Rosenberg Research

Strategizer

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A Monthly Guidebook for Active Investors | February 2022

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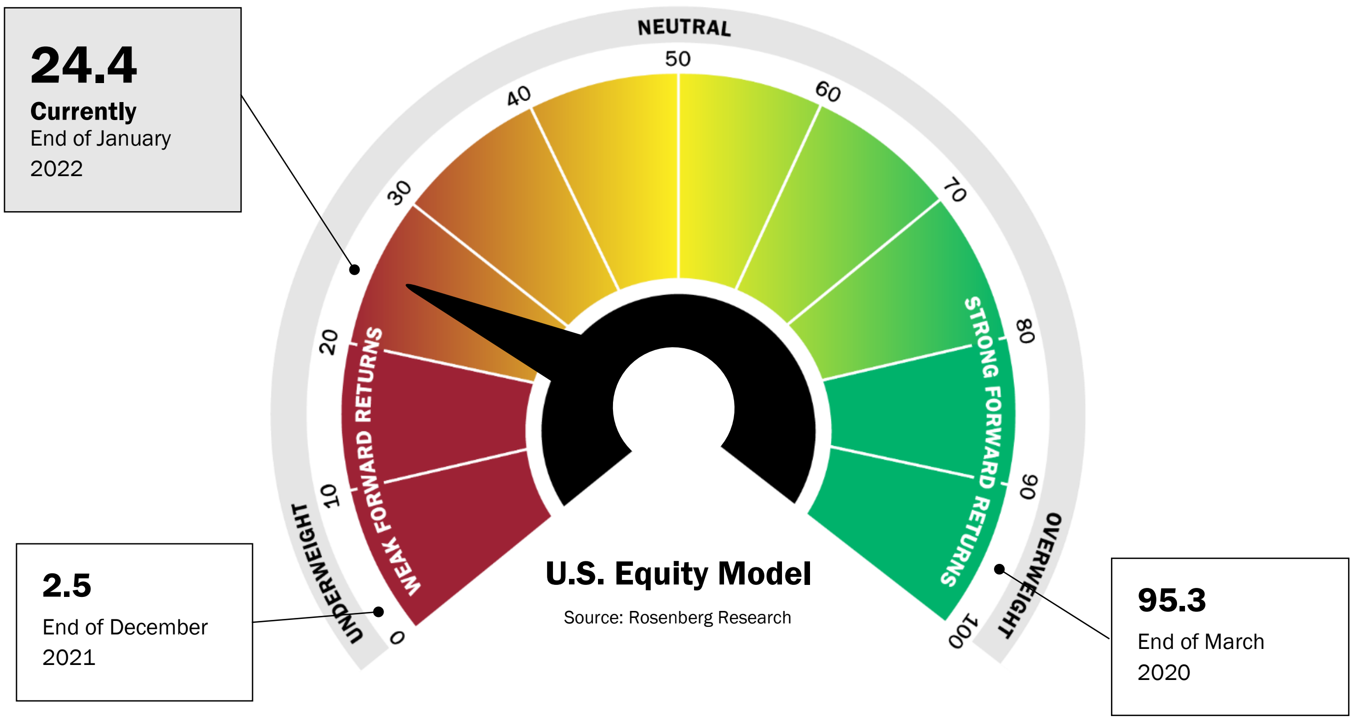


HIGHLIGHTS

Despite the recent sell-off, our message is the same for equity investors: focus on ex.-U.S. exposure where valuations are more favorable

As such, we remain underweight on the U.S. equity market, although there was a notable upgrade to our model's score this month

According to our duration model, the recent up-move in Treasury yields is overdone, leading to a counter-consensus overweight call

Conversely, our U.S. dollar model is quite bearish, suggesting a declining profile over the next year, particularly against the Japanese yen and, to a lesser extent, the euro

In our monthly theme, we look at the challenging start to 2022, and how the most expensive stocks have fared the worst

Our research strongly suggests that investors should be focused on parts of the equity market that have retained earnings visibility in this period of heightened uncertainty and have the most alluring valuation support

Contents

Summary of Our Models' Key Views

Equities

- **After the recent sell-off, which we had been calling for, *Strategizer's* equity models have become more constructive about forward return prospects**
- In particular, there are a couple of items worth highlighting: i) our model for Asia flipped to overweight from neutral and ii) Canada is looking increasingly attractive
- **In contrast, we remain underweight on the U.S.**, although there was a notable upgrade to our model's score (now 24.4 from 2.5 at the end of December)
- Thus, our overarching message is that, while the U.S. market looks more attractive than it did at our last update, it is not yet at a level that we feel is a strong entry point
- **Instead, we believe long-term equity investors should continue to focus on ex.-U.S. exposure**, where the valuations backdrop is considerably more favorable

Treasuries

- With the recent move higher in yields, **our Treasury bond duration model has a counter-consensus overweight call**
- This reflects a combination of: i) depressed positioning; ii) bearish sentiment; and iii) oversold technicals, all of which are contrarian positives
- **Furthermore, we expect inflationary pressures to have peaked and thus inflation rates are set to subside in the coming months/quarters**
- Against this backdrop, it has generally been prudent to have above-average duration exposure

Currencies

- ***Strategizer's* U.S. dollar model, with a score of just 11.6, retains a have a negative outlook**
- Beyond exceptionally crowded positioning (99th percentile), valuations (99th percentile) also represent a key headwind
- **However, we are not calling for broad-based U.S. dollar weakness** — while we expect the yen and euro to rally against the greenback, we are looking for the Canadian dollar and British pound to decline over the next 12 months

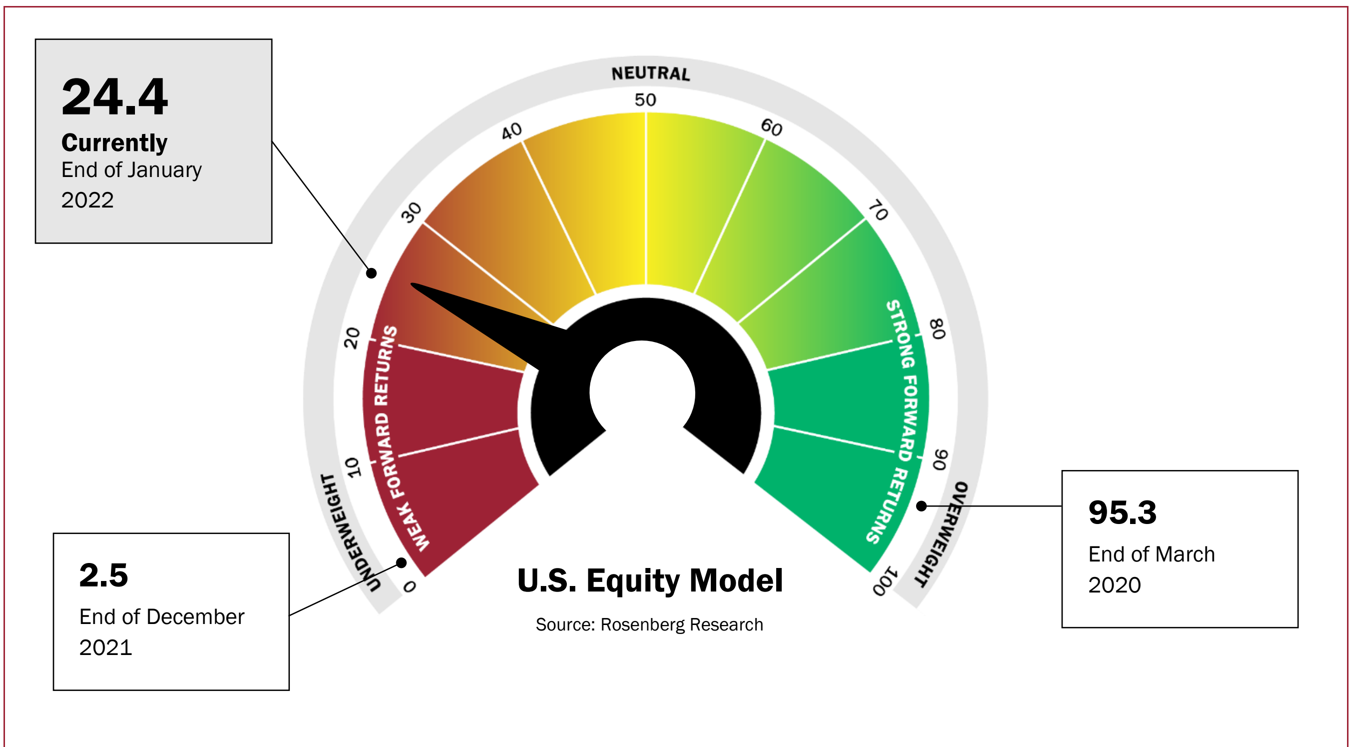
Equity Models

Highlights

- *Strategizer's* U.S. equity model correctly predicted that the market was vulnerable and due for a pullback
- This ended up foreshadowing a 10% peak-to-trough decline (so far) in the S&P 500, the first real setback since September 2020
- However, we still believe an underweight position is warranted on the U.S. equity market — in our view, the corrective phase hasn't run its course even though the model scoring became less negative this past month
- Conversely, our ex.-U.S. equity models point to an increasingly favorable risk/reward profile, suggesting investors should make international exposure a point of emphasis within their portfolio

U.S. Equities: Still Underweight Despite the Sell-off

Our U.S. equity model entered the year extremely bearish as rich valuations, crowded positioning and ebullient sentiment combined to create a backdrop that has historically been unfavorable for returns. This was further complicated by the Fed's hawkish pivot, thus removing a key source of support (ample liquidity) in the market's rally off the March 2020 lows. Ultimately, as we expected, the S&P 500 ended up experiencing a peak-to-trough decline of about 10% (so far), and finished the month with its worst performance since March 2020 (even with the late-month rally off the lows). While this development represented a much-needed reset, **we do not believe the corrective phase has fully run its course**, and thus our model continues to believe an underweight position is warranted.



