BANK OF AMERICA

CHIEF INVESTMENT OFFICE

Equity Spotlight

Strong Corporate Earnings Face Storm Clouds Ahead

September 2022

All data, projections and opinions are as of the date of this report and subject to change.

SUMMARY

Though resilient in Q2, cracks in the earnings picture are beginning to emerge amid a weakening economic outlook. Shifting earnings dynamics could contribute to the uncertain backdrop for Equities over the next several months.

Earnings have remained resilient so far this year, supported by solid nominal growth, company pricing power and a strong consumer. But looking forward, we see cracks emerging in the earnings picture as the economic backdrop continues to weaken. In our view, this could potentially keep Equity volatility elevated over the next several months.

Looking back, earnings held strong

According to the September 8, 2022 FactSet Earnings Scorecard, the S&P 500 Index delivered a year-over-year (YoY) blended earnings growth rate of over 6% in Q2, beating estimates by 3%. From a sector perspective, Energy supercharged results. The sector produced a whopping YoY growth rate of 293% in Q2 2022.[1] While comprising just 4.6% of the S&P 500, Energy was able to contribute 10.1% to the index's overall growth, overpowering those with negative growth and a larger share of the market, such as Consumer Discretionary and Communication Services. Other notable sectors include Industrials, Materials, Real Estate and Healthcare, which saw earnings growth of 27%, 12%, 11% and 7%, respectively.

Shifts in consumer behavior have also influenced earnings trends this year amid the emergence of a more conservative and deliberate spending pattern. Amid higher costs and a slowing economy, consumers have been prioritizing essentials over more discretionary spending, leading the Consumer Staples sector's results to come in better than expected. Meanwhile, the Consumer Discretionary sector was the biggest drag on the index's overall earnings, with a negative YoY growth rate of -18%. Food and Staples Retailers noted an increasing "trade down" trend as consumers increasingly settled for the store-brand items, according to the Food Marketing Institute.

[1] FactSet Earnings Scorecard. September 8, 2022.

CIO ASSET CLASS VIEWS

Asset Class	CIO View				
	Underweight		Neutral	Overweight	
Equities			●		
U.S. Large-Cap				●	
U.S. Mid-Cap				●	
U.S. Small-Cap			●		
International Developed		●			
Emerging Markets			●		

Source: Chief Investment Office as of September 6, 2022. CIO asset class views are relative to the CIO Strategic Asset Allocation (SAA) of a multi-asset portfolio.

CIO EQUITY SECTOR VIEWS

Sector	CIO View				
	Underweight		Neutral	Overweight	
Energy				●	
Utilities				●	
Healthcare				●	
Financials				●	
Real Estate				●	
Information Technology			●		
Consumer Staples			●		
Industrials			●		
Materials		●			
Consumer Discretionary	●				
Communication Services	●				

Source: Chief Investment Office as of September 6, 2022. All sector and asset allocation recommendations must be considered in the context of an individual investor's goals, time horizon, liquidity needs and risk tolerance. Not all recommendations will be in the best interest of all investors.

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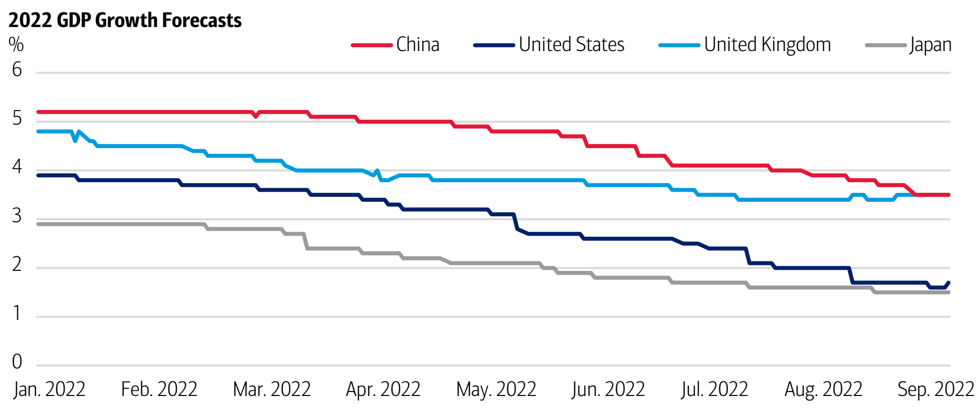
Looking forward, the earnings picture is cloudy

We think that the strength seen in Q2 could soon begin to fade against an increasingly uncertain macro backdrop. In the U.S., the Federal Reserve (Fed) is under pressure to continue to aggressively tighten policy amid multidecade high inflation and a historically tight labor market. Investors are currently pricing in almost 150 basis points (bps) of additional interest rate hikes this year and quantitative tightening recently kicked into second gear, with the Fed doubling their balance sheet runoff cap to $95 billion per month starting in September. As financial conditions have tightened, gross domestic product (GDP) forecasts are being revised lower for most major global economies (Exhibit 1), which raises the specter for lower earnings estimates.

