Allison Nathan: It's been a bleak year for the stock market, which despite some short-term rallies, is still firmly entrenched in bear market territory. So, where do we go from here?

David Kostin: A source of great uncertainty is around the path of inflation. And that is also going to carryover into the path of the equity market.

Allison Nathan: I'm Allison Nathan. And this is Exchanges at Goldman Sachs.

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Allison Nathan: To help us understand the drivers behind the equity market volatility and the road ahead, I'm sitting down with David Kostin, Chief US Equities
Strategist for Goldman Sachs Research. David, welcome back to the program.

**David Kostin:** Thanks, Allison. Nice to be here.

**Allison Nathan:** So, let's start with this roller coaster ride that we've been on with US stocks this year. The S&P 500 has been down as much as 25 percent peak to trough. We're now bouncing around the lower edge of that range. But one day we're in a rally. The next day we're in a sell off. Give us some context on what we're seeing and what's driving these moves.

**David Kostin:** My belief is that it is inflation and the expectations on Federal Reserve policy that have been the key drivers of the equity market. So, it's really been a macro-driven market, to use that terminology, as compared with more micro developments at the company level.

Of course, the micro developments matter for individual stocks. But at the overall index level, it's been a shifting of perceptions on whether inflation is going to be coming a little bit lower, or whether it's actually remaining high. And therefore, by extension, will the Federal Reserve have to
lean in harder in terms of raising rates more aggressively? Or whether there'll be a proverbial pivot and they'll be able to move towards a shallower trajectory of interest rate hikes.

Now, to be fair, the Goldman Sachs expectation is that the inflation rate will be coming lower. And the Fed will be raising rates several more times this year and early part of 2023. And therefore, the equity market forecast that we have is the index level, the S&P 500, will close the year around 3,600. Which is down modestly from the current level. And we'll be down for a while in the early part of next year until some evidence builds that the inflation rate is coming lower.

On the other hand, if there is a belief that the Fed is going to be hiking a lot and moving into recessionary territory, then the equity market could be trading lower. And so, we want to think about that as a trader, that the index level in three-months time at the end of the year, probably somewhere between 3,400 and 3,600. Those are sort of some levels to think about for the end of the year.

And as we think about next year, broadly speaking, the
equity market moves higher by the end of 2023. But in a recessionary scenario, you could hit a low of around 3,150 or so. That's actually meaningfully below where we are now.

**Allison Nathan:** So yeah. So, you think the market can move moderately lower from here, even on our main line scenario. But if we think about there've been so many big down days. There have been some up days too, but there have been so many big down days. How are investors positioned right now on equities? And how does that inform your view?

**David Kostin:** So, Allison, our data would suggest that investors are relatively lightly positioned, which is to say they are below average in terms of their exposure. This would represent positioning across the retail investor community. The institutional investor community, which would be both hedge funds and mutual funds, foreign investors. All of these categories are somewhat below their average level of exposure.

One way to think about this would be the cash levels for equity mutual funds, which are currently around 2.5
percent of their equity holdings, compared with 1.5 earlier this year. So, they've raised their cash positions. And the net leverage of the hedge fund community has declined by almost 20 percentage points from around 85 percent net leverage to around 65 percent net leverage. Those are two strong indications of a relatively risk-off positioning in their portfolios right now.

**Allison Nathan:** So, with real yields now in positive territory, so, interest rates adjusted for inflation, you've written that we're moving from a TINA mindset that really had prevailed for quite some time. TINA meaning "there is no alternative." To equities, and in particular, US equities. To a TARA mindset. So, "there are reasonable alternatives." What does that mean for equity demand going forward? Especially since a lot of these investors are underinvested right now.

**David Kostin:** So, the idea of going from TINA, T-I-N-A, there is no alternative, to TARA, there are reasonable alternatives, is an important construct when we think about but the supply and demand of equities. First of all, with the interest rates on short-term cash positions starting to approach 4 percent, it means that from an
income point of view is a pretty attractive rate of return. So, the cash return terms. As compared with the risk-adjusted returns you're going to be getting in equity market where, while earnings may be rising potentially in an economic scenario that's a soft landing, there is obviously downside risk in the event of inflation. And there's much more volatility in terms of the path of the market, as we've been discussing today.

