Perspectives

MAY
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Flirting With a Bear Market

HOW DID WE GET HERE, AND WHAT COMES NEXT?

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Quite simply, this has been the worst start to a year since the 1930s:

- One of only 19 quarters since 1976 when both bonds and stocks posted negative returns;
- One of only six of those quarters when bonds have underperformed stocks;
- The worst four-month return for the S&P 500 since 1939.

2022 to date has featured a myriad of macroeconomic factors coming to a head: inflation at its highest level since the 1980s, the Federal Reserve responding with aggressive rate hikes, and increasing concerns about the health of the consumer leading to a possible recession. An evolving pandemic, a war in Eastern Europe, and draconian lockdown policies in the world's second-largest economy and largest manufacturing hub have further added to the problem and complicated the solution. With these macro headwinds and uncertainties driving markets year-to-date, Marquette's fixed income, U.S. equities, and non-U.S. equities teams discuss the impacts on their asset classes and weigh in on the outlook from here.

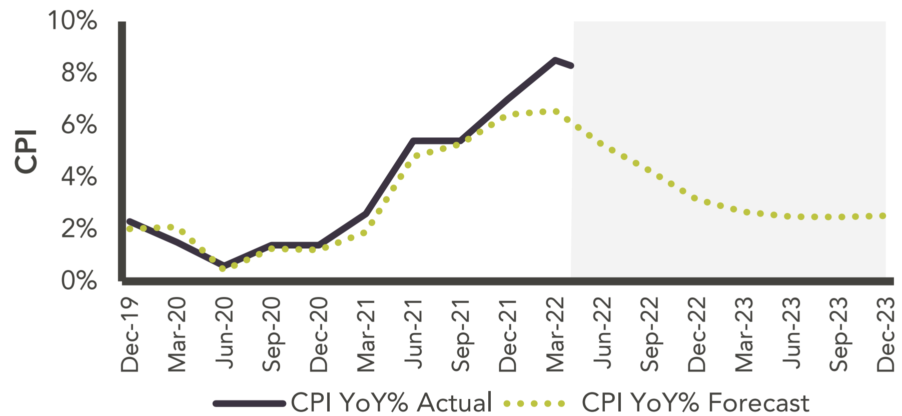
IT STARTS WITH THE BIG PICTURE: MACROECONOMIC HEADWINDS

INFLATION

Government stimulus, a shift in demand from services to goods, an extremely tight labor market, and supply chain disruptions and bottlenecks have all contributed to decades-high inflation in the U.S. Headline CPI hit 8.5% in March, the highest level since 1982, before ticking down slightly to 8.3% in April. While peak inflation should be a market-moving milestone, the dip in April did little to assuage concerns, with a short-lived reprieve in gasoline prices responsible for 45 basis points of improvement over the prior month. Prices at the pump were back to new all-time highs by early May. Inflation impacts all consumers — though disproportionately — as a loss of purchasing power. Higher prices and consequentially higher interest rates, the Federal Reserve's primary tool for controlling inflation, can cut into consumer spending and slow growth. With current inflation driven by supply as much as demand dynamics, an even more daunting scenario — stagflation

— is not out of the realm of possibilities. Monetary policy tools are designed to influence inflation by reducing overall demand yet offer little influence on supply side factors. Thus, even if monetary policy successfully slows demand, supply constraints can still keep prices high; this combination of slowing growth and rising prices could eventually take a toll on the red-hot labor market.

Exhibit 1: Inflation has continued to exceed expectations, with CPI hitting a 40-year high in March

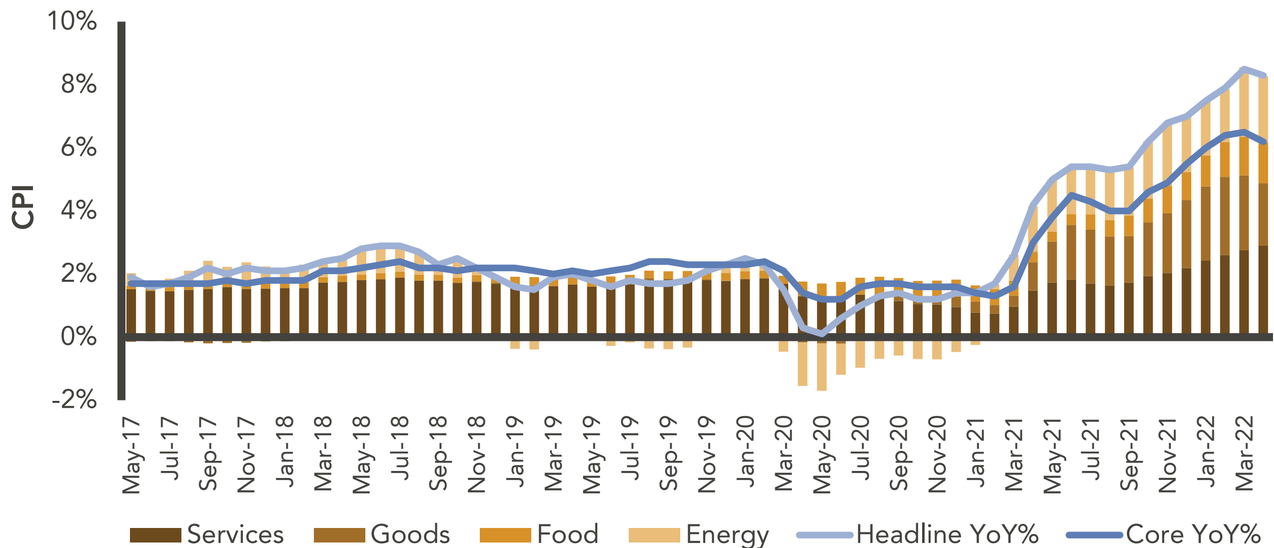


Sources: OECD, Bloomberg as of May 11, 2022

RUSSIA/UKRAINE

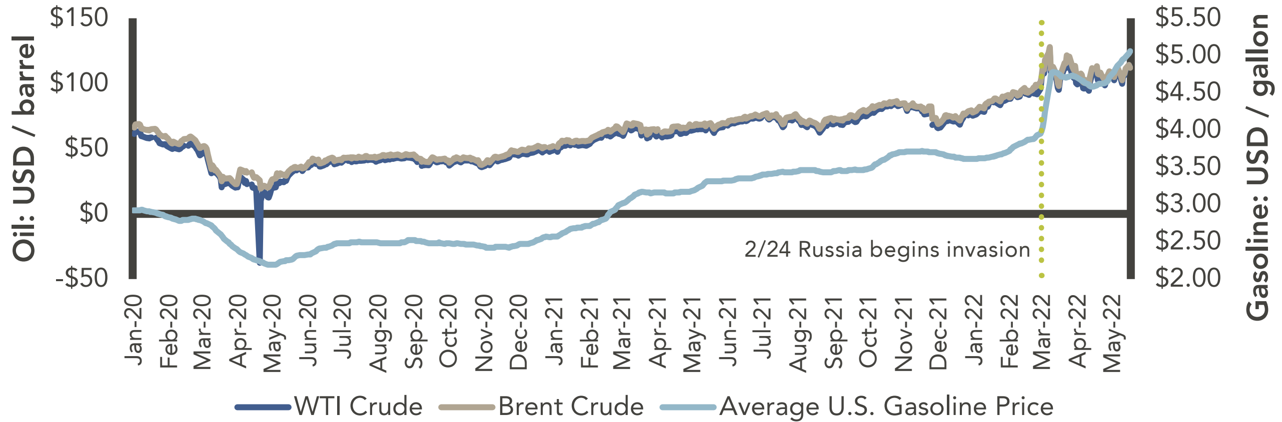
Prior to Russia's invasion of Ukraine, there was hope that February would represent the peak in inflation, with COVID-related supply chain bottlenecks starting to ease and key contributors like used car prices beginning to correct. The March CPI number, driven higher by rising energy and food costs as a direct result of the conflict, reset expectations. Ukraine is an important producer and exporter of food commodities and Russia is a major player across energy, agricultural, and metals commodity markets. The damage and disruption to supply chains in Ukraine and the sanctions levied against Russia have reduced supply and driven up prices and inflation expectations. Europe, which relies more heavily on commodity imports than the U.S., will likely see the greatest impact. The effects of higher energy and food prices, in addition to the general uncertainty of heightened geopolitical tensions and a nearby war, are already taking a toll on consumer spending and business investment in the region, with spillover effects likely for the U.S. and rest of the world.

