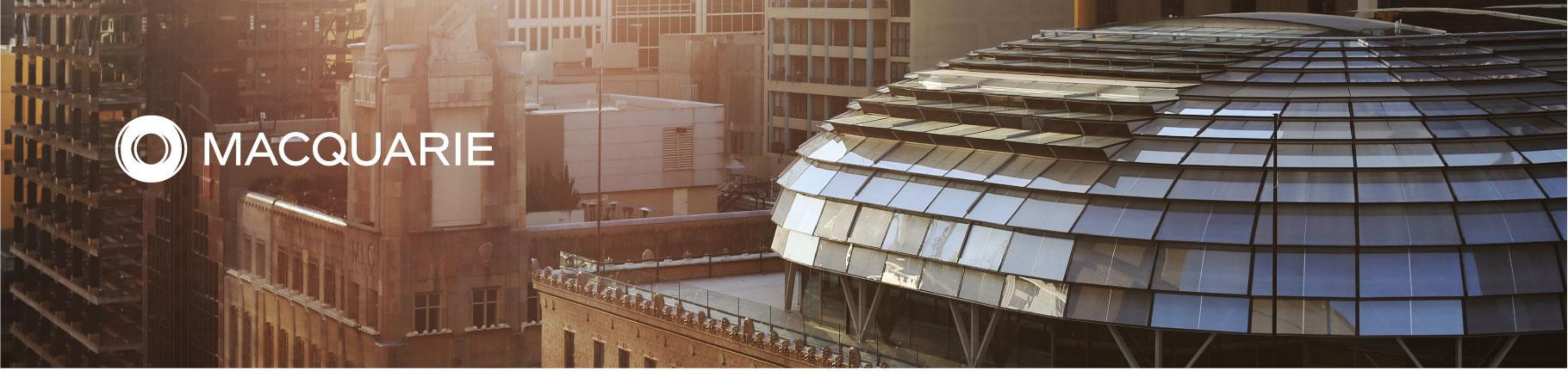


Investment Strategy Update #104

The anatomy of an equity bear market

- Year to date, global equity markets have come under significant pressure as policy makers ratchet up interest rates in response to a worse than expected inflation backdrop. This has led to a significant unwind of inflated valuations across growth stocks and many areas which had been beneficiaries of strong momentum inflows during the COVID period. More recently, concerns that policy makers will need to slow growth in order to bring inflation down has driven fears of a recession, which is now driving a second leg down in equity markets.

- The S&P500 index has now fallen 22% from its early January peak, putting it into “bear market” territory (a sell-off greater than 20%) and at this stage with little to prevent it falling further. In comparison, Australian equities, have outperformed its global counterparts, down only 13% due to a strong contribution from the materials sector but also because its economic and inflation cycle has lagged the US due to economic lockdowns in late 2020.

- The US equity market comprises around half of global equity market capitalization. Therefore, where the US market goes, most other (developed) equity markets follow. Consequently, most analysis on bear market corrections focus on US equities. Over the last 50 years, every US bear market has preceded a recession, with the exception of the 1987 crash, meaning there is a very high probability that we are on the verge of a US recession

- Historically the S&P500 has fallen on average 36% during bear market corrections with the duration of the decline being 13 months. Earnings fall on average 18% and to date there has been little adjustment seen in analyst bottom-up expectations. For Australia, the price decline has been similar to the US at 37% lasting 13 months.

- The current equity market sell-off has not been accompanied by a broad deterioration in economic data and so its ferocity has been a surprise. However, the correction is now in a dangerous phase because stubbornly high inflation is raising the risk that interest rates will have to rise to a level where recession is the only outcome.

- We have previously set out a number of factors as being required to drive a sustainable bottom in equities and a stabilization in bond yields / credit spreads. This includes: 1) a moderation in inflation pressures (and/or some evidence that the breadth of price increases is lessening); 2) A more dovish shift in central bank rhetoric which in turn will help alleviate overtightening fears); 3) An end to the conflict in Ukraine and/or a more aggressive pro-growth policy push by the Chinese Administration; and 4) Risk assets becoming outright cheap.

- At this stage, Macquarie believe the US is likely to slip into a recession in 2H23 but that this will be short and shallow. In comparison, Australia should escape this outcome, but the need for the RBA to follow the path of other global central banks and aggressively hike rates will drive a sharp economic slowdown into 2023.

- Investors should be prepared for more of the same in coming months. Inflation is key to where rates go and where rates go is key for equities. We continued to reduce risk in our May Investment Matters report and continue to use non correlated assets as our key portfolio diversifying agent.

US equities are in a bear market

We think it is getting increasingly difficult to see how equity markets can move sustainably higher without a rapid decline in inflation that would release some of the pressure on the Fed and other central banks to raise policy rates. This is because equities are now battling numerous headwinds including a deceleration in economic growth, peaking profit margins, rising interest rates and shrinking liquidity. If the inflation handcuffs are removed, then we think the economic growth backdrop is solid enough for risk assets to keep rising even if there is no further multiple expansion and earnings growth is slowing but not negative (see Investment Strategy Update #103: US inflation shock(er) pushes equities into bear market).

