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Equity market downturn

The path forward

:::: AUGUST 11, 2022

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In the post-Volcker era, the Federal Reserve (Fed) has typically exhibited a vigilant approach to fighting inflation. Whenever labor market tightness appeared and inflation was beginning to approach its target rate of 2% Core PCE, the Fed would often spring into action with rate hikes. This cycle, however, has been unique, with the Federal Reserve instead permitting inflation pressures to build-up rather than promptly stamping them out.

Now, having allowed inflation to garner a foothold well above its own target, the Fed is having to respond by aggressively tightening credit and financial conditions via sharp rate hikes and quantitative tightening. This backdrop has led equity markets down a path littered with periodic selloffs, punctuated by sharp relief rallies. While the trend is certainly downwards, investors need to be attentive to 'bear-market rallies', their short-lived character, and the risk of becoming enticed into an enduring bear market, one with many underappreciated risks.

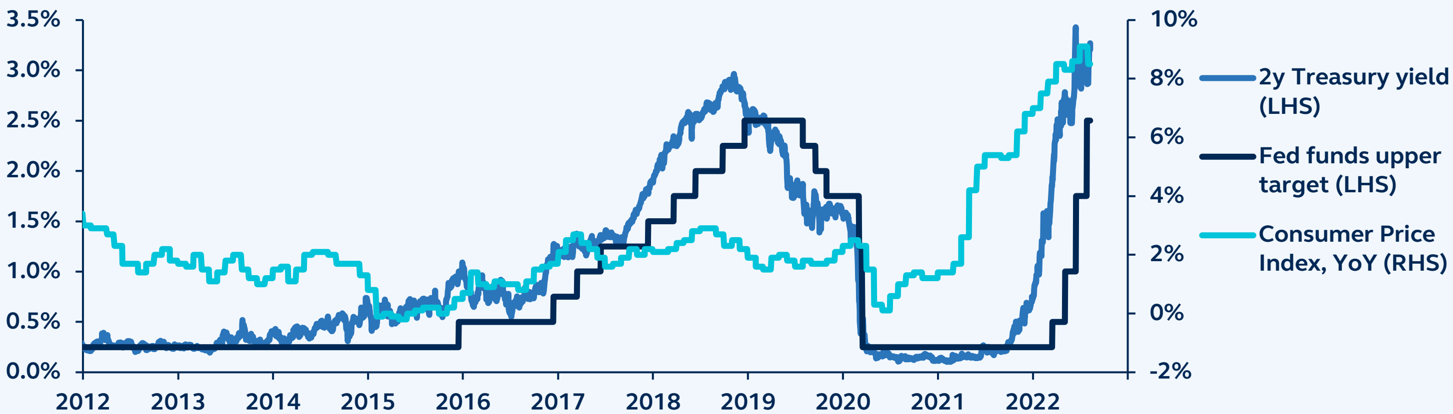
We see the current bear market as potentially having two phases; the first having been driven by an inflationary rates scare, together with a valuation multiple contraction.[1] The second phase ahead could yet unfold as an economic growth slowdown and corporate earnings scare.

Bear market phase 1: Inflation scares and an earnings multiple contraction

High inflation, and now a hawkish stance from the Fed, challenged the initially extended valuations of U.S. equities going into 2022. The market sell-off in the first half of the year was dominated by heightening investor risk aversion and a realization that the days of generous liquidity conditions and zero-rate Fed funds were in the rearview.

On the back of the equity market slide and volatility spike, forward consensus price-to-earnings multiples compressed from 21.8x in early 2022, to a more modest and approximately historical average of 18.5x – a behavior that is consistent with the market discounting inflation's effects on future earnings.

U.S. inflation, interest rates, and fed funds rate
January 2012-present



Source: Bureau of Labor Statistics, Federal Reserve, Bloomberg, Principal Global Investors. Data as of August 9, 2022.