Exhibit 2: Rising food and energy prices, as a direct result of Russia's invasion of Ukraine, have added to inflationary pressures



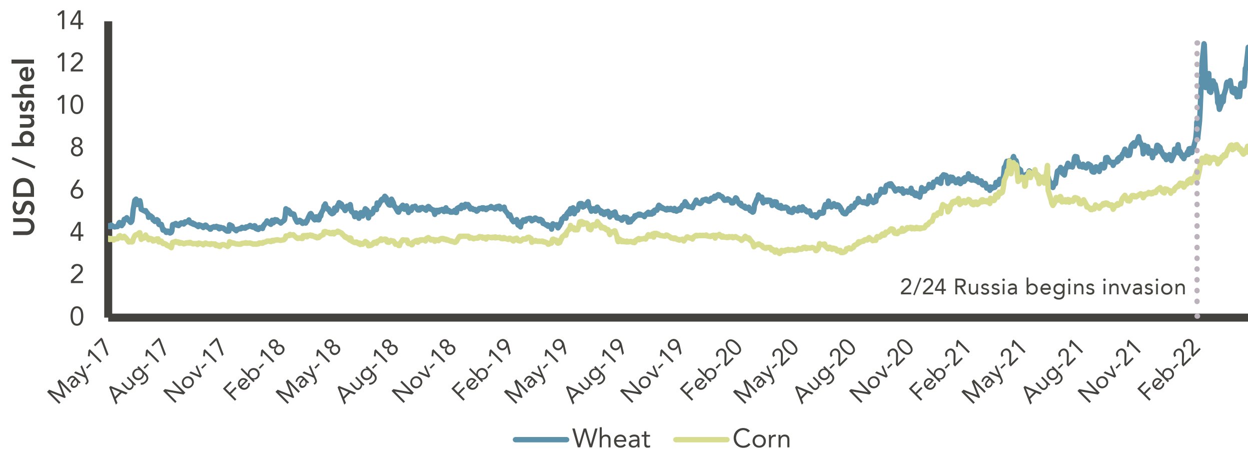
Sources: Bureau of Labor Statistics, Bloomberg

Exhibit 3: Oil and gasoline prices spiked after Russia's invasion in anticipation of sanctions against the producer. Russia is the world's third-largest oil producer, behind the U.S. and Saudi Arabia, and the second-largest exporter.



Sources: IEA, New York Mercantile Exchange, ICE Futures Europe Commodities, Bloomberg

Exhibit 4: Russia and Ukraine together account for 28% of global wheat exports and 15% of global corn exports



Sources: USDA 2020/2021, Chicago Board of Trade, Bloomberg

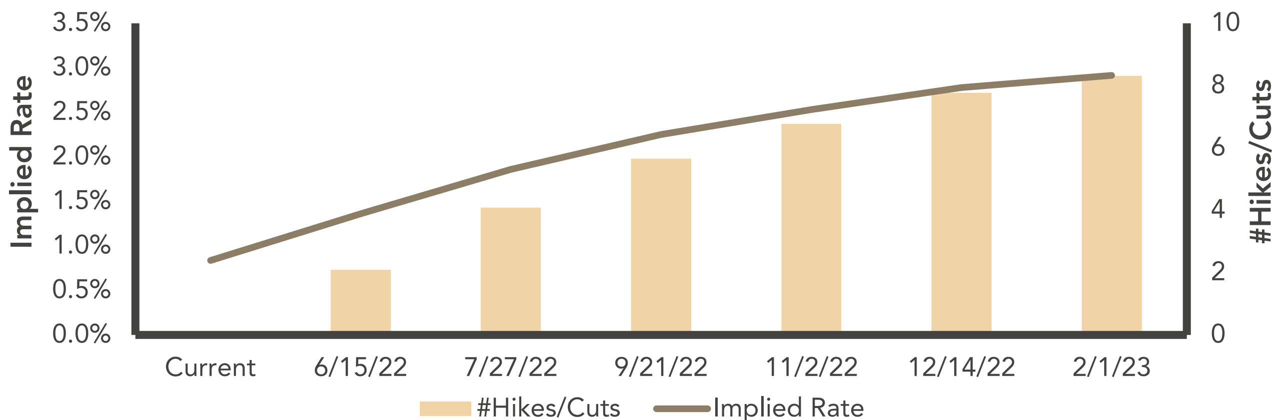
CHINA LOCKDOWNS

Further exacerbating existing supply chain disruptions and adding to inflationary pressures has been China's zero-COVID policy and strict lockdowns. China accounts for 29% of global manufacturing output and Shanghai, shut down since March 28th, is the world's largest container port. Supply chains around the world that rely on inputs out of China have suffered as a result. Plans to fully reopen Shanghai as of June 1st have now been announced, but even then, pent-up demand will likely lead to higher freight rates and additional port congestion, furthering the disorder and ripple effect on prices. Moreover, a slowdown in the world's second-largest economy, projected to drive 25% of global economic growth through 2026, will have widespread implications. Beyond the lockdowns — which have already hit consumer spending, factory output, and the jobless rate in the country — other trends such as stricter regulation in China's technology and education sectors, disarray in the key real estate sector, and fallout from China's connection to Russia amid its invasion of Ukraine have all weighed on growth prospects. While China is in a better place than the U.S. or Europe to provide additional policy support, conflicting priorities of the Chinese government will likely not allow for a quick fix.

RATES

The primary tool to combat high inflation is higher interest rates, which can also negatively impact economic growth. In March, at its second FOMC meeting of the year, the Federal Reserve raised its benchmark federal funds rate for the first time since 2018, up 25 basis points to a target range of 0.25–0.50%. At its next meeting in May, the Fed raised rates another 50 basis points, the first increase of that size since 2000, to a range of 0.75–1.00%. From here, the futures market is pricing in 50 basis point increases at the next two meetings, followed by a series of 25 basis point increases over the next four meetings to a rate of 2.86% by February 2023.

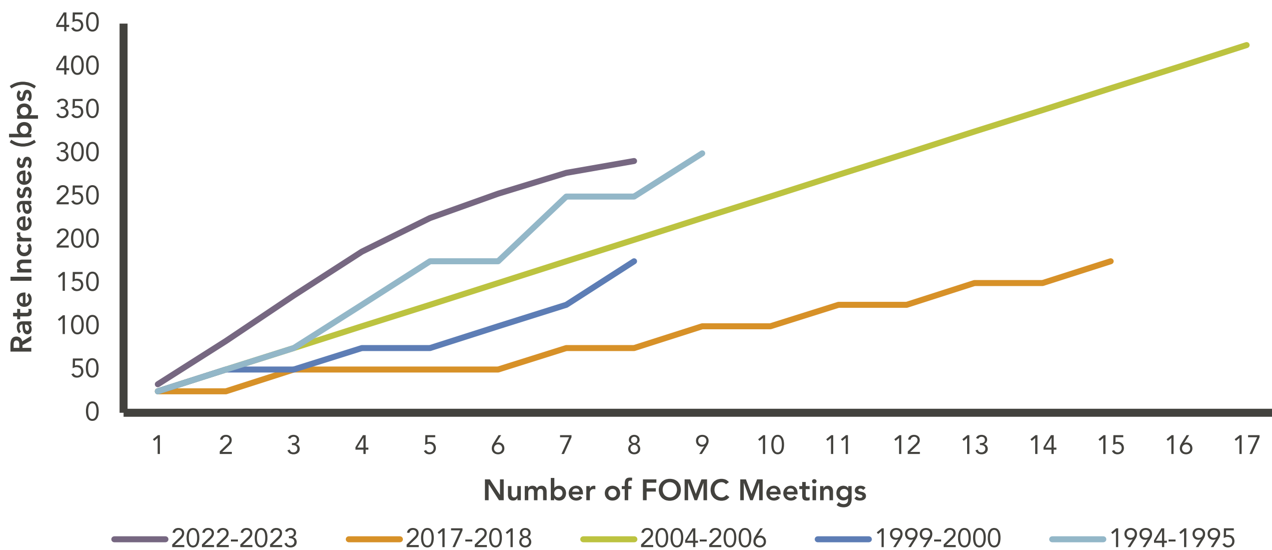
Exhibit 5: Fed funds rate to approach 3% by 2023



Source: Bloomberg

If expectations prove correct, it would be the fastest pace of increases since the 1980s. At the same time, beginning in June, the Fed will start to reduce its historically large balance sheet, despite Federal Reserve Chairman Powell emphasizing how uncertain the effect will be. While rampant inflation certainly needs to be contained, supply-side dynamics, the Federal Reserve's delayed response, and the imprecision of raising interest rates increase the risk of unintended and overwhelming impacts to growth.