But without some rate (expectation) relief, then the deceleration in economic and earnings growth combined with shrinking liquidity and deteriorating confidence are sizable headwinds for the market when valuations have not reached levels that would underpin downside into further negative surprises and because markets are some way from capitulation levels.

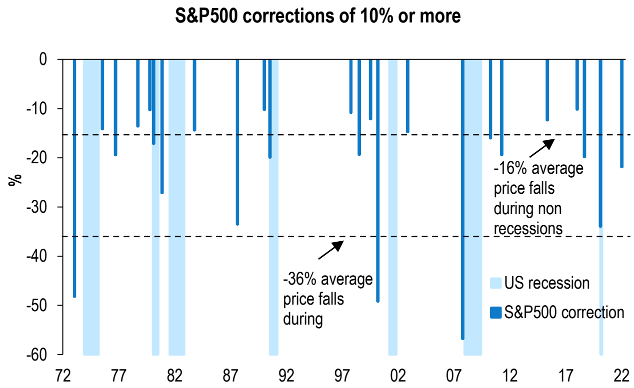
Similarly, if the US was to fall into recession earlier than we are forecasting in 2H23, then the market correction is not yet complete even for an average short/shallow recession decline of ~30%. We don't want to react to every data point, but it is inevitable to that the market will oscillate between soft and hard landing scenarios.

Bear markets versus corrections

The S&P500 index has fallen 22% to date, making it a bear market (a fall of 20% or more) rather than a correction (a fall of 10% or more).

- Over the last 50 years the S&P500 index has experienced 24 corrections and of these, seven have been bear markets.
- Historically, bear markets have tended to precede recessions. The only bear market that did not precede a recession in the past 50 years was the 1987 crash (33.5% fall).

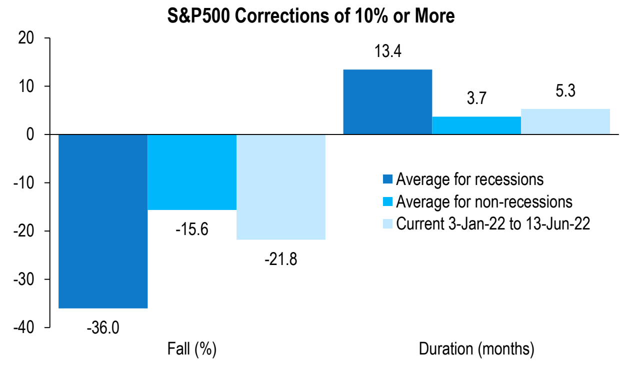
Bear markets are usually associated with recessions



Source: Factset, MWM Research, June 2022

- The average fall for the S&P500 during a sell-off preceding a recession was 36% with an average duration of 13 months. The recent sell-off has seen a 22% fall over 5 months meaning it is looking more consistent with a recession.

Average size and duration of S&P500 equity sell-offs



Source: Factset, MWM Research, May 2022

- Recession and non-recession sell-offs also differ in terms of the magnitude of the fall in both the market valuation (P/E multiple) and earnings.
- Recession sell-offs see a much bigger fall in valuation (-31% versus -18% for non-recession sell-offs) and much bigger falls in earnings (-20%) compared to an average rise in earnings of 3% for non-recession sell-offs. This latter result is not surprising given earnings are correlated with the economic cycle.

S&P500 sell-offs of 10% or more (recessions shaded)