So, the idea of pure cash returns pushing almost 4 percent and the expectation that the Fed Funds rate will be somewhere between 4.25 and 4.5 percent by the early part of next year, that would suggest that there are reasonable alternatives, just on the cash positions alone. And that, I think, would be something we are focused a lot on. And where are the sources of demand, where they may be, in the case of equities.

Now, the biggest source of demand for the last ten years, and likely to continue to be the best source of demand for shares, is corporate repurchases. And so, that is a source of cash and demand for shares that is likely to remain in existence, despite the fact while there may be reasonable alternatives for asset allocators, individuals, households,
mutual funds, pension funds, other investors, corporates sitting there with very large, pretty still high profit margins, are likely to be spending quite a lot of money repurchasing their stock as we move into the fourth quarter.

After earnings season, there's a blackout period. Companies are prohibited from repurchasing shares during the earnings period until they report results. And then they can resume repurchases. And we think that will probably take place by the middle of November.

**Allison Nathan:** So, you mentioned the upcoming earnings season. It's going to be closely watched because all investors are looking for indicators of the path of the economy. So, how important is this earnings season? And what metrics are you most closely watching?

**David Kostin:** This earnings season will be very consequential. If we want to think about the comparison in the middle of September when the CPI reading came out for the Consumer Price Index, it was a big surprise that it increased more than people were anticipating. In fact, investors were expecting it to decline. And it moved in entirely the other direction.
The comparison would be for equity markets is the upcoming third quarter earnings season. And it will kick off on the 14th of October. And will extend for about three weeks. And in that period of time, we're expecting year over year earnings growth to be around 4 percent. That's the current consensus expectation. Of course, that is going to benefit from energy companies showing earnings growth of more than 100 percent.

If we remove the energy sector, the earnings for the market are going to be down. This will be notable. They'll be down around 2 percent. And that is the first time we'll see a decline in the level of earnings since the recovery from the pandemic. Particularly of focus will be the margins. And corporate margins we would anticipate declining. Which is not something we've seen for some time. And the idea of a decline in margins is definitely not anticipated by the consensus expectations.

The sources of the decline in margins are likely to be a strong US dollar, which is a big headwind for companies when they translate foreign sales into domestic related profits, in terms of their accounting representation. So,
that's one source of headwind. The second is higher labor costs. Higher materials costs. Et cetera. So, these are going to be big headwinds for corporate earnings, corporate margins, as a result corporate earnings.

To put some context around that, we see in the first quarter expectations were plus 5 percent year over year growth. And companies actually reported plus 12. If we think about the second quarter, expectations were plus 6 percent or so. And it came in at plus 10 percent growth. And now we're expectations around plus 4. And given the headwinds, it's likely to be disappointing compared to the last couple of quarters.

**Allison Nathan:** But as you just said, the market was pessimistic for the first two quarters of the year. So, what are the chances that it's going to end up a better result again?

**David Kostin:** Anything is possible. It is not so probable in our estimation, in part because some of the major companies have preannounced and given negative guidance with respect to their overall business activities. So, there are different companies in the industrial sector,
companies in technology that have been giving a description of the upcoming, not just earnings season, but the forecast into 2023 as a more challenging environment. Many companies would probably agree with that. I think we'll hear that story from managements in their conference calls that take place right after the earnings season.

**Allison Nathan:** So, a key feature of this difficult environment is tightening financial conditions. What equity sectors and/or styles are still working in that environment? You mentioned the strong returns in energy companies. Are there any other sectors that are outperforming?

**David Kostin:** So, the most important macro development that's taking place across financial markets are the tightening of financial conditions. And the tightening of financial conditions, of course, is a big focus on the part of what the Fed is going to do. But there are other attributes of financial conditions that are tightening. Higher bond yields. Wider credit spreads. Stronger dollar. Lower equity prices. All of those are generally contributors to a tightening financial conditions environment. And in that kind of a backdrop, the type of companies in the equity market that tend to do well are companies with
stronger balance sheets, companies with higher return metrics, return on equity, return on capital, companies with less drawdown in terms of their share prices, more stable growth in terms of different metrics. So, those are the attributes, if you will, quality attributes that are likely to be rewarded by investors in the uncertain environment of tightening financial conditions. And I think that's a broad statement about how we would position portfolios in terms of it tilting towards higher quality as compared with a lower quality portfolio, for example, weaker balance sheets that, in another context, might be a good place to be. And that would not be the characterization of what we are going into in the fourth quarter.

