



Citi Global Wealth Investments

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It's Officially a Bear Market... Now What?

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Summary

- Equity markets plunged into bear market territory on Monday following a 1-2 punch of hawkish ECB rhetoric and a stronger-than-expected US CPI print late last week. Long duration Treasuries continue their price descent after a brief pause over the past few weeks, contributing to the ongoing reassessment of valuations in riskier assets. Up next is the Fed's June meeting on Wednesday, where a 50 basis point hike was telegraphed, though markets are now pricing some chance of a 75 bp move.
- Amid rising gas prices and sticky inflation, consumer confidence as surveyed by the University of Michigan has fallen to its lowest level in decades. At the sector level, this portends a particularly challenging few quarters for retailers, as many of the group's highest profile stores over-ordered household electronics, furniture and apparel in anticipation of much stronger demand than has actually materialized.
- Global risk assets were introduced to another central bank scared of inflation last week: the ECB. Meanwhile the yen has depreciated sharply as Japanese government bond yields pale in comparison to even European sovereigns. A weaker yen is not as bullish for local Japanese shares as it used to be, though the sharp selloff could be an opportunity for active managers to pick up higher quality Japanese names that sell to a global customer base. We remain underweight broader European and Japanese equities.
- Global equities are now pricing in outright earnings contraction over the next year as odds of a recession rise, a more pessimistic outlook than our estimates at Citi Global Wealth. However, valuations are also being pressured by rising bond yields. Our expectation for rates to peak this year should eventually provide support for equities, but we could see more near-term volatility as the market focuses on imminent Fed tightening risks.
- The bear market of the early 2000s is not a perfect comparison to today, but it does share some similarities with the current unwind of pandemic-related tech spending as well as a surge in energy prices following geopolitical conflict. During that bear market, dividend growers and defensives outperformed the broad market, and we take a similar strategy today as we grapple with acute near-term macro uncertainty.

It's Officially a Bear Market... Now What?

Equity markets plunged into bear market territory on Monday following a 1-2 punch of hawkish ECB rhetoric and a stronger-than-expected US CPI print late last week (Figure 1). Long duration Treasuries continue their price descent after a brief pause over the past few weeks, contributing to the ongoing reassessment of valuations in riskier assets. Up next is the Fed's June meeting on Wednesday, where a 50 basis point hike was telegraphed, though markets are now pricing in a decent chance of a 75 basis point move. Chair Powell's discussion of inflation and the potential impact that tightening is having on employment will be a key focus for investors trying to gauge the Fed's commitment to fighting inflation and therefore the severity of this bear market.

We expect that implied and realized volatility will remain elevated through the summer. Reduced summertime liquidity can precipitate market downside even in the best of years, and this year markets face a significant headwind from [rising rates plus a shrinking Fed balance sheet \(QT\)](#). Financial conditions are certainly no longer "easy": rapidly rising mortgage rates are contributing to slowing housing activity while credit spreads and equity risk premiums are widening, raising the cost of financing for corporations (Figure 2).

Figure 1: Global equity performance YTD

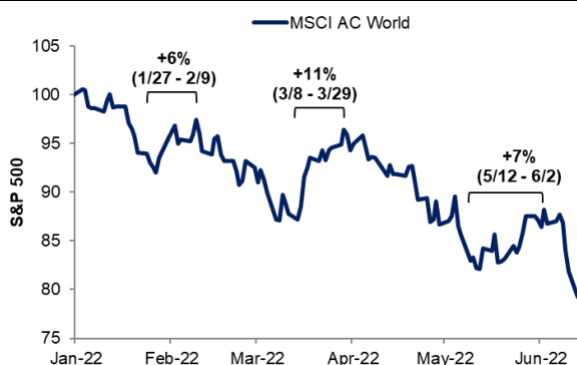
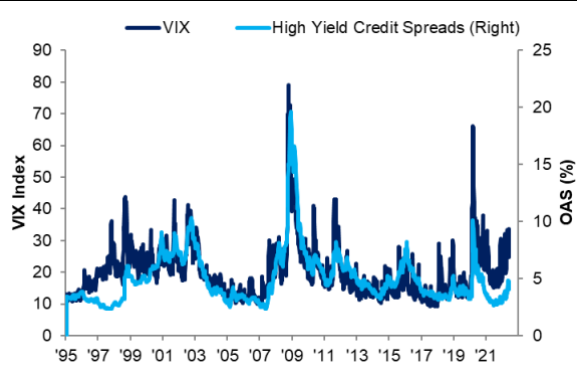


Figure 2: The VIX vs HY credit spreads



Source: Bloomberg and Haver as of June 13, 2022. 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. Past performance is no guarantee of future results. Real results may vary.

