ClearBridge Investments

The Long View: Are We There Yet?

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Key Takeaways

- The current bear market is in its early stages with multiple compression driving losses so far. Where equities ultimately bottom will depend on how well the economy holds up and the trajectory of corporate earnings.
- With inflation remaining elevated and maximum employment achieved, the Fed has dramatically ramped up its tightening cycle to restore price stability and prevent long-term inflation expectations from unanchoring. The economy is also facing elevated risks from the traditional lag before policy actions have an impact.
- A recession does not appear imminent; however, the ClearBridge Recession Risk Dashboard is showing signs of strain. While the overall dashboard remains an expansionary green, Credit Spreads, ISM New Orders and Retail Sales saw worsening signal changes during the month.

The Bad News May Not Be Over for Equities

As the calendar turns to July, many families will be hitting the road for summer vacation. As a kid, we would make the 18-hour pilgrimage down I-95 to Disney World via station wagon. Packing took a solid week, and we would leave at 3 a.m. sharp to avoid traffic, which was almost certain somewhere in between New Jersey and Washington, D.C. At some point around a more normal waking hour, the inevitable question would come from me or my siblings: are we there yet? This question would be repeated every hour on the hour until we arrived. This dynamic is (unfortunately) familiar to many of us and is perhaps an appropriate parable for investors. When will the selling be over? Are we there yet?

While our view coming into the year was for tough sledding as laid out in "The Year of Transition," we did not expect the economic backdrop to deteriorate as quickly as it has over the past few months. However, a quote alternately attributed to John Maynard Keynes, Paul Samuelson and Winston Churchill seems appropriate (whoever said it) to describe our recent shift in thinking: "When the facts change, I change my mind. What do you do, sir?" Specifically, last month we highlighted that the odds of a hard landing (recession) have increased dramatically given the rapidly evolving economic backdrop, which we laid out in a special AOR blog.

The key question for market participants now is whether all the bad news is already priced in, providing the foundation for a potential durable bottom? History suggests further digestion may be needed in order for markets to see sustained upside. This bear market has run six months so far, with investors enduring a -23.6% drawdown from January 3 through June 16 as measured by the S&P 500 Index. While this has felt severe, historically bear markets tend to last 16 months and witness a 35% drawdown on average with recessionary periods faring worse than non-recessions.

Exhibit 1: The Current Bear Market in Context

S&P 500 Bear Markets

Start Date	End Date	Duration (Months)	Percent Change
May 1946	June 1949	37	-29.1%
Aug. 1956	Oct. 1957	15	-21.6%
Dec. 1961	June 1962	6	-28.0%
Feb. 1966	Oct. 1966	8	-22.2%
Nov. 1968	May 1970	18	-36.1%
Jan. 1973	Oct. 1974	21	-48.2%
Nov. 1980	Aug. 1982	20	-27.1%
Aug. 1987	Dec. 1987	3	-33.5%
March 2000	Oct. 2002	31	-49.1%
Oct. 2007	March 2009	17	-56.8%
Feb. 2020	March 2020	1	-33.9%
Jan. 2022	**?**	**6***	**-23.6%***
	Average	**16**	**-35.1%**

Recessionary Bear Markets

Average Duration
17 Months

Percent Change
-39.0%

Non-Recessionary Bear Markets

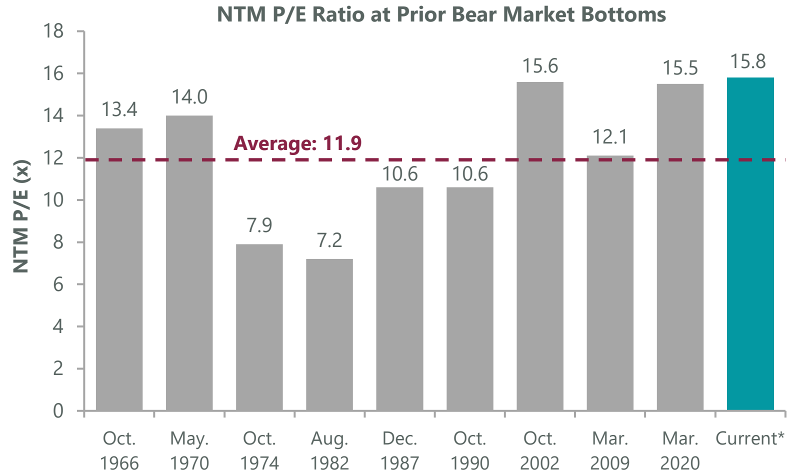
Average Duration
13 Months

Percent Change
-28.2%

Data as of June 30, 2022. Source: FactSet.

