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CIO Strategy Bulletin(s)

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The US: Bear Today, Bull Tomorrow

SUMMARY

- As the market is experiencing what appears to be the third bear market rally of 2022, it's useful to understand the bull and bear views and how we see reality.
- The bull case: Bearish sentiment – a positive sign for equities – has been rising sharply this year. A year ago, 24% of investors said they were “bullish.” Today, net bearishness is -22% -- and that's *after* the S&P has dropped by 18%.
- The bear case: There is enough data to suggest a sharp economic slowdown will unfold in 2023: the Fed will likely raise rates further as it also reduces liquidity. Quantitative Tightening will shrink money supply and credit outright, forcing banks to tighten lending standards. And remember, in the last 100 years, equities have never reached bottom before a recession started.
- In our view, the powerful impact of the Fed's rapid rate increases can't be underestimated. With a dramatic rise in yields, the economy will weaken. We expect earnings to contract 10% in 2023, after rising 6% this year.
- We will overweight equities during the trough of the recession – and we'll seek even stronger opportunities in riskier market segments in the coming year.

The Bull Is in China's Shop

- US investors have had a rough year, but investors in Chinese equities have suffered through two painful years of a bear market. In the 20 months through October, the MSCI China Index plunged 63%.
- Since the start of November, there's been a decisive turn in China policy meant to address key issues required for a recovery. In the past two weeks officials have announced 20 measures to ease China's zero Covid policy, the biggest drag on the economy and consumer sentiment. Financial authorities have also put forward policies to support a recovery in the beleaguered property market, including easing purchase and mortgage restrictions and protecting borrowers' credit scores. And on the geopolitical front, Presidents Xi and Biden met at the G20 and agreed to soften bilateral tensions.

Sentiment vs. Reality, Bull vs. Bear

Right now, there is a bull vs. bear tug-of-war going on. We have written that this is a perplexing market, full of hopes and fears (see our Oct. 29 [CIO Bulletin](#)). We believe we are experiencing a third bear market rally of 2022 just now, so it is useful to lay out how the bulls are seeing things and how a bearish investor might reply.

The Bulls

2021 saw real economic growth of nearly 6%. US employment grew by 514,000 per month throughout the year. Policy rates were held at zero while the Fed accumulated \$1.4 trillion in bonds, injecting a bolus of liquidity to ensure a complete recovery. It was also a great year for equities, with the S&P 500 up a whopping 27%.

Investors remained positive coming into 2022. Then everything changed. 24% of investors said they were “bullish” a year ago. Today, net bearishness is -22% (Haver Analytics through Nov. 18, 2022). And this bearishness remains *after* the S&P has fallen by 18%.

Bearish sentiment is actually good for equity performance. And given that a “coming recession” has been anticipated for most of 2022, it is well priced into markets. When markets have declined this much and sentiment remains low, future prospective returns have often been unusually strong (Figure 1). Short positioning in markets suggests the same. Across stocks and bonds, short positions have also surged toward historical record highs (Figure 2). Ultimately, these shorts must be covered, creating a material source of buying power.

Finally, the calendar fourth quarter of the year is statistically the strongest for risk assets based on seasonal inflows (Figure 3). Companies will soon be buying back stocks to the chagrin of short-sellers. The US dollar has reached an “exhaustion point” and will harm US corporate profits less in the future. Investors could reposition portfolios as the decline in valuations for the strongest growth sectors has worsened markedly (see our Nov. 13 [CIO Bulletin](#)).

The bull case was powerfully evident on November 10 when broad US markets jumped 5.5% and the Nasdaq surged 7.4%. They did so after just a whiff of good news on inflation. More should be expected. Supply chains have been clearing and the only major inflation source remains shelter costs. With the Fed fixated on seeing real evidence that inflation is coming down, this was truly good news. With layoff announcements mounting and inflation slowing, bulls expect that the Fed will declare victory soon, as evidenced by a 27-basis-point drop in 2-year US Treasury yields on the day the [October CPI](#) was released.

