early 2016 and about 15 percentage points lower than the 20-year average [**Figure 5**].

5 Financials and Even Energy Valuations Still Look Good Relative to History

Source: LPL Research, FactSet as of 01/03/23
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The LPL Research Strategic and Tactical Asset Allocation Committee's recently upgraded the financials sector to neutral on signs of technical improvement.

Supportive valuations, along with tight global supplies, upside potential from China's reopening, and increased financial discipline from producers are all supportive of the sector. The possibility of further U.S. dollar weakness in the near term could also help give the sector a boost by making oil cheaper to foreign buyers. *The STAAC's energy view is positive.*

Financials also look attractively valued, both on a P/E and book value basis. On a P/E basis, the sector is trading at a more than 25% discount to the S&P 500 P/E, compared with the 20-year average 19% discount. On a price-to-book value basis, the sector trades at a nearly 60% discount to the S&P 500, larger than the 20-year average discount of 50% [**Figure 5**]. Book value is a more widely used valuation measure for financial companies.

Fundamental challenges remain for the sector, particularly the inverted yield curve. Short term interest rates remain higher than long-term rates, signaling recession and creating a less profitable lending environment. Capital markets activity is also understandably constrained and loan demand has started to soften—especially for mortgages. But the STAAC's recent upgrade to neutral on signs of technical improvement makes this a sector to watch. Inexpensive valuations and an improving technical analysis picture can make a profitable combination, much like international equities lately. And after double-digit earnings declines in 2022, the sector is poised to return to profit growth this year, which may provide a catalyst for better performance. *The STAAC's financials view is neutral.*

IMPORTANT DISCLOSURES

This material is for general information only and is not intended to provide specific advice or recommendations for any individual. There is no assurance that the views or strategies discussed are suitable for all investors or will yield positive outcomes. Investing involves risks including possible loss of principal. Any economic forecasts set forth may not develop as predicted and are subject to change.

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Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

All index data from FactSet.

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