Exhibit 6: The futures market is pricing in the steepest pace of increases in the fed funds rate since the 1980s

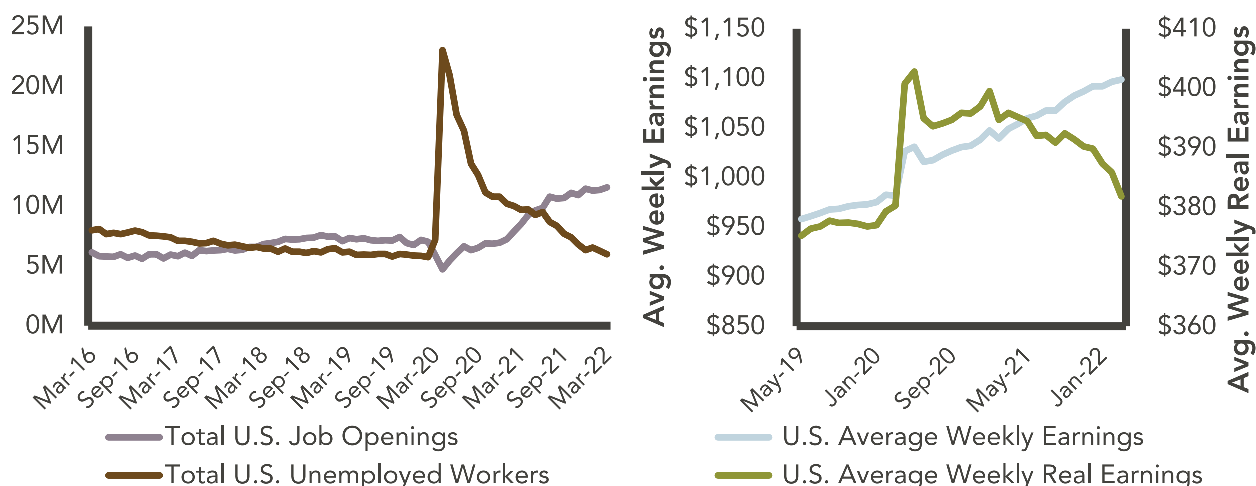


Source: Bloomberg

GROWTH

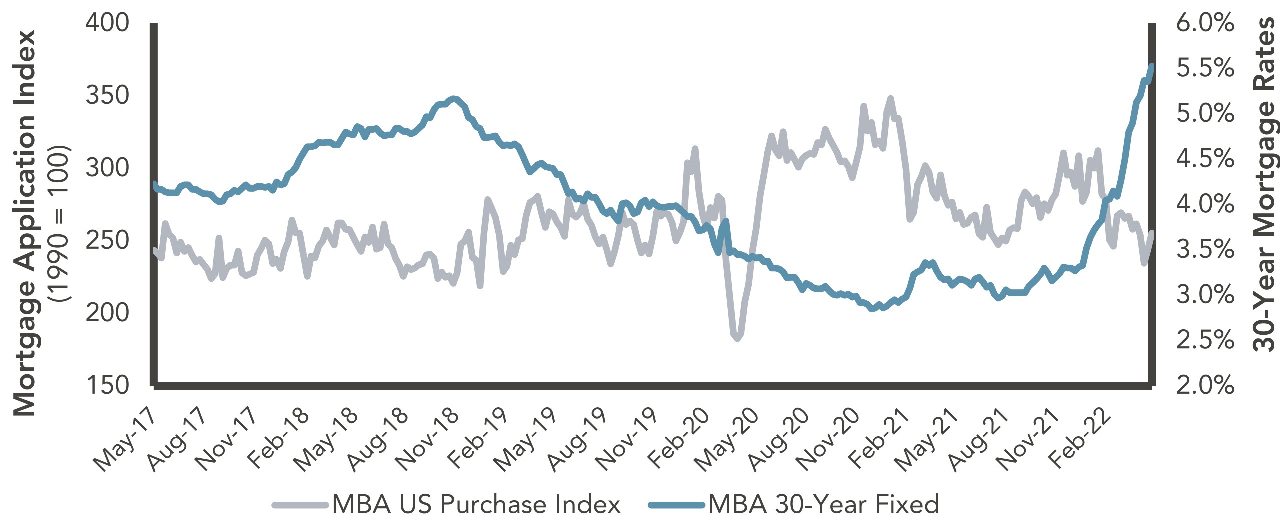
While the U.S. consumer remains strong by many measures with high savings rates, a tight labor market *(Exhibit 7)*, and increased demand for services as COVID concerns fade, the risks are to the downside. Tighter monetary policy has started to impact more rate-sensitive sectors like housing *(Exhibit 8)* and earnings from large retailers are beginning to reflect higher costs and more tepid demand. The University of Michigan Consumer Sentiment Index has continued to drop *(Exhibit 9)*, now well below marks at the height of the COVID pandemic, to levels not seen since the Global Financial Crisis and the slow recovery that followed. While initial estimates of first quarter U.S. GDP came in below expectations at -1.4%, the move lower was due to inventories and trade, more volatile categories, while consumer spending and business investment remained strong. The real test will come in future quarters, as the effects of as-yet unrelenting inflation and higher interest rates broadly take hold.

Exhibit 7: While the U.S. labor market remains extremely tight (left) and nominal wage growth has been strong (right), increasing inflation has eaten into consumer buying power, with real wages trending lower since early 2021



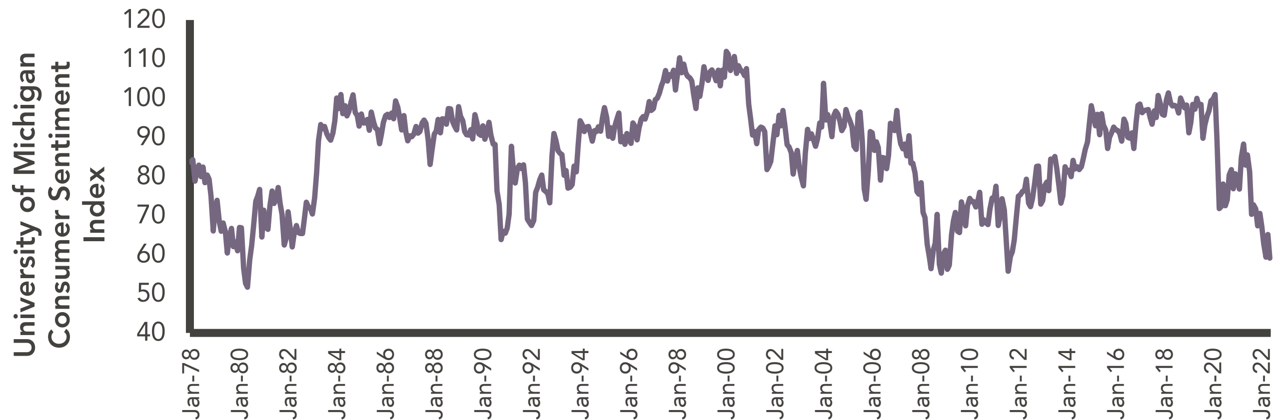
Source: Bloomberg as of March 31, 2022

Exhibit 8: Mortgage applications have fallen as 30-year mortgage rates have spiked



Sources: Mortgage Bankers Association, Bloomberg

Exhibit 9: Consumer sentiment has fallen to levels last seen in the wake of the GFC, with weaker expectations across income, age, education, geography, and political affiliation brackets



Sources: University of Michigan, Bloomberg

Collectively, these factors have created a high degree of uncertainty about future growth prospects, for both individual companies as well as the overall economy. Predictably, these concerns have manifested themselves via capital market returns. With the Federal Reserve focused on raising rates in order to slow inflation — rather than dropping them to stimulate growth — the markets are left to their own devices. The results have been painful, and the outlook for the remainder of the year appears murky as well.