Figure 1: Individual investor net bullishness and S&P 500 12-month returns at extreme lows

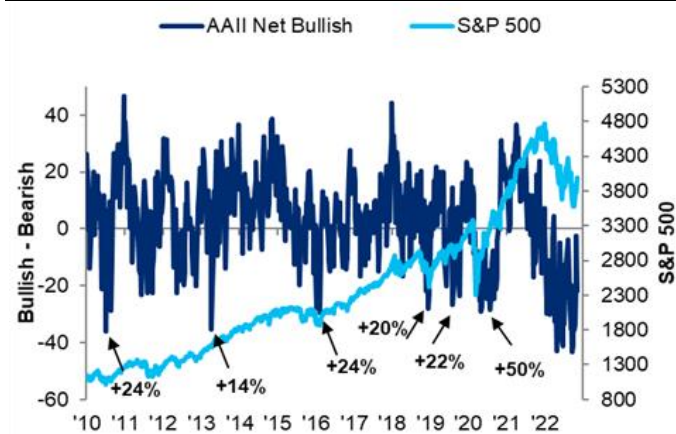


Figure 2: S&P 500 net short positions in futures



Source: Bloomberg as of November 16, 2022. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is no guarantee of future results. Real results may vary.

Figure 3: Seasonality of returns: Winter for bulls, summer for bears

Seasonality of Global and Regional Share Market Performance (Total Returns By Calendar Quarter)								
Index	1Q Avg	2Q Avg	3Q Avg	4Q Avg	3Q Low	3Q High	4Q Low	4Q High
MSCI World Index	2.0	3.1	0.1	4.7	-21.8	15.2	-20.7	19.0
US	2.3	3.4	1.4	4.8	-16.1	14.2	-27.5	17.8
Europe	0.0	3.1	-0.4	4.5	-22.9	18.3	-22.1	25.1
UK	1.2	2.2	0.8	4.6	-19.8	22.0	-9.7	16.8
Japan	1.4	1.6	-1.3	2.4	-32.2	21.9	-22.3	17.6
Asia Ex-Japan	3.0	3.3	-0.0	6.1	-23.7	17.6	-21.6	48.7
China	-1.7	5.4	0.1	3.1	-34.6	41.0	-33.4	47.5
Latam	2.5	3.0	1.2	5.1	-21.9	25.1	-20.4	31.0
EM EMEA	2.3	1.9	0.7	4.5	-26.0	25.1	-27.5	34.3
Seasonality of Global Fixed Income Market Performance (Total Returns By Calendar Quarter)								
Index	1Q Avg	2Q Avg	3Q Avg	4Q Avg	3Q Low	3Q High	4Q Low	4Q High
US Treasury	0.7	1.2	2.1	1.0	-1.1	7.3	-3.8	8.9
German Bunds	1.1	0.7	1.9	1.2	-1.2	7.8	-3.2	7.8
UK Gilts	0.7	1.2	2.8	2.1	-2.0	9.0	-4.7	10.6
US MBS	1.1	1.2	1.7	1.3	-0.1	5.5	-2.0	5.0
HG Corps (USD)	0.8	2.0	2.1	1.4	-7.4	8.2	-3.0	5.2
HY Corps (USD)	2.5	2.5	1.1	1.7	-9.1	13.7	-17.2	8.6
Seasonality of Commodity Market Performance (Total Returns By Calendar Quarter)								
Index	1Q Avg	2Q Avg	3Q Avg	4Q Avg	3Q Low	3Q High	4Q Low	4Q High
WTI Crude Oil	4.0	7.9	5.3	-3.8	-28.1	131.8	-55.7	28.4
Gold	0.9	0.4	2.2	1.3	-9.4	14.6	-13.5	14.8
Nominal Broad TWD	1.0	0.3	0.3	0.6	-3.7	5.0	-3.9	11.9
Real Broad TWD	0.5	-0.1	-0.1	0.1	-3.5	3.4	-3.6	9.5

Source: FactSet and Haver Analytics as of November 15, 2022. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is no guarantee of future results. Real results may vary.