Amid spiking gas prices and sticky inflation, consumer confidence as surveyed by the University of Michigan has fallen to its lowest level in decades (Figure 3). At the sector level, this portends a particularly challenging few quarters for retailers, as many of the group's highest profile stores over-ordered household electronics, furniture and apparel in anticipation of much stronger demand than has actually materialized (Figure 4). That said, what is certainly bad news for consumer discretionary stocks could contain a silver lining for the goods segment of our inflation outlook. Inventories are essentially trapped revenues and retailers are likely to slash sticker prices or write down inventories altogether in order to clear up their warehouses and storefronts of unwanted items. Falling goods prices will not solve the commodity shortage or a tight housing market, but this trend is consistent with our view that inflation will begin to fall in the second half of this year.

Figure 3: Consumer sentiment vs equity valuations

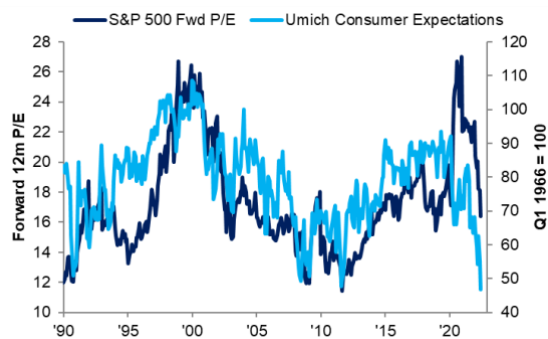
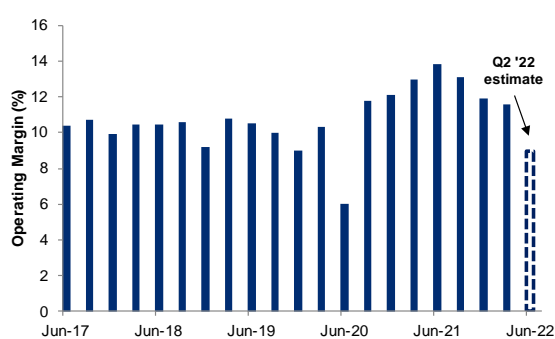


Figure 4: S&P 500 Retailing quarterly operating margins



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Angst over global central banks

Global risk assets were introduced to another central bank scared of inflation last week: the ECB. [Our Europe strategists dug into the details](#), but in short markets now expect the fastest pace of rate hikes ever attempted by the ECB (Figure 5). In addition, the European central bank will be tightening into a slowing economy with business expectations already in negative territory. This compares to previous hiking cycles in the mid-00s and just after the Great Financial Crisis when the ECB hiked into a strengthening macro backdrop (of course the latter tightening period helped precipitate a double dip recession in 2011).

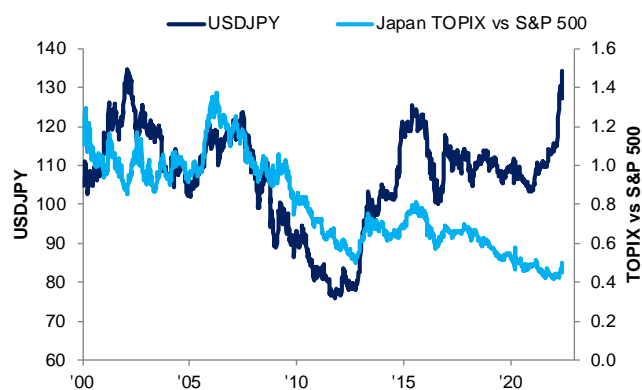
The only major developed central bank steadfastly retaining its easy money stance is the Bank of Japan. This has led to a sharp weakening in the yen as Japanese bond yields now pale in comparison to even European government debt. It was historically conventional wisdom that a weakening yen is bullish for local Japanese shares, as Japanese exporters benefit from a cheapening of the goods they sell to overseas buyers. Over the past several years, however, we have seen this relationship break down, as a weakening yen is also an incentive for domestic Japanese savers and pension funds to keep funds offshore (Figure 6). This trend deprives local capital markets of investment and limits upside for Japanese equities. That said, we could see the yen's weakening as a potential opportunity for global active equity managers to pick up higher quality and truly global companies domiciled in Japan that will now be selling cheaper products to a global market.

