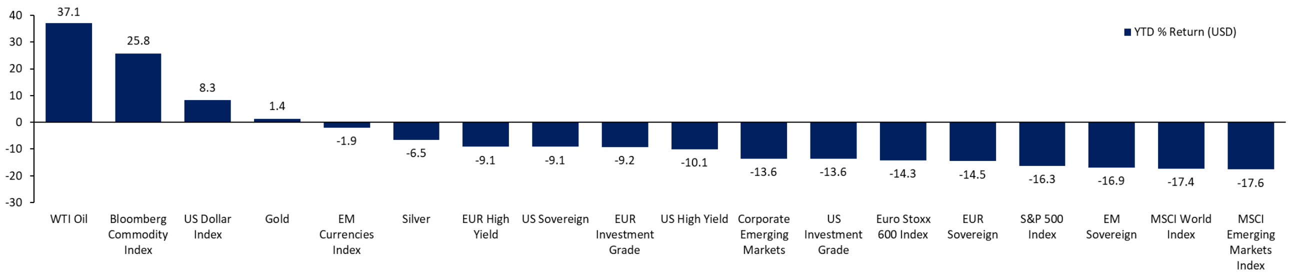
May 10, 2022

Navigating Bear Market Volatility

"Missing the bottom on the way up won't cost you anything.
It's missing the top on the way down that's always expensive." - Peter Lynch

Chart 1. Cross-Asset Returns (USD Terms)



Source. Bloomberg, MAM Research

Financial markets are in disarray. The combination of stubbornly high inflation, rapidly higher interest rates, and prospects of a global economic slowdown created an environment last seen in the 1970s. During stagflationary periods, asset correlation rises, causing bonds and equities to sell off simultaneously. It is an environment some market participants have underestimated could happen and where the more traditional "60/40" portfolio of equities and bonds is down 17% YTD. At MAM, we repeatedly warned about risks associated with elevated levels of non-transitory inflation and conserved a relatively cautious positioning in portfolios. This has helped us navigate these turbulent times.

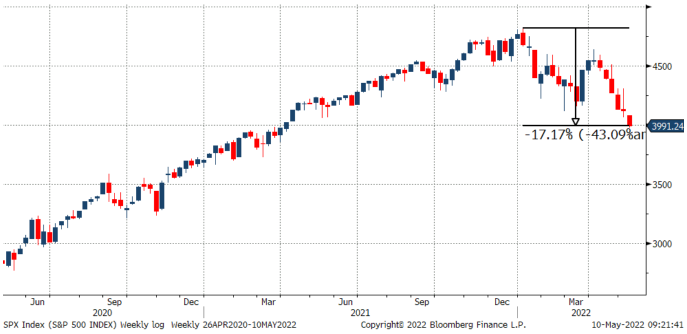
What to expect next? On a trade duration, we believe markets are overdue for a relief rally. We track a large number of technical indicators. Many point to extremely oversold conditions. Our proprietary short and medium-term models are suggesting high conditional probabilities for a relief rally over the coming days. Volumes alone are also showing signs of capitulation in the last two trading days. Some of the catalysts for a market bounce would include a more dovish tone from Fed members with six of them scheduled to speak publicly today alone. The next data-driven catalyst will be the US April CPI to be released tomorrow. Signs of inflation peaking could alleviate some of the short-term pressure in financial markets. A 5-10% bounce in major indices is a possible, if not probable, scenario. Bear market rallies can be vicious. During the 2008 bear market, we saw no less than 8x 10%+ bear market rallies. Inversely, another high or accelerating inflation print may swiftly drive markets lower. Even if inflation shows signs of deceleration, we do not think the bear market will be over yet. As explained in our Q2 2022 Outlook, it is the Fed's objective to slow the economy. The Fed knows it is behind the curve and needs to cause a harder landing to jump ahead of the curve (i.e., Powell's "soft-ish landing" comment).

