



## CIO Strategy Bulletin

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# The Market Outlook in Three Phases: Bull/Bear/Bull Revisited

## Key Takeaways

- In our last [CIO Bulletin](#), we answered questions posed to us from investors tied to particular risks. All were about feared negatives. Our own question is “why so glum?” Global economic growth seems to be stabilizing and broadening. Corporate profits are rising. US employment growth – which drove interest rates pressure – is slowing.
- To be clear, in our “three phases” thesis in [Wealth Outlook 2024](#), we are heading toward a “normalization period” rather than a “V-shaped” collapse and recovery pattern in financial markets. Unlike 2023, markets are not broadly depressed, investors are not “bearish on everything” and certain US policy risks (such as excessive trade protectionism) remain. Yet investing only during depressed periods is a *strategy of underperformance*.
- If one had implausibly perfect knowledge of when US equities bottomed in recessionary troughs and invested only for the year of recovery (earning T-Bill interest at other times) the return in the past 50 years would have trailed a buy-and-hold S&P 500 return by 3.1% per annum. This is the case even when including eight recessions and four severe bear markets.

## Potential Portfolio Implications

As we discussed in our [CIO Bulletin](#) two weeks ago, we don’t think “normal” interest rates will fall to post-2008 lows. The risk of supply shocks and other negative catalysts is ever present. The Fed may still slow the US labor market more than it intends to. This does not dissuade us from sticking to balanced investment allocations with equities overweight during an economic expansion (the US economy has expanded in 86% of all months since WWII).

Bond yields have begun to fall again but remain compelling for intermediate durations. US Treasuries have posted a positive return in all but two US equity bear markets during the past 50 years, providing a “hedge with yield.” The most recent experience in 2022 differed from this as US yields were at 1.3%, just above historic lows. Today, the average US Treasury yield is 4.6%<sup>1</sup>.

Our Global Asset Allocation is overweight US assets and underweight non-US in both equities and bonds. With global growth stabilizing and US interest rate pressure again subsiding, we look with interest at broad non-US equities for diversification and opportunity. Non-US equity returns have trailed behind the US by 15 percentage points over the past 12 months. At the recent low, this outperformance was the most extreme since 2012, the European sovereign debt crisis.

<sup>1</sup> Source: Bloomberg as of May 16<sup>th</sup>, 2024.

# Firmly in Phase 3: Normalization and Growth

## Three phases: Bull/Bear/Bull Revisited

Last year, we delineated “three phases” to best describe the world financial market outlook.

1. In 2020-2021, both equity and bond markets saw strong, stimulus-induced returns despite severe economic weakness and building inflation pressure.
2. In 2022 and much of 2023, markets reset lower in value, depressed by monetary policy tightening.
3. Lower inflation allowed for a more normal functioning of the world economy and markets by mid-2023. This pointed to higher returns after two “payback years.”

As **FIGURE 1** shows, 2022 was one of just three years in the last century during which combined bond and stock returns were negative together. In the previous cases (including those that did not fit neatly into a calendar year) returns twenty-four months ahead were well above average. Yet despite the opportunity presented by this “great valuation reset,” many investors told us they wouldn’t allocate more to bond investments because rates “will stay higher for longer.” They also said they wouldn’t allocate more to equities because of a coming recession. We saw these views as inconsistent (please see our November 2023 [Quadrant](#)).

**FIGURE 1:** Strong returns followed years when US stocks and bonds fell together

YEAR	MSCI USA TOTAL RETURN YoY % CHANGE	10-YEAR TOTAL RETURN YoY % CHANGE	60/40	1-YEAR FORWARD 60/40	2-YEAR FORWARD 60/40
1931	-43.9%	-2.6%	-27.3%	-1.8%	28.0%
1969	-8.5%	-5.6%	-7.3%	10.5%	24.3%
2022	-19.5%	-12.3%	-16.6%	17.9%	

Source: CGW Global Asset Allocation and Quantitative Research Team, Global Financial Data (GFD) as of December 31, 2023. MSCI USA is used for US stocks and US 10-Year Govt is used for bonds total return index (Provider: GFD) is used for the 10-Year Total Return. The 60/40 column represents hypothetical combination of 60% equities and 40% bonds. The historical allocation levels use indices and are provided for informational purposes only. The historical index allocation levels should not be taken as an indication of future performance, which may be better or worse than the levels set forth above. The index returns shown do not represent the results of actual trading of investor assets. The indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is not necessarily indicative of future returns. Real results may vary.