On the glass half full side, as China's lockdowns continue to ease, we are potentially starting to see signs of a recovery in Chinese equities, which remain deeply depressed after a year-and-a-half of aggressive fiscal and monetary tightening. [Please see the latest from our Asia Strategy team](#) covering these developments in more detail.

Figure 5: Expectations for ECB rate hikes vs German ZEW Business Expectations



Figure 6: A weaker yen is not a clear bullish catalyst for Japanese equities anymore



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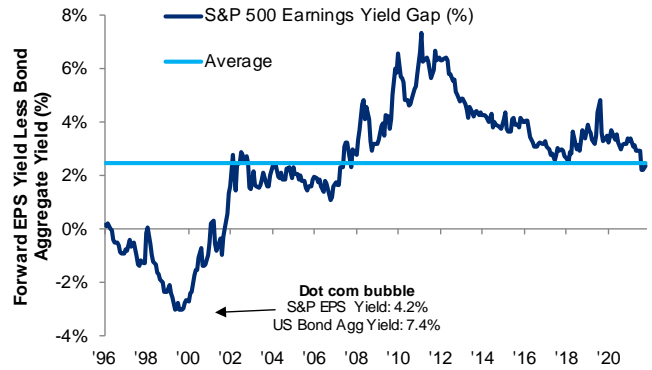
Check-in on earnings and valuations

Global equities are now pricing in outright earnings contraction over the next year as odds of a recession rise, a more pessimistic outlook than our estimates at Citi Global Wealth (Figure 7). But earnings are not the only consideration for investors, as the backup in long-term yields is also a drag on valuations. Forward earnings yields remain around average levels versus 10-year bonds, though the higher rates rise in the short-run the more equity valuations likely need to contract. We continue to expect that long-term rates will roll over (i.e., fall) into year-end, which should help support valuations in equities over the medium term (Figure 8).

Figure 7: Global equity prices vs EPS



Figure 8: Earnings yields vs 10-year Treasury yields



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How to invest in a bear market: Early 2000s case study

All bear markets are different, as each selloff is precipitated by a unique set of macro circumstances. That said, history often does rhyme. [Last month](#), we discussed the similarities between the current moment and the era of stagflation in the 1970s.

While the dot-com boom and bust had its own extremes, the recession and bear market of the early 2000s was relatively mild and precipitated by somewhat similar circumstances to what we see today: a slowdown of spending on technology (in today's case, excessive expectations among stay-at-home trends) coupled with a commodity shock following the World Trade Center attacks on 9/11/01 (today, a war in Ukraine). Even our more pessimistic RECESSION scenario for today's environment assumes a relatively mild Fed-induced contraction, not a major financial crisis driven by the unwind of excesses.

While US equities fell 37% from peak to trough from 2000 to 2002, high quality stocks across sectors were able to eke out a positive return over that period (Figure 9). Meanwhile, defensives outperformed cyclicals the whole way down, with cyclicals like tech and discretionary only beating defensives once the market bottomed in October 2002 (Figure 10). We take a similar approach today, leaning into defensive sectors like health care (pharma) and staples, while also maintaining exposures to energy and other commodity-sensitive equities given ongoing supply constraints.

Figure 9: Dividend Growers vs S&P 500 during the 2000-02 bear market

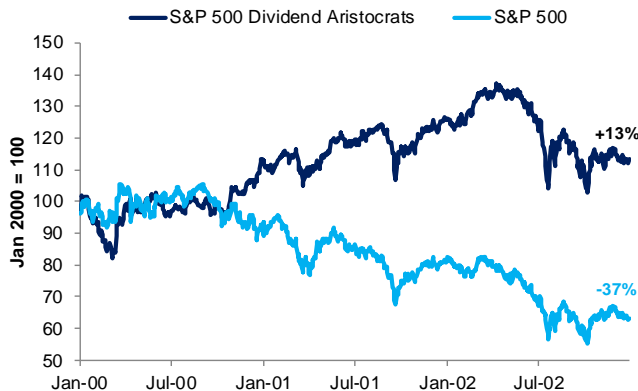
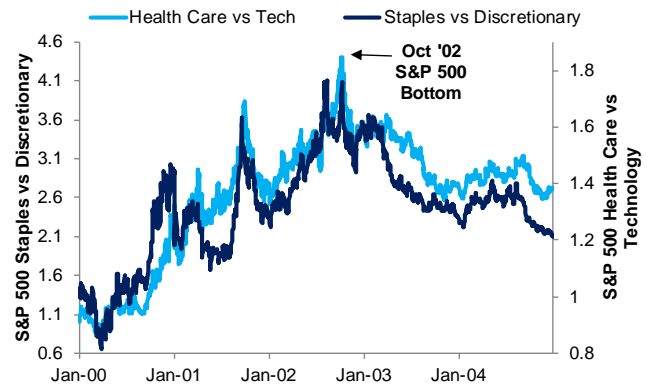


