Uncovering Quality Through the Fog

Equity markets outlook

Ann Miletti

Head of Active Equity, Chief Diversity Officer

Given *everything* that transpired in 2023 and the ramifications that will carry forward, the outlook is foggy for equity markets in 2024. However, three expectations stand out for me:

01 **Bad news first: The prospects are increasing for a 2024 recession.**

02 **Quality small- and mid-cap equities may be poised to outperform.**

03 **Defensive sectors could rally.**

Yes, a recession may be in the cards.

Allspring's analyses indicate we could see a global recession in 2024. However, any meaningful slowdown could help lower inflation further. Also, interest rate expectations could adjust lower—which may be a mixed blessing initially for the equity market as it could possibly pressure earnings.

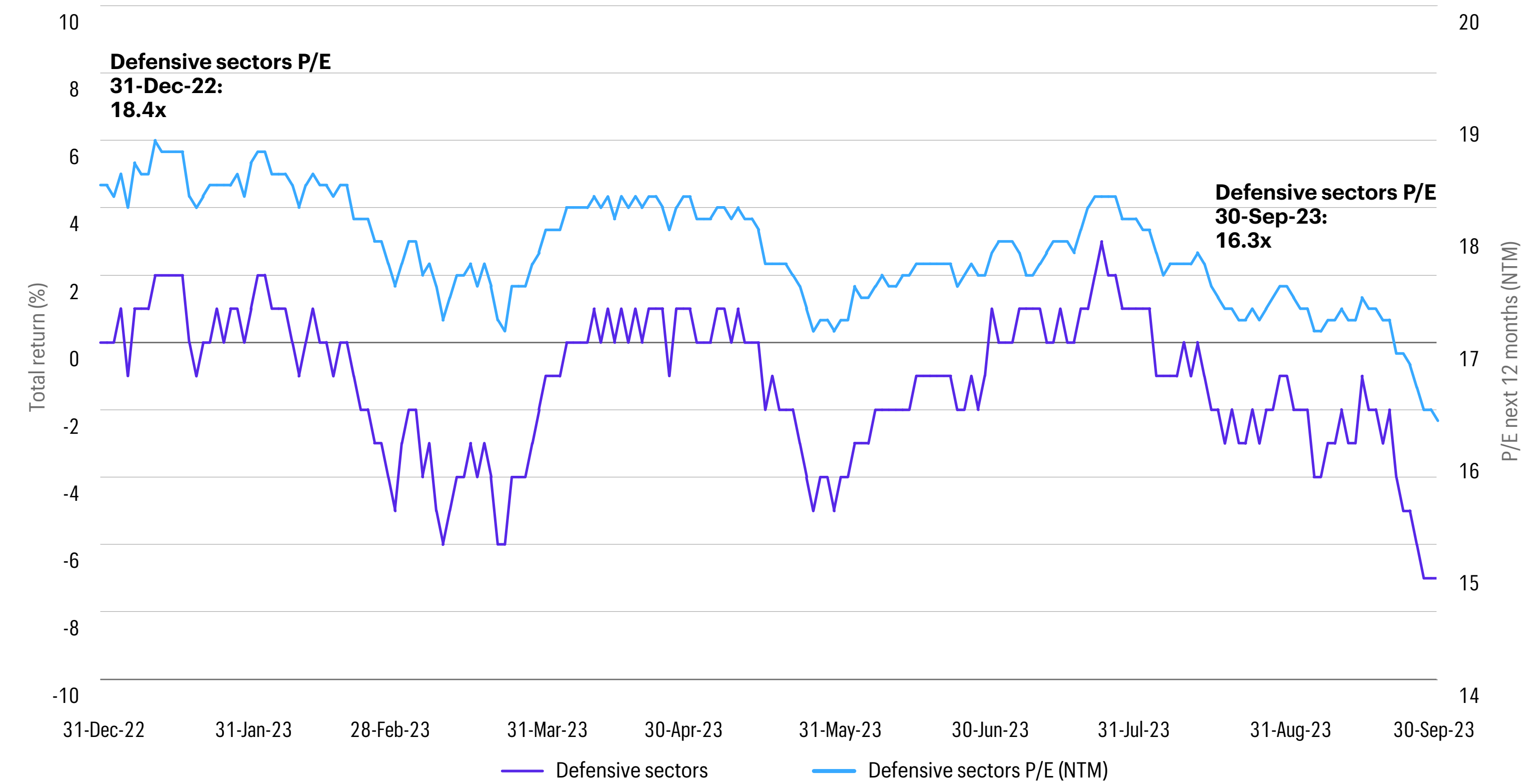
Think quality small/midsize when pursuing 2024 equity opportunities.

