ROCKMAN CAPITAL UPDATE

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1st November 2022

The market enviroment

Earnings recession

An earnings recession occurs when corporate profits decline for two consecutive quarters. This may occur when the market is either in an economic slowdown or a recession.

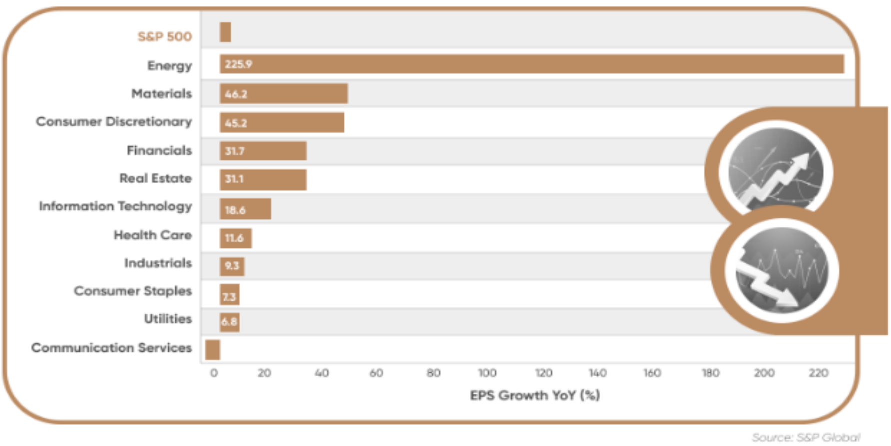
2022 has seen a continued equity bear market, with risk sentiment pricing the risk of recession more and more likely, owing to:

- Persistently high inflation,
- Continued hawkish monetary policy from global central banks,
- Steadily increasing borrowing costs,
- Declining asset valuations, and
- The pressure on energy and food owing to the ongoing Russia/Ukraine war.

As mentioned in our previous market updates, the US Federal Reserve's ("the Fed") stated policy is to slow aggregate demand by raising interest rates and Quantative tightening. This is to ensure that the current high rate of inflation does not become embedded in US economic expectations.

However, with the present rate hiking cycle heavily front-loaded and showing no signs of slowing down, there is a high risk of an economic contraction. First quarter earnings for 2022 for the S&P 500 Index, showed growth of 9%: the lowest growth rate since quarter 4, 2020. This growth was skewed significantly by the energy sector, which was driven to record highs by the Russia/Ukraine war (refer below).

