Market Strategy Outlook

The bear market view

Ben Laidler
benla@etoro.com

June 21, 2022

Disclaimer

"eToro is a multi-asset platform which offers both investing in stocks and digital assets, as well as trading CFDs.

Please note that CFDs are complex instruments and come with a high risk of losing money rapidly due to leverage. **68% of retail investor accounts lose money when trading CFDs with this provider.** You should consider whether you understand how CFDs work, and whether you can afford to take the high risk of losing your money.

This is a marketing communication and should not be taken as investment advice, personal recommendation, or an offer of, or solicitation to buy or sell, any financial instruments. This material has been prepared without taking into account any particular recipient's investment objectives or financial situation, and has not been prepared in accordance with the legal and regulatory requirements to promote independent research. Any references to past or future performance of a financial instrument, index or a packaged investment product are not, and should not be taken as, a reliable indicator of future results. eToro makes no representation and assumes no liability as to the accuracy or completeness of the content of this publication, which has been prepared utilising publicly available information."

Summary: going down before up in second half

Risk of further downside before a second-half relief rally

- Slump to bear market as Central Banks prioritise driving out sticky inflation, raising recession fear. **Earnings next shoe to drop.**
- See slowdown not big recession, inflation expectations controlled and few big macro imbalances. **Room for 2H 'U-shape' recovery.**
- Crypto fell into capitulation territory on **'perfect storm'** of equity sell-off, self-inflicted weakness, and asset class contagion.

Focus on deep Value and Defensives to manage higher risks

- **A new investing world.** Less growth, higher rates, more volatility
- Be **invested**, for recovery, but **defensive**, to manage high risks
- Favour cheap **defensives** such as healthcare and high dividends. Also cheap or uncorrelated markets like UK and China.

We also look at....

- Opportunities in **Automation** and **Energy** sell-off
- The wide **investment style** divergence
- The challenges for the **European Central Bank**

The eToro Markets View	
Overview	Sticky inflation drives hawkish central banks and rising recession risks. See only a gradual 'U-shaped' recovery. Favor defensive, and inflation-proof assets, like Value equities and commodities, in this 'new' investment world.
Traffic lights*	**Equity Market Outlook**
United States	Profits resilience, now lower valuations, well-priced Fed. Value to lead, but 'big-Tech' sector better supported.
Europe & UK	Cheap EU valuations and strong macro 'buffers', from fiscal to FX, but high macro risks. Favour 'defensive' UK.
Emerging Markets (EM)	China opportunity in covid reopening. Cutting rates, with stability focus, cheap valuations. Helps materials, luxury.
Other (JP, AUS, CN)	Canada and Australia benefit from commodity and financials focus. Japan 'Europe with less risk' with weak JPY.
Traffic lights*	**Equity Sector & Themes Outlook**
Tech (IT, CO, CD)	Structurally good growth, high profitability, fortress balance sheets, but still valuation pressure. Avoid 'disruption'.
Defensives (HC, CS, UT, RE)	Our focus with market risks raised, and US bond yields already up significantly. Healthcare cheapest/focus.
Cyclicals (CD, ID, EN, MT)	Resilient to 'slowdown not recession' GDP and higher bond yields, with depressed earnings and cheap valuations.
Financials (FN)	Benefit of higher bond yields and already very cheap valuations increasingly offset by rising recession risks.
Themes	Value to lead on resilient GDP exposure, lower valuations, under-ownership. ESG and renewables accelerating.
Traffic lights*	**Other Assets Outlook**
Currencies	USD benefits as a safer-haven for now. EUR pressured by Ukraine risks and is a key macro buffer for equities.
Fixed Income	Higher US bond yields (lower prices) as Fed accelerates policy tightening. Structural headwinds prevent more.
Commodities	Tight supply, China reopening, Russia sanctions, inflation 'hedge' demand offsets to global demand slowdown.
Crypto	16th big correction of last decade on rising equity correlation. But building institutionalization and use cases.
*Methodology:	Our guide to where we see better risk-adjusted outlook. Not investment advice.
Positive	Overall positive view, and expected to outperform the asset class on a 12-month view.
Neutral	Overall neutral view, with elements of strength and weakness on a 12-month view.
Cautious	Overall cautious view, and expected to underperform the asset class on a 12-month view.

Source: CD=Consumer Discretionary. CO=Communications. CS=Consumer Staples. EN=Energy. FN=Financials. HC=Healthcare. ID=Industrials. IT=Information Technology. MT=Materials. RE=Real Estate. UT=Utilities.

Past performance is not an indication of future results.