U.S. Equity Model

Source: Rosenberg Research

As shown below, the improvement to our model's score this month (now 24.4 from 2.5 last month) has taken our 12-month return expectation to just under 10% from levels at the end of January. **In essence, this implies the S&P 500 will finish the year little changed, which would represent a considerable softening relative to its pace over the past two years (+21.4% annualized).** Also, note that the +9.7% return forecast is below the median (+11.4%) over our sample period (2006 onwards). In other words, even with the sell-off, our model is still calling for below-average returns. **For us to turn more bullish, we will need to see a further improvement in valuations as well as less crowded positioning.**

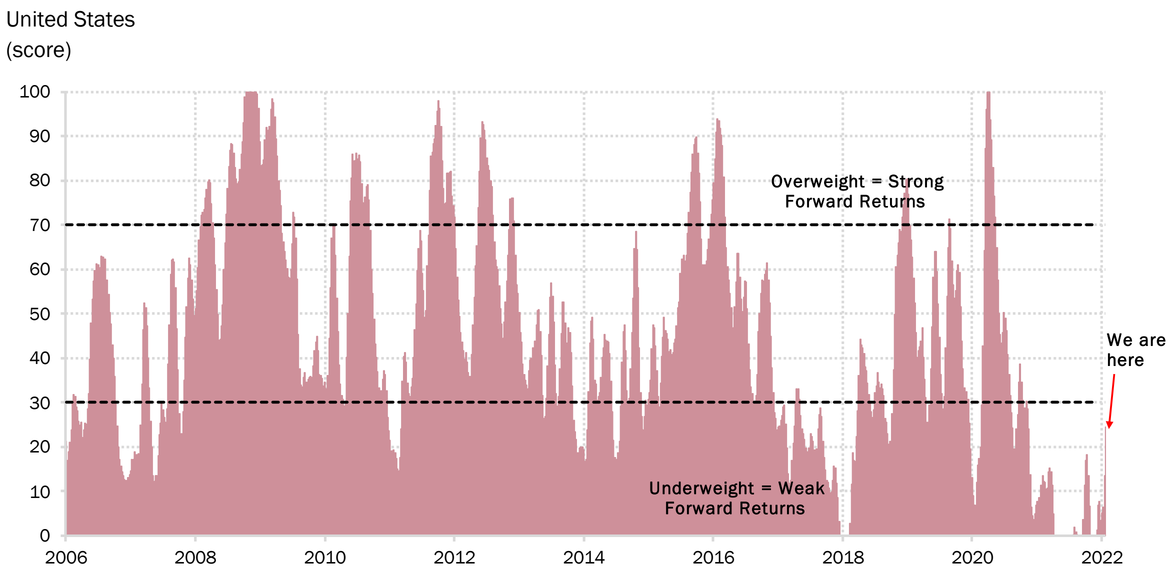
What Our U.S. Equity Model is Predicting for S&P 500 Returns

We are here

	Model Score Ranges							
	<10	<20	20 to 40	40 to 60	60 to 80	>80	>90	
Period	Forward Returns							Median
13 Weeks	-0.8%	1.8%	2.9%	3.8%	5.6%	6.3%	7.0%	3.3%
26 Weeks	3.2%	3.9%	4.4%	6.2%	7.4%	10.9%	12.0%	5.4%
52 Weeks	2.3%	4.9%	9.7%	12.6%	13.8%	21.1%	24.2%	11.4%

Source: Rosenberg Research

U.S. Equity Model Historical Values: Modest Improvement, But Still Quite Negative



Source: Rosenberg Research

Value has exhibited good relative strength versus growth and our sector ranks are suggesting investors should stick with this theme. Note that this view is largely informed by the fact that valuations are considerably more attractive for value (16.7x forward P/E) compared to growth (24.7x forward P/E). Given the Fed's hawkish pivot, **we believe high multiple companies/sectors are especially vulnerable as liquidity is removed, hence our preference for segments of the market that look more attractively priced.** Admittedly, while our Treasury model is bullish on duration — which would ordinarily favor growth over value — we believe the valuations overhang will more than offset any positive windfall from lower bond yields.

This month, our U.S. equity model's top picks are: Energy, Materials, Financials and Industrials (all sectors that have a value tilt). Energy, with an average rank of 1.25 across the four categories we measure (technicals, fundamentals, valuations and positioning) is by far and away our top call. This reflects a continued move higher in oil prices (WTI is trading at ~$90 per barrel, the highest it has been since mid-2014) as well as ongoing capital discipline amongst producers. Together, these dynamics will ensure strong free cash flow growth and thus favorable payouts to investors going forward.

Materials has an average rank of 4.25, helped in large part by its favorable ranking on valuations (tied for first with Energy). For example, the sector trades at a 15.8x forward P/E ratio, a considerable discount to the broader S&P 500 (20.0x), and below its average for the last 10 years (16.5x). **In our view, this represents an attractive entry point, especially considering it was trading closer to a 20x forward earnings multiple at this time last year.**

After Energy and Materials, there are no clear-cut top picks. While Financials and Industrials (both with an average rank of 5.25) slightly edged out Health Care (5.50) and Real Estate (5.75) it is by no means convincing. Thus, although we are inclined to overweight Financials and Industrials (given the strength of the value trade and their slightly higher score) we also fully understand the appeal of more defensive sectors (such as Health Care and Real Estate) given the anticipated slowdown in economic activity.

U.S. Equity Sector Ranks: A Preference for Value

United States

	Technicals	Fundamentals	Valuations	Positioning	Average Rank	Overall Rank
Energy	1	1	1	2	1.25	1 (1)
Materials	5	3	1	8	4.25	2 (2)
Financials	4	9	4	4	5.25	3 (7)
Industrials	8	2	8	3	5.25	3 (5)
Health Care	7	6	3	6	5.50	5 (4)
Real Estate	6	6	6	5	5.75	6 (3)
Consumer Staples	2	9	7	6	6.00	7 (6)
Communication Services	10	8	5	1	6.00	7 (8)
Technology	9	5	11	8	8.25	9 (9)
Utilities	3	11	9	10	8.25	9 (11)
Consumer Discretionary	11	4	10	11	9.00	11 (10)

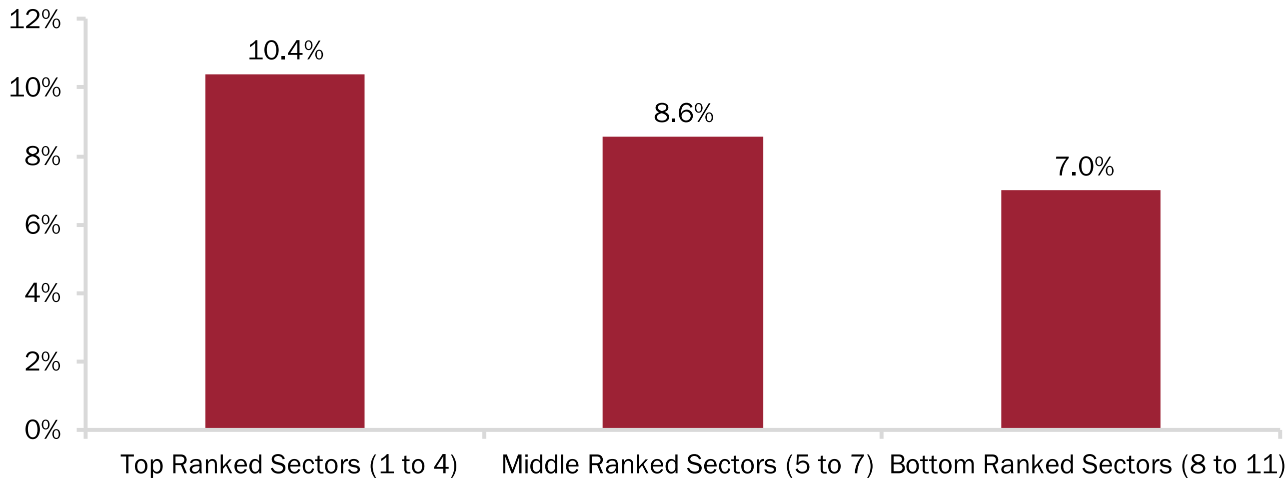
Note: i) lower rankings denote strength whereas higher rankings denote weakness and ii) values in brackets indicate prior month ranking

Source: Rosenberg Research

Historically, our top-ranking sectors (1 to 4) have produced above-average returns whereas our bottom-ranking sectors (8 to 11) have produced below-average returns (see below). **In the case of the S&P 500, our top four ranking sectors had a median 52-week forward return of 10.4% whereas our bottom four sectors had a return over the same period of 7.0%.**

Median 52-Week Forward Returns by Sector Ranking in our U.S. Equity Model

United States
(percent change)

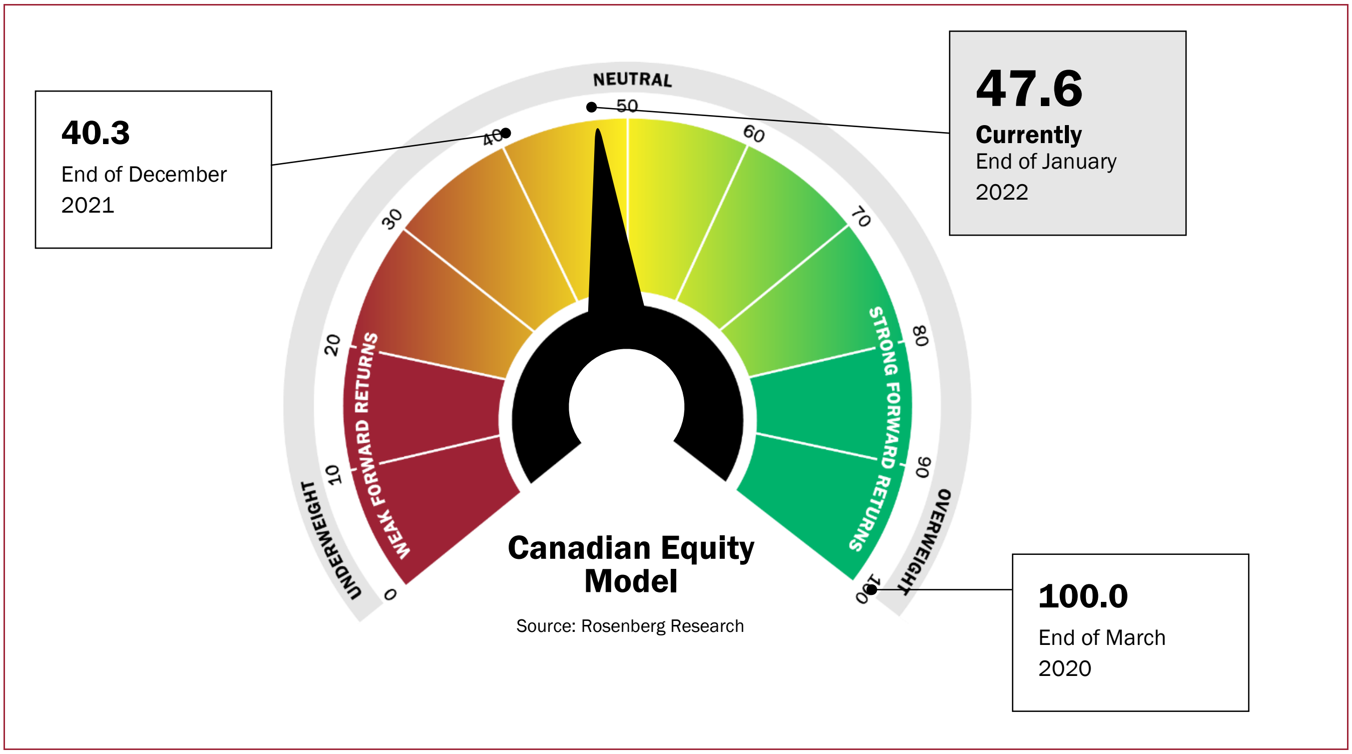


Current ranks are as follows: Energy (1), Materials (2), Financials (3), Industrials (3), Health Care (5), Real Estate (6), Consumer Staples (7), Communication Services (7), Technology (9), Utilities (9), Consumer Discretionary (11)

Source: Rosenberg Research

Canadian Equities: Firmly in Neutral Territory

Strategizer's Canadian equity model is becoming increasingly constructive, now up to 47.6 from 40.3 at the end of December. Note that this is the most positive our model has been since the middle of 2020 alongside a meaningful improvement in valuations. Indeed, the S&P/TSX Composite now trades at 14.5x forward earnings, below-average for the last 10 years, and the steepest discount (relative to the S&P 500) on record. In addition, in light of recent weakness in growth stocks, the Canadian equity market (with its low weight in Technology) is better positioned to weather a period of multiple compression.



At current levels (47.6), our Canadian equity model is forecasting returns (price only) of 4.5% over the next 12 months. This is consistent with the median return (+4.5%) over our sample period (since 2006), informing our neutral weight on the S&P/TSX Composite.