S&P 500 year-on-year earnings per share growth in Q1 2022



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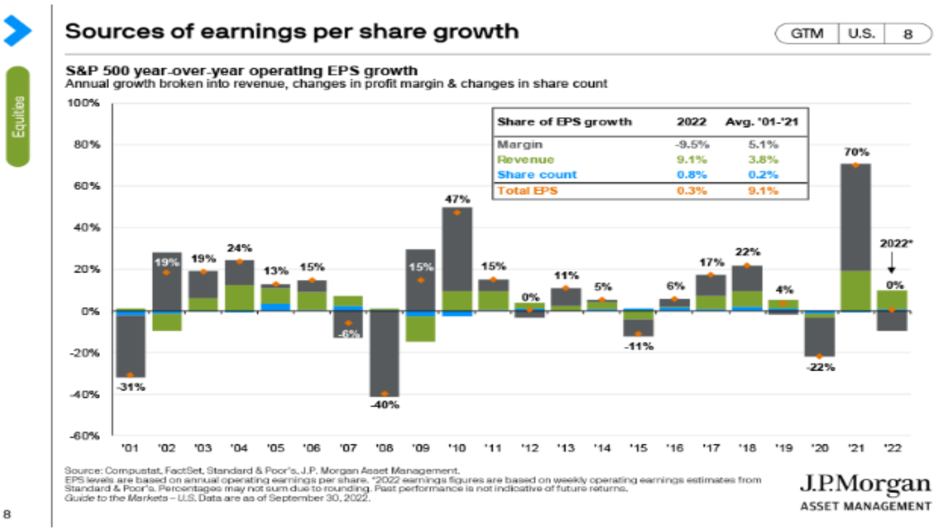
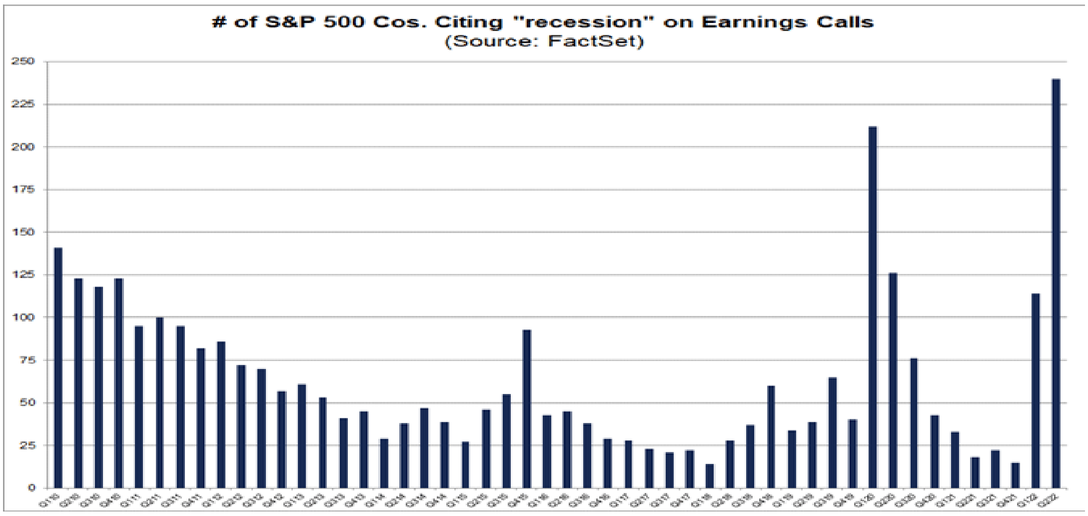
In 2021, earnings per share growth came in at 70%. With EPS falling by 3.2% in the first half of 2022 and analysts predicting further growth of less than 1% for the remainder of the year, we see profits growing at a slower pace in 2022. We foresee US companies' overall profit margins, continuing to come under pressure, with higher labor and input costs, rising interest rates and a slowdown in sales.



Are we in a recession?

A FactSet survey on the number of S&P 500 companies using the term *recession* within their earnings conference calls, from 15th June – 8th September 2022, showed 240 companies citing the term. This is the highest number of S&P 500 companies using the term, since 2010 (refer to graph below).



According to research firm Ned Davis (A global provider of independent investment research), there is now a 98% chance of a global recession. It cites the following factors:

- US Dollar ("*USD*") Strength: As the Fed has increased interest rates continuously, it has increased the value of the US Dollar, relative to all other global currencies. Globally, this has made fuel and food more expensive to import.
- Bellwether corporates (*Corporates seen as leading indicators for economic and market trends*) reducing earnings expectations: US companies including FedEx and Dow Chemicals, have reported lower 3rd quarter earnings and reduced the earnings for their outlook statement.

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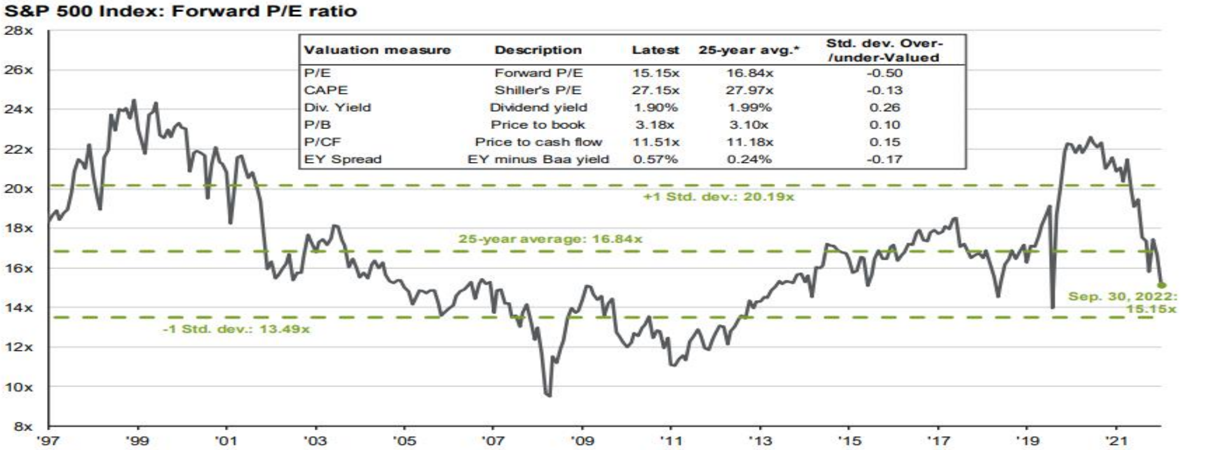
Other than bumper profits in the energy sector, analysts' EPS estimates (a lagging indicator) for the third quarter 2022, have plunged 7 per cent in the past three months.

