Despite recession, inflation, and geopolitical fears, we believe the value opportunity is compelling, even after its best relative performance in more than two decades.

Macroeconomic and geopolitical fears seemed to be the primary drivers of global equity markets throughout 2022. Inflation worries and the continuing concerns surrounding Russia's invasion of Ukraine are at the top of investors' minds, as disruption in the energy market significantly increases the probability of a global recession in 2023.

Acknowledging that we are not geopolitical experts, we believe there are valuable lessons to be learned from economic history to help navigate today's uncertain markets, including the following:

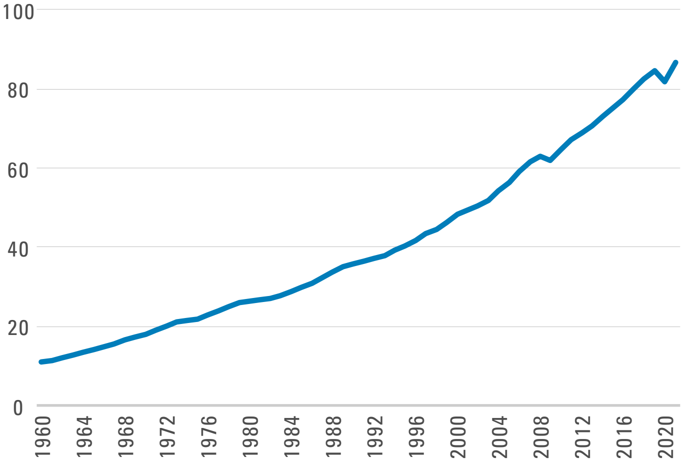
- Typical recessions are not as severe as the two most recent recessions (COVID-19 and the Global Financial Crisis)
- The peak-to-trough share price decline in 2022 was in the range of typical recessions
- The five-year period following the start of a recession has proven to be a good entry point for stocks in general, and value stocks specifically[1]
- Value equities is one of the few asset classes offering a positive real earnings yield

RECENCY BIAS AND RECESSIONS

While recessions are bad for economies, the economic disruption from a recession is typically a discrete, brief period until worldwide economic growth continues its long and steady upward trajectory (Exhibit 1). Therefore, long-term investors should be largely unphased by recessions.

Exhibit 1: Global Recessions Are Brief Disruptions in Steady Growth

World Real GDP (trillions)



Source: The World Bank, Pzena analysis
Annual data in constant 2015 US dollars from 1960 – 2021.

Not surprisingly, recessions have a detrimental impact on equities, with global markets down on average 32% peak-to-trough around recessions. Global equity markets were down 26–34% peak-to-trough in 2022, while earnings grew in most regions other than emerging markets. This means multiple contractions represented all the declines in those indices and then some. While 2023 could see earnings decline, PE multiples have already discounted some recession fears (Exhibit 2).

Exhibit 2: Significant Multiple Contraction in 2022

	2022 Peak-to-Trough Decline	2022 Year Total Return	Fundamental Return	Multiple Contraction	2023 P/E
Global	-27.1%	-17.7%	5.5%	-23.3%	15.0x
US	-26.0%	-19.1%	4.1%	-23.2%	16.7x
Europe	-32.4%	-14.5%	10.4%	-24.9%	11.7x
Japan	-29.9%	-16.3%	-0.9%	-15.4%	12.2x
E.M.	-33.5%	-19.7%	-13.8%	-5.9%	11.7x

Source: FactSet, Pzena analysis

Table represents the MSCI World Index, Russell 1000 Index, MSCI Europe Index, MSCI Japan Index, and MSCI Emerging Markets Index. Fundamental Return = Dividend return + EPS growth. Multiple contraction and EPS growth is calculated using forward 12-month consensus estimates per FactSet on December 31, 2021 and 2022. All data in US dollars. Past performance is not indicative of future returns.