[1] Read more about what drove phase 1 of the current bear market

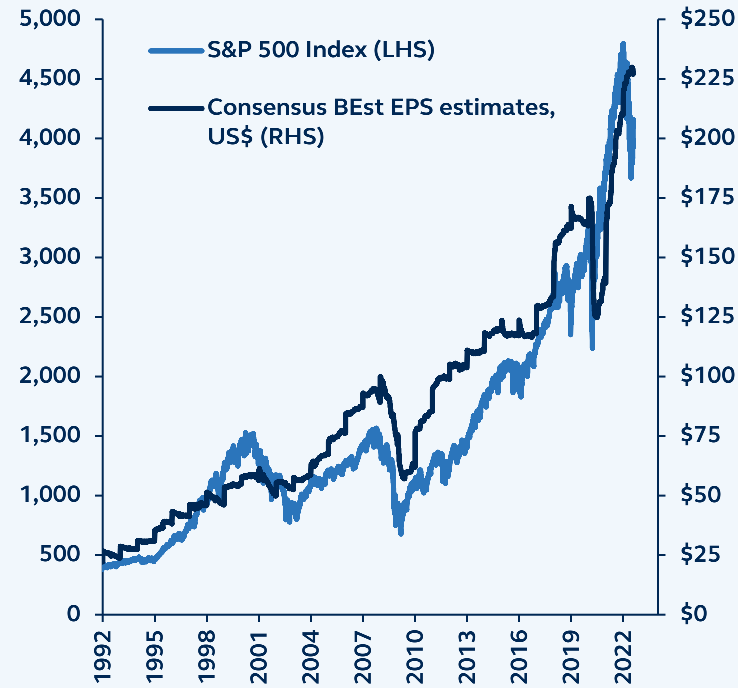
Today's diminished valuation multiple, however, may not sufficiently capture the impact of potential aggressive Fed rate hikes into 2023, nor the effects that the Fed's aggressive policy may have on the real economy.

Indeed, while stocks have sold-off in 2022, aggregate earnings estimates, so far, have barely budged, primarily as a result of an enormous 96% upgrade of energy earnings, which only occupies a 4.2% sector weighting within the S&P 500. While current market valuations are certainly more reasonable than in January, at-best they could be considered fair-value–but by no means cheap. The deteriorating macro backdrop and inherent policy risks may still warrant further sector earnings downgrades and potential market declines.

S&P 500 sector *(as of Aug 9, 2022)*	YTD % chg in fwd EPS	S&P 500 weight
Information technology	3.9%	28.0%
Healthcare	0.1%	14.2%
Consumer discretionary	-13.8%	11.5%
Financials	-4.7%	10.7%
Communication services	-11.4%	8.5%
Industrials	-1.8%	7.9%
Consumer staples	-0.3%	6.6%
Energy	96.1%	4.2%
Utilities	2.4%	3.1%
Real estate	18.0%	2.9%
Materials	11.6%	2.5%
S&P 500	**3.1%**	**100%**
S&P 500 (ex-Energy)	**-17.0%**	**95.8%**

Market performance and earnings estimates

S&P 500 Index, January 1992-present



Source: Bloomberg, Principal Global Investors. Data as of August 9, 2022.

Bear market phase 2: Growth scares and earnings risks amid hawkish central banks

Risks embedded in earnings growth estimates remain an underappreciated risk in the second half of 2022 and into 2023. Most notably, the raising of interest rates by global central banks will inevitably weigh on both economic activity and corporate profitability. Consumers too, who are already feeling the pinch from inflation, are likely to adjust their spending behavior in response to higher prices.

Global manufacturing PMIs and global rate cuts

Monthly net rate cuts, negative = rate hikes

Source: Bank for International Settlements, Bloomberg, Principal Global Investors. Data as of August 9, 2022.

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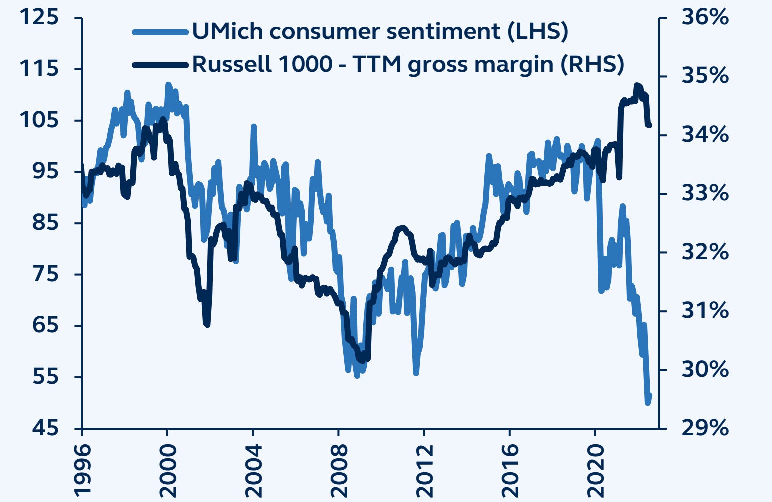
Central bank liquidity has been extraordinarily important for economic activity in the post-Global Financial Crisis era, and the major reversal currently being instituted by global central banks could severely damage growth. Since March 2021, there have been 165 separate occasions of global central bank rate hikes, which will inevitably restrain economic activity and challenge corporate operating leverage and profitability in 2023.