Whilst in the past 11 months stocks have been sold off periodically, there has been no big capitulation event. Similarly, the bear market of 1982 never reached a culmination point. To bottom out, the market requires two things: stable earnings expectations and stable valuation multiples.

For earnings expectations to stabilize, it first needs to come down. On average, a recession means EPS are likely to fall a further 17 per cent. With companies talking down guidance's for next year (and therefore prices), earnings expectations continue to decline. This cements the foundation of an economic recession. Stable multiples will be derived from a clear inflation and rates trajectory. Multiples (refer below) have already come down, with the S&P down 22.4% year-to-date, its worst year since 2008.

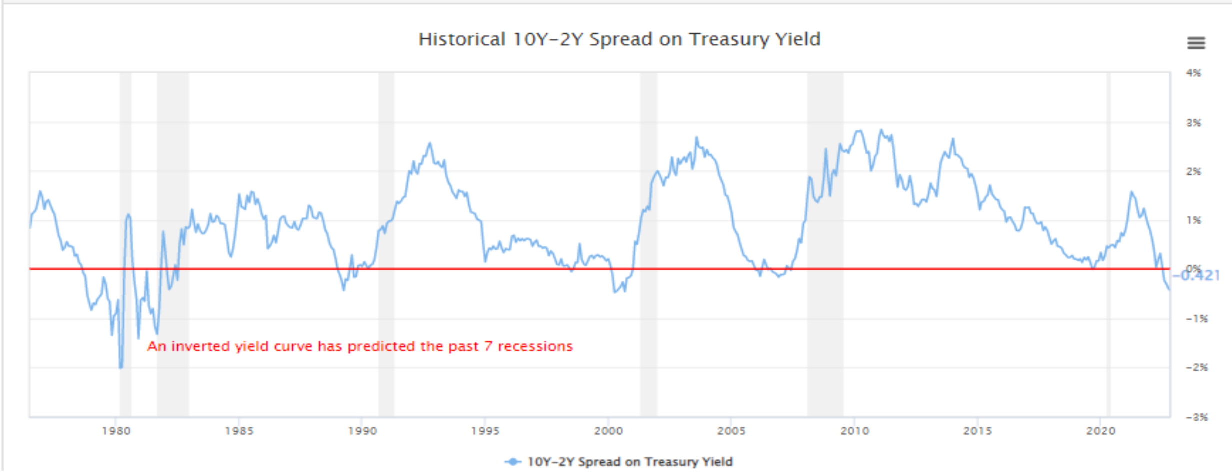
S&P 500 valuation measures GTM | U.S. | 5



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	15.15x	16.84x	-0.50
CAPE	Shiller's P/E	27.15x	27.97x	-0.13
Div. Yield	Dividend yield	1.90%	1.99%	0.26
P/B	Price to book	3.18x	3.10x	0.10
P/CF	Price to cash flow	11.51x	11.18x	0.15
EY Spread	EY minus Baa yield	0.57%	0.24%	-0.17

US treasury rates have risen with the 10-year US treasury at 4,06% (its highest level in 14 years) and 2-year yield is presently 4,45% which has resulted in a negative treasury spread of -0,39%. As discussed in *Global equity perspectives, The treasury spread,* a negative treasury spread has been indicated in all the past 7 major recessions.

Historical 10Y-2Y Spread on Treasury Yield



As we enter the 4th quarter for 2022, we continue to anticipate a recession next year, mild or severe.

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