



# What will stop the equity bear market?

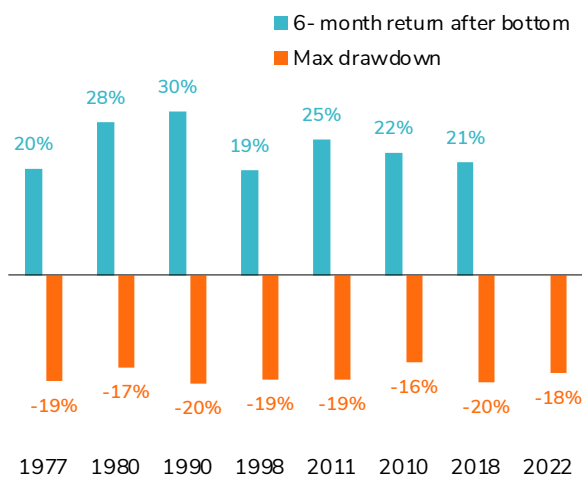
Global stocks market indices are on the cusp of entering bear market territory, being down around 20% from their late 2021 all-time-highs. What would be the main triggers for a sustainable rebound of equity markets?

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Volatility on Wall Street remains elevated as the leading US stock index - the S&P 500 - has just recorded its sixth consecutive week of decline. Investors seem increasingly skeptical about the Fed's ability to achieve a "soft landing" for the economy. At its lowest point last Thursday, the S&P 500 was down nearly 18% from its highs, just 2% above the threshold that usually defines a bear market. US equity markets are not the only ones to suffer: international stocks and bond markets are experiencing their worst start to a year in decades.

Should we give in to panic and pessimism? Such corrections have often provided great buying opportunities in the past. As the chart below shows, over the past 50 years, the S&P 500 index has fallen by around 20% several times and then rebounded dramatically - as long as corporate and economic fundamentals remained strong.

### Every decade has had bull markets that included near 20% declines



Source: Edward Jones, Factset.

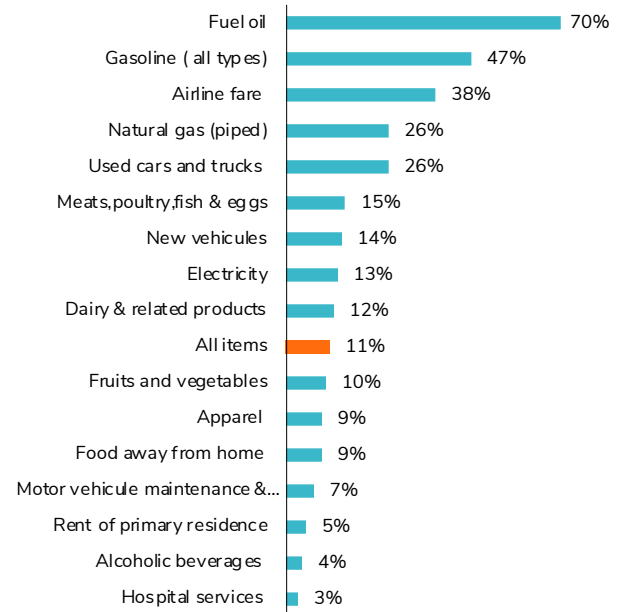
So what could be the catalyst(s) for a trend reversal in risky assets? Here are some clues...

### A sharp decline in commodity prices?

Rising energy, industrial metals and food prices are major contributors to the current crisis, with uncomfortably high inflation forcing central banks to turn off the liquidity tap.

The publication of the latest US inflation figures provided further evidence of this: the year-on-year rise in petrol prices was over 70%, while gas bills rose by almost 25% and electricity by over 10%.

### CPI select categories (y/y % change)



Source: Charles Schwab, Bureau of Labor Statistics, as of 4/30/2022.

In Europe and Japan, both major energy importers, the rise in oil and natural gas prices is putting household consumption and the smooth running of production facilities at risk.

Unfortunately, Russia's invasion of Ukraine has complicated matters considerably. The country led by Putin exports a wide array of raw materials. The sanctions are having a major impact on world supply, even though demand remains high after the pandemic. In terms of energy, and particularly for oil, few initiatives have been put on the table by OPEC to increase production. In the US and Europe, climate priorities continue to take precedence over new exploration and production projects. For example, the Biden administration has just cancelled oil drilling sales in Alaska and the Gulf of Mexico. Similarly, Europe seems to be running out of solutions as the Russian threat to gas supplies becomes clearer. Finally, no progress seems to have been made in the negotiations with Iran and Venezuela. Only a major destruction of demand following a sharp recession seems likely to restore the balance between energy supply and demand, a scenario that is not the most favorable for risky assets.

As for agricultural products, the situation continues to tighten, with several developing and emerging countries preferring to secure their stocks. For example, India has just banned wheat exports in order to favor its own supply. This protectionism further reinforces the spiral of rising prices.

Another complication: the resurgence of Covid-19 in China and the strict confinements imposed are weighing on supply chains and therefore on prices.

## Peak inflation ?

For a majority of economists, there are many indications that we are close to what is known as peak inflation. In other words, inflation figures should soon start to fall, even if commodity prices remain at current levels. There are several reasons for this.

Firstly, "base effects" (i.e. a fall in inflation due to more favourable comparison levels) should soon materialise. Unless we assume that oil prices continue to double every year, base effects will eventually lead to a decreasing contribution of energy, commodity and some other goods (e.g. second-hand cars) to year-on-year inflation figures.

