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Investment Strategy Bulletin

Investing through bear markets – where to from here?

Investment Solutions

26 July 2022

Key takeaways

- Recessionary bear markets have seen peak-to-trough falls of 35% in the S&P500's recent history, and non-recessionary ones 19%
- Cyclical bear markets are less painful for equities than structural ones, but more painful that event-driven ones
- We forecast a recession in 2023, with equity market valuations and sentiment consistent with this, but earnings and outflows with potentially further to fall
- Our current equity allocation is underweight, with options strategies on major indices. We favour quality and value stocks, the UK and Chinese markets, energy and healthcare sectors. We would caution against attempts to time the market.

Equity investors are bruised and seeking solace. The S&P500 had its worst first-half performance since 1970. Most major equity markets are down between 10-25% year-to-date, and a downtrend remains in place, despite some rebounds off May and June lows. Recessionary fears have added to – and now eclipsed – concerns about high inflation and a protracted war in Ukraine, driving a rotation from cyclicals towards defensive names and sectors. Investor sentiment has rarely been as negative. What impact might an upcoming recession have on markets, and how much further could they potentially fall? In this scenario, which stocks, sectors, regions and styles should we favour – and when might it be time to buy the dip?

History lessons

Recent bear market episodes are one place to look for clues about the scale and timing of market falls. One rough-and-ready measure is to look at the time taken to fall from peak-to-trough. Reviewing 15 corrections of greater than 15% in the S&P500 since 1960, eight were associated with recessions, and seven were not (see chart 1 on page 2). In the former, markets took 14 months to reach their lows on average, with a median peak-to-trough drawdown of 35.0%. Only half the time was typically needed in the seven non-recessionary episodes, with a median drawdown of 19.4%.

Viewed through this lens, the S&P500's current 17% drawdown over almost 7 months is consistent with a market split on the probability of an upcoming recession, suggesting that a recession might see further falls of ~10-15%+ ahead, or that the market may find a bottom soon if not. Further analysis suggests that a soft landing could be consistent with ~10% upside from here.

To complicate matters further, with recession, the pain could be either short or lengthy. In 2000, markets took 2+ years to reach a trough despite a shallow recession, and 1.5+ years in 1980 and 1973 where contractions were deep; but just over a month in 2020 despite a deep economic contraction. Typically, during recessions Purchasing Managers Indices (PMIs) – a measure of prevailing economic conditions – drop to the low 30s (anything below 50 signals a contraction), along with meaningful increases in unemployment. Market recoveries can be sharp too, although consistent with the sell-off patterns, they have taken much longer to regain previous highs during recessions (a median of 13 months) than in non-recessionary corrections (4 months).

We can therefore say that an important determinant of the depth and duration of bear markets seems to be whether or not they are accompanied by a recession. Their timing, however, moves independently. Markets are anticipatory: they tend to peak about six months ahead of recessions "officially" starting (which is only known months later with the benefit of hindsight), and trough ahead of recessions ending.