Conceptually, most bear markets have two components: multiple adjustment and earnings contraction. Typically, declining P/Es kick off a bear market, with lower P/Es following in every Fed tightening cycle. So far in 2022, this has been playing out with the S&P 500 forward P/E contracting from 21.3x coming into the year to 15.8x today. While this derating rivals some of the largest six-month declines in modern history, multiples could have further to fall given the average trough P/E in historical bear markets was 11.9x. That said, the last 20 years have seen major market lows bottoming at 14.4x on average in part due to lower interest (discount) rates.

Exhibit 2: Finding Fair Value



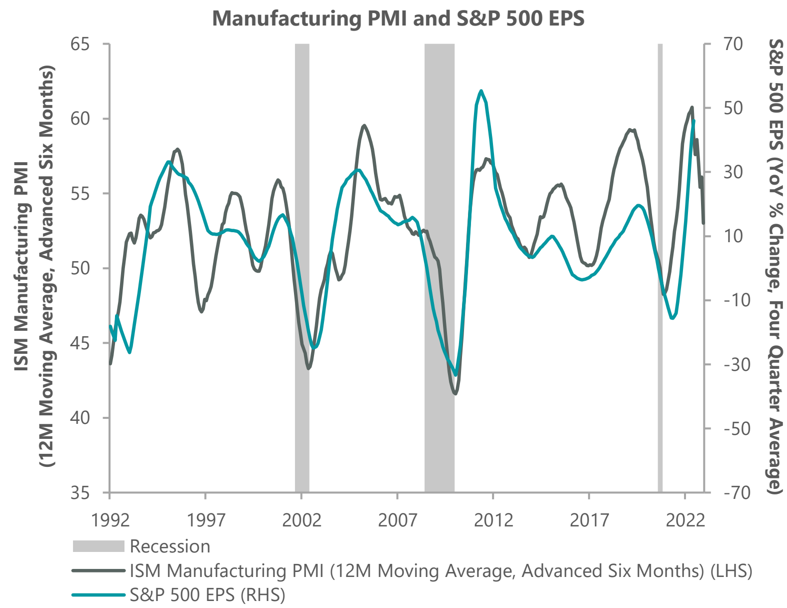
*As of June 30, 2022. Note: Chart uses monthly next twelve months (NTM) P/E ratios on the S&P 500 Index since 1964. Data as of June 30, 2022. Source: Federal Reserve, Standard & Poor's, FactSet, Credit Suisse.

The second leg of most bear markets features earnings contraction. The current bear market has been entirely driven by P/E compression, while forward earnings expectations have risen by a healthy 7.4% this year. In the last two weeks, earnings revisions have started to drift lower, and we see a strong possibility of more meaningful downward revisions as we move through the back half of the year. Ultimately, the degree to which earnings expectations decline will determine the degree of the economic slowdown.

One thing we monitor to help evaluate this dynamic is the ISM Manufacturing PMI (the ISM), which tends to lead S&P 500 earnings by six months. Historically, the ISM has fallen below 43 — a level typically consistent with double-digit earnings declines — during prior bear markets that came after Fed tightening cycles. Should this relationship hold, the market could see new lows in the coming months.

Where equities ultimately bottom, however, will depend on just how well the economy holds up and in turn where earnings head. With inflation remaining elevated and maximum employment achieved with unemployment below 4%, the Fed is increasingly fearful of inflation expectations unanchoring. Its research supports the notion that the longer inflation remains elevated, the greater the risk of inflation expectations unanchoring. Put differently, the risks of doing too little to tame inflation are far greater than the risks of doing too much. This thinking has helped drive a dramatic shift in monetary policy expectations over the past six months, moving from three 25 basis point rate hikes expected coming into the year to slightly more than 13 today, implying a fed funds rate of 3.25% to 3.5%. If this tightening comes to fruition, it would be the second-fastest bout of first-year monetary tightening in over 65 years, trailing only 1980 when then-Fed Chair Paul Volcker broke the back of double-digit inflation.

