Bear In Mind

Last year was an historical reckoning on the financial markets which continued to reflect symptoms of the pandemic. The bear market is front of mind for equity investors, as the S&P 500 finished 2022 down nearly 20%, its worst year since 2008 during the Global Financial Crisis ("GFC"). The S&P 500 technically entered this bear market in June (falling more than 20% from its high on January 3, 2022), making this the longest bear market since 2001 during the tech stock bubble. Like twenty years ago, technology was not spared in 2022, as the tech-heavy Nasdaq lost 33%, while the more value-oriented Dow Jones Industrial Average lost just 9%. This very volatile year saw the S&P 500 have 46 intra-day moves of more than 2%, the most since the GFC, and just one record close versus the 70 record closes in 2021[i]. While historically acting as a ballast for portfolios, bonds experienced their worst year on record, as the Bloomberg U.S. Aggregate dropped 13%, passing the previous worst annual drop of 3% in 1994[ii]. The 10-year treasury yield rose an unprecedented 2.35%, ending the year at 3.88%, after closing at a 15-year high of 4.25% in October.

The health of the economy also shows ongoing symptoms from pandemic impact and society's response. The initial shock in 2020 sent markets violently lower as the economy effectively shut down. The resulting fiscal response helped business stay open and consumers to boost personal savings, fueling the "stay at home" economy. Accommodative monetary policy implemented by the Fed dramatically increased liquidity and boosted valuations in the financial markets. The incredible scale of the government's intervention spurred the persistent inflation and ongoing supply/demand issues faced by businesses and consumers. It also contributed to the volatility and exuberance witnessed in the financial markets. Many companies saw a spike in short-term demand for certain products and services, resulting in shortages, higher prices, and higher headcount needs, followed by a swift "return to normal", resulting in over supply, dampened demand, and lower headcount needs. This change in spending habits led to inventory gluts and margin pressure from retailers, like Walmart and Target, to semiconductor companies, like Nvidia and Qualcomm. The "FAANG" stocks plus Microsoft had their worst year since 2008 and lost around $4 trillion in market cap. These technology companies and others are now laying off tens of thousands of employees after over-hiring during the pandemic. Global events like Russia's invasion of Ukraine and China's zero-Covid policy, as well as restrictive actions by central banks, have exacerbated many of these issues and remain sources of risks in 2023.

- The war in Ukraine, which is the largest conflict in Europe since WWII, caused a shock to energy and commodity prices in the spring, sending the price of WTI crude to more than $120/bbl and the price of wheat to an all-time high. Since Russia supplied more than 40% of the EU's natural gas imports, this resulted in a destabilization of global energy markets and heightened the need for energy security and national defense. This conflict remains a risk as it could drive energy and commodity prices back up, contributing to higher global inflation.

- China maintained its zero-Covid policy longer than anticipated with targeted lockdowns and strict quarantine requirements. This weakened its reputation as a reliable manufacturing center and prolonged supply chain issues for companies concentrated there, like Apple, and dampened consumer demand for those levered to the Chinese market, like Starbucks and Nike. Despite its recent relaxation of the policy, China still presents risk to supply chains and consumer demand if the reopening is halted. Conversely, a continued reopening of the world's second largest economy could spur global inflation in commodities and goods, causing central banks to remain restrictive for longer.

- The Federal Reserve set the tone for the financial markets, raising the Fed funds rate seven times to a range 4.25 – 4.50%. For perspective, consensus projections (including that of the Federal Reserve) in late 2021 were for about three rate hikes for 2022, implying a Fed funds rate around 1.0%. The historic pace of the rate increases resulted in last year's valuation multiple reset, driving the forward P/E ratio of the S&P 500 from 21.4x to 16.7x, which is in line with its 25-year average. As the Fed raised interest rates quicker than other countries, and economic growth concerns persisted across Europe and Asia, the U.S. dollar index reached its highest level in twenty years. Many U.S companies earn a high percentage of income abroad; thus, foreign exchange headwinds have meaningfully lowered corporate earnings when translating back to the dollar. The Fed remains a risk given it could over-tighten monetary policy, meaningfully weaken the labor market and corporate earnings, and push the economy into a recession.

Investors must bear in mind the following historical market data that suggest a possibility of a recession or further market downturn. The treasury yield curve is at deeply inverted levels that have always preceded recessions over the past sixty years[iii]. The inverted yield curve is when short-term rates, pushed higher by the Fed's actions, are higher than long-term rates, which reflect the market's assumption that economic growth will slow, and rates will eventually be cut. The 10-year treasury yield fell below the 3-month treasury yield in October and was 54 bps below by year-end (as of early January, the spread was at its highest level in forty years). If there is a recession, no market trough has ever been made before one began, implying the October 2022 lows would be undercut. Notably, the current multiple of the S&P 500 does not reflect a recessionary scenario. While consensus earnings estimate for 2023 have been revised lower, there is a potential for a deeper cut to earnings in a recessionary environment. If the Fed tightens for too long, both the multiple and earnings numbers would be lower, resulting in further market downside. Lastly, while a Fed induced recession would bring inflation lower, it would also raise unemployment and curb elevated wage growth. Typically, the market tends to trough before the peak unemployment rate, which is a lagging economic indicator and remains historically low at 3.5%.

A more optimistic assessment would bear in mind that inflation levels, relative dollar strength, and treasury yields all appear to have rolled over. This can imply that the Fed may not need to proceed with further rate hikes, or that the market assumes the Fed is nearing the end of its tightening cycle. Once the Fed does reach its peak rate, past tightening cycles show that it remains there for just 2 to 15 months, with an average holding period of about 6 months, before pivoting[iv]. Real GDP grew at an annual rate of 3.2% for Q3 2022, after two quarters of contraction, and consumption is in focus as it is the largest driver of GDP (nearly 70%). While consumer spending became more deliberate by the year-end, there are still consumer tailwinds that could negate a mild recessionary impact. Household debt service as a percentage of disposable income remains near forty-year lows at 9.8%, and while wage growth lagged inflation last year, that trend is likely to reverse in 2023 giving consumers real wage growth and spending power. Additionally, although consumers have drawn down on excess savings accumulated during the pandemic, excess savings are estimated to still total $900 billion[v]. Lastly, the markets may have already factored in most of the potential risks. The S&P does not typically have back-to-back down years and has only done so four times since 1928 (the last being three down years from 2000 – 2002). Notably, when considering the abysmal price performance of 2022, the five-year average return of the S&P is 9.3%, which is in line with the 30-year average of 9.1%, as opposed to an average five-year return of 17.1% from 2017 – 2021. In lieu of betting on a market call, investors must recognize that the financial markets are not through unwinding from the pandemic impacts. This investing environment offers a chance to be defensive, with cash and bonds now yielding meaningful interest, yet also opportunistic, namely in equities that have fallen out of favor, but are backed by strong fundamentals and secular growth stories.

[i] Dow Jones Market Data
[ii] Bloomberg, FactSet, J.P. Morgan Asset Management
[iii] Bloomberg, Piper Sandler
[iv] Bloomberg, Piper Sandler
[v] J.P. Morgan Asset Management

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