8 Reasons for Optimism in U.S. Stocks

Around the world, economies are slowing, with some developed markets likely already in recession, thanks in no small part to tightening monetary policies. Nowhere is this more apparent than in the United States, where the U.S. Federal Reserve (Fed) has moved more aggressively than in any other rate-rising period since the 1970s.

Against this backdrop, and recognizing that interest-rate changes can have a lagged impact on the economy and corporate profitability, it may take some imagination to paint a constructive scenario for the U.S. stock market. While we are not out of the woods yet, we are beginning to see some positive catalysts that could brighten the outlook.

Let’s review some reasons for optimism as we look ahead.

1. **Bearish sentiment is pervasive at both the corporate and individual investor level.** A challenging year for markets across many asset classes has led some corporations and investors to seek refuge in cash to ride out the volatility, where they are taking advantage of higher interest rates. As inflationary conditions improve, we could see corporations and investors step off the sidelines and move back into U.S. stocks.

2. **Inflation, both nominal and core, should continue to slow.** Consumer price increases eased in October and November, a sign that persistent inflation may be slowing. While it will take time for inflation to return to more normalized levels, new data is encouraging and indicates that the economy may have moved past peak inflation.

3. **The U.S. economy continues to show positive relative and absolute strength, with consensus expectations for positive gross domestic product (GDP) growth in the fourth quarter of 2022.** We continue to see some tailwinds for economic growth, including tight labor markets that support wage growth and consumer spending, and relatively healthy balance sheets for both companies and consumers.

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4. **Supply-chain bottlenecks and freight rates should continue to ease.** Trucking is the largest input into shipping costs across the U.S. economy, and trucking spot rates continue to ease. The fall in spot rates should meaningfully curtail the pricing power of transportation providers in 2023. This could benefit shippers by reducing their costs and also ease supply-chain bottlenecks.

5. **Gridlock will likely prevail in U.S. politics.** With Donald Trump declaring his candidacy for president in 2024 and President Joe Biden saying he intends to run again, expect turmoil in U.S. politics as both the Democratic and Republican parties point fingers and question the other party’s candidate. The turmoil, and a split Senate and House of Representatives, will likely lead to gridlock, which tends to create stability for stocks.

6. **The stock market is thought to be a leading economic indicator by six to nine months.** If we believe that the U.S economy will bottom in the next 12 to 18 months, it is very likely, in our opinion, that the stock market could react positively six to nine months earlier. This suggests that we could witness a material recovery before the end of 2023.

> We believe we could witness a material stock-market recovery before the end of 2023.

7. **A true “pivot” by the Fed, should inflation metrics demonstrate consistent monthly declines, could ignite a sustained market rally.** The Fed started slowing the pace of monetary policy tightening earlier in December. Should the Fed reach its neutral monetary policy sometime in 2023, this could bode well for U.S. stocks.

8. **Quality investments should perform relatively better as investors navigate these uncertain times.** In this evolving environment, we believe high-quality companies that generate market-leading returns on capital and have a differentiated set of products or services—and can adjust pricing based on the differentiated value they provide their customers—are better positioned to meet the challenges ahead.

Leaning Into Quality

No one rings a bell at the bottom; it’s always darkest before the dawn. We are not explicitly calling for the equity markets to bottom in 2023. However, we believe that the risk/reward balance has improved given the valuation reset and market decline of 2022. In other words, a lot of bad news has already been factored into stock prices.

Our suggestion for longer-term investors: lean into it!

As we look ahead, we see opportunities across our investment universe. Our quality investment approach seeks to invest in durable business franchisees, which we define as companies that can drive revenue and earnings growth more consistently than their peers, regardless of the economic backdrop. As mentioned in No. 8 above, those tend to be companies that have a differentiated set of products or services relative to their competitors and are positioned to meet many of the challenges mentioned above, such as higher input costs. Furthermore, higher-quality investments generally did not outperform for much of 2022, resulting in compelling valuations for these businesses as we look ahead.

We can’t tell you exactly when or how share prices will bounce back, but what we do know from experience is that company fundamentals matter over the course of the market cycle and the opportunity offered by higher-quality companies may be looming large in front of us.

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