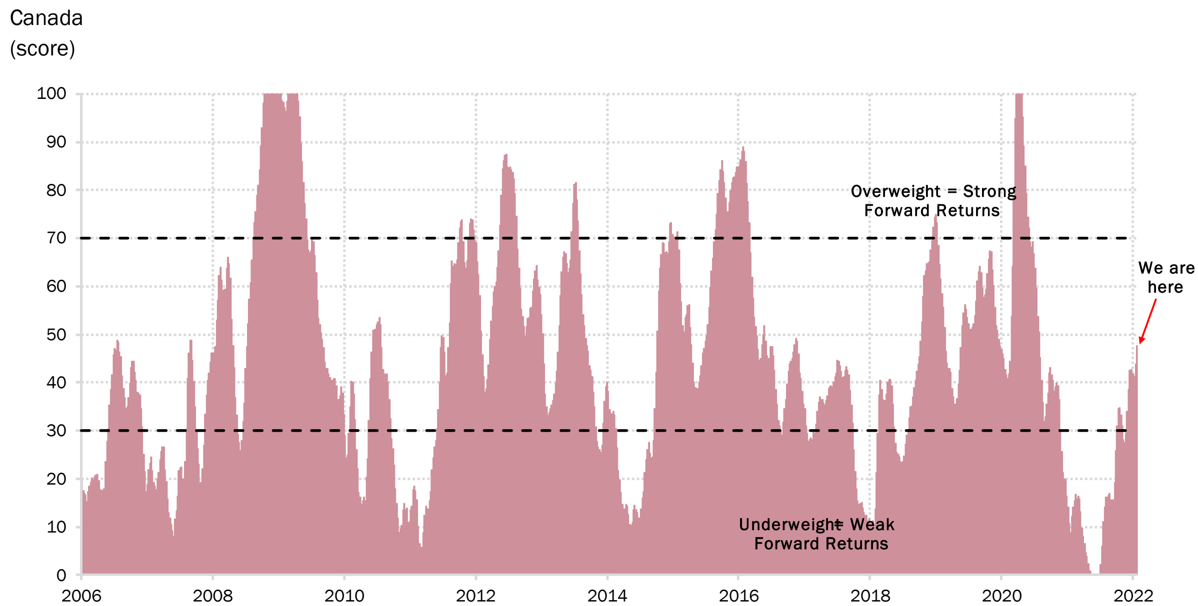
What Our Canadian Equity Model is Predicting for TSX Returns

We are here

	Model Score Ranges							
	<10	<20	20 to 40	40 to 60	60 to 80	>80	>90	
Period	**Forward Returns**							**Median**
13 Weeks	-3.2%	-0.4%	1.1%	1.9%	3.7%	6.5%	10.2%	2.0%
26 Weeks	0.4%	0.0%	1.7%	3.5%	3.3%	13.1%	20.9%	2.7%
52 Weeks	-6.4%	-0.6%	3.7%	4.5%	5.7%	22.8%	31.5%	4.5%

Source: Rosenberg Research

Canadian Equity Model Historical Values: Continuing to Trend Higher



Source: Rosenberg Research

Our top-rated sectors in Canada this month are: Energy, Financials, Real Estate and Materials. Outside of Communication Services, Energy has the most attractive dividend yield (3.9%) of any sector. However, it is expected to see dividend growth of 7.5% (annualized) compared to 4.6% for Communication Services. **Thus, Energy has the best combination of current dividend yield and future dividend growth, providing investors with a very compelling income stream in today's low interest rate world.**

***Strategizer* has had Financials as a top pick each and every month over the past year. This has been a great trade thus far, and we think it has room to run.** In particular, the sector screens very well from a technicals perspective (we have it ranked first overall), but also benefits from favorable scores on positioning and, to a lesser extent, valuations and fundamentals.

Due in part to the upward pressure on government bond yields, Real Estate has been range-bound over the past several months. **However, with the economy now re-opening after capacity measures were implemented to curtail the spread of the omicron variant, the sector once again looks appealing.** In addition, there is already a lot of BoC tightening priced in by the bond market, meaning the "bad news" on this front is already accounted for.

Finally, Materials (mostly gold names in Canada) rounds out our list of top picks. We have the sector ranked first from a valuations perspective (it trades at a forward P/E of only 11.7x), which is the biggest reason for our favorable assessment. **In addition, if our U.S. dollar model is correct that we are due for a period of dollar weakness, then this should also serve as a key source of support** (due to the high weighting of gold names, which tend to move inversely to the U.S. dollar).

Current Canadian Equity Sector Ranks: Energy and Financials Remain Our Top Picks

Canada

	Technicals	Fundamentals	Valuations	Positioning	Average	Overall Rank
Energy	2	2	2	4	2.50	1 (2) ↑
Financials	1	4	4	2	2.75	2 (1) ↓
Materials	8	3	1	6	4.50	3 (3) →
Real Estate	6	1	7	4	4.50	3 (5) ↑
Consumer Staples	4	8	3	10	6.25	5 (4) ↓
Communication Services	3	10	10	3	6.50	6 (5)
Consumer Discretionary	5	7	5	11	7.00	7 (10) ↑
Health Care	10	11	6	1	7.00	7 (9) ↑
Utilities	7	9	8	8	8.00	9 (7) ↓
Industrials	9	5	11	7	8.00	9 (8) ↓
Technology	11	6	9	9	8.75	11 (11) →

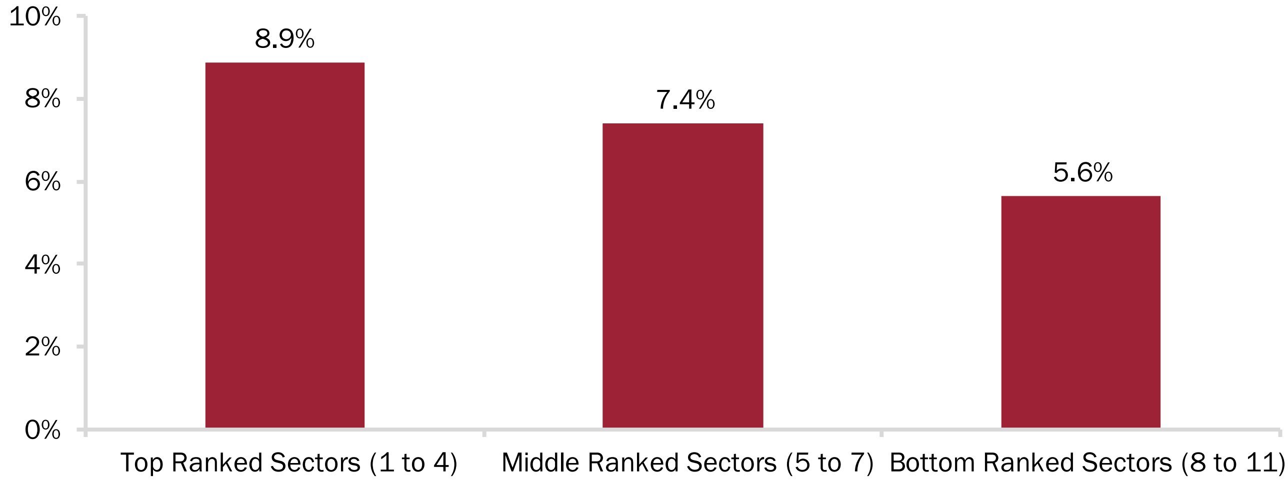
Note: i) lower rankings denote strength whereas higher rankings denote weakness and ii) values in brackets indicate prior month ranking

Source: Rosenberg Research

For reference, below are the backtest results of our top ranking (1 to 4) and bottom ranking (8 to 11) sectors within the TSX. **Our highest-ranking sectors have historically returned 8.9% on a 52-week basis versus 5.6% for our lowest ranking sectors.**

Median 52-Week Forward Returns by Sector Ranking in Our Canadian Equity Model

Canada
(percent change)

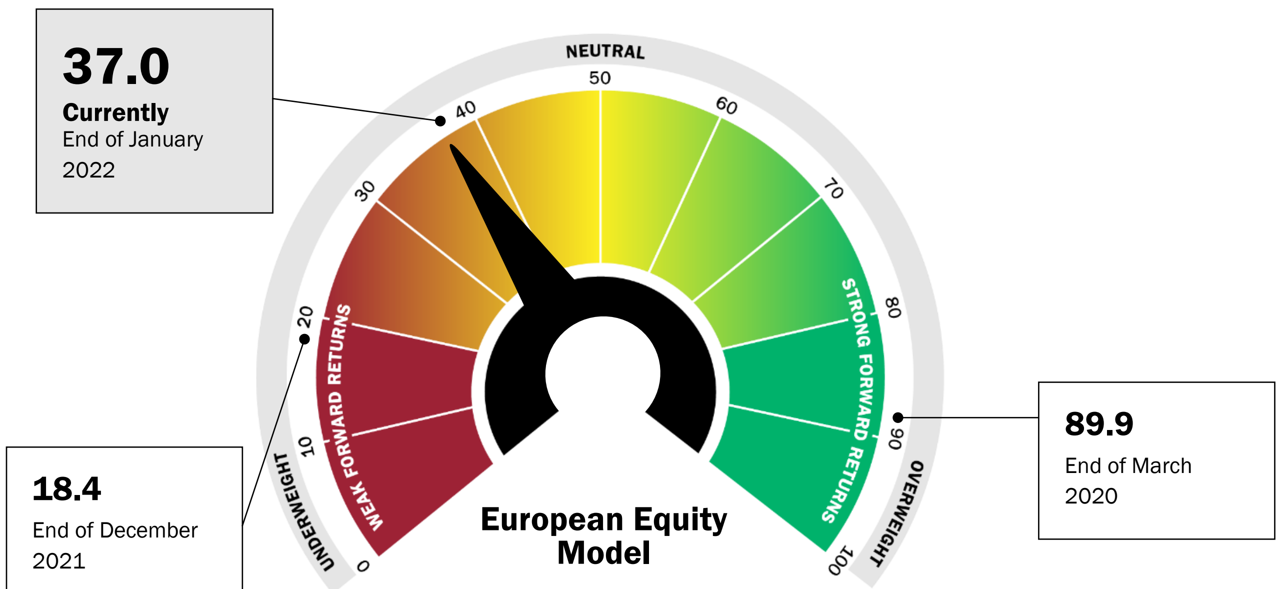


Current ranks are as follows: Energy (1), Financials (2), Materials (3), Real Estate (3), Consumer Staples (5), Communication Services (6), Consumer Discretionary (7), Health Care (7), Utilities (9), Industrials (9), Technology (11)

Source: Rosenberg Research

International Equities: A Big Improvement in Asia and Europe

Our European equity model's score improved meaningfully during the month — up to 37.0 from 18.4 at the end of December. That being said, while we have a strong preference for ex.-U.S. exposure, we believe Europe is less appealing than either Asia or Canada. This is due to elevated positioning and sentiment, which are contrarian negatives and argue for weaker returns (all else being equal).