## From “Bearish on Everything” to Sustained Expansion

The return environment following this “bearish on everything” period was unusually strong. The S&P 500 returned 11.7% in 2023’s final quarter and another 10.6% in 1Q 2024. During these six months, the US Treasury market was strong as well, returning +4.6% (non-annualized).

The gains of 2023 were unusually high because 2022 was dreadful. In other words, equity and bond markets recovered sharply because of depressed expectations priced in at the time. But measured over five years, a global benchmark mix of 60/40% equities and bonds<sup>2</sup> has had a far from extraordinary return: 5.9% annualized.

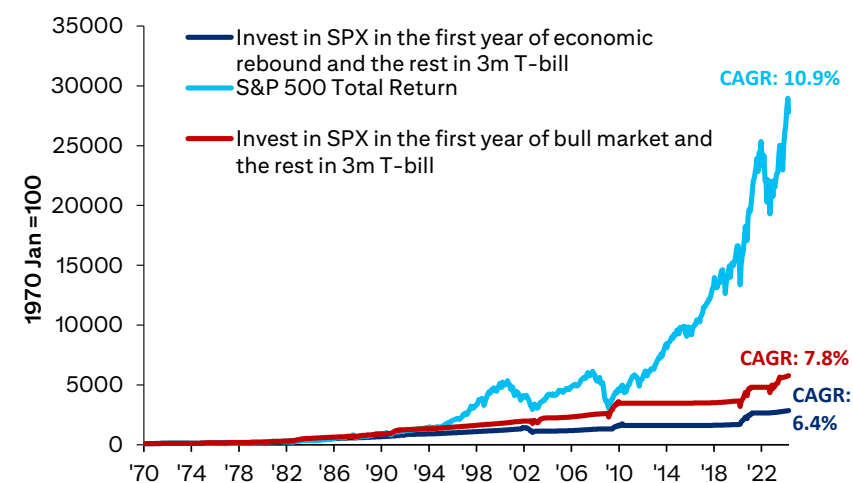
Our message here is not to dwell on the past and a missed opportunity for some, but rather to recognize the present: an ongoing economic expansion rather than a recession/recovery pattern.

<sup>2</sup> 60% MSCI AC World Index IMI and 40% Bloomberg Global Aggregate Index.

Investors cannot succeed by investing only when markets and the economy are depressed. As **FIGURE 2** shows, an investor who put money to work in the S&P 500 only in the 12 months following a recessionary trough in the economy – assuming one could tell perfectly when this is, earning cash yields in other periods – missed out on the returns of “routine” expansions. Consider, US economic expansions comprised 86% of all months since WWII. The strategy of “buy only when the economy reached a bottom” returned 6.4% per year vs 10.9% for a “buy and hold all periods” strategy.

Another scenario that would require “perfect insight” is the following: if one could know exactly when the S&P 500 would hit a bottom associated with recession during the past 50 years and invest only in the recovery year following equity market low points (earning cash otherwise), the return annualizes 7.8%. This is still inferior to “buy and hold” to the tune of 3.1 percentage points per annum.

**FIGURE 2: “New expansion strategy” – invest in US market or business cycle bottoms for a year vs “buy and hold” during all periods**



Source: Haver Analytics as of May 15th, 2024. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

## Pick Your Risk Tolerance

Living with the full downside exposure to equities at all times is not a choice one has to make. The bond market “collapse” of 2022 came from history’s *lowest yields of all time*. During other periods in recent decades when bear markets gripped US equities, *high quality* bond returns were positive (see **FIGURE 3**). This property of negative correlation between high risk and low risk assets allows the combination of stocks and bonds to be less volatile for the same level of risk. Since 2000, the correlation of the US Treasury index 12-month return and the S&P 500 is -0.4%. Meanwhile the US Treasury yield (average duration) is now 4.6%. At the start of 2022, the average yield was just 1.4%.