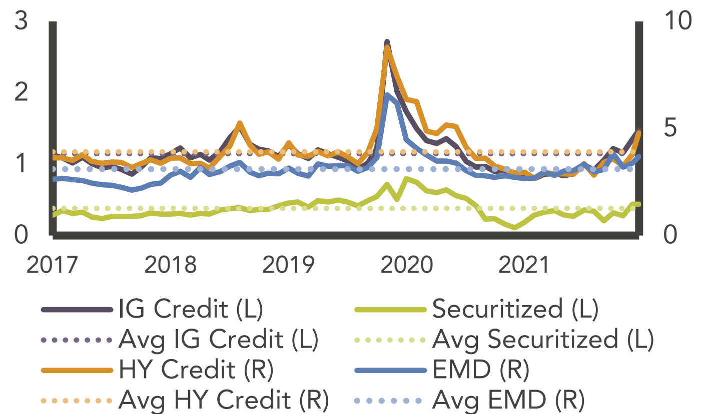
FIXED INCOME: NOT SURPRISING, BUT STILL PAINFUL

IT ALL STARTS WITH RATES

When interest rates increase, the duration component of fixed income naturally suggests negative price returns. Certainly, the Fed's strong statements about raising rates to combat inflation coupled with its first two moves are the primary causes of the overall increase in rates. What has surprised investors, though, is how quickly rates have risen, both in reaction to the Fed's comments as well as expectations about future increases. The last time the market saw such large movements was the late 1970s and early 1980s when the Fed undertook aggressive rate hikes to counter inflation, ultimately causing the infamous "double-dip" recession. What was different that time, however, was that rates were so high on an absolute basis that the Fed had room to cut rates as an escape mechanism from the recession. Given the still overall low-rate environment (at least from a historical perspective), the Fed has less wiggle room this time which has also fueled concerns about policy errors.

Of course, rates are not the only driver of non-Treasury bond returns — spreads also play a role. Since the start of the year, we have seen a modest uptick in spreads, though they have not been the major driver of the bond market losses. Investment grade corporate spreads have increased approximately 55 basis points, while high yield corporates are up about 200 basis points and emerging market credit has risen about 75 basis points. While spreads have bumped up, the rate increases are responsible for most of the damage.

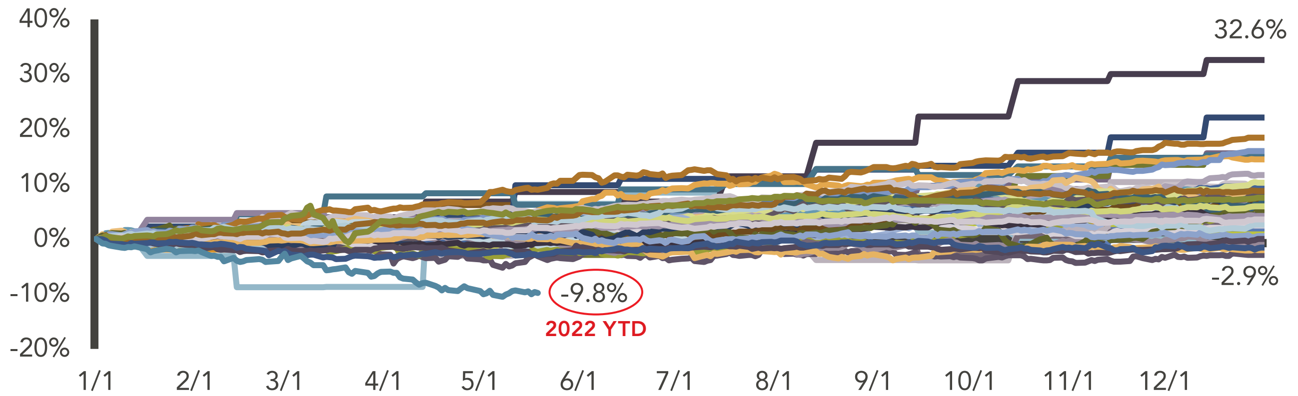
Exhibit 10: Spread levels



Source: Bloomberg

Using the Bloomberg Aggregate ("the Agg") bond index as a proxy for bond returns, the rapid rise in rates has fueled the worst start to the year in recorded history for the asset class, as shown below:

Exhibit 11: The rapid drop of the Aggregate Index is unprecedented

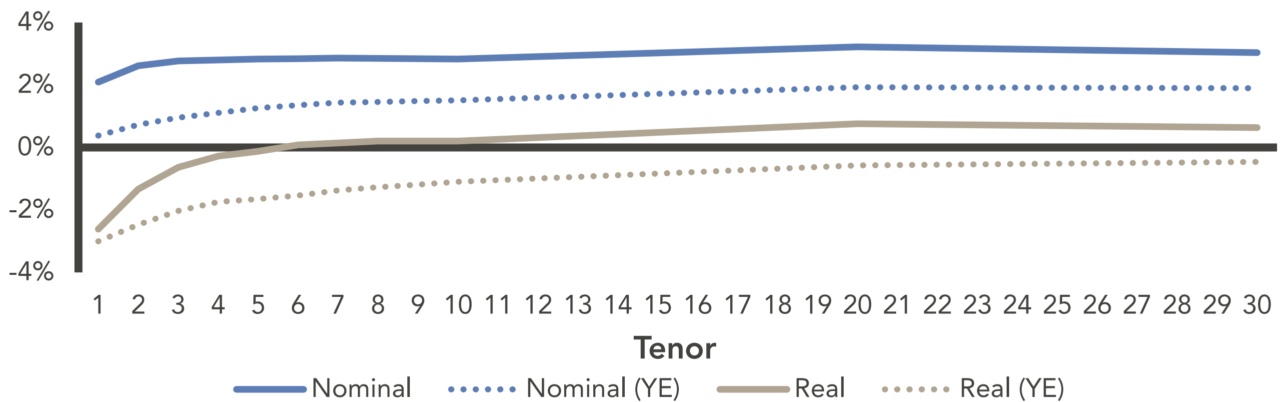


Source: Bloomberg

BONDS GO "BACK TO BEING BONDS"

The silver lining is that fixed income now offers a more meaningful yield, so investors are actually getting paid to hold fixed income. As shown in the chart below, yields have materially increased across the curve since the end of 2021, and real yields are now positive for maturities greater than six years.

Exhibit 12: Nominal and real Treasury curves



Sources: U.S. Treasury, Bloomberg. The real yield is the market yield using the on-the-run inflation protected par curve. The difference between the two curves is a naive estimate of forward-looking inflation expectations. They are not a pure estimate of inflation expectations due to the differences in risk premia of the two securities.

Spread volatility is expected to persist — largely due to the factors discussed in the macroeconomic section — but the current environment is a superior entry point compared to last year when spreads were tight for the entire year. High-quality credit offers additional carry, and fundamentals based on strong balance sheets for corporations and consumers should support credit markets in spite of the macroeconomic headwinds. Furthermore, limited issuance as a result of record-high issuance in recent years combined with higher borrowing costs in today's environment should also be supportive of credit for the remainder of the year. We are less bullish on lower-quality credit, however, since it is more exposed to the economic slowdown and withdrawal of liquidity from the market than investment grade credit.

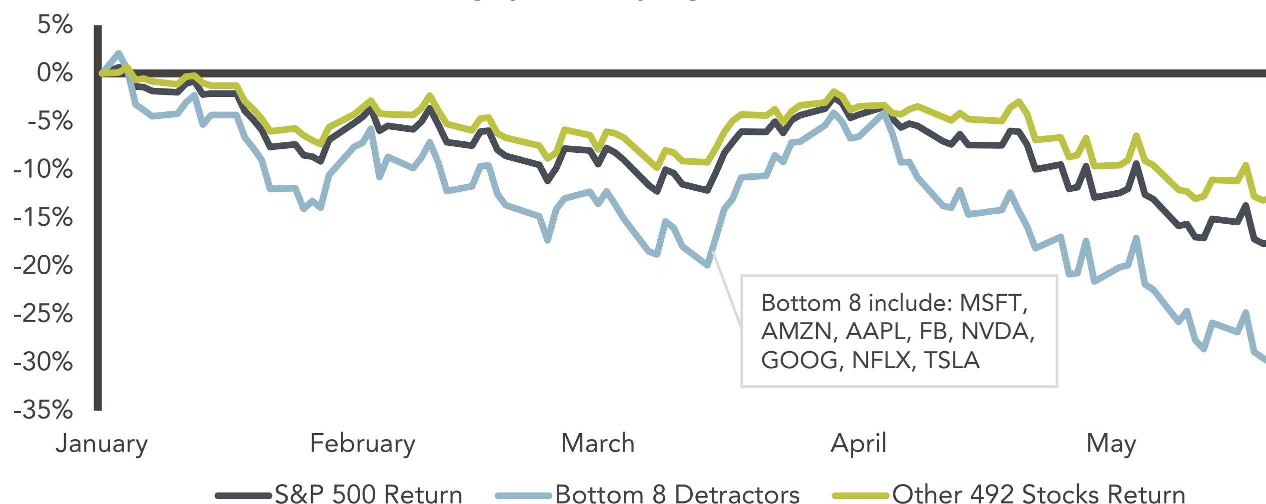
Since year-end, the yield on the Agg has doubled from 1.75% to 3.50%. At this point, the general consensus is that most of the movement in yields beyond the fed funds rate is currently priced into the market, so

the majority of price losses may have already been absorbed, and given the higher level of income now available, fixed income returns could be more stable for the rest of the year. Overall, the bond market is healthier today from an investment perspective than it was at the start of the year and is better positioned to resume its traditional role in portfolios — offering income, diversification, and liquidity this year and beyond.