Source: Rosenberg Research

With a score of 37.0, our model is still forecasting negative returns (-1.9%) over the next 12 months. This is why, internationally, we prefer Asia and Canada. However, note that our European equity model is on the high-end of our 20 to 40 bucket and thus on the verge of seeing a meaningful upgrade to its expected return profile (+4.2%). **Should this occur, we would turn more constructive on the region.**

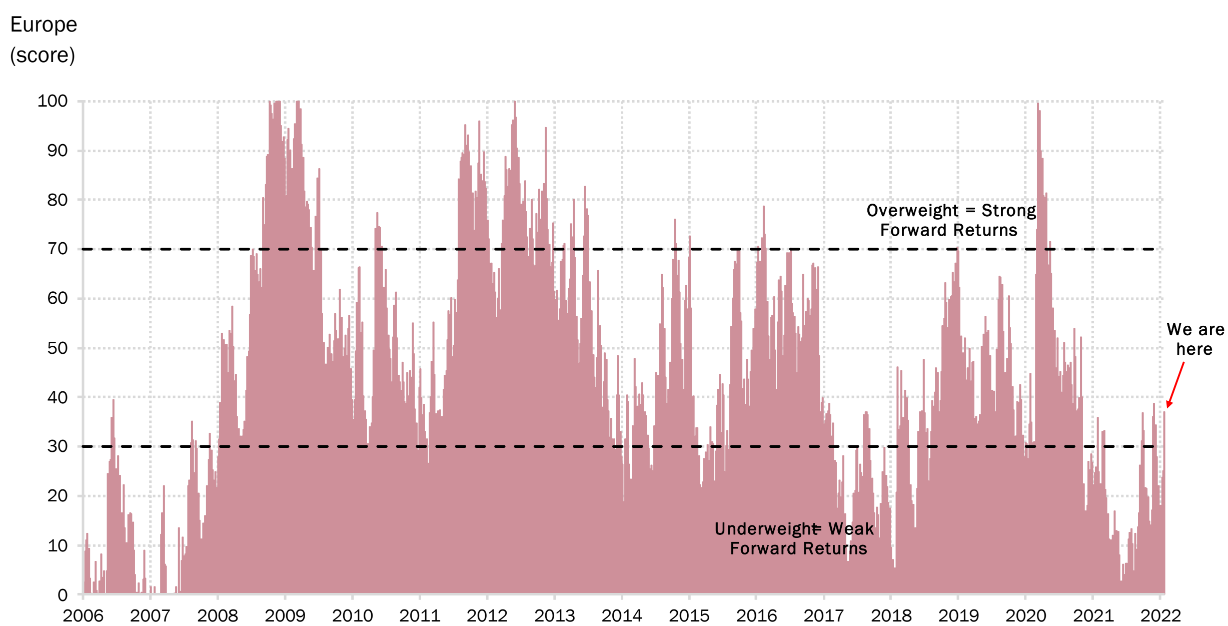
What Our European Equity Model Is Predicting for Stoxx 600 Returns

We are here

	Model Score Ranges							
	<10	<20	20 to 40	40 to 60	60 to 80	>80	>90	
Period	Forward Returns							Median
13 Weeks	-4.6%	-2.7%	-0.2%	1.5%	4.8%	8.1%	12.6%	1.9%
26 Weeks	-2.0%	-2.1%	-1.2%	4.5%	8.1%	11.5%	17.4%	2.5%
52 Weeks	-6.3%	-3.3%	-1.9%	4.2%	13.4%	18.8%	25.1%	6.3%

Source: Rosenberg Research

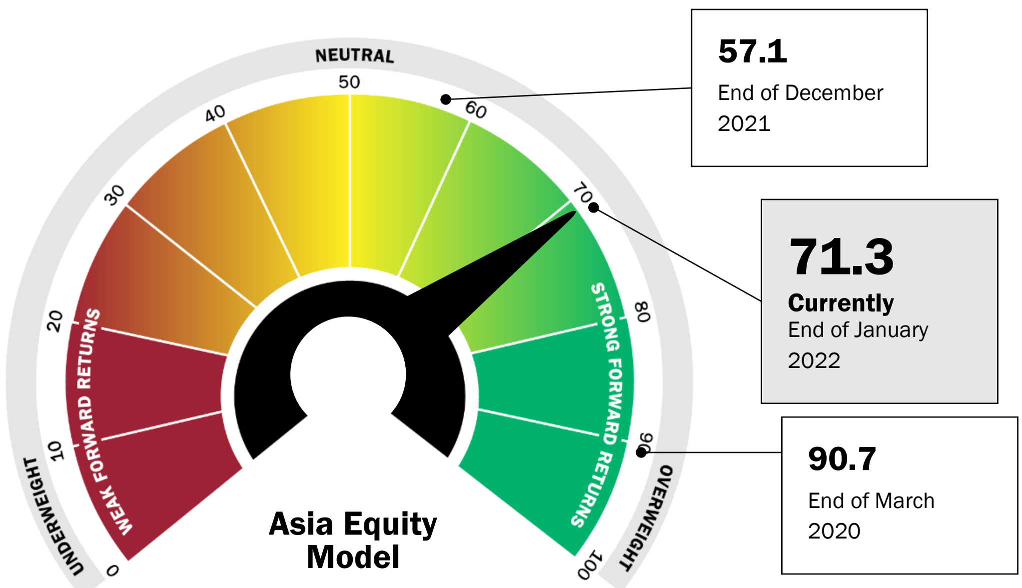
European Equity Model Historical Values: Big Improvement this Month



Source: Rosenberg Research

In contrast, Asia is an area we would feel increasingly comfortable shifting exposure towards. Indeed, *Strategizer's* model for the region saw its score improve to 71.3 (highest since May 2020) from 57.1 at the end of December. For reference, the last time our model was this optimistic, the MSCI Asia Pacific Index went on to gain 42% over the next year. While this is not our forecast (we are looking for returns of ~10%), it does highlight the increasingly attractive risk/reward profile.

Admittedly, China's heavy-handed approach to handling the pandemic has weighed on economic activity in the region (and, by extension, earnings growth). However, one positive element of this is that it has forced the PBOC into an easing posture. With the Fed signalling a desire to rapidly remove accommodation, we believe investors should shift exposure away from areas where liquidity is being restricted (the U.S.) to areas where it is being loosened (Asia). **After all, if the post-Financial Crisis period has taught us anything, it is that easing by central banks can provide tremendous support to risk assets even in the context of lacklustre GDP growth.**



Source: Rosenberg Research

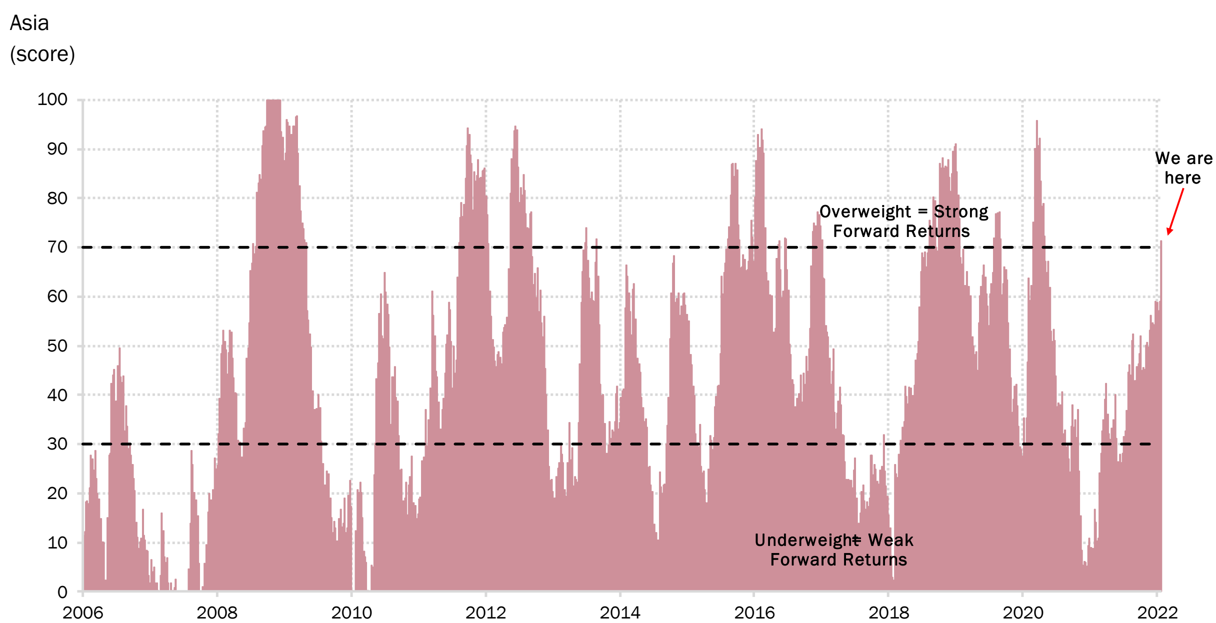
Below are the median forward returns for the MSCI Asia Pacific Index at different model scores. As you can see, **at similar levels in the past, returns have amounted to 9.8% (price only) over the next year.**

What Our Asia Equity Model Is Predicting for MSCI Asia Pacific Returns

	Model Score Ranges				We are here			
	<10	<20	20 to 40	40 to 60	60 to 80	>80	>90	
Period	**Forward Returns**							**Median**
13 Weeks	-0.4%	1.4%	1.8%	2.9%	2.5%	3.9%	3.4%	2.3%
26 Weeks	-2.8%	-1.9%	1.6%	3.1%	6.5%	8.6%	12.9%	3.0%
52 Weeks	-7.0%	-1.4%	3.5%	6.6%	9.8%	16.8%	25.4%	6.1%

Source: Rosenberg Research

Asia Equity Model Historical Values: Now Recommending an Overweight Position



Source: Rosenberg Research

Treasury Bond Duration Model

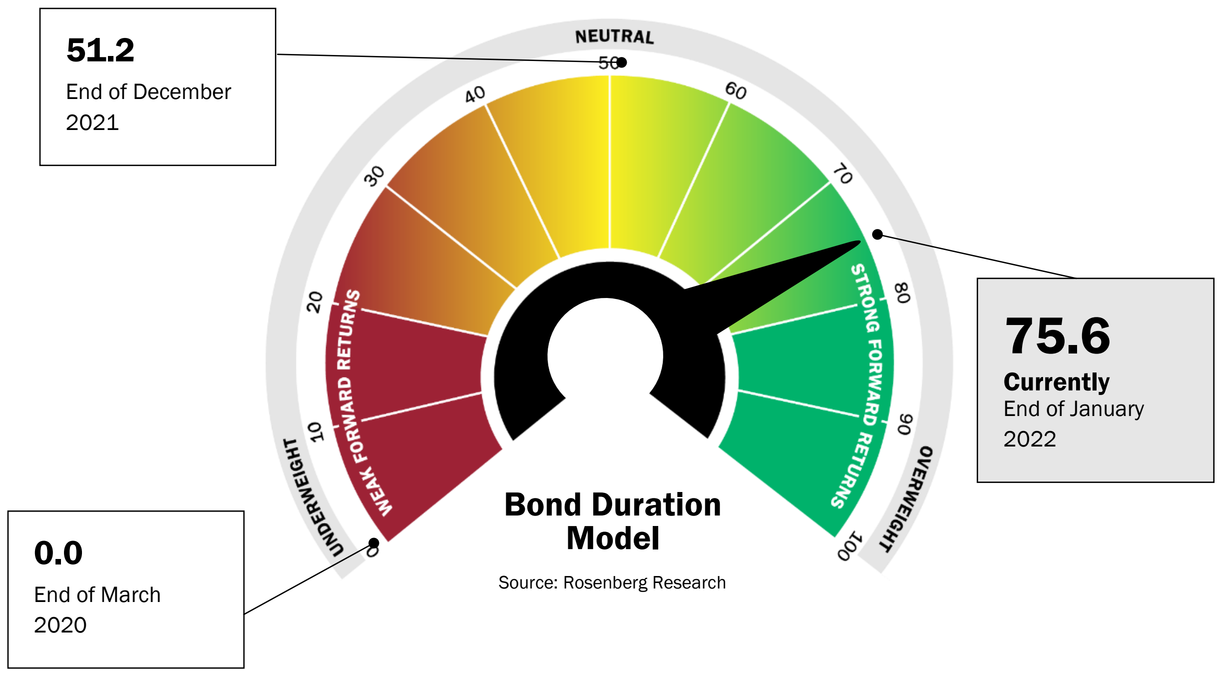
Highlights

- After the recent up-move in Treasury yields, our bond duration model has flipped overweight
- While valuations remain an ongoing headwind, this is more than offset by a number of positive forces
- Notably, sentiment is extremely bearish and market positioning has moved to an extreme negative posture, both of which have tended to foreshadow above-average returns in the past
- In addition, the Fed's hawkish pivot is now priced in, meaning a key catalyst behind the move higher in yields has already played out

After spending the past two months in neutral terrain, our Treasury bond duration model flipped overweight at the end of January — now 75.6 versus 51.2 previously. We fully appreciate this is a counter-consensus call, especially in light of the Fed's hawkish pivot, but **history tells us that long-dated Treasury yields fall, not rise, when Quantitative Easing (QE) comes to an end. In contrast, it is during QE periods when investors should look to minimize duration exposure.** This dynamic can be traced to the fact that risk appetite increases when the Fed engages in asset purchases, but fades when they pull back support. We saw this through QE1, QE2, and QE3, and we expect this time will be no different.