What's more, consumer budgets have been massively crimped in 2022, specifically on the back of surging inflation. In particular, energy inflation has been raging in double-digits since February 2021, peaking in June, at over 41% YoY, while food prices too have taken off, recently reaching 10.9% YoY in July (the highest food inflation since 1979). It's highly possible that consumers pare back their propensity to spend, adjust down budgetary allocations of necessities to lower cost alternatives, and even forego aspects of discretionary consumption altogether.

Consumer sentiment and sales margins

S&P 500 Index, January 1996-present



Source: University of Michigan, FTSE Russell, Bloomberg, Principal Global Investors. Data as of August 9, 2022.

So far, earnings estimates don't incorporate these abundant risks, but such top-line contractions would likely permeate to margin pressures, eventually negatively impacting corporate earnings. While inflation and tighter Fed policy have precipitated this year's equities drawdown, the second act to this bear market could be the realization of inherent growth concerns.

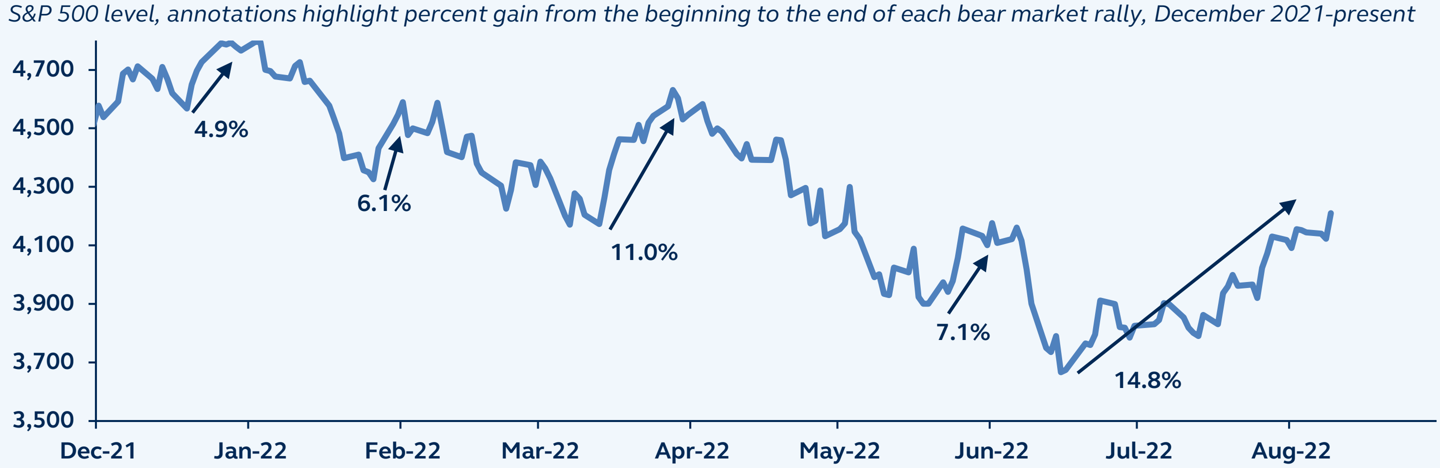
Bear market dynamics

Bear markets are characterized by a persistent downward trend, exhibiting lower highs and lower lows within that downtrend. Bear market rallies are temporary countertrends, usually off lower lows, during such secular declines. These bear markets rallies are typically caused by technical factors such as rebounding from oversold conditions, a reversal of extreme short-seller positioning, and sudden reactions to any shift in sentiment from an extremely bearish condition.

The protracted down markets of 1973-1974, 2001-2003 and 2008-2009 each experienced multiple bear market rallies, while this year's bear market has experienced five through August. The latest, starting in mid-June, has seen the year-to-date equity market decline diminish from 24% to just 11%. While this represents a sizeable gain, it is, in fact, exactly in line with the average magnitude of bear market rallies in previous cycles. Ultimately, fundamentals typically prevail in the medium and longer-term, with bear market rallies delivering only temporary gains.

Bear market rally

S&P 500 level, annotations highlight percent gain from the beginning to the end of each bear market rally, December 2021-present



Source: Standard & Poor's, Bloomberg, Principal Global Investors. Data as of August 10, 2022.

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For investors in 2022, this equity market downtrend will likely persist until:

- Inflation demonstrates a clear and persistent downward trajectory, or…
- The Federal Reserve begins to indicate sufficient tightening is behind us, or…
- Downward earnings revisions become more widespread and more reflective of macro deterioration.