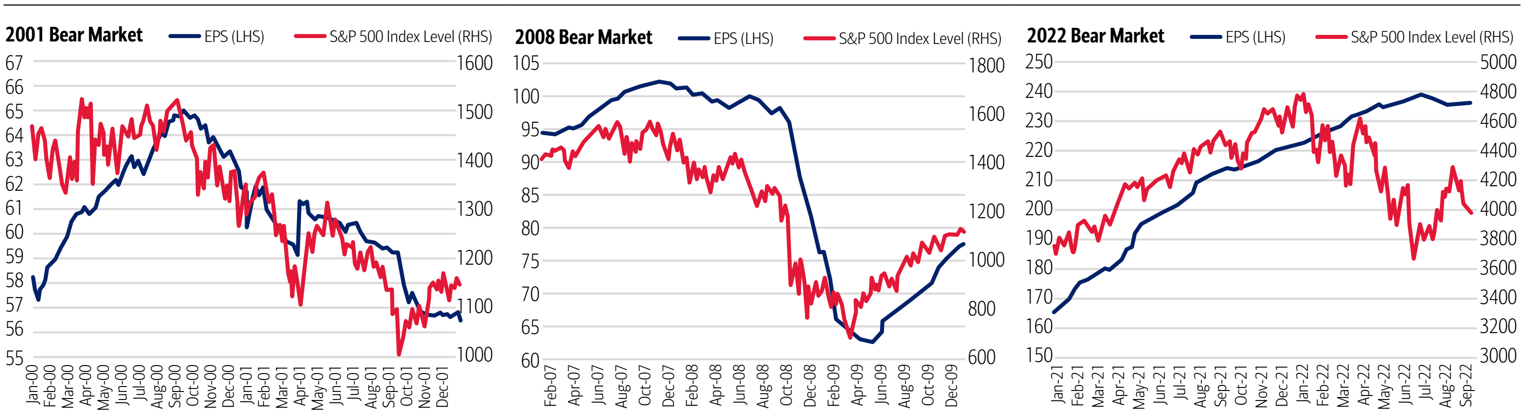
Exhibit 1: GDP Forecasts Have Moved Lower But Earnings Expectations Have Yet To Follow.



Source: Bloomberg as of September 7, 2022.

These conditions have already led to a diminishing risk appetite among investors and subsequent weakness in Equities, with the S&P 500 entering bear market territory earlier this year and remaining down by 13% YTD. But so far, the drawdown has been almost exclusively attributable to multiple compression. Equity valuations have slipped by about 20% this year, from 21.5x at the end of 2021 to 17.3x today.[2] Over the same time period, earnings estimates had kept increasing until recently. This is unusual compared to past bear markets, when downward earnings revisions tended to coincide with falling asset prices (Exhibit 2). Lower Equity prices today are factoring in the rise in interest rates and Fed hawkishness but have yet to price in the evolving weaker earnings dynamics as we head in to the back half of the year and into 2023.

Exhibit 2: 2022 Is Unlike Past Bear Markets, When Earnings Typically Declined.



Source: Bloomberg. August 30, 2022. **Past performance is no guarantee of future results. It is not possible to invest directly in an index.**

DID YOU KNOW?

- Germany's producer price index rose by a shocking +37.2% in August.[3]
- 76% of S&P 500 companies exceeded earnings per share (EPS) estimates in Q2, on par with the five-year average of 77%.[4]
- The yen has weakened against the dollar by almost 20% year-to-date (YTD) and now stands near the lowest levels seen since 1998.[5]

[3] Strategas Research Partners as of August 30, 2022.
[4] Factset. September 1, 2022.
[5] Bloomberg as of September 6, 2022.

[2] Bloomberg. September 12, 2022.

In addition to the slower growth picture, another risk factor for earnings is that companies' ability to pass higher input costs to consumers is starting to diminish amid weakening consumer confidence, still elevated wage pressures, improving but still elevated costs associated with supply chain issues, and higher commodity prices. Over the last decade plus, corporate profit margins have benefited from secular and cyclical forces such as globalized just-in-time supply chains, slower wage gains, availability of cheap labor from Asia, immigration adding to the pool of workers, and lower corporate taxes. However, some of these trends are either reversing or have already stopped acting as tailwinds for U.S. companies. As such, operating margins for the S&P 500, after rising to 16% given the vigorous recovery in the economy, have begun to moderate, declining almost 100 bps this year. Over the next year, as the top line slows further due to weakening nominal GDP, employers are likely to initially take a hit to their profitability and then take more assertive measures such as laying off workers and curtailing other expenses.