Admittedly, according to our model, unfavorable valuations (83rd percentile) remain an ongoing headwind. However, in addition to the fact that the Fed is ending QE, which has overwhelmingly been bullish for duration exposure, there are other key sources of support. Notably, sentiment is extremely bearish and positioning is light, both of which are contrarian positives. **Furthermore, the bond market has already priced in an aggressive rate hike path by the Fed, meaning a lot of the "bad news" on this front is already "in the price."**

Beyond this, there are also tentative indications that supply chain disruptions are easing, thus removing a key source of inflationary pressures. As an example, the ISM manufacturing PMI's supplier deliveries sub-index fell to its lowest level since November 2020, suggesting delivery times are improving. This should ultimately flow through to prices and lead to much slower growth in headline inflation measures. Against this backdrop (fading inflation), it has usually been a good time to have above-average duration exposure.



As shown below, at current model readings, returns have been slightly above average across all maturities. However, note that returns have been more favorable at the long-end of the curve (+10.6%) than the middle part of the curve (+6.2%), reinforcing our overweight call on duration.

What Our Bond Duration Model Implies for 5-7-Year Treasury Returns

We are here

	Model Score Ranges							
	<10	<20	20 to 40	40 to 60	60 to 80	>80	>90	
Period	Forward Returns							Median
13 Weeks	0.3%	0.5%	1.1%	0.9%	1.1%	1.4%	2.1%	1.0%
26 Weeks	1.1%	1.3%	2.0%	1.8%	2.5%	3.9%	6.0%	2.1%
52 Weeks	-0.7%	3.2%	4.5%	3.3%	6.2%	6.2%	8.0%	4.8%

Source: Rosenberg Research

What Our Bond Duration Model Implies for 10-Year Treasury Returns

We are here

	Model Score Ranges							
	<10	<20	20 to 40	40 to 60	60 to 80	>80	>90	
Period	Forward Returns							Median
13 Weeks	-0.4%	0.0%	1.6%	0.9%	1.3%	1.7%	3.2%	1.2%
26 Weeks	0.7%	1.3%	2.1%	2.6%	2.9%	5.1%	6.9%	2.7%
52 Weeks	-3.7%	3.5%	5.7%	4.4%	8.1%	7.3%	12.5%	6.0%

Source: Rosenberg Research

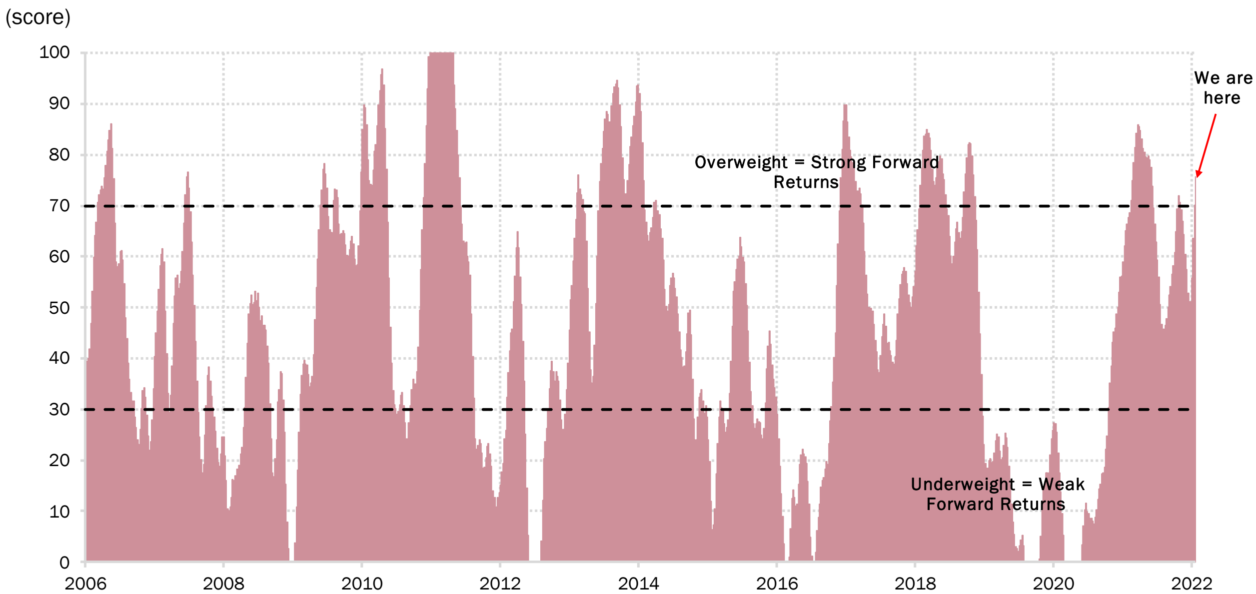
What Our Bond Duration Model Implies for 30-Year Treasury Returns

We are here

	Model Score Ranges							
	<10	<20	20 to 40	40 to 60	60 to 80	>80	>90	
Period	Forward Returns							Median
13 Weeks	-1.7%	-0.8%	2.1%	2.5%	2.4%	3.3%	5.0%	2.0%
26 Weeks	-1.4%	2.2%	2.4%	3.6%	4.1%	9.5%	11.8%	4.0%
52 Weeks	-6.6%	2.0%	5.6%	5.3%	10.6%	13.3%	29.3%	7.6%

Source: Rosenberg Research

Treasury Bond Duration Model Historical Values: Buying the Price Dip in Bonds



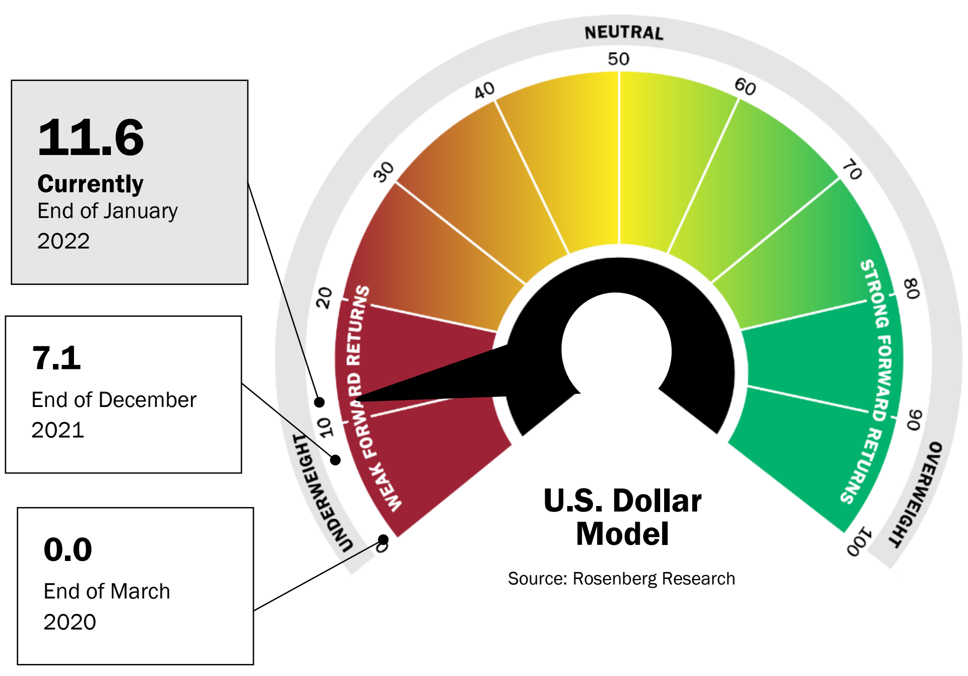
Source: Rosenberg Research

Currency Models

Highlights

- *Strategizer* continues to be negative on the U.S. dollar, with a score of just 11.6 this month
- While the Fed's hawkish pivot has provided support of late, in our view this trade now looks complete
- Thus, we expect very expensive valuations and exceptionally crowded positioning (both ranking in their 99th percentile) to now be the primary driving forces behind the greenback's path forward
- As a result, our model is forecasting the U.S. dollar will decline over the next 12 months

***Strategizer's* U.S. dollar model is negative about the currency's forward return prospects, with a score of just 11.6 this month.** Admittedly, although our call for dollar weakness over the last few months has proven premature, we were surprised by the extent of the Fed's hawkish pivot. **This has temporarily provided support for the U.S. dollar — on diverging central bank bets — but we believe this trade has now run its course.** As a result, our model is expecting the dollar to decline over the next 12 months, driven primarily by a combination of rich valuations and extended positioning (both categories rank in their 99th percentile historically).



Source: Rosenberg Research

As shown below, at current model readings (11.6), the DXY dollar index has tended to decline slightly over the next year. Thus, we believe investors should position their portfolio for U.S. dollar weakness — this means a focus on companies that derive a greater-than-average share of their revenues from overseas and therefore are able to take advantage of this tailwind.