For the US market, which has a longer and more precise history, in the 15 recessions over the past 100 years, GDP has fallen on average by 5.4% through recessions. The recency bias of COVID-19, which saw US GDP fall by 8.5%, may have created the impression that recessions are far more damaging than they typically are. However, the COVID-19 recession was somewhat of an outlier. Removing the extreme recessions, which include the Great Depression, World War 2, and COVID-19, US GDP fell just 2.7% in more "typical" recessions (Exhibit 3). While value has historically trailed the market in recessionary periods, the Russell 1000 Value Index has seen a 20% decline from peak-to-trough this year. This is not unprecedented, as value has lost less than the market in three of the previous seven US recessions.

1. Past performance is no guarantee of future returns

Exhibit 3: Recessions and Equity Performance

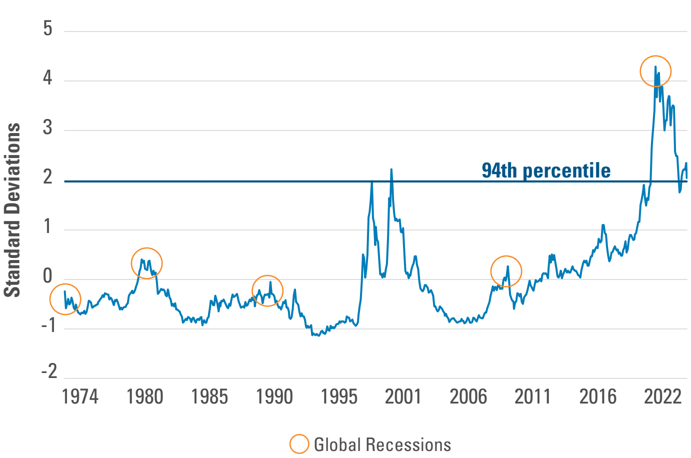
	Change in Real GDP	Peak-to-Trough Return		Next 5YR Return from Start of Recession	
		Market	Value	Market	Value
Global	-0.2%	-32%	-32%	80%	149%
US - All	-5.4%	-28%	-35%	53%	91%
US - All *(excluding Depression, WW2, & COVID)*	-2.7%	-26%	-32%	62%	104%
Japan	0.1%	-31%	-29%	69%	170%

Source: Cabinet Office of Japan, Kenneth R. French , MSCI, National Bureau of Economic Research, Sanford C. Bernstein & Co., The World Bank, Pzena analysis

Table is based on 15 US recessions from 1929 – 2020, nine Japan recessions from 1977 - 2020, and five global recessions from 1974 – 2020. The market universe used for global is the MSCI World Index. The market universe used for Japan is the MSCI Japan Index. The market universe used for the US is all NYSE, AMEX, and NASDAQ stocks defined by Kenneth R. French data library and excludes the smallest 30% of the universe based on aggregate market capitalization to remove the small cap effect. Value (equal-weighted data) is defined as the cheapest quintile of stocks on a price-to-book basis for each respective universe. All total return data in US dollars. Past performance is not indicative of future returns. Does not represent any specific Pzena product or service.

Based on history, once a recession sets in, equities perform quite well over the subsequent five-year period, generating significant outperformance for both US and Global markets. Interestingly, for the three recessions where value outperformed in the cycle's down-leg, it also generated significant alpha in the subsequent five-year period. Not coincidentally, those three periods started at multiyear peaks in valuation spreads, which subsequently narrowed for several years during long and sustained value rallies (Exhibit 4).

Exhibit 4: Global Valuation Dispersion



STAGFLATION: CHEAP STOCKS OFFER SUPERIOR REAL RETURNS

Equity market performance in periods of high inflation and slow or negative GDP growth has been top of mind for many of our clients. While no two periods are exactly alike, history once again provides an interesting comparison, as the period starting in late 1973 and lasting through late 1982 saw a similar geopolitical and macroeconomic backdrop to what we are seeing today (Exhibit 5).