Exhibit 3: ISM Manufacturing Survey Leads Earnings



Data as of June 30, 2022. Source: FactSet, ISM, Standard & Poor's.

Rate Hikes Take Time to Bite

Beyond the dramatic shift in tightening, the economy is also facing elevated risks from the traditional lags between monetary policy actions and their impact. This means the effects of tightening today (and in the coming months) may not be fully felt for a few quarters, by which time the economy (and inflation) maybe be slowing, risking a rollover into recession. Fed Chair Jay Powell has discussed an "unconditional" commitment to bringing inflation back down to the 2% target and has implied a willingness to accept higher unemployment in order to restore price stability. This trade-off is fully evident in the Fed's latest Summary of Economic Projections (SEP), commonly known as the "Fed dots." The dots show a rise in the unemployment rate from today's 3.6% to 4.1% by the end of 2024. Historically, there has never been a U.S. business cycle in which the unemployment rate rose more than 0.5 percentage points from its recent low (over the prior 12 months) without a recession, a trend known as the Sahm Rule. Although the dots suggest this could play out over a longer horizon (24 months), the margin for error for achieving a softish landing is narrow.

In the end, recessions are like death and taxes: they can't be avoided forever. A recession does not appear to be on the immediate horizon based on the ClearBridge Recession Risk Dashboard. Some indicators, however, are softening, including Commodities, Retail Sales and Money Supply, consistent with an

> Contrary to popular wisdom, a recession is not defined simply as two consecutive quarters of negative real GDP growth.

economy slowing from strong levels. Three indicators changed this month: Credit Spreads worsened from yellow to red with the mid-month update while ISM New Orders and Retail Sales both deteriorated from green to yellow. As such, the dashboard currently has six green, four yellow, and two red indicators with the overall signal remaining an expansionary, albeit closer to yellow, green signal. As the economy continues to slow, we expect further signal changes in the second half of 2022.

Exhibit 4: ClearBridge Recession Risk Dashboard

		June 30, 2022	May 31, 2022	April 30, 2022	March 31, 2022
Consumer	Housing Permits	⬆	⬆	⬆	⬆
	Job Sentiment	⬆	⬆	⬆	⬆
	Jobless Claims	⬆	⬆	⬆	⬆
	Retail Sales	●	⬆	⬆	⬆
	Wage Growth	✖	✖	✖	✖
Business Activity	Commodities	●	●	●	⬆
	ISM New Orders	●	⬆	⬆	⬆
	Profit Margins	⬆	⬆	⬆	⬆
	Truck Shipments	⬆	⬆	⬆	⬆
Financial	Credit Spreads	✖	●	●	⬆
	Money Supply	●	●	●	●
	Yield Curve	⬆	⬆	⬆	⬆
	Overall Signal	⬆	⬆	⬆	⬆

⬆ Expansion ● Caution ✖ Recession

Data as of June 30, 2022. Source: BLS, Federal Reserve, Census Bureau, ISM, BEA, American Chemistry Council, American Trucking Association, Conference Board, and Bloomberg. The ClearBridge Recession Risk Dashboard was created in January 2016. References to the signals it would have sent in the years prior to January 2016 are based on how the underlying data was reflected in the component indicators at the time.

With first-quarter GDP contracting by -1.6% and second-quarter GDP estimates from the Atlanta Fed's Nowcasting tool firmly in negative territory, it's important to address a common misconception about recessions. Contrary to popular wisdom, a recession is not defined simply as two consecutive quarters of negative real GDP growth. Instead, the official arbiter of U.S. business cycles — the National Bureau of Economic Research (NBER) — defines a recession as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales. A recession begins just after the economy reaches a peak of activity and ends as the economy reaches its trough." The NBER ultimately considers a wide range of data in determining when the economy has entered or exited a recession, but several of the economic data points it mentions are at or near cycle peaks, suggesting that a recession has not yet begun.

Exhibit 5: What Exactly is a Recession?