**Allison Nathan:** Of course, long-duration stocks and, notably, tech has been among the hardest hit sectors this year. So, when can we expect tech to rebound?

**David Kostin:** So, the story of the US equity market this year has really been about rates and the impact of higher bond yield. So, at the start of the year, the US equity market traded at 21 times forward earnings. Today, the market trades at around 15 times forward earnings. And that big multiple compression has been concentrated, in
particular, in the highest growth companies. These are companies where their revenue growth is expected to be above 20 or 30 percent. And many of those stocks have derated or having multiple compression of, perhaps, 50 to 60, even more, percent decline. And that is, in some cases, heavily concentrated in some of the technology companies where they are really forecast to have very strong growth.

A company with very strong earnings growth means a large percentage of the valuation of the company is attributable to the earnings that are well into the future. And that would be characteristic of a long-duration stock. Companies where their earnings power is closer to the present time, so nearer term, would have shorter duration. And that gap between shorter-duration stocks and longer-duration stocks has been very significant in terms of the relative performance.

So, technology companies tend to be longer-duration equities. And they are still well challenged. And so, I would separate the technology sector into two pieces. Companies that are forecast to have very rapid revenue growth. Those would be longer-duration companies. They're more challenged in this environment because rates are likely to
stay high. Companies with more nearer-term visibility on their cash flows in technology are likely to do better in the environment that we're anticipating.

Allison Nathan: So, given the strong outperformance of the energy sector, has that affected the composition of the S&P 500 in any meaningful way?

David Kostin: So, one of the arguments we put forward for energy sector is that the sector is currently generating around 9 to 10 percent of the earnings of the market. But it only comprises around 5 percent of the equity capitalization. And over time, going back 40 years, energy has tended to punch its weight in the sense that the share of earnings and the share of equity capitalization tends to be pretty similar. And so, the idea that it is generating far more earnings than it is as a weight in market would be suggestive that if those earnings can be delivered, that the weighting in the market should increase. And as a result, that's another way of calculating and showing the outperformance.

And so, the argument would be that if energy prices stay high and the energy earnings can be delivered, those
companies should be outperforming. And that is an area of emphasis for our team in terms of sector recommendations.

**Allison Nathan:** What I'm taking away from our conversation is that the range of possible paths is just much wider than it's been historically. But do you have a view on when this volatility might start to subside?

**David Kostin:** The clarity on inflation is critical. Clarity on the path of forward inflation would indicate some clarity in terms of the Federal Reserve policy and interest rate policy. And that will be a trigger for the investors to be more confident in the outlook for corporate earnings. And that would be, I'd say, the linchpin for what would cause equity volatility to decline. And for equity prices, if you will, to move higher.

So, a source of great uncertainty is around the path of inflation. And that is also going to carry over into the path of the equity market.

**Allison Nathan:** Goldman does expect inflation to come down and to see some of these pressures ease over the
course of the next six to 12 months. So, if that does happen, we can expect the volatility to decline somewhat.

**David Kostin:** So, the expectation from Goldman Sachs Economics is that the core PCE rate of increase would be going from around 4.9 percent at this time to around 2.7 percent at the end of 2023. And that trajectory, to the extent that the rate of inflation decelerates from close to 5 percent to a little roughly 3 percent, that path, if that's the actual path that the inflation rate transpires, equity prices will do okay. And that won't be clear, really, until some time in the middle part of 2023. And so, I think that the uncertainty is at least lasting for at least another six months.

**Allison Nathan:** David, thanks so much for joining us and talking us through this very volatile market.

**David Kostin:** Thanks Allison.

**Allison Nathan:** Thanks for joining us for another episode of Exchanges at Goldman Sachs, which was recorded on Thursday October 6th. If you enjoyed this show, we hope you follow on your platform of choice and tune in next
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