U.S. EQUITIES APPROACH BEAR MARKET TERRITORY

The entire U.S. equities space has been severely impacted by the changing macroeconomic landscape, though growth-oriented securities have borne the brunt of recent market turmoil. Growth stocks, often concentrated in sectors like Information Technology and Health Care, derive a greater portion of their value from expected future cash flows. As the Federal Reserve forces interest rates higher, the present values of those cash flows diminish, and the current value of the stocks declines. With market-capitalization weighted indices like the S&P 500 becoming increasingly concentrated in a handful of large technology companies over the last few years, those benchmarks are now even more sensitive to rising interest rates. Eight of the S&P 500's largest technology companies, which constitute approximately 26% of the index by weight, have driven 46% of the year-to-date drawdown for the benchmark, with Apple and Microsoft contributing the largest share. The remaining 492 stocks in the S&P 500 have generated an approximate -13.6% return, just crossing the threshold required for a correction.

Exhibit 13: Year-to-date decline largely driven by Big Tech



Source: FactSet as of May 20, 2022; SPY used as a proxy for the S&P 500 index

Value-oriented stocks, on the other hand, tend to have intrinsic values rooted in current book value and near-term cash flows, making their share prices less susceptible to changes in interest rates. These types of businesses have protected on the downside relative to their longer-duration peers, with the Russell 1000 Value index outperforming the Russell 1000 Growth index by 17.5% through the end of last week.

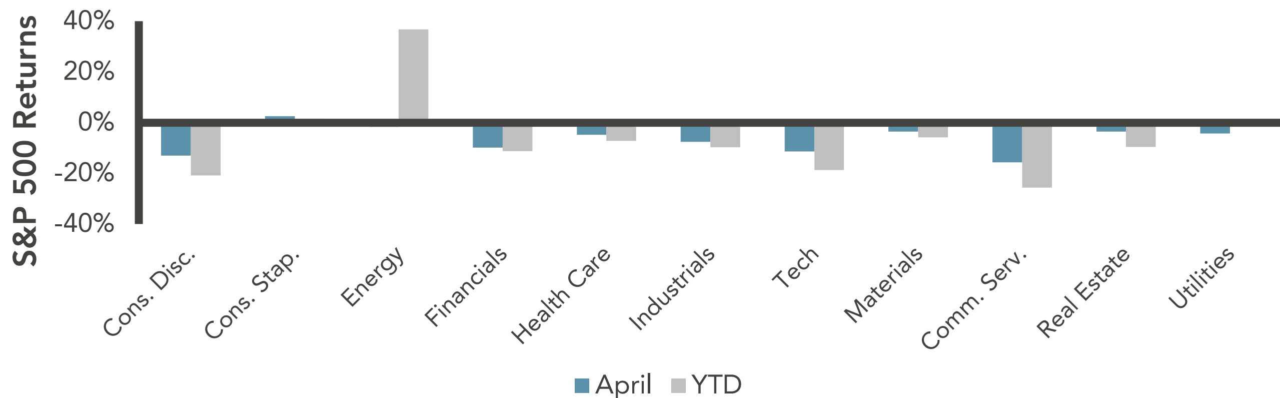
Exhibit 14: Value outperforms growth year to date

	Value	Core	Growth
Large	-8.9%	-18.1%	-26.4%
Mid	-10.8%	-17.2%	-28.8%
Small	-13.2%	-20.7%	-28.0%

Source: Bloomberg as of May 20, 2022

At the sector level, Energy has dramatically outperformed this year, up 36.9% through the end of April amid the rise in commodity prices. Unfortunately, this sector has done little to pull the index into positive territory as it constitutes less than 5% of the S&P 500 index. Consumer Staples and Utilities, traditionally considered safe havens, are the only other sectors in the S&P 500 that have logged positive absolute year-to-date returns, up 1.5% and 0.3%, respectively.

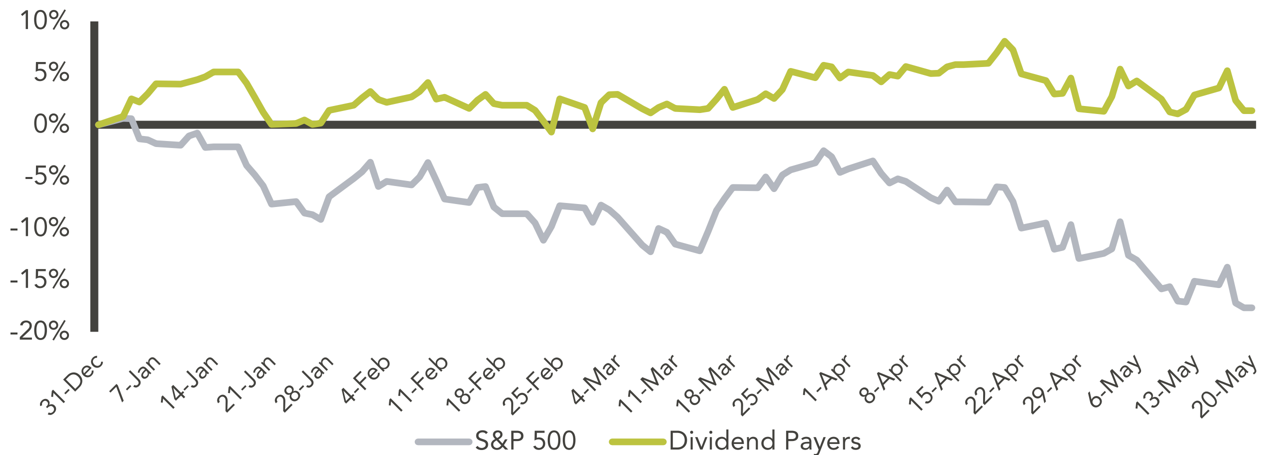
Exhibit 15: Energy outperforms



Source: Morningstar Direct as of April 30, 2022

Investors' flight to safety has also benefited dividend payers, which have held up well on a year-to-date basis, as investors have favored current income over the prospect of future growth.

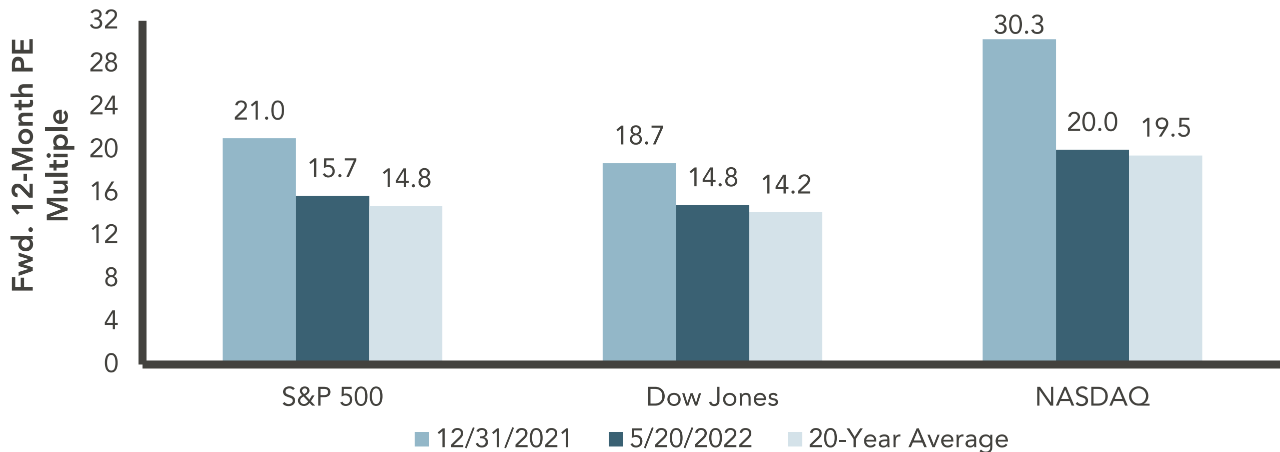
Exhibit 16: Dividend payers outperform the broad market



Source: Bloomberg as of May 20, 2022; SPYD used to represent dividend payers

While this macroeconomic-induced sell-off has been aberrational when viewed in the context of the last few years alone, a larger correction is less surprising when considering the valuation landscape. Price multiples for the S&P 500 index at the end of 2021 sat in the top decile of levels over the last three decades, with sales and cash flow-based metrics at particular extremes. The 2021 year-end trailing price-to-earnings multiple on the NASDAQ Composite ranked in the 97th percentile versus its long-term history. Year-to-date, multiples for the NASDAQ, S&P 500, and the Dow Jones Industrial Average have compressed 33%, 25%, and 20%, respectively. Nonetheless, valuations across most domestic stock indices remain slightly elevated relative to 20-year averages, thus implying, from a valuation perspective, that a continued pullback may not be out of the question.