While major equity indexes rose during 2023, large-cap indexes led the market by far. Given the huge return disparity between large-cap and small-/mid-cap stocks, the valuation spread between these groups has widened tremendously—and this valuation differential makes small/mid caps quite attractive relative to their larger counterparts. When seeking small-/mid-cap opportunities, however, it's critical to evaluate each company's quality to help determine whether it's an appropriate holding for your portfolio and tolerance for risk.

Defensive sectors could be attractive in 2024.

Utilities, consumer staples, real estate investment trusts, and health care—four defensive sectors—delivered weak results in 2023. Health care in particular underperformed substantially amid secular and cyclical concerns. The projected impact of GLP-1 drugs and their ability to dramatically lower obesity levels caused widespread multiple contraction as the market began assessing what impact a "thinner" population could have on volume and demand trends across the health care system. That came on top of some cyclical pressures the industry was already dealing with, such as ongoing staffing problems, reduced patient volumes, and rising inflation since the pandemic. However, trends like the application of more artificial intelligence (AI) capabilities, greater focus on preventative health care, and quality-of-life improvements for the elderly hold promise for a turnaround in 2024. In addition, should 2024 deliver a recession, defensive sectors have tended to withstand that pressure.

WITH DEFENSIVE SECTORS DOWN OVER 7% YTD THROUGH 30-SEP-23, THEIR VALUATIONS HAVE BECOME MORE ATTRACTIVE



Sources: Allspring and FactSet, as of 30-Sep-23.
Defensive sectors' average returns and P/E NTM are based on S&P 500 sector total returns and average P/Es NTM, respectively.
Note: Real estate multiple is calculated via price/funds from operations (P/FFO) NTM
P/E = price/earnings ratio, which relates a company's share price to its earnings per share.

Key characteristics of quality companies:

Competitive advantage: A differentiated product or service with strong customer demand

Fluid cash flow: Sustainable cash generation through all parts of the economic cycle

Proven management team: Skilled capital allocators who have experience navigating through an economic cycle

Well-structured balance sheet: Modest financial leverage, elongated maturity profile, margin of safety versus debt covenants

FOR PROFESSIONAL INVESTOR USE ONLY WHEN USED OUTSIDE OF THE U.S.

"Leaning in" to quality to drive performance

Bryant VanCronkhite, CFA
Managing Director, Senior Portfolio Manager,
Special Global Equity

Before: Fed monetary policy amid low inflation enabled low-quality companies to thrive.

Up until 2021, the U.S. enjoyed several decades of below-target inflation. Globalization and technological advancements dominated those decades, driving meaningful reductions in costs for basic goods and services and the labor required to produce them. During this period, the Fed's freedom to add capital and keep rates low biased its support toward the weakest companies in every industry. Low loan rates minimized interest expenses for highly indebted companies, which could then spend more cash on investments, share buybacks, and dividends. This reduced the ability for high-quality companies to differentiate from low-quality firms.

In that environment, increased use of passive indexes over active management became a dominant equity theme. This wasn't without cause. For over 20 years, it became challenging for the average active manager in certain equity categories to beat their respective benchmarks. When viewed through the lens of the Fed's continuous capital injections and low rates that supported low-quality businesses, this makes sense. Active managers don't own low quality—it's their job to find and own high quality. But the indexes hold all companies, including low-quality ones. The monetary paradigm at the time directly supported passive investing at the expense of quality active managers.

Now: The paradigm has shifted, and high-quality companies are poised to stand out.

The deflationary drivers of globalization have moved toward deglobalization—for example, friendshoring (shifting production away from geopolitical rivals to friendly countries)—which tends to be inflationary. The energy transition toward sustainable/green sources also is inflationary.

We'll likely be living in this higher interest rate regime for an extended period, which will remove the tailwind for low-quality companies and passive investing—providing active managers with a more productive opportunity for outperformance. Higher interest rate environments increase the cost of capital, thus reducing the number of viable uses of capital to a small subset that can produce adequate returns. With less capital available and a shrinking set of strong risk-adjusted projects, the number of firms demonstrating the ability to sustain and grow returns on invested capital is likely to shrink.

Quality businesses with strong competitive advantages, strong earnings and cash flow, and low levels of debt are poised to clearly differentiate themselves via competitive, sustainable results going forward. Active management via the ownership of quality is well positioned to support investment goals under the current paradigm.

> " Active management via the ownership of quality is well positioned to support investment goals under the current paradigm.