The Bears

The US recession has not happened yet. And there are many data sets to suggest that a sharp slowing will unfold as we enter 2023.

- The Fed is likely to increase rates further and sustain higher rates into a shrinking employment picture. The 12-month pace of core PCE inflation, the Fed's favorite measure, was 5.2%. They keep referencing that pace – a consequence of their 2021 easing – not where it is headed after a likely 450 basis points of rate hikes in just nine months.
- The Fed is reducing liquidity even as it raises rates. Its Quantitative Tightening program is poised to shrink money and credit outright in 2023. As a result, banks are tightening lending standards and Fed policy rates are now above long-term bond yields (Figure 4). The high level of real short-term rates siphons away credit supplied for “big ticket” spending, such as financing constructing of a new home.
- The US money stock has slowed from a 28% growth rate in early 2021 to 2% in late 2022. Demand in the economy is being limited where it once was allowed to boom (Figure 5).
- Even though stocks rallied recently, the yield curve remains inverted. This has signaled an impending recession in 90% of prior instances since 1960, with an average lead time of 10 months.
- Finally, in the last 100 years, equities have never bottomed before a recession has begun.

Hearing Fed Chairman Powell draw attention to an upward surprise in the September CPI report helped prepare markets for a sharp recovery once a comparable downward inflation surprise for October was reported. Bears fear, however, that this is just a roller-coaster ride of short-termism. The issue is not month-to-month changes to perception, but rather: “is anything the Fed is doing likely to prevent the economy from weakening”? Bears don't think so.

Our Balanced, Realistic View

The bull's best case would be a “soft landing” for the US economy, a period of moderating growth with demand and supply growing together in a moderate sustainable pace. However, the speed of Fed rate increases and their impact cannot be underestimated.

The impact of higher rates is now rippling through the economy, with a lag. The housing sector, a leading indicator of the economy overall, has seen a stunning 41% decline in sales to-date. Mortgage purchase applications, a timelier indicator, have fallen 51%. Similarly, homebuilders report prospective buyer traffic has fallen 74%. Yet, there have been no losses in residential construction jobs. Once the homes that are now under construction are finished, we expect up to 400,000 job losses in 2023.

A recent drop in long-term US bond yields won't stop a decline in the housing sector in 2023. The housing industry still faces a collapse in production and employment in 2023 just to “catch down” to the present home sales pace.

Powell's comments, deliberately reiterated by regional Fed presidents in the press every week, point to a Fed using the rear-view inflation mirror to drive forward-looking policy (see our Nov. 6 [CIO Bulletin](#)). Forward-looking inflation data suggests that inflation will cool while employment weakens in a way that will force the Fed to react once again.

With a dramatic rise in yields and drop in wealth, the economy will weaken, and earnings should contract 10% in 2023, by our estimates, after rising 6% in 2022. As we've described in the last two Quadrant reports in [October](#) and [September](#), we think the decline in share prices in 2022 is a “down payment” toward reaching a bear market bottom in 2023 (Figure 6).

Finally, when the Fed is “done” and begins to reduce rates, we remind investors that “early cycle” easing periods have been historically negative for both financial markets and labor markets (Figure 7). There has not been a single

case in which a bear market associated with recession found its low point even before the first of the job losses and profit declines occurred.

Figure 4: US yield curve (leading 1-year) vs net % of US banks tightening lending standards for consumer loans