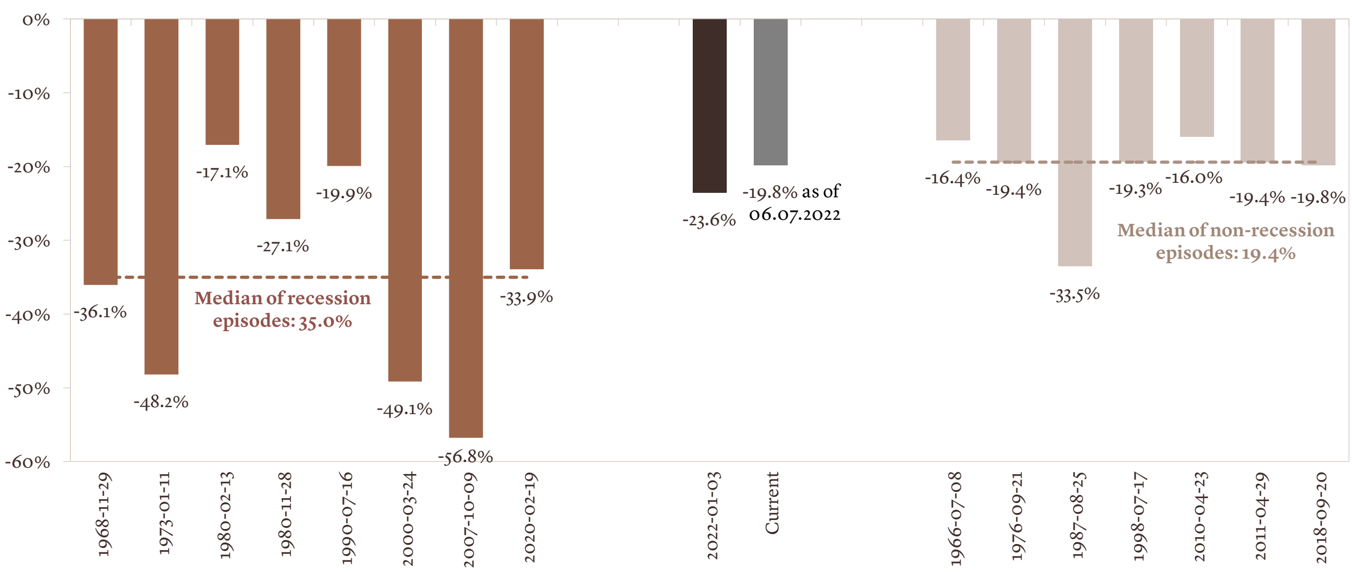
Analysing the type of bear market can also potentially tell us more about the current correction. Structural bear markets arise from underlying economic imbalances – a credit-fuelled housing bubble collapsing in 2008, or a huge run-up in technology and broader stock valuations bursting in 2000. These were the longest lasting and most painful in the sample we analysed. Cyclical bear markets reflect a more classic 'boom and bust' cycle, typically triggered, or stopped, by rate rises. Event-driven bear markets follow impactful one-off shocks, regardless of whether they lead to a recession or not, e.g. the Covid-19 pandemic. The latter tend to be short-lived, albeit painful. Our view is that we are in a cyclical bear market, without large imbalances that need correcting. Average maximum drawdowns here have been 29.3%, with a median 21.6 months' duration.

Where are we now in the cycle?

Does a recession look inevitable, and where are we now in the cycle? US rate hikes in July and September look all but certain to hit levels that start actively restricting future growth. Although retail sales continue to rise, US consumer sentiment remains near record lows, and soaring prices will increasingly force households to spend more of their budgets on essential items.

1. Spotlight on past corrections

Maximum drawdown of S&P 500 in 15 episodes since 1960 with a market correction > 15%



Sources: Bloomberg, Lombard Odier

Our proprietary World Economic Indicator, which tends to lead global GDP by 6-8 months, has recently moved from slowdown to contractionary territory, implying a recession starting in Q1 2023. Our core scenario of a mild 2023 recession has now become the consensus view among economists, notes a [Financial Times survey](#).

As a result of rising recessionary expectations and already higher interest rates, the downward move in equity valuation multiples has already been in line with historical recessionary episodes (see chart 2). Yet because multiples started at such high levels, recent falls have merely brought them down to levels consistent with average historical market peaks. We therefore see little room for them to rise anew before a decisive peak in US inflation is reached. Measures of investor sentiment, too, reflect pessimism consistent with prior market bottoms. The latest Global Fund Manager Survey by Bank of America makes this abundantly clear. In addition, mega-cap firms including Goldman Sachs and Meta Platforms plan to slow hiring, and/or make lay-offs, further contractionary indicators.

Earnings – the dog that has yet to bark?