There is also the question of whether companies will be able to keep up the strong trend in buybacks, which have added 11% to S&P 500 earnings over the last decade.[6] We think it's likely that business executives will begin to pivot back to building cash reserves and fortifying their balance sheets as economic concerns rise. The proposed tax changes in the 2022 Inflation Reduction Act could also present headwinds on this front, with BofA Global Research estimating a 1% hit to EPS in 2023 from 15% minimum tax and buyback tax.

A strong dollar also poses risks to earnings, with the greenback recently surging to its highest level since 2002. This is already pressuring profits for large multinational companies as their international sales become less valuable at home—in Q2, companies with more U.S. exposure posted higher growth rates and increased positive earnings revisions compared to companies with more international exposure.[7] It's our view that the dollar is likely to remain elevated as macro pressures persist in the near term.

CONCLUSION

Amid these headwinds, analyst downgrades are beginning to accelerate. EPS estimates for Q3 decreased by an above-average rate of 5.4% from June 30 to August 31, marking the largest decrease in estimates during the first two months of a quarter since Q2 2020.[8] BofA Global Research expects earnings to decline by 8% from $218 in 2022 to $200 in 2023. We expect revisions to move lower over the next several months, adding to the volatile and uncertain environment for Equities. While the near term presents a shaky earnings picture, we remain favorable on Equities in the long run, which should benefit from secular trends like accelerated innovation, productivity boosting digitization, and a budding Equity culture as more Millennials enter their prime age of earnings and investing.

PORTFOLIO CONSIDERATIONS

Companies with higher-quality balance sheets, stable earnings and sustainable dividend yields are likely to be rewarded against a backdrop of slowing economic growth and falling EPS estimates. Defensive sectors, like Utilities and Healthcare, should exhibit relative earnings strength in such an environment. And even though oil prices have declined recently, they are still in a range where earnings and cash flows for the Energy sector will be healthy and growing.

[6] BofA Global Research. August 24, 2022.

[7] FactSet, Bernstein Analysis. September 2022.

[8] FactSet Earnings Insight. September 2, 2022.

Data as of 9/12/2022 for full table					Valuations**									Consensus Earnings Estimates***					
	Performance				P/E (FWD)			P/B			P/S			2021A		2022E		2023E	
Index	1 Month	3 Months	6 Months	1 Year	As of 9/12/2022	20 year Average	Percentile (%)*	As of 9/12/2022	20 year Average	Percentile (%)	As of 9/12/2022	20 year Average	Percentile (%)	Value	% Year-over-Year	Value	% Year-over-Year	Value	% Year-over-Year
S&P 500 Index	-3.8%	5.8%	-1.4%	-6.4%	17.3	15.7	80	4.1	2.9	94	2.5	1.7	91	208	48%	226	8%	244	8%
NASDAQ 100 Index	-6.0%	7.9%	-3.8%	-16.8%	21.9	20.3	65	6.8	4.6	90	4.1	3.1	89	502	38%	491	-2%	563	15%
Russell 1000 Total Return (TR)	-3.8%	6.0%	-1.6%	-8.2%	17.4	16.1	77	4.0	2.8	93	2.4	1.7	90	219	49%	235	8%	257	9%
Russell 1000 Growth TR	-4.9%	9.0%	-2.6%	-14.9%	23.1	18.4	89	10.3	5.6	91	3.7	2.4	90	60	33%	62	4%	72	16%
Russell 1000 Value TR	-2.7%	3.3%	-0.7%	-0.7%	13.9	14.1	51	2.5	1.9	92	1.7	1.3	88	60	59%	66	11%	70	6%
Russell 2000 TR	-5.4%	6.3%	-3.1%	-13.4%	19.8	23.2	26	2.3	2.1	75	1.2	1.1	70	186	166%	226	22%	263	16%
Russell 2000 Growth TR	-4.8%	11.2%	-1.8%	-21.3%	24.7	32.0	38	6.5	3.7	99	1.4	1.5	49	129	299%	245	89%	305	25%
Russell 2000 Value TR	-6.0%	1.9%	-4.4%	-5.1%	16.4	17.8	30	1.4	1.5	36	1.0	0.8	80	476	156%	503	6%	562	12%
MSCI Daily TR Net World Ex USA USD	-3.9%	-2.4%	-6.6%	-17.5%	12.0	13.5	23	1.6	1.7	35	1.3	1.3	82	149	52%	156	5%	161	3%
MSCI Europe	-4.4%	1.9%	2.0%	-3.7%	11.3	13.0	24	1.8	1.9	41	1.3	1.1	89	135	60%	140	4%	143	2%
MSCI Japan****	0.2%	1.6%	11.7%	-3.1%	12.5	15.0	18	1.3	1.4	42	1.0	0.8	88	77	51%	91	18%	95	5%
MSCI Daily TR Net EM USD	-3.6%	-5.9%	-7.9%	-23.0%	11.0	11.3	45	1.5	1.7	21	1.2	1.3	40	92	46%	85	-8%	89	5%