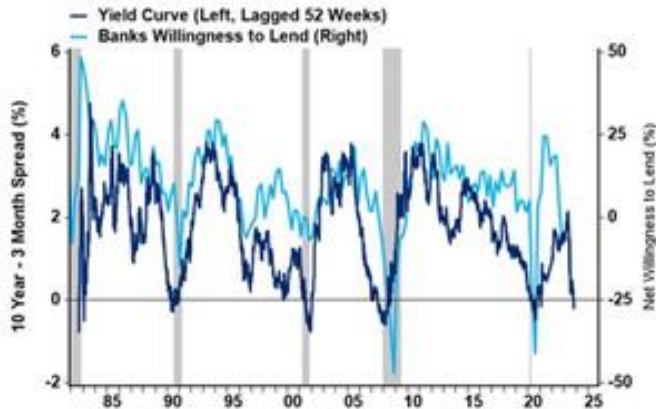
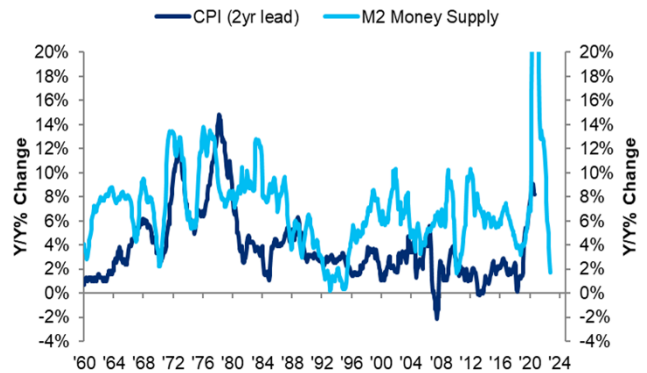
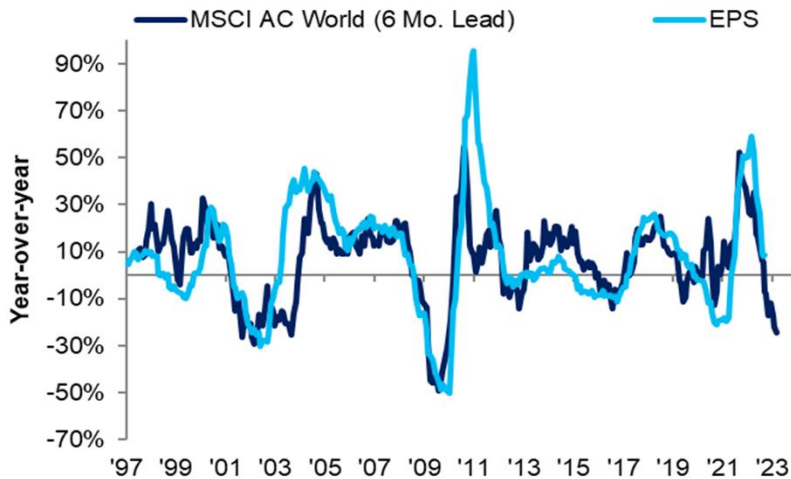


Figure 5: US M2 money supply (2-year lead) vs inflation



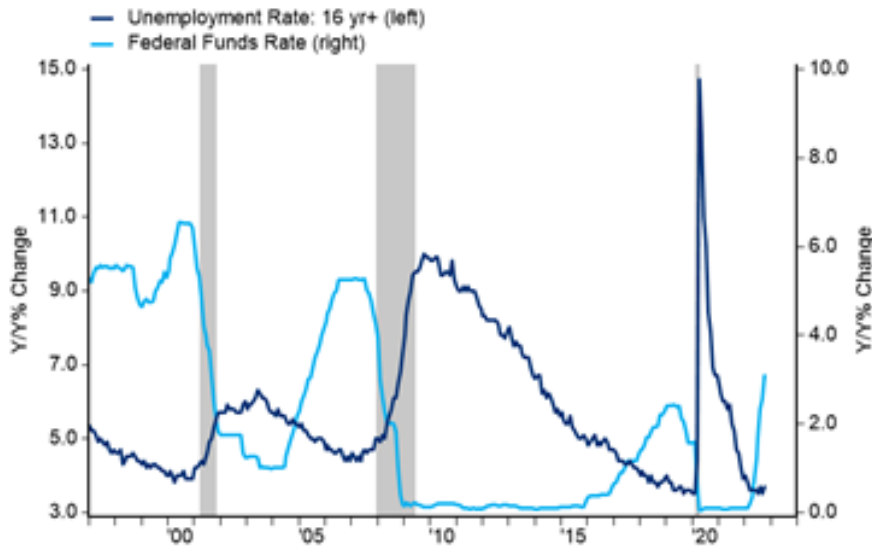
Source: Haver Analytics as of November 15, 2022. Gray areas are US recessions. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is no guarantee of future results. Real results may vary.