Earnings, however, have yet to sound the same warning bells. Analysts expect companies to grow earnings per share (EPS) 5.6% on average for the current Q2 reporting season, a healthy figure, albeit one heavily skewed by energy firms' outperformance. Earnings remain supported by strong GDP growth and elevated commodity prices. But as activity slows and higher prices bite, the situation should deteriorate. In our view, this is not yet reflected in the +10% consensus EPS growth estimates in both Q3 and Q4. Indeed, analysts still expect companies to grow earnings and margins in 2023. While earnings typically continue to grow in non-recessionary market downturns, past recessions have seen trailing (and forward) measures of EPS contract by 17% on average. Any disappointment in Q2 earnings – or more likely in managements' 'forward guidance' – will be heavily scrutinised and could trigger a further leg down in markets.

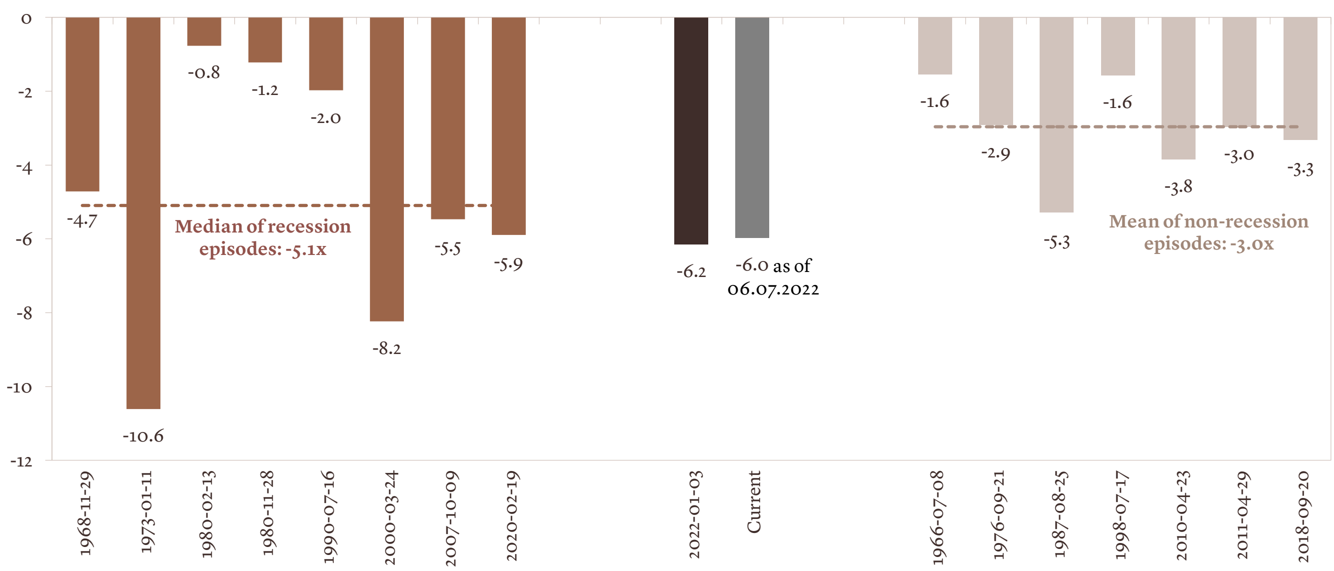
Meanwhile, we have also seen few signs of investor 'capitulation' that normally signals a market trough, shorthand for swift and indiscriminate selling of stocks and soaring trading volumes. Equity outflows have certainly accelerated and selling is more evident in high yield credit than in equities – yet it feels as if we are some way from panic selling of stocks.