Our initial targets for the S&P 500 Index and Nasdaq 100 Index remain 3,600 (-10%) and 11,000 (-11%) and imply a cycle peak-to-trough performance of -26% and -36% , respectively. Given where we are in the cycle, we believe these targets are "fair" rather than overly bearish. In the past 140 years, financial markets have experienced a total of 19 bear markets. Average price declines were -37.3% over a 10-month period. Based on our fundamental review, we are expecting a similar aggregate drawdown at some point in 2022. While the Fed promptly pivoted in 2018 to rescue financial markets (Fed put), it is a much lower probability scenario today. Today, the Fed's focus is not tighter financial conditions but curbing inflation expectations. Lower long-term rates, markets shifting away from cyclicals and defensives into growth, and a weaker dollar are some of the indicators that we are tracking which would imply we are nearing a bottom. We clearly are not there yet. As it stands, we will use short-term market rallies to roll our hedges into H2 2022. Expectations are for a market bottom to occur before year-end but we should prepare for further market volatility and drawdowns ahead. Now, even though we are not calling the bottom, at all, we believe mid-to-small cap growth and tech may be at or near a bottom.

Market Comments

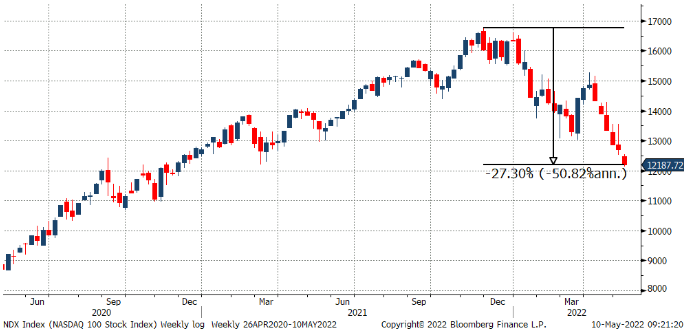
The Nasdaq and Russell have already corrected -27.3% and -28.3% from their respective cycle peaks. Bitcoin is down -53.8% from its peak.

Chart 2. S&P 500 Index (Weekly)



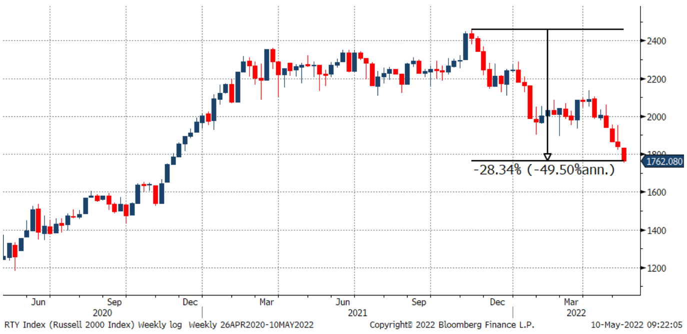
Source. Bloomberg, MAM Research

Chart 3. Nasdaq 100 Index (Weekly)



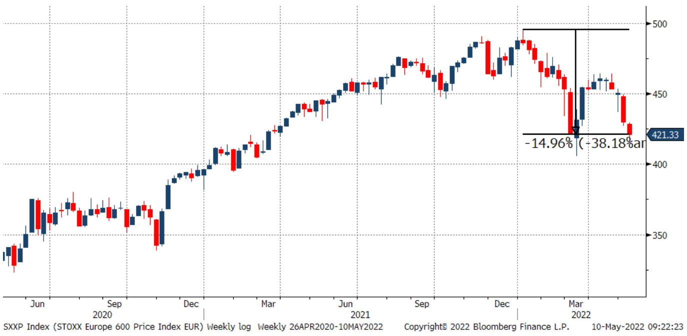
Source. Bloomberg, MAM Research

Chart 4. Russell 2000 Index (Weekly)