Figure 6: Global equities lead EPS by 6 months



Source: Bloomberg and FactSet as of November 15, 2022. Gray areas are US recessions. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is no guarantee of future results. Real results may vary.

Figure 7: No quick rebound in labor markets once the Fed eases: Fed funds rate vs unemployment rate



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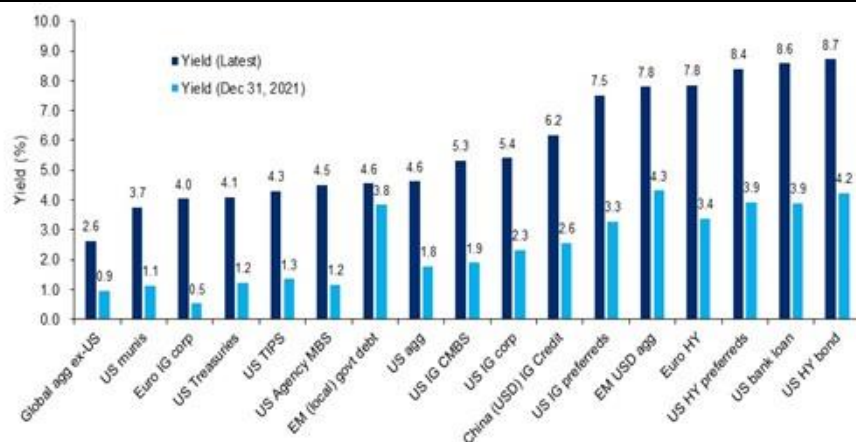
2023: Bear Today, Bull Tomorrow

Once the scope of the 2023 recession is understood and a path to recovery is visible, equities will almost certainly lead the economy out of recession, if history is a guide. Remember, there have only been two bear markets in the past 100 years that took more than two calendar years to find a bottom.

We will overweight equities during the trough of a recession. The median 12-month US equity return once a bear market bottom has been reached is 37%. Even stronger opportunities in riskier market segments will be worth our attention in the coming year.

In the meantime, the unusually severe repricing of fixed income markets offers us the chance to add income and rebuild risk diversification into portfolios, likely for the longer run (Figure 8). The combination of an “activist Fed” and a cyclical contraction for the economy suggests that today’s higher bond yields won’t last. If overzealous Quantitative Tightening and a consequent employment contraction forces the Fed to correct itself, we would expect 10-year US Treasury yields to fall back to 3% by year-end 2023. **If this proves correct, the prospective total one year return on the 10-year Treasury would be roughly +10%.**

Figure 8: Bond yields across segments now vs Dec 31, 2021



Source: Bloomberg as of November 17, 2022. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is no guarantee of future results. Real results may vary.

The Bull Is in China’s Shop

While investors in the US have had a bad year, investors in Chinese equities have endured two years of a painful bear market. The MSCI China index fell 63% in the past 20 months through October.

A recovery in China and in Chinese markets requires that policy makers address four key domestic problems. These are the Covid zero policy, the property crisis, tech regulations and geopolitical escalations. In the few weeks since the Party Congress concluded in late October, there have been meaningful signs that change is forthcoming. Substantial policy actions have been announced to address three of the four.

A Major Pivot in China

We believe this moment marks a major policy pivot that has the potential to restore economic confidence and activity. It will take time for a recovery to gain momentum, as the post-Covid return of mobility will initially be slow. And the slowdown in the US and Europe will be headwinds for Chinese exports. But it is our assessment that the bottom for Chinese equities had been reached in the week after the Party Congress.