Exhibit 17: Strong multiple compression across major indices year-to-date

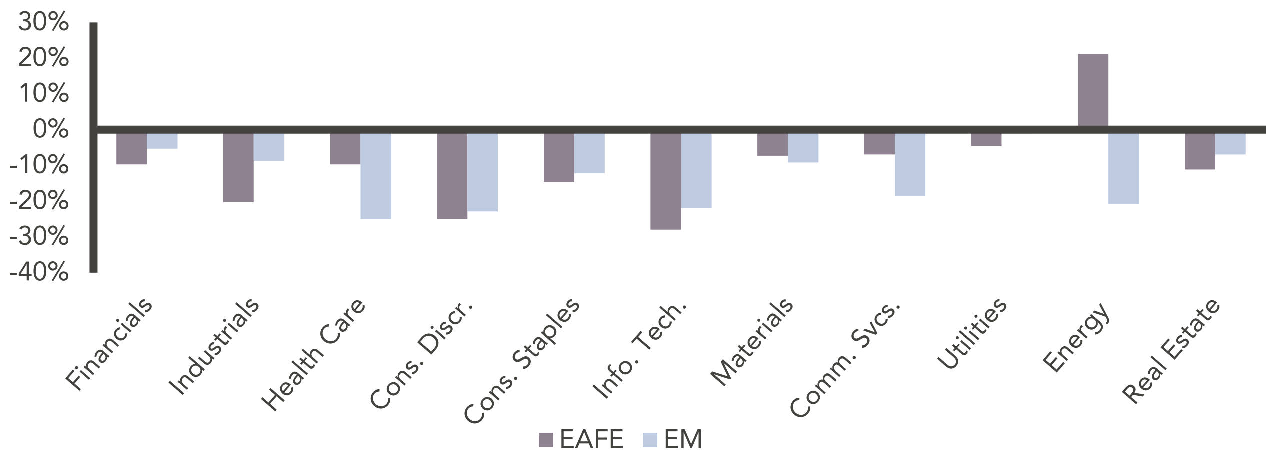


Source: Bloomberg as of May 20, 2022

NON-U.S. EQUITIES: NOT MUCH BETTER

Similar to U.S. stocks, international equities have also faced challenges due to many of the same macroeconomic factors. Specifically, higher levels of inflation, slowing economic growth, and increasingly restrictive monetary policy have all largely served as performance headwinds for global equity markets. Since the beginning of the year, each segment of the MSCI EAFE index has notched a negative return except for the Energy sector, as the Russia/Ukraine conflict has pushed commodity prices higher. Conversely, companies reliant on commodity inputs have faced tighter profit margins, and it remains to be seen whether these firms will be able to pass on price increases in the coming months. Despite poor absolute performance, more cyclically-oriented sectors of both Developed and Emerging Market equity indices like Materials and Utilities have led on a year-to-date basis. Exhibit 18 highlights sector performance since the beginning of 2022 for both indices below.

Exhibit 18: Energy leads while all other sectors are negative

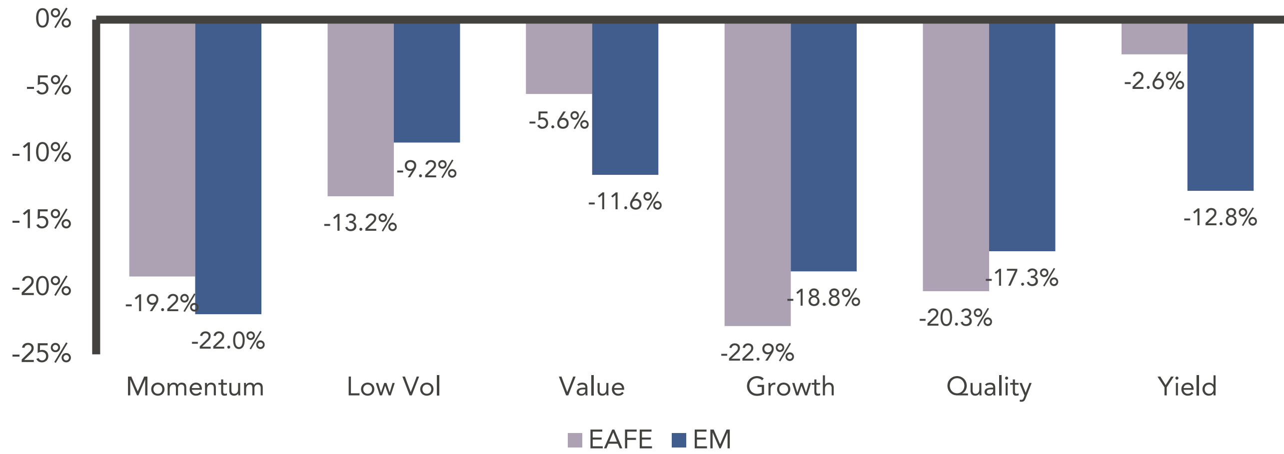


Source: Bloomberg; data as of May 20, 2022; returns calculated assuming dividend reinvestment

From a factor perspective, rising yields in Europe and Japan, which reached multi-year highs in recent weeks, have led investors to increasingly favor shorter-duration stocks at the expense of those with significant cash flows expected in the future. This preference can be inferred by the behavior of factors like growth and momentum in Exhibit 19. To this point, while value-oriented international stocks have

largely notched negative returns on a year-to-date basis, 2022 remains a “value” year insofar as relative style performance is concerned. Interestingly, the yield factor is only slightly negative since the beginning of the year for developed large-cap stocks.

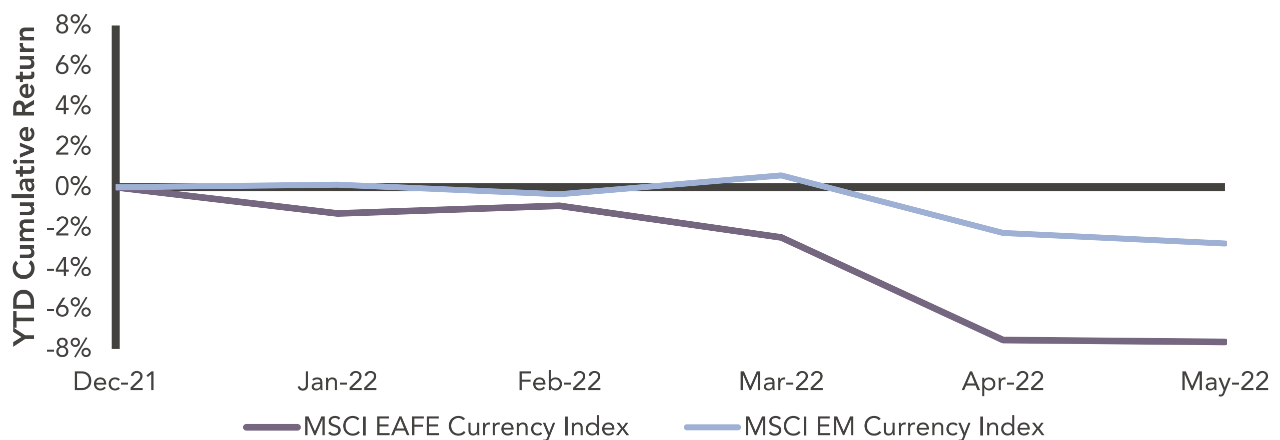
Exhibit 19: Growth and momentum factors struggle mightily in 2022



Source: Bloomberg; data as of May 20, 2022; returns calculated assuming dividend reinvestment

Another factor weighing on the performance of international equities has been the strength of the U.S. dollar, which has served as a safe haven for investors in recent time. Fueled by a more hawkish turn from the Federal Reserve, the U.S. Dollar index has climbed over 10% since the start of year. To that point, the yield on the 10-year Treasury note is now roughly 2.8%, compared to 0.9%, 1.9%, and 0.2% for government bonds of the same tenor in Germany, the United Kingdom, and Japan. These figures imply an incentive on the part of investors to allocate capital to the U.S. relative to other countries around the world and help explain relatively poor returns of stocks denominated in foreign currencies. Exhibit 20 highlights the extent to which both Developed and Emerging Market currencies have weakened against the dollar since the beginning of the year.