*Percentile refers to the percentile rank of the current P/E (FWD). **Monitors commonly used valuation ratios (P/E (FWD) = Forward Price/Earnings, P/B = Price/Book, P/S = Price/Sales). Source: Bloomberg. ***Yearly Earnings Per Share (EPS) estimates for indices referenced. A= Actual. E = Estimate. Source: Factset. **** MSCI Japan earnings expressed in Yen. For illustrative purposes only. Securities indexes assume reinvestment of all distributions and interest payments. **Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index.** Indexes are all based in U.S. dollars, unless indicated otherwise. Performance during periods of exceptional market conditions should not be expected to be repeated in a normal market environment. Performance results are extremely short term and do not provide an adequate basis for evaluating performance potential over varying market conditions or economic cycles. **Past performance is no guarantee of future results. See Index Definitions at the end of this report.**

The table below provides a rough indication of where the S&P 500 Index's central tendency could be, given various scenarios for EPS in 2023 and price-to-earnings (P/E) ratio multiples. These scenarios are not official price targets and are not meant to signal levels where portfolio actions may always be needed. However, during times of market volatility, it's useful to keep this basic framework in mind when considering whether to incrementally add to or trim risk from portfolios while staying invested in one's strategic asset allocation framework.

S&P 500 SCENARIOS BASED ON FORWARD P/E AND 2023 EPS

Forward P/E (Next 12 months)

2023 EPS	Forward P/E (Next 12 months)				
	15.0x	16.0x	17.0x	18.0x	19.0x
$250	3,750	4,000	4,250	4,500	4,750
$240	3,600	3,840	4,080	4,320	4,560
$230	3,450	3,680	3,910	4,140	4,370
$220	3,300	3,520	3,740	3,960	4,180
$210	3,150	3,360	3,570	3,780	3,990
$200	3,000	3,200	3,400	3,600	3,800
$190	2,850	3,040	3,230	3,420	3,610

For illustrative purposes only. Forecasts are subject to change. Source: Chief Investment Office as of September 6, 2022.

Asset Class Proxies and Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index.

Equities/S&P 500 Index widely regarded as the best single gauge of the U.S. equities market, includes a representative sample of 500 leading companies in leading industries of the U.S. economy.

Russell 1000 Total Return (TR) Index consists of the largest 1000 companies in the Russell 3000 Index. This index represents the universe of large capitalization stocks from which most active money managers typically select.

Russell 1000 Growth TR Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

Russell 1000 Value TR Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values.

Russell 2000 TR Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index.

Growth/Russell 2000 Growth TR Index measures the performance of the broad growth segment of the U.S. equity universe. It includes those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values.

Value/Russell 2000 Value TR Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 2000 companies with lower price-to-book ratios and lower expected growth values.

MSCI All Country World Index (ACWI) is a stock index designed to track broad global equity-market performance.

MSCI All-Country World ex-U.S. Index is a float-adjusted market capitalization index that is designed to measure the combined equity market performance of large- and mid-cap securities in developed and emerging market countries excluding the United States.

MSCI Daily TR Net World Ex USA Index USD captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries – excluding the United States. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI Europe Index is a free-float weighted equity index measuring the performance of Europe Developed Markets.

MSCI Japan Index is a free-float weighted equity JPY Index.

MSCI Daily TR Net EM Index USD captures large and mid cap representation across 23 Emerging Markets countries and targets coverage of approximately 85% of the free float adjusted market capitalization in each country.

NASDAQ 100 Index is a stock market index that includes almost all stocks listed on the Nasdaq stock exchange

Energy/Materials/Financials/Technology/Communication Services/Industrials/Real Estate/Healthcare/Consumer Discretionary/S&P 500 Sector and Industry Indexes measure segments of the U.S. stock market as defined by GICS® – Information Technology, Health Care, Financials, Consumer Discretionary, Communication Services, Industrials, Consumer Staples, Energy, Utilities, Real Estate, and Materials.

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