A Slow End to the Covid Zero Policy

China’s Covid zero policy has been the biggest drag on its economy and consumer sentiment. In October, when China enforced partial lockdowns ahead of the Party Congress, retail sales fell by 0.5%/y/y, the first decline since the March-May lockdowns (Figure 9). Unlike past cycles when investment drove recoveries, restoring consumption is critical to China’s recovery this time.

Here are the actions we have seen:

- The newly inaugurated Politburo Standing Committee—China’s top decision-making body—unveiled 20 measures to ease Covid zero policy. This included reduced quarantine requirements and scrapped circuit breaker for international flight arrivals. Many cities have cancelled previously planned compulsory PCR tests since.

- Official media have applauded Hong Kong as a success case in scientific pandemic management. Two domestic-made vaccines, one inhaler and one mRNA, have been approved for emergency use. More government marketing is being done to tout vaccine effectiveness and to play down the severity of the disease.
- Restoring economic vibrancy has taken a higher political priority than Covid prevention.

Still, the re-opening won't happen overnight. As China experiences a winter wave of infections, with 20,000-30,000 new cases per day, a rapid re-opening will not happen. Indeed, daily mobility data show continued deterioration in November to date (Figure 10). But we expect data to improve as it has across the globe, opening up more opportunities for China travel internally and, ultimately, externally.

Figure 9: Poor macro data through October were concentrated on retail sales, making consumption the key driver for upcoming recovery

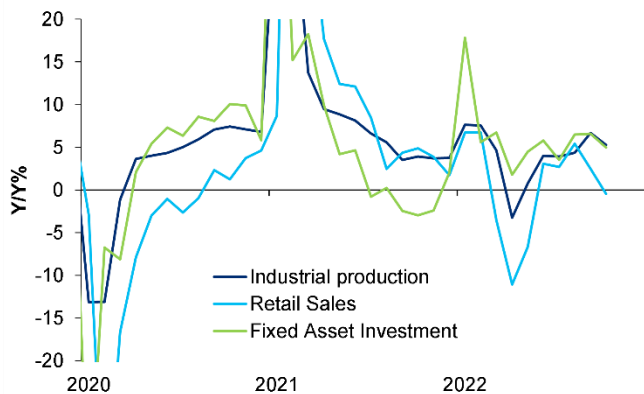
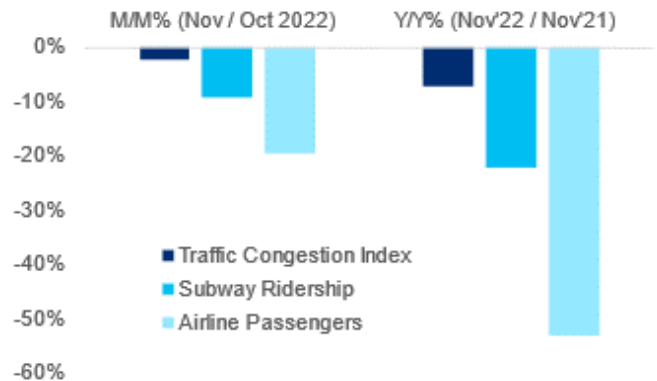


Figure 10: Recent data show still declining domestic mobility in November, as COVID cases rise



Source: Haver as of Nov. 15, 2022, and Bloomberg as of Nov. 16, 2022.

Real Estate Repair

A day after the Politburo meeting, China's financial authorities circulated a 16-measure policy package to support a recovery in the badly damaged residential real estate market in China. These included support for loan and bond issuance and extension, borrower credit score protection, and dedicated lending programs for project construction and debt restructuring.

These measures have benefits far beyond real estate. They will benefit the financial sector, too. The property crisis started with a few egregiously indebted companies failing. The contagion spread last year to include all developer high-yield issuers, then investment-grade issuers, and finally state-owned developers. This was followed by buyers renegeing on their mortgage obligations.