Exhibit 20: Dollar strengthens, international currencies weaken



Source: Bloomberg; data as of May 20, 2022

Finally, it is worth emphasizing the outsized negative impacts that more exogenous factors have had on international stocks versus those in the United States. First, the conflict in Ukraine has disproportionately impacted the eurozone, as most European countries import the majority of the energy used for

consumption, leaving European consumers with lower discretionary spending budgets and the area with reduced aggregate real income when commodity prices rise. Indeed, purchasing power of individuals on the continent has been eroded in recent months, as the European Central Bank estimates that increased energy costs have led to an outflow of spending power from the region of more than 1% of GDP. Policymakers in Europe must now walk a fine line between helping promote growth and combatting rampant inflation without sending the region into a prolonged slowdown. In Asia, COVID-related crackdowns by Beijing authorities, combined with the weakening of the Chinese housing market, have stalled the nation's economic engine; the International Monetary Fund now expects economic output in China to grow at a rate of 4.4%. This figure is well below the 8.0% growth rate posted in 2021, and close to this year's projection for growth in the United States of 3.7%. Should these forecasts come to fruition, economic growth rates in 2022 for China and the U.S. will be closer this year than they have been since 1989. Further, the yuan has plunged in the last month thanks in part to the actions of officials in Beijing, who may hope that a weaker currency may stimulate export activity and stabilize the teetering economy. Chinese stocks have returned -20.1% since the beginning of 2022, one of the worst year-to-date figures for a basket of stocks of any major country.

PATIENCE AND DISCIPLINE TEND TO PAY OFF

For both U.S. and non-U.S. equity markets, the majority of indices have not yet breached bear market territory, but the presence of economic headwinds overlaid with market-specific risk factors suggest that official entry into bear market territory could be imminent. Regardless of whether or not each index drops by the "official" 20%, the path forward to recover this year's losses will not likely be a sudden rebound; patience will be required.

BEAR MARKET RECOVERIES CAN TAKE TIME

As equity markets flirt with bear market territory, some precedence on recovery time could be helpful. On average, it has taken the S&P 500 about 15 months to recover all of its lost ground, with the caveat that this is an average and the actual historical incidents have significant divergence from this average; the same trends are true for non-U.S. equities.

Exhibit 21: Bear Markets Recovery

S&P 500

Bear Start (Peak)	Bear End (Trough)	Duration (Months)	Drawdown	1 Year Post-Bear	2 Year Post-Bear
2/19/2020	3/24/2020	1	-27.7%	58.9%	84.7%
10/9/2007	3/9/2009	17	-56.8%	68.6%	95.1%
3/24/2000	10/9/2002	30	-49.1%	33.7%	44.5%
8/25/1987	12/4/1987	3	-33.5%	21.4%	56.9%
11/28/1980	8/12/1982	20	-27.1%	58.3%	61.5%
1/11/1973	10/3/1974	20	-48.2%	38.0%	67.3%
11/29/1968	5/26/1970	17	-36.1%	43.7%	59.7%
2/9/1966	10/7/1966	7	-22.2%	32.9%	41.7%
12/12/1961	6/26/1962	6	-28.0%	32.7%	55.7%
8/2/1956	10/22/1957	14	-21.6%	31.0%	43.7%
	Average	**14.9**	**-35.8%**	**40.0%**	**58.4%**

Note: Daily price indices are used to capture longer time periods and to represent the sensitivity to short-term market stress
Source: Bloomberg as of March 9, 2020; data since 1950

MSCI EAFE

Bear Start (Peak)	Bear End (Trough)	Duration (Months)	Drawdown	1 Year Post-Bear	2 Year Post-Bear
10/31/2007	3/9/2009	16	-61.8%	70.4%	89.6%
1/3/2000	3/12/2003	38	-53.6%	57.3%	90.0%
7/20/1998	10/5/1998	2	-24.6%	39.1%	40.9%
1/4/1990	4/9/1992	27	-32.5%	23.3%	43.0%
5/15/1987	11/11/1987	5	-21.7%	35.7%	40.4%
4/2/1984	7/23/1984	3	-20.4%	40.7%	151.4%
10/30/1980	8/12/1982	21	-27.5%	32.5%	47.8%
3/15/1973	10/9/1974	18	-47.2%	26.8%	27.4%
	Average	**16.3**	**-36.2%**	**40.7%**	**66.3%**

Note: Daily price indices are used to capture longer time periods and to represent the sensitivity to short-term market stress
Source: Bloomberg as of March 9, 2020; data since 1970

MSCI EM

Bear Start (Peak)	Bear End (Trough)	Duration (Months)	Drawdown	1 Year Post-Bear	2 Year Post-Bear
10/29/2007	10/27/2008	11	-66.1%	108.4%	141.9%
5/8/2006	6/13/2006	1	-24.5%	52.6%	68.4%
9/16/1994	9/10/1998	47	-59.8%	73.7%	77.5%
8/1/1990	1/16/1991	5	-31.9%	74.8%	83.5%
	Average	**16**	**-45.6%**	**77.4%**	**92.8%**

Note: Daily price indices are used to capture longer time periods and to represent the sensitivity to short-term market stress
Source: Bloomberg as of May 20, 2022; data since 1989

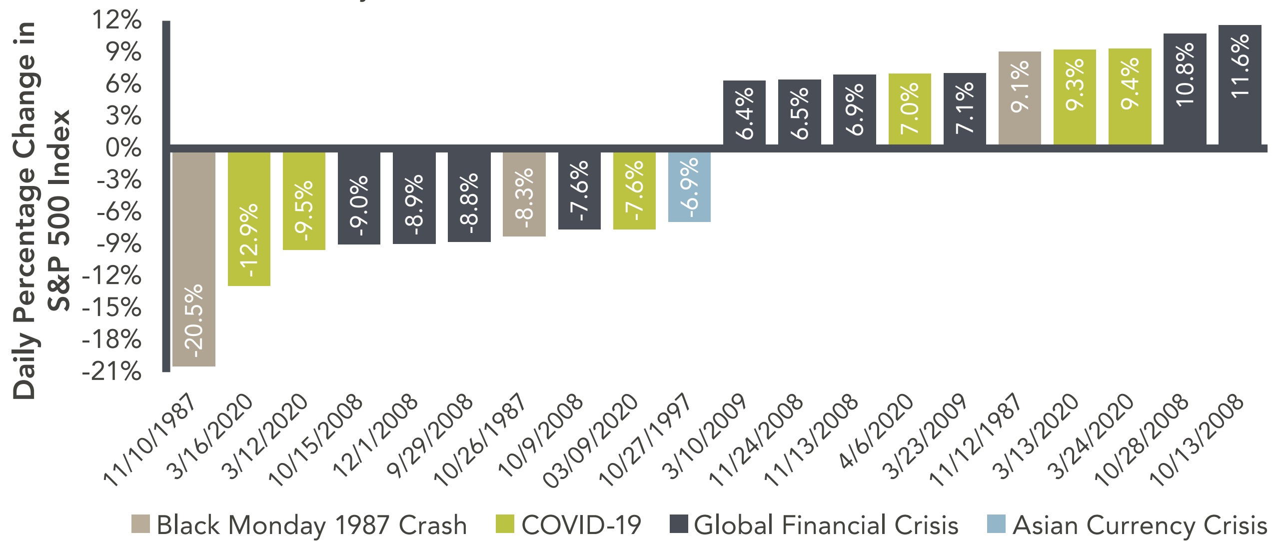
As of May 20th, the market[1] is down 19% year-to-date. Getting back to its level at the start of the year will require a 22% return; if the market drops further from this point that number will increase. Given the macroeconomic headwinds coupled with the overall uncertainty in the market, at this point it is difficult to see such a return over the next seven months. With that said, although it may be tempting for investors to pull cash from the market to protect against further drops, timing the market is notoriously difficult and can lead to even greater losses over market cycles.