How the NBER (National Bureau of Economic Research) Defines Recession

A recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales. A recession begins just after the economy reaches a peak of activity and ends as the economy reaches its trough.

Sample NBER U.S. Economic Indicators

Indicator	Percent Change from Peak	Recessionary Flag
Consumption	-0.4%	No
Manufacturing Sales	-2.7%	???
Payrolls	At Peak	No
Personal Income	At Peak	No

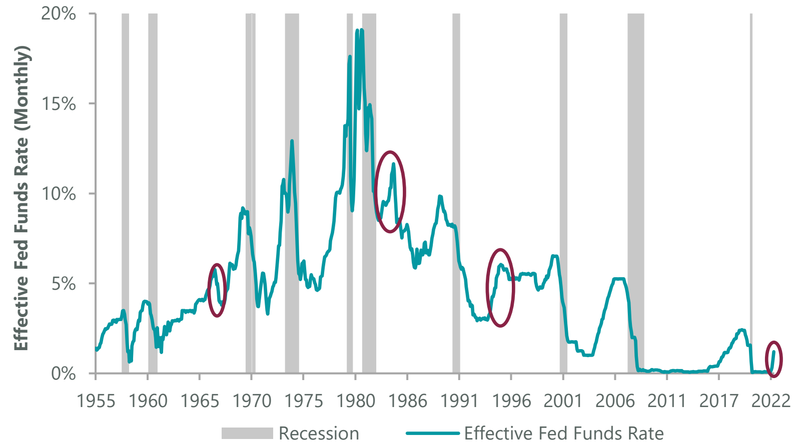
Personal Income: Real Personal Income Less Transfers – excluding current transfer receipts, Billions of Chained 2012 Dollars, Monthly, Seasonally-Adjusted Annual Rate (1 month lag); Payrolls: Nonfarm Payrolls - All Employees, Total Nonfarm, Thousands of Persons, Monthly, Seasonally-Adjusted; Consumption: Real Personal Consumption Expenditures, Billions of Chained 2012 Dollars, Monthly, Seasonally-Adjusted Annual Rate (1 month lag); Manufacturing Sales: Real Manufacturing and Trade Industries Sales, Millions of Chained 2012 Dollars, Monthly, Seasonally-Adjusted (approx. 3 month lag). Source: Federal Reserve Bank of St. Louis.

Three Keys to a Soft Landing

Although engineering a soft landing is no easy feat, particularly given the expected path of monetary policy, it's not impossible. There have been three soft landings following 13 primary tightening cycles since 1955, occurring in 1965, 1984 and 1994. In evaluating these periods, it appears the health of the labor market has been key. The challenge is to cool labor demand without fully halting it, resulting in job growth slowing from elevated levels but staying positive.

Another path to a soft landing could be via energy price stabilization and moderation of broader inflation, allowing the Fed to back off its current tightening path. Further, the health of the consumer could prove decisive, with individuals digging into their savings and tapping sources of borrowing to maintain spending and keep the economy growing until inflation moderates. The financial position of households is beginning to deteriorate; however, this is occurring from a position of historic strength. Household net worth is up $32.5 trillion from the end of 2019 and household leverage is near 50-year lows. Moreover, wage growth remains robust. Put differently, the consumer may be less interest-rate sensitive than previous economic cycles.

Exhibit 6: The Case for a Soft Landing



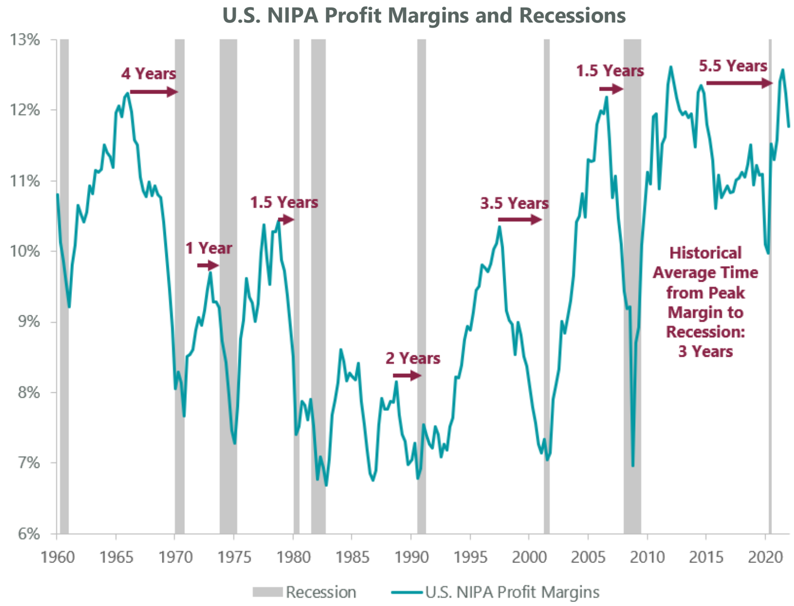
	Nov. 1966	Aug. 1984	Apr. 1995	Current (Jun. 2022)
Fed Tightening (bps)*	175	313	309	69
Payrolls (Monthly Change, 000s)**	165	243	162	390