Now, as the new policies were announced, real estate players, banks, insurers and wealth managers have joined the stock market's rally recognizing the policy pivot (Figure 11). This is a critical element for sustaining an economic recovery in China.

We now have to watch real estate and prices to see how the recovery unfolds. Recent measures include lifting purchase and mortgage restrictions, as well as protecting borrowers' credit scores as they renegotiate their mortgage obligations. We expect an acceleration of project completions will also help to restore demand.

New home sales have recovered from the -50% nadir during the national lockdowns in April, but remain 23% below a year ago (Figure 12). Over the past two years, new home sales have fallen by 42%, while housing starts have dropped by 58%. The scale of demand destruction for housing may be eclipsed someday by housing shortages in the future if China follows through on all of these policies.

Figure 11: End to contagion lifts all financial boats

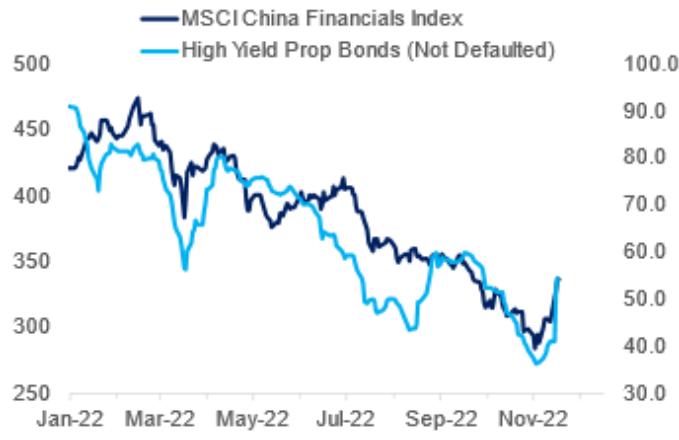


Figure 12: Restoring sales remains a tough task



Source: Haver Analytics as of Nov. 15, 2022, and Bloomberg as of Oct. 18, 2022.

US-China Relations

In the geopolitical arena, Presidents Xi and Biden met on the sidelines of the G20 gathering in Bali, Indonesia, and produced the first agreement to soften bilateral tensions since the trade war erupted under the Trump administration. The content and tone of their press announcements were focused. Biden recognized that military action across the Taiwan Strait is not imminent, and Xi joined Biden to criticize Russia's invasion of Ukraine. Xi then met with the heads of state of South Korea, Australia, Japan, and others and made consistent, constructive comments.

We believe the best future for the US-China relationship is one of strategic competition. While geopolitical risks are likely to rise and fall over time, dialing down tensions at this point lifts a major weight off of Chinese markets.

Now we need to see if there is follow-through. Will the latest de-escalation help to avoid a forced delisting of Chinese companies listed in the US? The market is eagerly awaiting the verdict from authorities on whether the information provided to them during their audits in Hong Kong was sufficient. Remember that the delisting threats weighed heavily on Chinese equities over the past year (Figure 13). Decisively lifting that risk would boost market momentum.

Technology Re-Regulation

The fourth hurdle, tech regulations, were addressed prior to the Party Congress. New rules were written and circulated. We have already seen IPO volume in Hong Kong rebound notably. Hong Kong IPOs amounted to \$83bn

in July through October – four times the total size of the first half. But the lack of flagship companies, like Ant Group, left investors still wanting. Any breakthroughs in this area would likely create additional upside momentum in Chinese equities. If markets see a return of major corporate IPOs in the tech sector, capital markets will open further.

Conclusion

We believe a decisive turn in China policy is underway and will support an economic revival. We also believe this recovery is leading that of US and Europe where monetary policy is still tightening. As always, there will be setbacks along the way. Yet, as strong as the rally had been in November, when the MSCI China index surged 27%, the index still only reversed a bit less than half of the 38% lost in July-October, and a small fraction of the two-year bear market. In our view, the recovery is still ahead, and equity markets will likely see improvements over the course of 2023.

Figure 13: Stages of China's bear market



Source: Haver Analytics as of Nov. 15, 2022. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

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