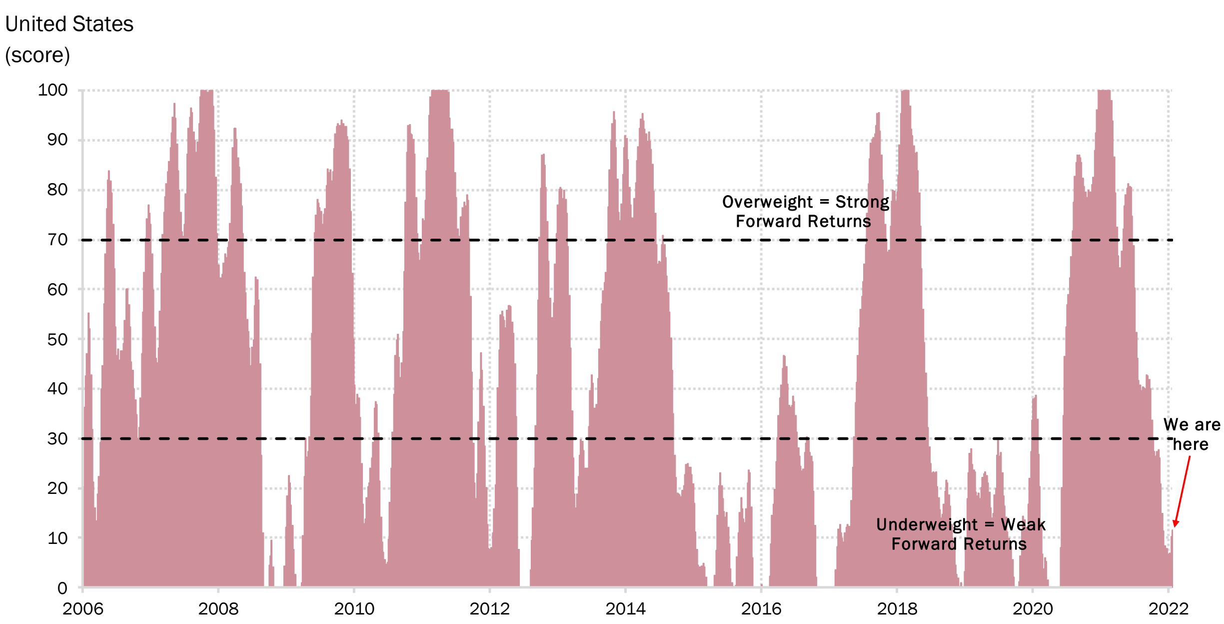
What Our U.S. Dollar Model Implies for 52-Week Returns for the DXY Dollar Index

We are here

	Model Score Ranges							
	<10	<20	20 to 40	40 to 60	60 to 80	>80	>90	
Period	**Forward Returns**							**Median**
52 Weeks	-2.3%	-1.6%	-1.1%	0.7%	4.0%	5.6%	6.2%	1.0%

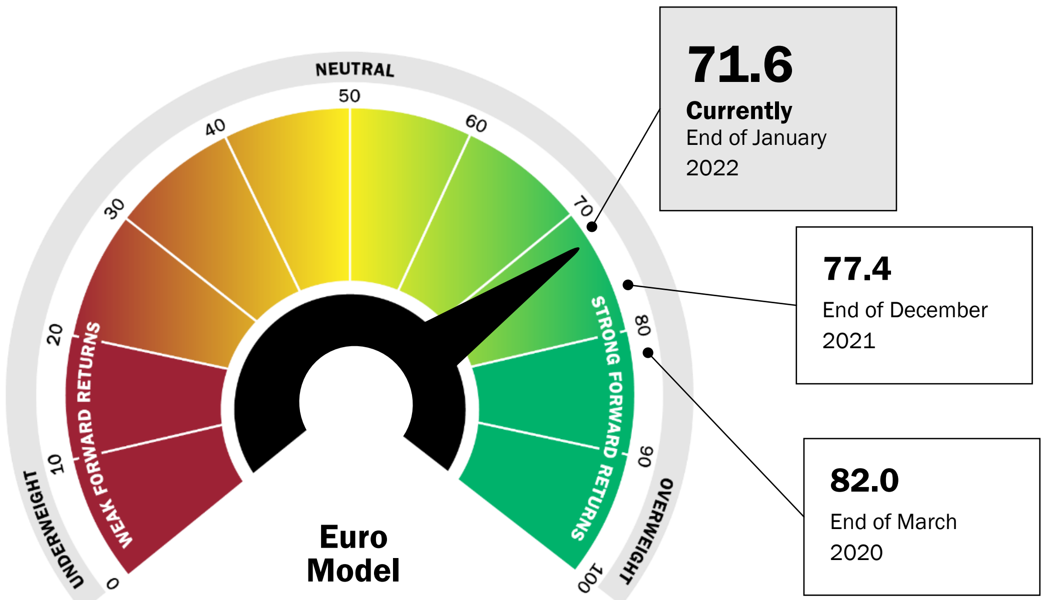
Source: Rosenberg Research

U.S. Dollar Model Historical Values: Still Quite Bearish



Source: Rosenberg Research

However, we do not expect the dollar to experience broad-based weakness. Instead, we believe the greenback looks vulnerable against certain currencies, meaning investors will have to opt for selectivity if they want to short the dollar. Notably, safe havens (like the Japanese yen and euro) have the greatest appreciation potential against the U.S. dollar based on our models. As a result, these would be good candidates for long positions against the greenback. Conversely, the Canadian dollar and British pound are expected to decline fractionally (versus the U.S. dollar) over the next 12 months.



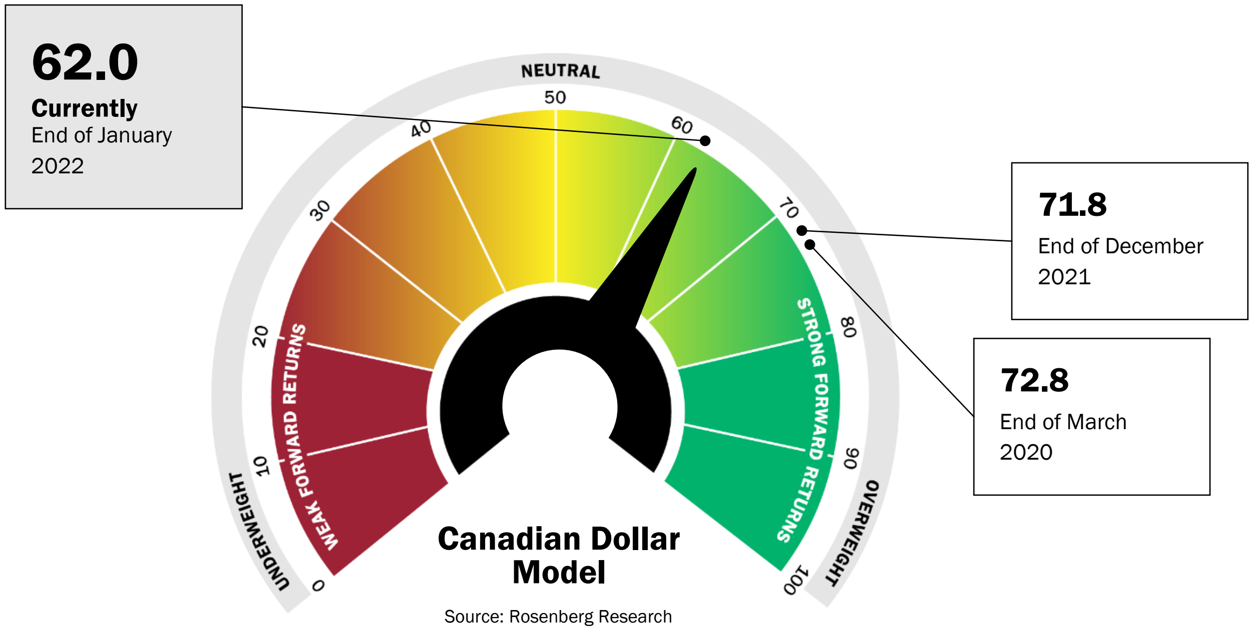
Source: Rosenberg Research

What Our Euro Model Implies for 52-Week Returns for EURUSD

We are here

	Model Score Ranges							
	<10	<20	20 to 40	40 to 60	60 to 80	>80	>90	
Period	Forward Returns							Median
52 Weeks	-8.1%	-8.0%	-1.7%	-0.2%	0.7%	4.7%	5.2%	-0.5%

Source: Rosenberg Research

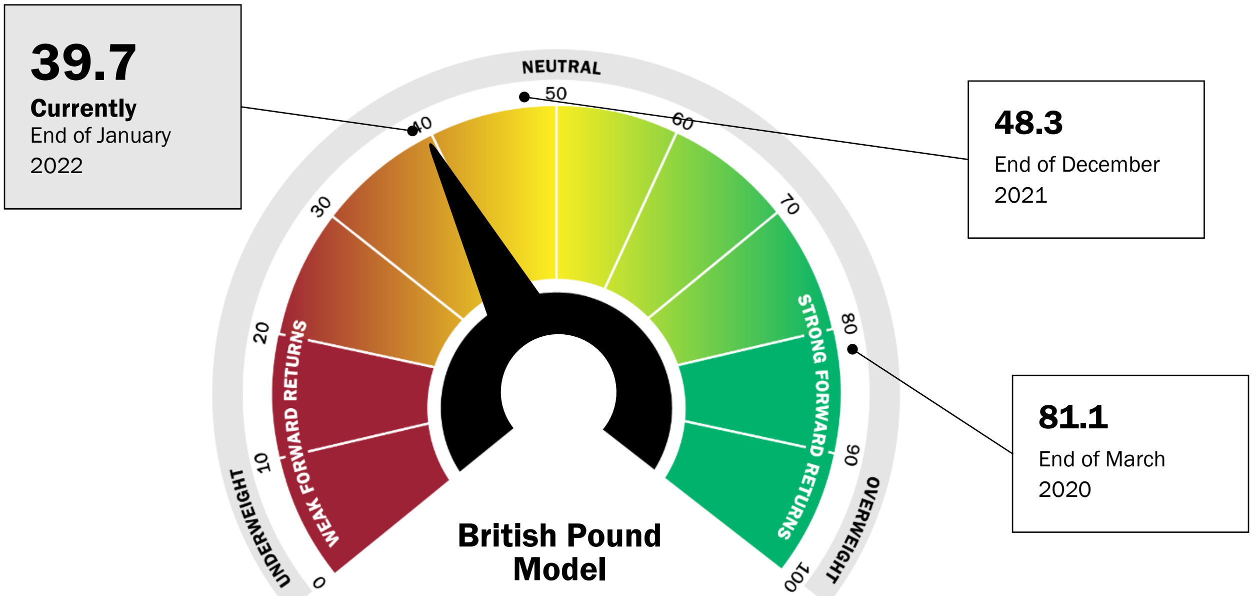


What Our Canadian Dollar Model Implies for 52-Week Returns for CADUSD

We are here

	Model Score Ranges							
	<10	<20	20 to 40	40 to 60	60 to 80	>80	>90	
Period	Forward Returns							Median
52 Weeks	-3.2%	-3.1%	-2.8%	-1.2%	-0.5%	3.6%	6.4%	-1.1%