As we discussed in our [CIO Bulletin](#) two weeks ago, we view both 2020 and 1980 yield extremes as historical aberrations. Long-term Treasury yields are *unlikely* to drop sharply in the economic outlook we expect. They might, however, if the economy contracts broadly and deeply. This makes bonds a potential equity and credit risk hedge with a positive yield. Suitable investors can also hedge equity risk directly with a much smaller share of a portfolio using derivatives. It is quite rare, however, for such a hedge to have a net positive yield.

**FIGURE 3: Strong returns following historically down years for stocks and bonds**

Total Return in Fixed Income during 20% US equity correction (%)		
Date of drawdown	# days	US Treasury
Nov-73	222	4.1
Feb-82	311	13.3
Oct-87	39	(2.0)
Mar-01	251	12.4
Jul-08	197	7.6
Mar-20	17	4.3
Jun-22	115	(10.2)
<b>Average</b>	<b>165</b>	<b>4.2</b>

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### What is “Phase 3?”

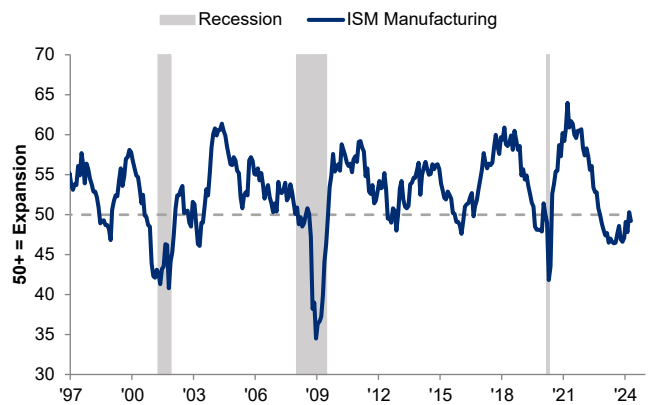
Our message on markets is that the depressed “snap back” phase is over. This means broad index returns – particularly for the S&P 500 – are likely to be less spectacular than the 47% annualized gain of the last two full quarters. However, the present period has some *positive* characteristics that are the mirror opposite of the unusual negatives of 2022.

In 2022, US employment growth exceeded real GDP growth by the most since 1974 (see **FIGURE 4**). The gain in US hiring through 2023 – led by services that were held back deep into the post-pandemic recovery – helped the economy grow through a period of sharp monetary policy tightening. The gain in employment also coincided with a drop in corporate profits in cyclical industries last year (see **FIGURE 5**). These declines for profits and strong gains for employment are reversing. In essence, the economy has been “out of sync” with historic norms. Recessions and recovery cycles tend to be more uniform across industries. The pandemic recovery broke this pattern.