DON'T TRY TO TIME THE RECOVERY

It would be naïve to assume the volatility to date will not continue; the overhang of a potential recession only adds to these worries. For long-term investors, however, the playbook remains the same: stay invested, and adhere to a disciplined rebalancing program. We have shared the following charts before in times of market volatility, but they are a powerful reminder of the dangers of market timing. Exhibit 22 *(next page)* reminds us that some of the best trading days follow some of the worst, and a knee-jerk reaction to a sharp drop will almost assuredly lead to missing a rebound of similar magnitude.

[1] As measured by the S&P 500

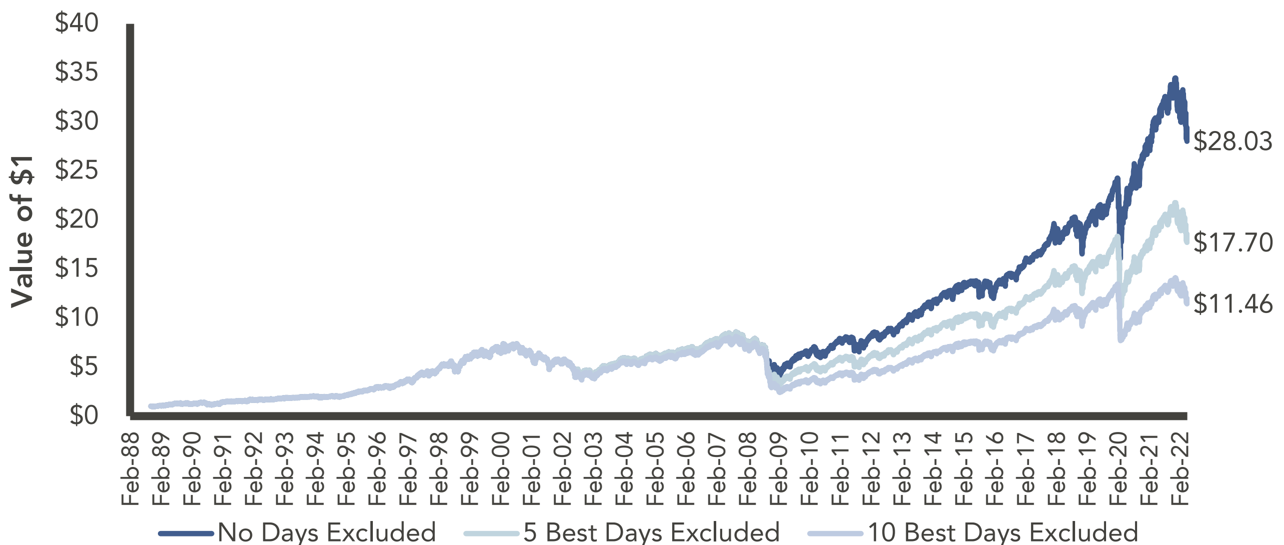
Exhibit 22: Market volatility moves in both directions



Source: Bloomberg; data since 1950

Predictably, missing some of these best days can greatly reduce what an investor accrues over multiple market cycles. In fact, missing the ten best days in the market can leave an investor with less than half of what the ultimate accrual could have been:

Exhibit 23: Market timing can be dilutive to portfolio growth

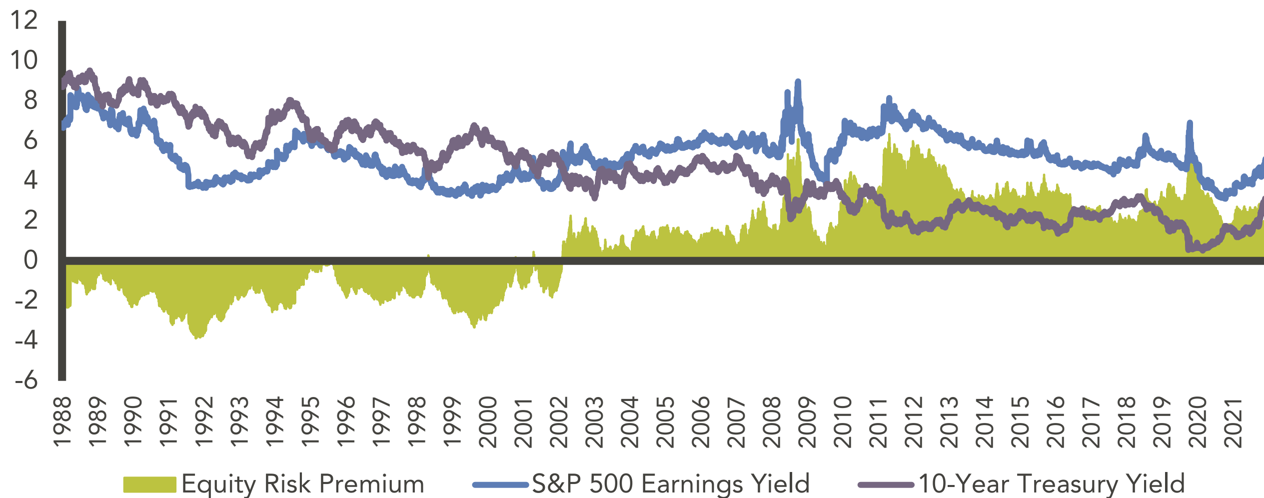


Source: Bloomberg; growth of $1 based on S&P 500 returns

THE EQUITY RISK PREMIUM REMAINS POSITIVE

As market participants continue to navigate the current environment and assess the shifting macroeconomic and geopolitical landscape, we expect market volatility to persist. Daily price volatility for major indices is already on pace to exceed that of 2021 by the middle of this year, and the VIX has remained above its 20-year average for most of 2022. While it may be a challenging period for investors to remain allocated to U.S. stocks, it is important to remember the equity risk premium remains positive, making the space more attractive than fixed income for the time being.

Exhibit 24: The U.S. equity risk premium remains positive



Source: Bloomberg as of May 20, 2022

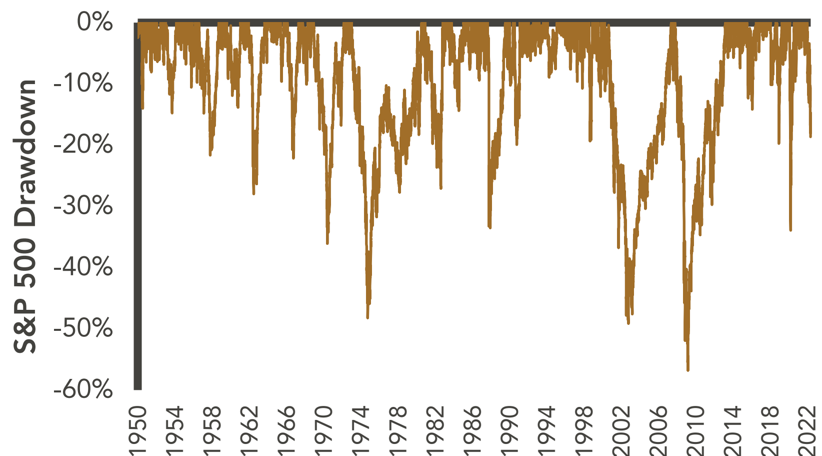
TAKING A LONGER-TERM PERSPECTIVE

The last three complete calendar years 2019–2021 featured the following returns from the S&P 500: 31.5%, 18.4%, and 28.7%. Even with the sharp drop year-to-date, cumulative U.S. equity returns are 164% since January 1st, 2019, which is a 15.7% annualized return and well north of long-term average equity returns.

Notably, these figures are also a significantly positive real rate of return in spite of recent inflation figures topping 8%.

And while it may be difficult for the market to recover all of its losses this year, history tell us that large drawdowns are not unusual most years, and markets tend to recoup at least some of their losses over the course of a year.

Exhibit 25: Large drawdowns are not uncommon



Source: Bloomberg as of May 20, 2022

THIS YEAR AND BEYOND

It has not been an easy first five months of the year and given the Fed's steadfast commitment to reining in inflation, there are no obvious remedies for the markets. Elevated inflation, higher rates, supply chain constraints, and geopolitical tension are headwinds that will likely persist into 2023. That said, markets are forward-looking and react to *changes* in expectations, so any positive developments on these fronts could benefit markets. On a positive note, companies remain profitable with healthy balance sheets, and the credit markets — typically the first to indicate structural risk — remain benign. We encourage investors to remain disciplined and adhere to their long-term target allocations. Although the outlook may be more murky today, markets have proven resilient over time and we expect this bout of market volatility to eventually subside and returns to normalize as economic conditions rebound from the current doldrums.

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