Source: Rosenberg Research



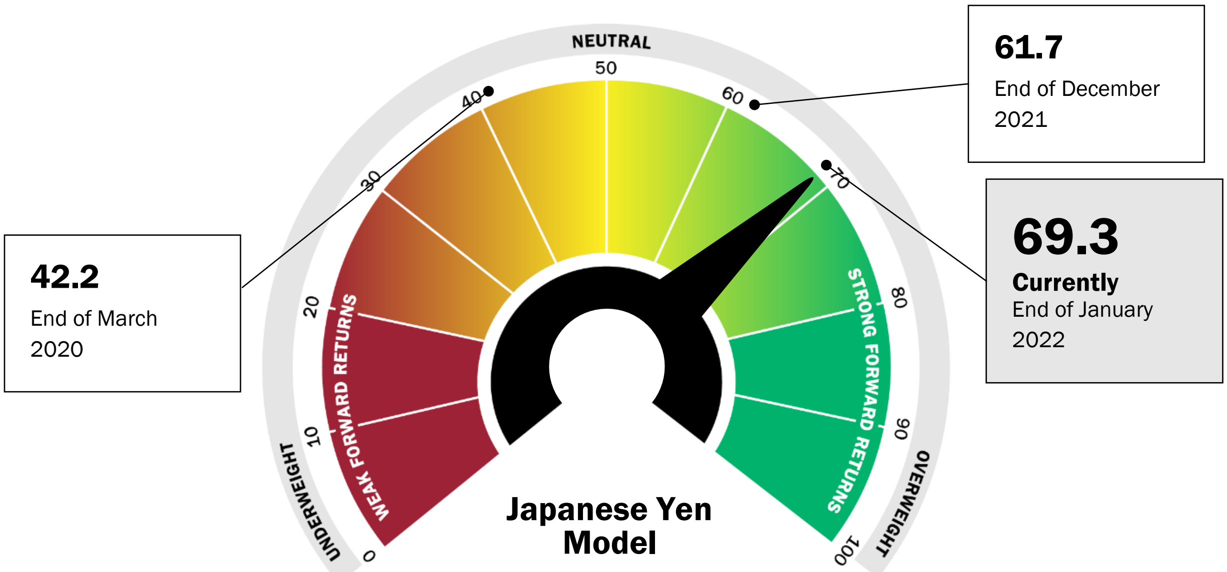
Source: Rosenberg Research

What Our British Pound Model Implies for 52-Week Returns for GBPUSD

We are here

	Model Score Ranges							
	<10	<20	20 to 40	40 to 60	60 to 80	>80	>90	
Period	Forward Returns							Median
52 Weeks	-5.0%	-4.9%	-3.9%	-1.1%	-0.7%	6.2%	7.4%	-1.4%

Source: Rosenberg Research



Source: Rosenberg Research

What Our Japanese Yen Model Implies for 52-Week Returns for JPYUSD

We are here

	Model Score Ranges							
	<10	<20	20 to 40	40 to 60	60 to 80	>80	>90	
Period	Forward Returns							Median
52 Weeks	-6.9%	-2.1%	-0.2%	1.8%	3.8%	3.7%	10.7%	1.6%

Source: Rosenberg Research

Identifying Favorable Opportunities Following January's Selloff

Highlights

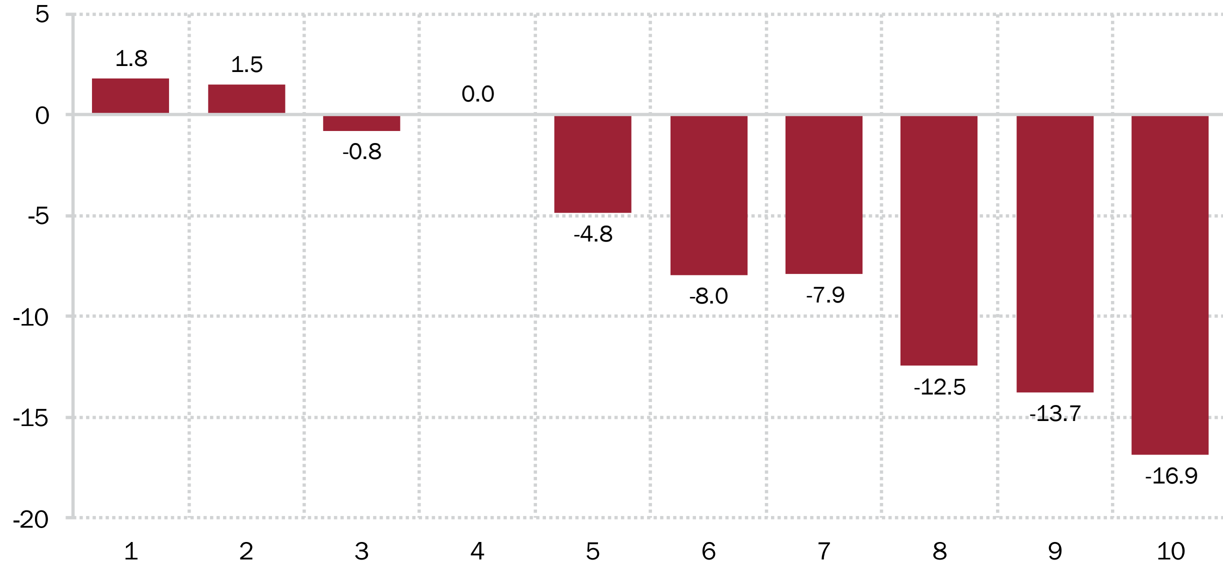
- The start to 2022 has been challenging and filled with volatility for equity investors
- The S&P 500 and Nasdaq experienced peak-to-trough declines of 10% and 15%, respectively, before recovering somewhat in the final days of January
- The damage was largely centered in high-valued names, as Fed concerns dominated
- The market environment this year is not conducive to valuations expanding, but rather contracting
- Going forward, as a result, we believe investors are best to focus on the parts of the market with favorable valuations that also offer a compelling earnings stream

It has been a challenging and volatile start to the year for equity investors, with the S&P 500 falling just over 5% on the month for the worst start to the year since 2009. It was rougher for the Nasdaq, which fell 9% in what was the weakest January since 2008. This is despite rallying to end the month as well, with intra-month declines reaching 15% for the Nasdaq and nearly 10% for the S&P 500 at their lows on January 27th. **The driving force behind these moves came courtesy of the Federal Reserve, as hawkish rhetoric began building following the most recent set of FOMC minutes and market expectations began ratcheting higher as a result — from three rate hikes to now stand at five (one bank is now calling for seven!).** Not to mention the anticipation of reducing the balance sheet this year (a process that took many years to begin in the previous cycle) and at a potentially faster pace.

A larger-than-expected monetary headwind, in addition to fiscal drags, slowing growth and peak earnings are not a good mix for risk assets. This is especially the case for companies that trade at higher valuations as the aforementioned conditions generally lead to multiple compression. Unsurprisingly, looking under the hood of the S&P 500 in this latest drawdown, this is exactly what we saw. **Breaking the index down into deciles by forward P/E reveals that those with the lowest valuations had a median gain of 2% to start the year, compared to a median loss of 17% for their high valued peers**. The latter tend to be more speculative in nature and/or longer duration assets — relying heavily on projected growth rates in the future, making them more sensitive to changes in interest rates/central bank policy.

Stocks With Higher Valuations Got Hit the Hardest

United States: *S&P 500 median January performance by forward P/E decile*
(percent)

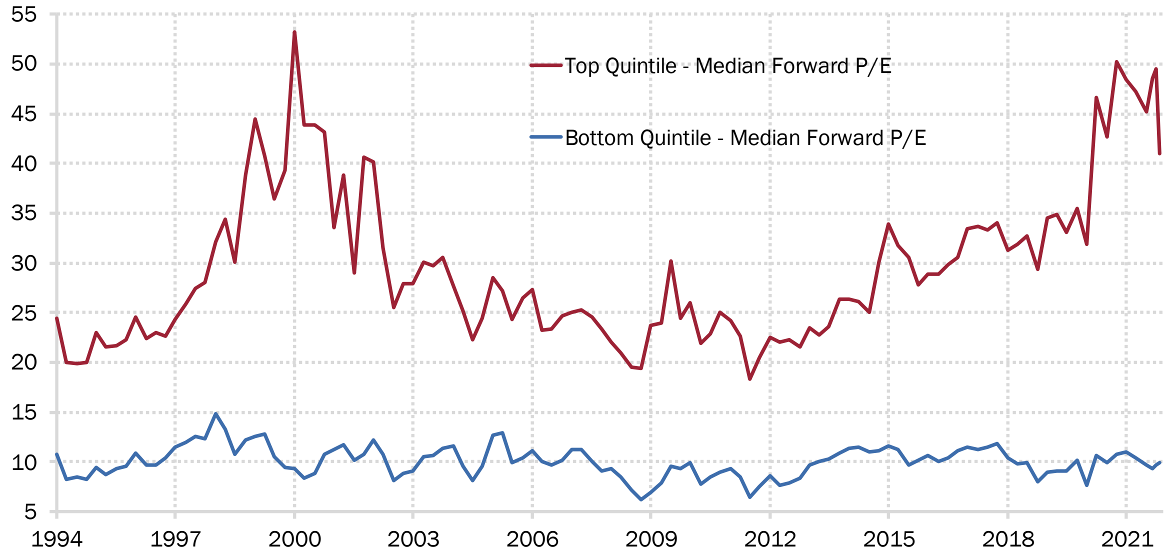


Source: Bloomberg, Rosenberg Research

Throughout 2021, *Strategizer* has had an increasingly pessimistic view at the headline level when it comes to the S&P 500. Our preference, rather than broad-based exposure, has been to focus on idiosyncratic opportunities beneath the surface. For example, on multiple occasions, we have highlighted the rising dispersion between valuations of the most expensive and least expensive stocks (see chart below). **Our recommendation has been to focus less on the high valuation names and more on those in the lower valuation bucket. Updating this chart to reflect the damage that took place in January reveals how prudent this strategy has been, but also how much "froth" is still present despite P/Es contracting as they have so far.**

Still A Ways To Go For the High Valued Names to Get to "Normal"

United States: *S&P 500 median forward P/E by quintile*

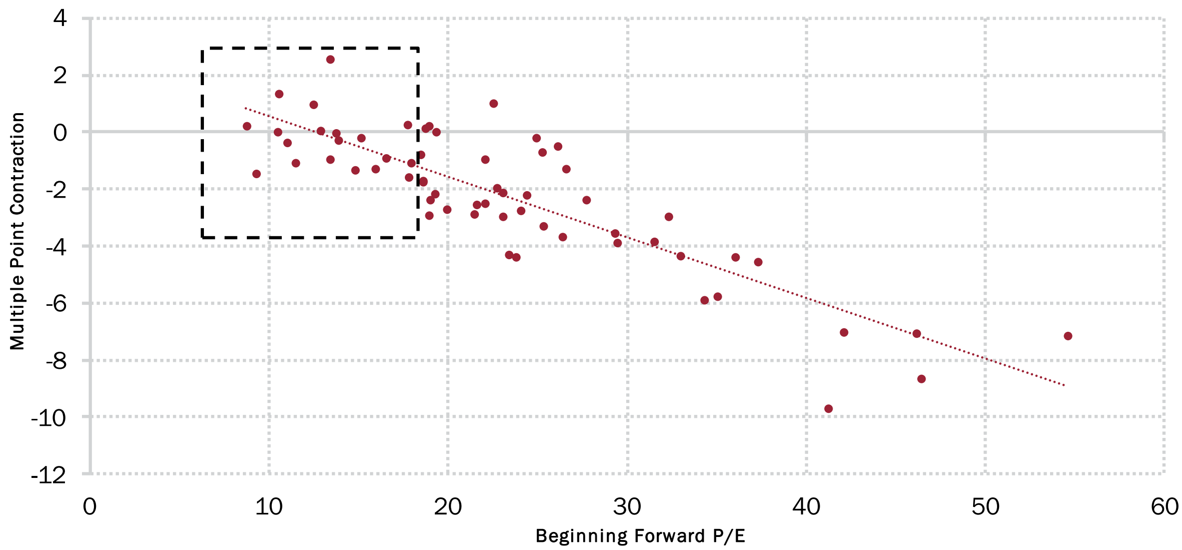


Source: Bloomberg, Rosenberg Research

That said, we believe that there are a number of opportunities that remain at the industry level, with rising dispersion in returns throughout this period of volatility (a huge benefit to portfolio managers and investors that have active mandates). As a starting point, plotting the forward P/E multiple at the beginning of January against the multiple contraction that occurred by the end of the month is a useful visualization. Not only does the scatter plot below demonstrate (again) how it was the higher valued industries that got hit hardest, but it should emphasize how well lower valued segments (our focus) have held in.