Expanding your toolkit could improve your outcomes

Megan Miller, CFA
Head of Systematic Edge Options,
Co-Head of Custom SMA Investments

Uncertainty was a major theme globally throughout 2023, and as Ann discussed earlier, we expect the foggy view to continue into 2024. In times like this, investors' uncertainty tends to create a double-edged sword: Market volatility has increased, but that may also lead to potential opportunities for outperformance. The environment we have now calls for bolstering portfolio assets by seeking more consistent returns and risk-reducing strategies. One approach to consider to meet this objective is employing an options-based strategy to complement an equity portfolio.

Equity market derivatives, such as options, are an effective tool to manage equity risk and provide increased flexibility, enabling investors to adjust portfolio risk and return expectations materially. In challenging times like now, it's important for market participants to reconfirm what kind of outcomes they're looking to achieve—whether that be steadying portfolio values, increasing cash flows from investments, or focusing on long-term growth despite short-term disruptions. Systematic option strategies may be used to achieve all of these outcomes and more.

Income generation from an options strategy could be particularly useful for defensive positioning when equity market outlooks call for increased risk or muted forward-looking returns. These strategies are designed to add value during times of market stress and could reduce the drag caused by portfolio volatility over the long run.

The lasting impact of portfolio losses is not symmetric: As the percentage of loss grows, the percentage of gain required to break even grows even faster. For example, a 30% loss on $100—to $70—requires a 43% gain to return to $100, while a 50% loss on $100—to $50—requires a 100% gain to get back to even. By helping smooth equity volatility and reducing the legacy of loss, option strategies could enable a portfolio to grow at a higher compounded return over time.

While 2024 may be foggy, expanding your investment toolkit increases your flexibility to take on the road ahead.

A systematic options strategy can generate consistent income while mitigating equity risk, adding value to a portfolio:

How is income generated?

Consistent cash flow from options offers a diversified source of income and can potentially add value to a portfolio's equity exposure.

How is risk mitigated?

By helping smooth the ups and downs from equity volatility, the impact of large portfolio losses due to volatility fluctuations can be reduced—securing larger portfolio balances that enable the portfolio to grow at a higher compounded return over time.

To learn more

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. Visit our website at **www.allspringglobal.com**.

Contact details

FOR U.S. INVESTORS ONLY

- For retail clients, contact your financial advisor.
- To reach our intermediary sales professionals, contact your dedicated regional director, or call us at **+1-866-701-2575**.
- To reach our institutional investment professionals, contact your existing client relations director, or email us at **AllspringInstitutional@allspringglobal.com**.
- To reach our retirement professionals, contact your dedicated defined contribution investment only specialist, or call us at **+1-800-368-1370**.

FOR EMEA AND APAC INVESTORS ONLY

- To reach our EMEA- and APAC-based investment professionals, contact us at **AllspringInternational@allspringglobal.com**.

FOR SUSTAINABLE INVESTING

- To discuss sustainable investing solutions, contact **Henrietta Pacquement**, head of Sustainability, and **Jamie Newton**, deputy head of Sustainability, at **henrietta.pacquement@allspringglobal.com** and **jamie.newton@allspringglobal.com**.

CFA® and Chartered Financial Analyst® are trademarks owned by CFA Institute.

Diversification does not ensure or guarantee better performance and cannot eliminate the risk of investment losses.

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index with each stock's weight in the index proportionate to its market value. You cannot invest directly in an index.

This material is provided for informational purposes only and is for professional, institutional, or qualified clients/investors. Not for retail use outside the U.S.

THIS MATERIAL DOES NOT CONSTITUTE AN OFFER OR SOLICITATION AND IN ANY CASE IS NOT INTENDED TO BE USED IN ANY JURISDICTION OR TO ANY PERSON WHERE IT WOULD BE UNAUTHORIZED OR UNLAWFUL TO DO SO.

Allspring Global Investments™ (Allspring) is the trade name for the asset management companies of Allspring Global Investments Holdings, LLC, a holding company indirectly owned by certain private funds of GTCR LLC and Reverence Capital Partners, L.P. Unless otherwise stated, Allspring is the source of all data (which is current or as of the date stated); **past performance is not a guarantee or reliable indicator of future results;** all investments contain risk; content is provided for informational purposes only with no representation regarding its adequacy, accuracy, or completeness and should not be relied upon; views, opinions, assumptions, or estimates are not necessarily that of Allspring and are subject to change without notice; and this communication does not contain investment advice, an investment recommendation, or investment research, as defined under local regulation of the respective jurisdiction.

FOR PROFESSIONAL INVESTOR USE ONLY WHEN USED OUTSIDE OF THE U.S.

© 2023 Allspring Global Investments Holdings, LLC. All rights reserved.

ALL-11202023-zlbxdpbs