Figure 10: Staples vs Discretionary and Health Care vs Tech from 2000-2004



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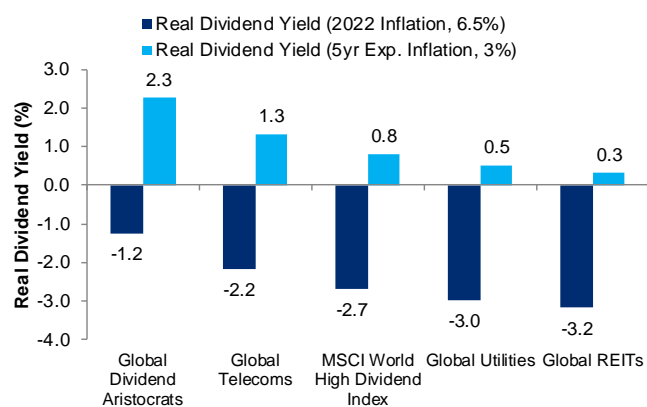
A longer-term perspective

For investors with a long time horizon, we conclude with a simple message. The post-WWII period suggests that now is the wrong time to sell out of equity portfolios. In every bear market over the past 80 years, equities have delivered positive returns over a 2-5 year period if an investor bought and held on the day markets reached bear market territory (Figure 11). This is not to say that the coming months won't be bumpy. The Fed is actively reducing market liquidity in an effort to crush inflation. But a strategy of identifying companies with strong balance sheets, sustainable business models, and stable cash payouts seeks to outperform in the short-run and also deliver positive and consistent inflation-adjusted returns over the longer term (Figure 12).

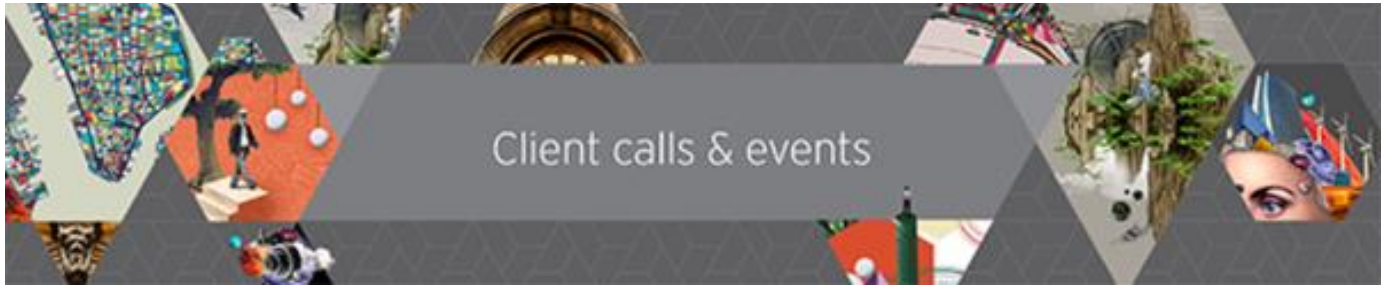
Figure 11: Forward returns following 20% S&P 500 declines

Figure 12: Inflation-adjusted dividend yields among high dividend payers

Date First Hit -20%	Forward 12 month return	Forward 2 Year Return	Forward 3 Year Return	Forward 5 Year Return
9/9/1946	-1%	7%	3%	57%
10/21/1957	31%	44%	38%	40%
5/28/1962	26%	45%	58%	63%
8/29/1966	25%	33%	27%	34%
1/29/1970	12%	21%	35%	-11%
11/27/1973	-27%	-5%	8%	-1%
2/22/1982	30%	38%	61%	153%
10/19/1987	24%	52%	36%	85%
3/12/2001	-1%	-32%	-6%	9%
7/9/2008	-29%	-13%	6%	33%
3/12/2020	59%	68%		
Average	14%	23%	27%	46%
Median	24%	33%	31%	37%
Max	59%	68%	61%	153%
Min	-29%	-32%	-6%	-11%
% Positive	63.6%	72.7%	90.0%	80.0%



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