At that point investors could resume a risk-on portfolio stance, reflective of a more justified faith in a renewed bull market. Until these conditions are met, however, (we do not envisage until 2023 at the earliest,) rallies are likely to be short-lived.

Investor roadmap

2022 is proving to be a typical echo of other bear markets in history, characterized by hopeful, yet humbling, temporary market rallies within a longer downtrend. The current prolonged drawdown, initially spurred by lower valuations (resulting from an initial inflation scare, and the subsequent rates scare), is also a market that is yet to grapple with the potentially severe risks to the wider economy and corporate earnings. Consequently, investors should not place too much faith in sharp, sudden but temporary bear-market rallies – the downward trend will likely soon reinstate itself.

As the adage states, time in the market is more important than timing the market – and today's market is no different. Since 2020, if investors were to have missed just the best 5 days of stock market performance, they would accumulated annualized losses of nearly 7% – in stark contrast to being up over 14% (or a 21% variance) for those that remained fully invested.

Rather than shunning risk assets, investors would be well suited to adjust their portfolios to take advantage of particular sectors and styles that can outperform during economic slowdowns.

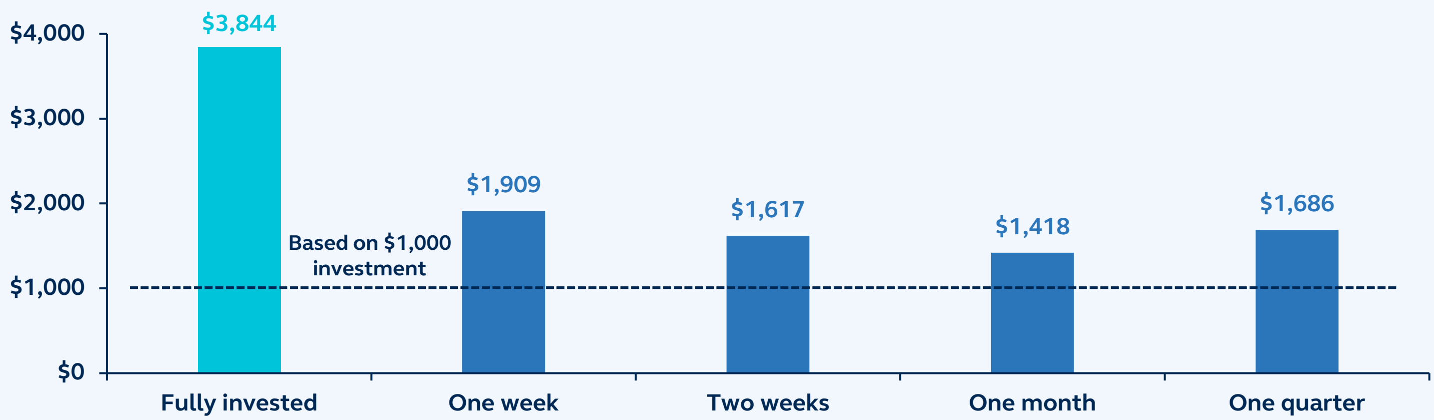
- Increase exposure to more defensive sectors such as Healthcare, Insurance, Utilities, and MLPs.
- Preferred equity has an appealing defensive quality, as it commits to a fixed coupon rate.
- Infrastructure and other real assets also may help deliver stable income with a defensive quality, as well as providing pricing power to help minimize inflation risks.

Despite short-lived bear market rallies that can tempt investors into putting capital at risk, there are investment strategies that can enhance a portfolio during volatility in markets.

In today's bear market, quality and defensive style characteristics can reduce portfolio volatility, permitting investors to remain fully invested and focused on their strategic asset allocation, while withstanding the challenging equity market backdrop, and the future risks ahead.

Staying invested: Time in the market

Effect of exiting the market the day after a -2% market move or worse and staying out for each time period, S&P 500 Index, past 25 years



Source: Clearnomics, Standard & Poor's, Principal Global Investors. Data as of August 9, 2022.

Risk considerations

Investing involves risk, including possible loss of principal. Past performance is no guarantee of future results. Equity markets are subject to many factors, including economic conditions, government regulations, market sentiment, local and international political events, and environmental and technological issues that may impact return and volatility. Infrastructure issuers may be subject to regulation by various governmental authorities and may also be affected by governmental regulation of rates charged to customers, operational or other mishaps, tariffs, and changes in tax laws, regulatory policies, and accounting standards. Inflation and other economic cycles and conditions are difficult to predict and there Is no guarantee that any inflation mitigation/protection strategy will be successful.

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