**FIGURE 4: US employment growth less real GDP growth y/y%**



**FIGURE 5: US Manufacturing Composite Purchasing Managers Index**



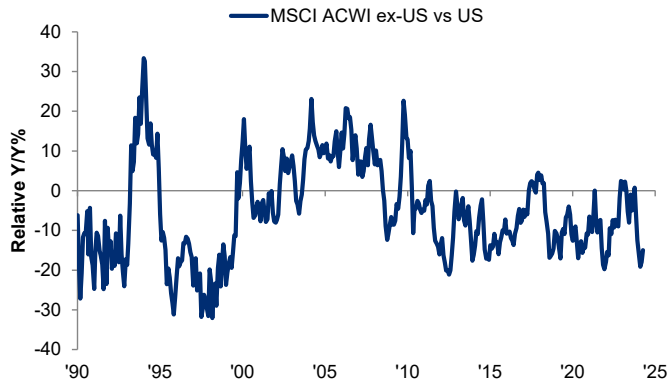
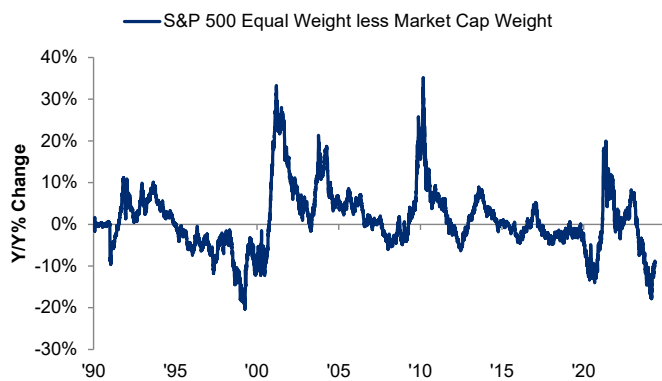
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Feeling “rolling recessions,” many industries posted EPS declines in 2023. As we discussed in our April 27<sup>th</sup> [CIO Bulletin](#), excluding the “Magnificent” 7 US tech companies<sup>3</sup>, EPS for the S&P 500 fell 6.7% over the past 12 months. The same pattern was felt even more sharply in economies lacking big AI and other tech services providers. As **FIGURE 6** shows, the “hidden recession” of 2023 left the average company to fall well behind the performance of US large cap tech shares.

Last year, the S&P 500 equal weight index trailed behind the S&P 500 market cap weighted index by the most since 1998. Also notable, equity returns for the rest of the world have fallen 15 percentage points behind US equities. This is the most severe underperformance for international markets since the European sovereign debt crisis of 2012 (see **FIGURE 7**).

**FIGURE 6:** S&P 500 equal weight less market cap weight return Y/Y%

**FIGURE 7:** Global equities ex-US less US return Y/Y%



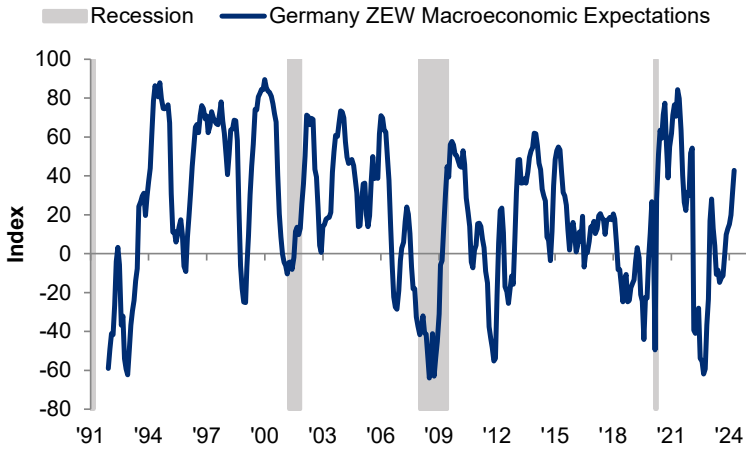
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Today, we expect a “normalization” of the conditions of 2022-2023. For a time, this will include rising profits and slowing employment together. This means less US interest rate pressure and exchange rate pressure – apart from the possibility of a new tariff shock we discussed in last week’s [CIO Bulletin](#). In the meantime, the world economy is regaining its footing, as demonstrated by new optimism in Europe following the trade and manufacturing weakness of the past two years (see **FIGURE 8**).

In conclusion, there is little holding back many of the world’s equity markets from delivering returns well in excess of cash, consistent with economic development and risk. We believe it is time to reexamine diversification and global exposures.

<sup>3</sup> The Magnificent 7 stocks: Amazon.com (AMZN), Apple (AAPL), Google parent Alphabet (GOOGL), Meta Platforms (META), Microsoft (MSFT), Nvidia (NVDA), and Tesla (TSLA).

**FIGURE 8:** German ZEW Economic Expectations Index



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<b>Credit risk</b>			
<b>Investment Grade</b>			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
<b>Not Investment Grade</b>			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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- volatility of returns;
- restrictions on transferring interests in the Fund;
- potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
- absence of information regarding valuations and pricing;
- complex tax structures and delays in tax reporting;
- less regulation and higher fees than mutual funds; and
- manager risk.

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Past performance is no guarantee of future results.

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