Focus on the Lower Valued Industries...

United States: *S&P 500*

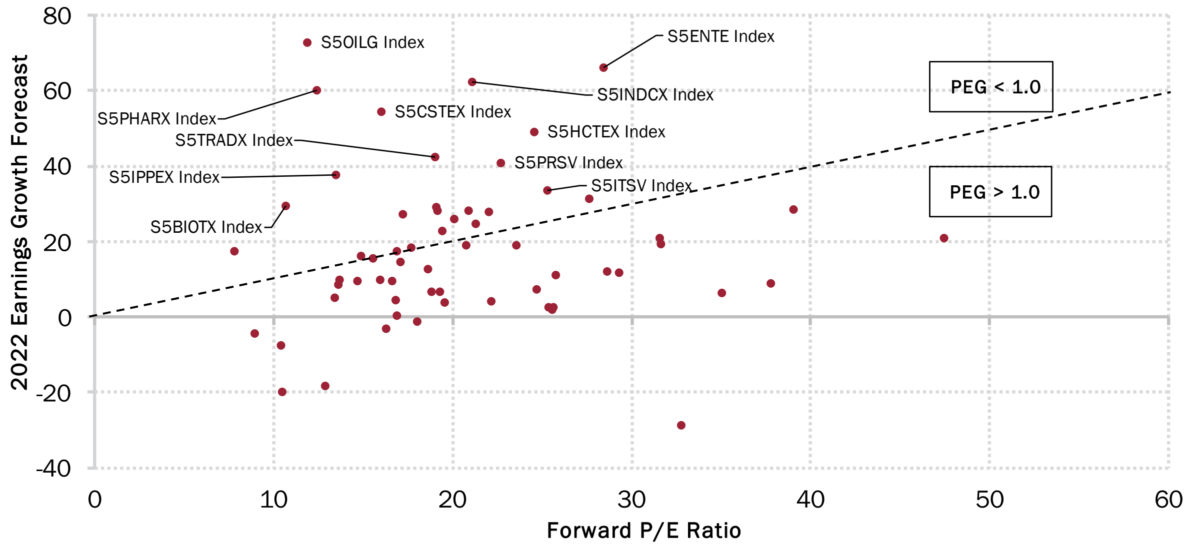


Source: Bloomberg, Rosenberg Research

Additionally, we can also layer on earnings expectations as it is possible that an industry is cheap for good reason (i.e., has an undesirable earnings profile). In essence, we are looking to identify opportunities with attractive P/E-to-growth (PEG) ratios — i.e., growth at a reasonable price, preferably <1.0x that is considered “undervalued.”

... Especially Those With Strong Earnings Projections

United States: *S&P 500*



Source: Bloomberg, Rosenberg Research

Our results are shown in the table below. **To summarize, we are screening for S&P 500 industries with forward P/Es of less than 20.0x that experienced some (or all) of the following: multiple contraction to levels that are at, or near, their five-year averages, positive earnings growth, low PEG ratios, and that (preferably) experienced a solid upward revision to their profits outlook over the past month while the market was sinking.** To be clear, all of these industries stand out as viable alternatives compared to their more expensive peers. **But, when combining these factors, Oil, Gas & Consumables and Pharmaceutical stocks appear as the best of the group, in our view, followed by Construction & Engineering, Trading Companies & Distributors, Communication Equipment and Household Durables industries.**

Oil & Gas and Pharmaceutical Sectors Look Like the Best Opportunities

United States

S&P 500 Industry	Forward P/E	5 Year Average	January P/E Change	2022 EPS Growth	PEG Ratio	1 Month EPS Revision	EPS Revision Percentile
Household Durables	7.8x	11.4x	-1.5x	17.3%	0.4	1.4%	63
Biotechnology	10.7x	12.1x	-0.3x	29.3%	0.4	-0.8%	5
Oil, Gas and Consumables	11.9x	20.0x	1.4x	72.8%	0.2	4.2%	82
Pharmaceuticals	12.4x	14.5x	-1.0x	60.3%	0.2	3.5%	96
Independent Power & Renewables	13.4x	12.4x	-1.3x	37.8%	0.4	0.0%	42
Containers & Packaging	14.9x	15.1x	-0.2x	16.1%	0.9	0.0%	41
Health Care Providers	15.6x	14.0x	-0.9x	15.4%	1.0	0.8%	45
Construction & Engineering	16.0x	15.9x	-2.9x	54.4%	0.3	1.4%	66
Chemicals	16.9x	18.5x	-1.7x	17.5%	1.0	0.6%	48
Communication Equipment	17.2x	18.6x	-2.7x	27.1%	0.6	0.5%	71
Machinery	17.7x	17.8x	-0.8x	18.3%	1.0	1.4%	60
Trading Companies & Distributors	19.0x	17.0x	-2.6x	42.6%	0.4	4.2%	95
Auto Components	19.1x	15.9x	-4.3x	29.3%	0.7	1.0%	58
Aerospace & Defense	19.2x	19.0x	0.2x	28.3%	0.7	0.1%	25
Semiconductor & Semi Equipment	19.4x	16.5x	-4.4x	23.0%	0.8	1.9%	59

Source: Bloomberg, Rosenberg Research

Ultimately, this is just one way to look for opportunities that have presented themselves following the January sell-off. But the core idea underpinning this stock screen is what is most important — the market environment that equity investors are facing in 2022 is not conducive to valuations expanding, but rather contracting. And, when the gap between the multiples of those in the top quintile group compared to the bottom are the widest they have been since the dotcom bubble, the pain will likely be felt primarily in those with the most “air” underneath their stock price. While the companies that dominate the top valuation quintile may well have attractive narratives or themes behind them, the reality is that multiples at these levels complicate forward returns. Thus, we believe investors will benefit from seeking out opportunities in the bottom quintile group — especially those that are poised to deliver strong earnings growth, like the Oil & Gas and Pharmaceutical groups mentioned above.

Key Charts We Are Watching

Despite the Volatility, Traders Are Net Long the S&P 500 the Most Since Dec. 2018!

United States: *S&P 500 futures and options positioning on the CME*
(thousands of contracts; >0 denotes net long)

Source: Haver Analytics, Rosenberg Research

Takeaways

- Does the above chart look like capitulation? The net speculative long on the S&P 500 is now up to 42,371 futures and options contracts, the highest it has been since December 2018
- For those wondering what we mean when we say more of a “washout” needs to take hold before we will become constructive on the U.S. market, this is exactly it
- Positioning is way too extended for our liking, suggesting investors are unperturbed by the recent sell-off
- We believe Warren Buffett’s quote is *apropos* in this case: *“Be fearful when others are greedy and greedy when others are fearful”* — if that time comes, we will become more bullish

Breadth Trending in the Wrong Direction

United States: *Share of Nasdaq members trading above their 200-day moving averages*
(percent)

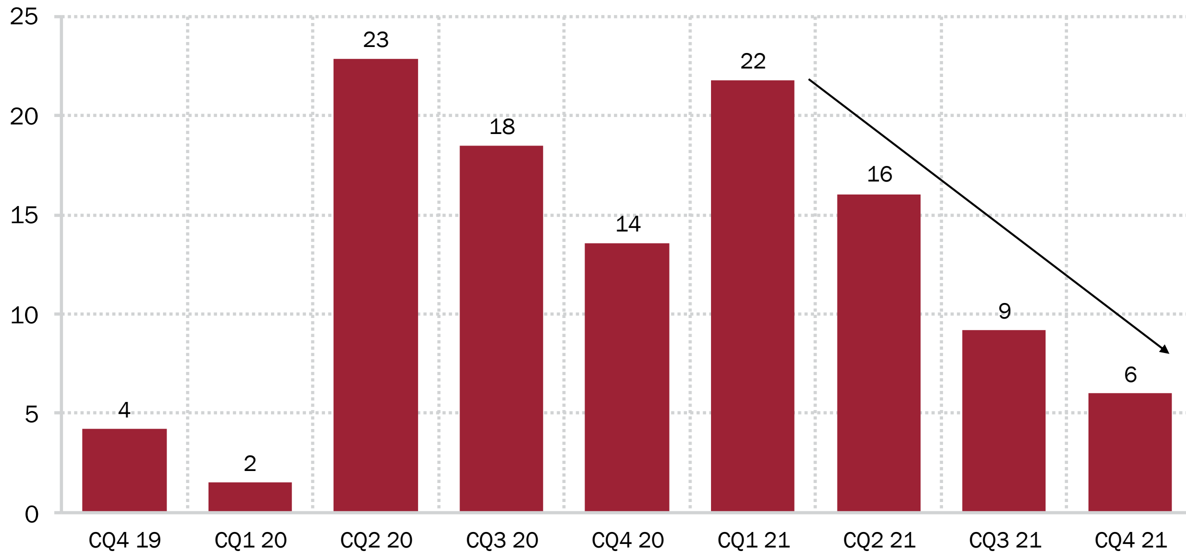
Source: Bloomberg, Rosenberg Research

Takeaways

- Breadth measures continue to deteriorate — particularly for growth stocks — as shown by the chart of Nasdaq members above their 200-day trendline
- After reaching a high of more than 90% in February 2021, this share now stands at just 25%, the lowest it has been since May 2020
- Until we see this trend reverse course, our message is to sell rallies — this is not a sign of a healthy market

EPS Surprises Are Shrinking in Size Providing Less Fundamental Support for Bulls

United States: *aggregate S&P 500 earnings surprise*
(percent)



Source: Bloomberg, Rosenberg Research

Takeaways

- According to Bloomberg, aggregate S&P 500 earnings surprises (with more than half of names reporting) is about 6% in the Q4 earnings season
- This is down from 9% in Q3, 16% in Q2 and 22% in Q1, providing a very clear pattern of erosion
- So, while the earnings news is still positive, it is less positive than before
- Financial markets respond to changes at the margin, so indications that EPS surprises are shrinking in size is not a positive development

Appendix: Basic Methodology of Our Models

We utilize a consistent framework in the creation of all our models. First, we assess each asset class across a variety of metrics that fall under the following broad categories: technicals, fundamentals, valuations, sentiment and positioning. Next, we arrive at a composite model score by taking a simple average across these five categories before re-scaling the result to fit a 0 to 100 scale (0 being the worst for expected forward returns, and 100 being the best for expected forward returns). Over time, this score will shift and help inform investors how much more (or less) exposure to a given asset class they should be adding (or subtracting) in their portfolio. **Please note that the models were developed based on their own history and thus scores are not directly comparable between asset classes or differing geographies.**

However, from an equity sector perspective, **our approach is slightly different.** For starters, **we do not directly measure sentiment as we believe there is insufficient data to be able to do it well at a sector level**. Consequently, our analysis is focused on the following four categories: technicals, fundamentals, valuations and positioning. **Furthermore, instead of generating a composite model score as we do with the headline equity indices, we simply rank each sector (against one another) across each category and then average their rank.** We utilize a 1 to 11 scale (where 1 is considered the highest possible result) to reflect the fact that there are 11 equity sectors as per the Global Industry Classification Standard (GICS). **Note that stronger technicals and fundamentals are considered to be positive, whereas lower valuations and less crowded positioning are also positive.**

For those clients who would like to go through our models and how the numerical scorecards are derived, please do not hesitate to contact us at strategy@rosenbergresearch.com.

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