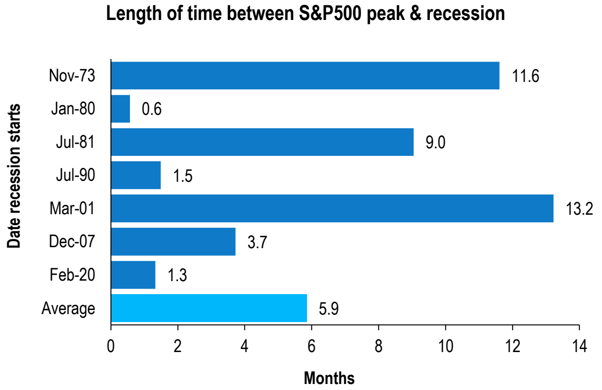
S&P500 Peak date	S&P500 Trough date	S&P500 Price fall	S&P500 Duration (months)	S&P500 P/E fall	S&P500 Earnings fall
11-Jan-73	03-Oct-74	-48.2%	20.7	-63.5%	-14.8%
15-Jul-75	16-Sep-75	-14.1%	2.1	-12.7%	-1.7%
21-Sep-76	06-Mar-78	-19.4%	17.5	-30.2%	15.4%
12-Sep-78	14-Nov-78	-13.6%	2.1	-16.1%	3.2%
05-Oct-79	07-Nov-79	-10.2%	1.1	-10.7%	0.5%
13-Feb-80	27-Mar-80	-17.1%	1.4	-17.9%	-4.6%
28-Nov-80	12-Aug-82	-27.1%	20.4	-23.3%	-19.1%
10-Oct-83	24-Jul-84	-14.4%	9.5	-29.7%	21.8%
25-Aug-87	04-Dec-87	-33.5%	3.3	-41.6%	13.8%
02-Jan-90	30-Jan-90	-10.2%	0.9	-10.2%	0.0%
16-Jul-90	11-Oct-90	-19.9%	2.9	-21.7%	-26.1%
07-Oct-97	27-Oct-97	-10.8%	0.7	-10.8%	0.0%
17-Jul-98	31-Aug-98	-19.3%	1.5	-18.1%	-1.5%
16-Jul-99	15-Oct-99	-12.1%	3.0	-18.0%	7.2%
24-Mar-00	09-Oct-02	-49.1%	30.5	-48.0%	-13.0%
27-Nov-02	11-Mar-03	-14.7%	3.4	-15.3%	0.7%
09-Oct-07	09-Mar-09	-56.8%	17.0	-44.0%	-32.6%
23-Apr-10	02-Jul-10	-16.0%	2.3	-21.2%	6.7%
29-Apr-11	03-Oct-11	-19.4%	5.2	-23.7%	5.7%
21-May-15	25-Aug-15	-12.4%	3.2	-12.0%	-0.3%
26-Jan-18	08-Feb-18	-10.2%	0.4	-11.5%	1.5%
20-Sep-18	24-Dec-18	-19.8%	3.1	-23.5%	4.9%
19-Feb-20	23-Mar-20	-33.9%	1.1	-33.5%	-17.2%
03-Jan-22	13-Jun-22	-21.8%	5.3	-26.4%	6.2%
Average		-21.8%	6.6	-24.3%	-1.8%
Average for recessions		-36.0%	13.4	-36.0%	-18.2%
Average for non-recessions		-15.6%	3.7	-19.1%	4.9%

Source: Factset, MWM Research, May 2022

Equities peak 6mths before a recession

Given the S&P500 index has just fallen into a bear market the next question is when will a recession begin? Historical experience suggests the market peaks around 6 months before the recession begins (with a range of 0.6 to 13.2 months). Considering the recent peak for the S&P500 was 3rd January (i.e., 5 months ago) this would suggest the equity market is expecting a recession sometime between now and 8 months.

Average size and duration of sell-offs



Source: Factset, MWM Research, June 2022

How does the Australian market perform?

- Over the last seven US recessions the Australian market has performed in line with the S&P500 – falling 37% over a duration of around 13 months.
- The biggest post-war fall in the Australian market – the 1987 crash – was not associated with a recession, with the All Ordinaries index falling 49% over 5 months.

Australian equity performance during US recessions

US recession starting	ASX Peak date	ASX Trough date	ASX Price fall	ASX Duration (months)	ASX P/E fall	ASX Earnings fall
Nov-73	31-Jan-73	31-Oct-74	-54.1%	21.0	na	na
Jan-80	14-Feb-80	28-Mar-80	-20.3%	1.4	-21.0%	-17.3%
Jul-81	17-Nov-80	08-Jul-82	-40.6%	19.6	-18.5%	-11.5%
Jul-90	29-Aug-89	16-Jan-91	-32.4%	16.6	2.6%	-40.3%
Mar-01	07-Mar-02	13-Mar-03	-22.3%	12.2	-33.2%	-10.0%
Dec-07	01-Nov-07	06-Mar-09	-54.6%	16.1	-46.4%	-36.6%
Feb-20	20-Feb-20	23-Mar-20	-37.1%	1.1	-37.0%	-25.9%
	04-Jan-22	14-Jun-22	-13.2%	5.3	-25.6%	16.7%
	Average		-37.3%	12.6	-25.6%	-23.6%

Source: Factset, MWM Research, June 2022

Expect more volatility ahead

The sell-off in US equities so far is already larger than the average “non-recession” correction. However, the US market has not yet given back the gains made through COVID. Given they were fuelled by unsustainably low rates and excess liquidity (which is now being unwound) it is not unreasonable to think they will disappear entirely.

This is (so far) a sharp economic growth slowdown, with elevated and sticky inflation, higher rates and ongoing volatility. At this stage Macquarie is holding onto its 2H23 US recession call and provided we are close to an inflation peak, then it is consistent with a sideways, volatile but range trading equity market. If inflation disappoints or growth risks rise, then it’s more likely we move towards pricing in recession like declines across both earnings and equities.

Ultimately, we think Australia will follow the same path of many other developed economies which saw inflationary pressures emerge slightly earlier. Australia’s economic momentum is past its peak. However, we do not forecast a recession for Australia, as it will be insulated somewhat by elevated commodity prices, a relatively more benign inflation backdrop; a solid consumer outlook; improving business investment; a tight labour market; and modestly supportive fiscal policy.

Australia is our preferred equity exposure in the current market. We expect domestic equities will continue to outperform global equities, supported by an attractive yield, stronger earnings growth, and cheaper valuations. The local market’s value-bias and overweight to mining and energy is providing a valuation cushion, earnings strength, and confidence in the outlook vis-à-vis global equities.

Macquarie WM Investment Strategy Team

Investment Strategy Update #104 was finalised on 15 June 2022.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return