Exhibit 5: Similar Geopolitical and Macroeconomic Backdrop

	1973-1982	Today
Regional Conflict	Middle East War	Russian Invasion
Oil	OPEC Embargo	Russian Sanctions
Inflation	8.2% Average	6.1% Current*
Recession	2 Global Recessions	Global Economy at the Brink

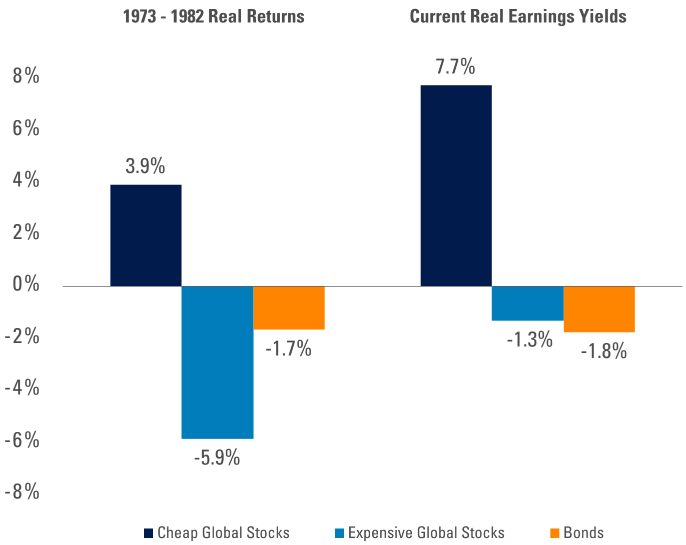
Source: Federal Reserve Bank of St. Louis, National Bureau of Economic Research, The World Bank, Pzena analysis
**Trailing 12-month average as of December 31, 2022. Inflation data based on annual US Core CPI.*

The near decade-long stagflation period saw two global recessions and 8.2% average annual inflation[2], hardly a backdrop conducive to investing in equities. However, real GDP still grew at 3.1% per year[3], global equities returned 5.5% per year[4], and value returned 12.5%[5]. This robust performance made cheap stocks one of the few asset classes that generated positive real returns during this turbulent period (Exhibit 6). We believe that one of the primary drivers of value's robust performance during this period was its starting point. Record-wide valuation spreads (at the time) following the Nifty Fifty era set the stage for a long and powerful value cycle.

Data through December 31, 2022. Source: Sanford C. Bernstein & Co., Pzena analysis Dispersion between cheapest and most expensive quintiles based on price to book; equal-weighted data. Universe is the MSCI World.

2. Source: Federal Reserve Bank of St. Louis
3. Soucre: The World Bank
4. MSCI ACWI Universe, Sanford C. Bernstein & Co., Pzena analysis
5. Based on price/book of the cheapest quintile, MSCI ACWI Universe

Exhibit 6: Positive Real Returns



Source: FactSet, Federal Reserve Bank of St. Louis, Sanford C. Bernstein & Co., Pzena analysis
Bonds = 10-Year Treasury. Cheap and expensive defined as the cheapest and most expensive quintile of stocks on a price-to-book basis within the MSCI ACWI universe (equal-weighted data).
Current earnings yield based on 2023E earnings per FactSet.
Real returns and real earnings yields are calculated using US Core CPI data.
All returns are annualized in US dollars. Data as of December 31, 2022.
Past performance is not indicative of future returns.

Similarly, the regional conflict in Ukraine has brought higher energy prices, which increased already high inflation and raised the prospect of recessions, particularly in Europe. Despite valuation dispersions narrowing significantly over the past 18 months, largely reflecting the correction in expensive growth stocks, the backdrop remains quite positive for cheap stocks, which are once again one of the few options asset allocators have that offer a positive real earnings yield.

CONCLUSION

Geopolitical and macroeconomic concerns led to global equity market declines this year that were, on average, in line with past recessions. While the macroeconomic environment has not become any clearer this year, it bears remembering that recessions are typically short and manageable and the seeds of market rallies are planted during recession-driven market selloffs, as the market performs particularly well in the five-year period following the start of a recession, and value tends to outperform. Similar to the prior period of stagflation, we believe cheap stocks globally appear to stand out in offering solid positive real earnings yields.

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