Positioning equity allocations

In an unusually uncertain investment environment, and weighing the potential for upside or significant further falls for stocks, our equity position is slightly underweight when we take into account our options strategies on US

2. Valuations have fallen considerably – but from high levels

Change of P/E from market peak to market trough for the S&P 500 in 15 episodes since 1960 with a market correction > 15%



Sources: Bloomberg, Lombard Odier

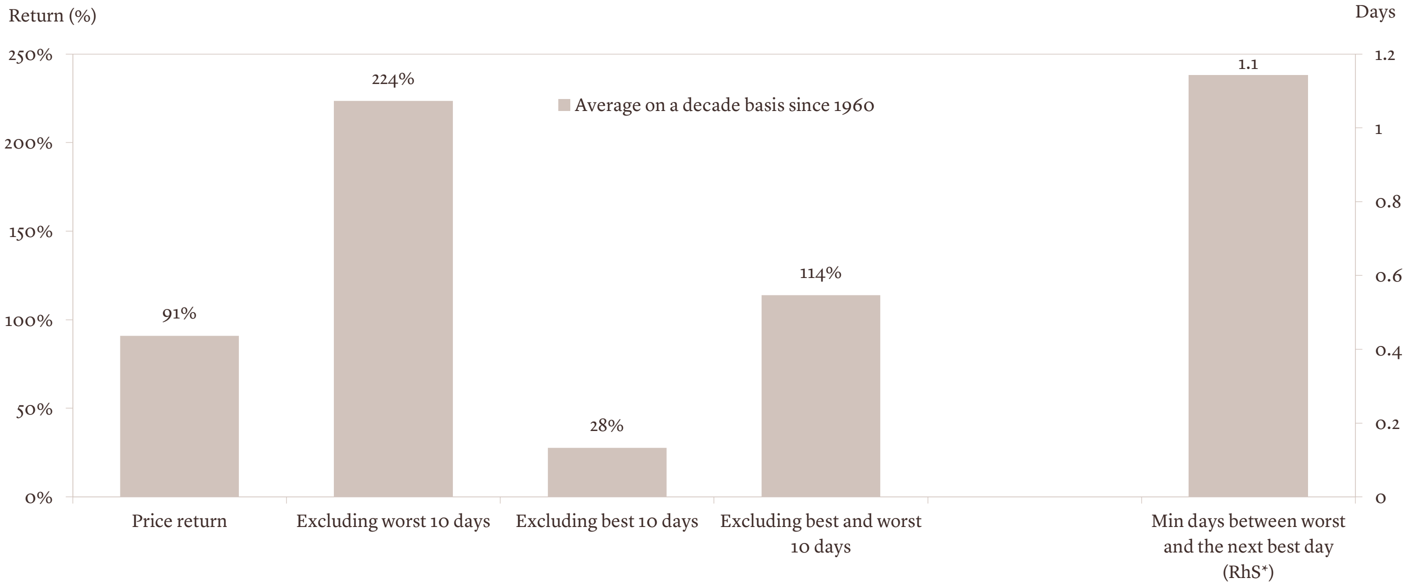
and European indices. These are designed to partially shield investors from future drawdowns. While we note that there could be a tactical bounce from 'oversold' levels on any good news, given the prevailing bearish sentiment, we would need more clarity on the inflation-growth-rates mix to become more positive on equities.

With dispersion in performance high, micro opportunities from stock-picking remain attractive. In terms of style tilts, we favour quality and value stocks, which have historically done best in recessionary market corrections, (with quality and growth outperforming in non-recessionary ones). We favour energy and healthcare among sectors, and the UK, the US and China among regions.

We would also caution investors against attempts to time the market, a strategy that can prove costly. Painful down days for markets are frequently followed by extremely positive ones and judging when to move in and out, effectively and consistently, is virtually impossible. By way of example, over the past seven decades, if investors had missed the best 10 days performance for the S&P500, he or she would have sacrificed returns of 63% on average per decade (see chart). The impact of missing both the best and worst days is overall negligible and perhaps even negative once transaction costs are factored in. We therefore favour a long-term, diversified investment strategy, for equities, as for other asset classes.

Christian Abuide, Head of Asset Allocation
Jianwen Sun, Quantitative Analyst - Asset Allocation

3. Timing trap



* right hand scale
Sources: Bloomberg, Lombard Odier calculations

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