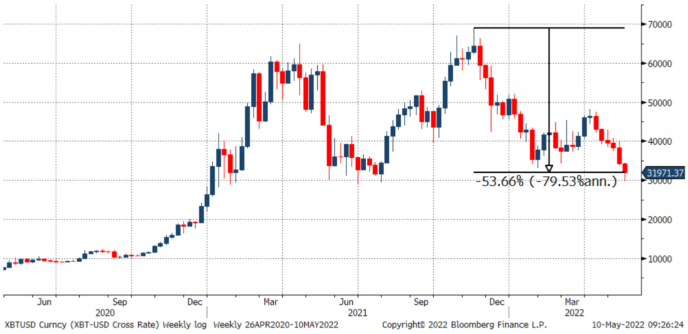
Source. Bloomberg, MAM Research

Chart 5. EuroStoxx 600 Index (Weekly)



Source. Bloomberg, MAM Research

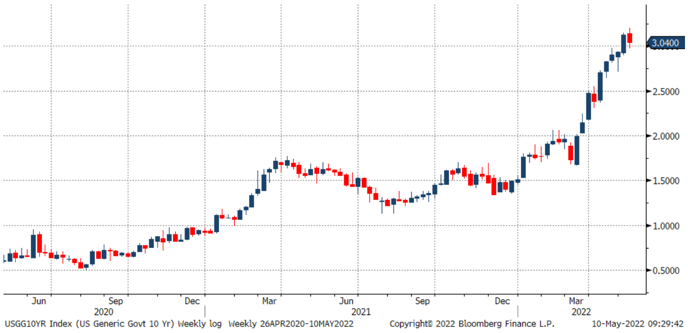
Chart 6. Bitcoin/USD (Weekly)



Source. Bloomberg, MAM Research

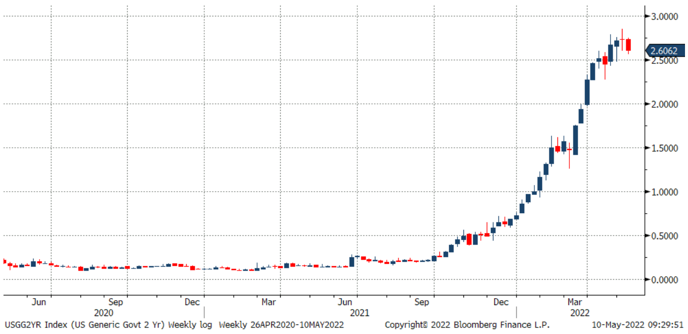
Long-term US Treasury yields (10-Year) are still trying to find a top heading into the next CPI print tomorrow, but the risk-reward is progressively turning positive to being long longer-term US sovereign bonds. The Fed has been behind the curve. Markets have yet to realize the Fed cannot hike another 2% without something “breaking”. However, given headwinds from a potential economic recession, our view on corporate credit will remain impaired for the foreseeable future. Stay underweight.

Chart 7. US 10-Year Rates (Weekly)



Source. Bloomberg, MAM Research

Chart 8. US 2-Year Rates (Weekly)



Source. Bloomberg, MAM Research

DXY has been strengthening in the last couple months. Several factors have been contributing to its strength such as rates and growth differentials. At some point, policymakers will need to correct the current path of higher dollar and higher rates. A weaker dollar would be a path to ease financial market conditions.

Chart 9. US Dollar Index (Weekly)

Source. Bloomberg, MAM Research

Although often described as a commodity, gold is more of a currency. It trades as a function of real rates. The negative carry (negative real rates) was a tailwind back in 2021, but has been a source of headwinds since they turned positive this year. Given our high inflation and slower economic growth outlook, gold should start to outperform in the coming months.

Chart 11. Gold Spot (Weekly)

Source. Bloomberg, MAM Research

Chart 12. US Real Rates (Weekly)

Source. Bloomberg, MAM Research

As always, please feel free to reach out to us if you have any questions.

Kind regards,

MAM Investment Team

Disclaimer