Another phenomenon that should allow the inflation rate to fall is a slowdown in final demand. Should the "soft landing" scenario materialise, final demand should continue to grow in the coming months. However, it is no longer expected to accelerate and is even expected to slow down from 2021 levels. This means that demand pressures on consumer prices will no longer increase, leading to a gradual smoothing of inflationary pressures.

On the supply side, even a gradual reopening of the Chinese economy should help to gradually ease the pressure on supply chains, although normalisation may take time, as we saw in 2021.

There could therefore be some positive surprises on the inflation front in the second half of the year, but with one caveat - and a big one. If inflation slows down only gradually, it will still be well above central bank targets for the current year. Against this backdrop, it seems difficult to envisage a U-turn by the Fed, for whom it has become essential to remain credible with investors, consumers and businesses.

## A negotiated deal between Russia and Ukraine ?

While Russia's invasion of Ukraine was supposed to be a lightning strike or at least last only a few weeks, the prolongation of the conflict is seriously complicating the supply of raw materials and therefore inflation. For example, the fact that there is no longer any export of fertilizers from Russia will affect harvests beyond 2022, prolonging de facto the conflict's upward pressure on commodity prices.

Although no one seems to be making a move towards a peace agreement, it would appear that negotiations between Russia and Ukraine are continuing behind the scenes. At this stage, a successful outcome would of course have a very positive effect on the markets.

## A weakening of the dollar?

As we mentioned in our FOCUS note last week ("Our currency, your problem"), the sharp rise in the dollar since the beginning of the year could weigh on the growth of US companies' profits, but above all is a real headache for the rest of the world. The strength of the greenback makes raw materials valued in dollars (crude oil, copper, aluminum, etc.)

more expensive to import. It also forces central banks (ECB, emerging markets) to pursue a more restrictive monetary policy in order to fight imported inflation. The strong dollar also increases the cost of servicing the rest of the world's debt as many countries have denominated a large part of their borrowing in dollars. Finally, the difficulties faced by many countries with the appreciation of the dollar could tip us into a new international liquidity crisis. Indeed, the rise in commodity prices is forcing many countries to draw on their dollar reserves to finance their purchases.

Therefore, a weakening of the dollar would be seen as good news by the markets as it would imply an increase in liquidity and a decrease in insolvency risks. The end of restrictions in China and a start of monetary policy tightening by the ECB could help weaken the dollar.

## Investors on the hunt for bargains?

A review of the price/earnings (P/E) ratios of the various equity markets shows that most of the decline in equity indices is due to a compression of valuation multiples and not to a downward revision of earnings growth expectations. On the contrary, expectations have even been revised slightly upwards in most markets. This came as a surprise to many investors who expected inflationary pressures to have an immediate negative impact on margins.

The fact that equities have become cheaper than they were a few months ago must, however, be qualified by the following elements. Firstly, multiples as a whole have returned to the median levels of their 20-year history. We are therefore not (yet) at an undervalued level. Secondly, a downward revision of earnings can still occur in the second half of the year. Finally, equity markets are now competing with other asset classes: for example, bonds have seen their yields rise in recent months and are now considered as an attractive investment again by some asset allocators.

### 12m Forward P/E across key geographies

	Current	Current vs Jan 21	20Y Median	Median
Italy	9.3	14.7 -37%	12.3	-25%
Germany	10.9	16.2 -33%	12.5	-12%
Japan	12.5	18.2 -31%	14.6	-14%
Eurozone	12.3	17.6 -30%	12.8	-4%
Spain	11.5	16 -28%	12.0	-4%
EM	11	15.4 -28%	11.1	-1%
France	13.1	18 -27%	12.8	2%
World	16	21 -24%	15.0	6%
UK	10.9	14.1 -23%	12.5	-13%
US	17.7	22.8 -23%	15.5	14%
Switzerland	18.8	19.3 -3%	14.8	27%

Source: IBES as of 27 April 2022

## A shift in monetary policy ?

Ultra-dovish monetary policy implemented over the last decade has played a major role in the double bull market (stocks + bonds). The influx of liquidity propelled financial assets to the top. Investor confidence was fueled by the (implicit) existence of a "Fed Put", i.e. central bank support via rate cuts or an increase in the size of the balance sheet in case of a market crash. In recent months, this "Fed Put" seems to have disappeared to be replaced by a "Fed Call". Jerome Powell is now fighting inflation and sending a message to investors that the Fed is no longer there to "save" the markets.

A change of course by the Fed with a return to old habits could therefore be the most effective catalyst for a sustainable rebound in risky assets. The question is at what level of financial stress does the Fed believe the damage to markets is endangering US growth? Is it a pre-determined level on indices or on credit spreads? A major financial accident involving a bank or another financial institution?

In any case, a return to quantitative easing (QE) seems, in our opinion, very far from the current agenda of central banks, as inflation has become their priority. If a change were to take place, it would most certainly occur at stock market index levels well below those currently in place.

## Signs of capitulation?

The best buying opportunities in equities often occur when markets are "capitulating". While many sentiment indicators point to an "oversold" market, other evidence suggests that we have not yet seen a true sell-off. For example, retail investors continue to invest heavily in Ark Invest ETFs, icons

of the previous bull market, despite their steep declines. Moreover, the implied volatility index "VIX", nicknamed the fear index, has not yet reached the panic levels that have characterised market lows in the past. Is the real panic ahead of us?

## Conclusion

The decline in equity markets since the November highs already incorporates a lot of bad news. Its magnitude is prompting some investors to buy risky assets opportunistically. At this stage, we are looking to identify a real catalyst for a sustainable market rebound. We remain on the cautious side – at least for now.

## For further information

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