*Fed Tightening refers to the Cumulative Rise in Fed Funds Rate, Effective %.
**Payrolls refers to Non-Farm Payrolls, Month over Month change.
Data as of June 30, 2022, Source: Federal Reserve Bank of St. Louis, FactSet.

A final path to a soft landing could be a lack of margin pressure on companies, which could obviate the need for a full-scale layoff cycle. Businesses will typically endure significant margin compression, cash burn and balance sheet deterioration before reducing headcounts. The scarcity of labor in the current cycle could make corporations reluctant to trim staff. Historically, it has taken three years for a recession to ensue following the peak in corporate margins, which in the current cycle occurred just two quarters ago. This timeline could be condensed, but it seems more likely that corporations bend instead of break.

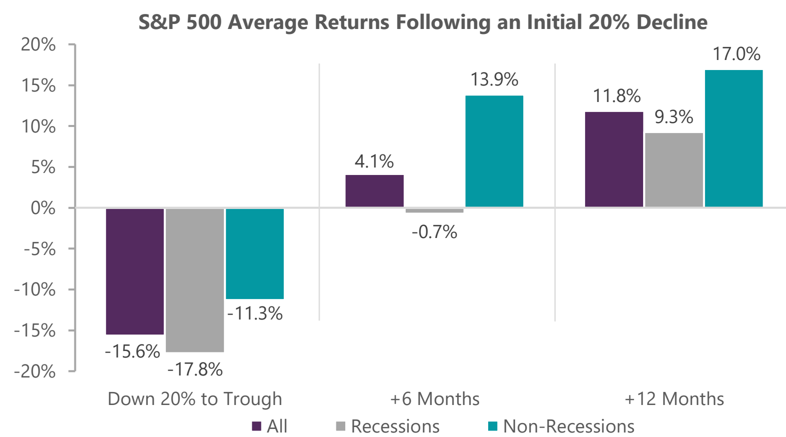
Regardless of whether we achieve a soft landing, or if the market low has already occurred, bear markets have historically been good entry points for long-term investors. In previous bear markets over the past 80 years, equities have fallen a further 16% on average after breaching the 20% mark. Subsequent downside has been greatest when the bear market coincided with a recession, but equities have still fallen a further 11% on average during non-recessionary bear markets. The good news is that those additional losses are usually recovered quickly, with 12% upside on average in the year following a 20% decline.

Exhibit 7: The "Margin" for Error



NIPA: National Income and Product Accounts. Data as of March 31, 2022, latest available as of June 30, 2022. Source: FactSet, Federal Reserve Bank of St. Louis.

Exhibit 8: Bear Market Achieved, Good Entry Point



	Median # of Days to Trough
All	144
Recessions	207
Non-Recessions	43

Source: S&P, FactSet, and NBER.

Many questions remain unanswered regarding inflation, Fed policy, interest rates, recession risk, valuations and earnings. And investors may not know if "we are there yet" for some time. Despite the trepidation caused by these uncertainties and the rocky start to the year, visibility is likely to improve as we move through the next couple quarters. Though the market's bottom will only be known in hindsight, eventually we will "be there." By the time this becomes obvious, equities are likely to have climbed well off the lows, albeit with the likelihood of false starts along the way. While bear markets are never a joyous experience, it's important to remember they are rare and typically provide excellent opportunities for long-term and patient investors.

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