Performance: slump into a bear market

Officially well into an equity 'bear market'

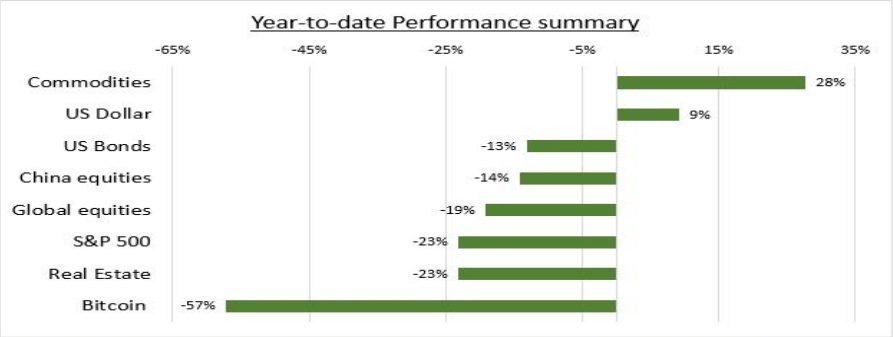
- S&P 500 plunged well into **'bear' market territory**, as Fed stepped up interest rate hikes, alongside others from UK to Switzerland and ECB struggled to contain peripheral bond yields.
- This **pushed up economic recession fears** significantly. The US dollar surged to new highs, 10-year bond yields well over 3%, oil stuck at $120, and crypto asset prices collapsed.

Commodities and US dollar only assets in positive territory

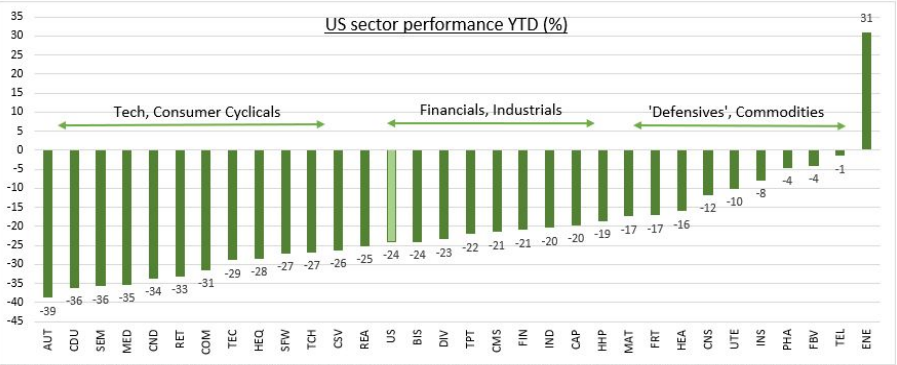
- Commodity (DJP) and US dollar (DXY) the **'safer havens'**
- Fixed income seen the **worst performance in a generation**
- Bitcoin (BTC) the laggard of major asset classes
- Global (ACWI) and Chinese (MCHI) equities **outperforming US**

Wide sector dispersion between tech and defensives

- Energy and traditional 'defensives', from telecoms to consumer staples, have been **most resilient**
- Financials benefit of higher bond yields offset by recession fear
- Tech and consumer durables hit by **double-whammy** of higher bond yields and rising recession fears



Source: Refinitiv. Global equities=MSCI ACWI. China equities=MSCI China. Real estate=S&P 500 real estate. USD=DXY US dollar index



Source: Refinitiv. AUT=Autos. BIS=Banks. CAP=Capital Goods. CDU=Consumer Durables. CND=Consumer Discretionary. COM=Communications.CMS=Commercial Services. CNS=Consumer Staples. CSV=Consumer Services. DIV=Diversified Financials. ENE=Energy.FBV=Food & Beverage. FIN=Financials. FRT=Food Retail & Tobacco. HEA=Healthcare. HEQ=Healthcare Equipment. HHP=Household Products. IND=Industrials. INS=Insurance. MAT=Materials. MED=Media. PHA=Phamaceuticals. REA=Real Estate. RET=Retail. SEM=Semiconductors. SFW=Software. TCH=Tech Hardware. TEC=Information Technology. TEL=Telecoms. TPT=Transport. US=S&P 500. UTE=Utilities.

Past performance is not an indication of future results.

Market: the bear market scenarios

History says bear market further to go

- S&P 500 in bear market territory, over 20% down for the year, and **history tells us there is still a way to go** yet. Recession risks are rising and could see this market fall another 20%.
- The average S&P 500 bear market, few and far between, lasts 19 months and sees a 38% drop in prices. This one has only lasted five months and is down 23%.
- We are invested, for a **gradual U-shaped recovery**, but defensive, to manage the rising risks.

Judging earnings versus valuations

- **Valuation and earnings matrix** to see S&P 500 risks.
- Valuations fallen below 10-year average 16.5x level, limiting risks unless see a big recession.
- But earnings growth is still seen a resilient 10%, and **the main risk** now. Profits typically fall over 20% in a recession. Caution for now as recession risks rising.
- But **base case** is for easing inflation, and a growth slowdown not recession. This gives eventual valuation-led market upside, offsetting modest cuts to the company profits outlook.

Source: S&P, Refinitiv. For illustration purposes only

S&P 500 Index level according to 2022 earnings and P/E valuation outlook

			2022 Price/Earnings ratio (x)							
	Change from current level		-20%	-13%	-7%	0%	7%	13%	20%	7%
			12	**13**	**14**	**15**	**16**	**17**	**18**	**19**
	10%	**276**	3,313	3,589	3,865	4,142	4,418	4,694	4,970	5,246
	5%	**264**	3,163	3,426	3,690	3,953	4,217	4,480	4,744	5,007
	0%	**251**	3,012	3,263	3,514	**3,765**	4,016	4,267	4,518	4,769
2022	-5%	**238**	2,861	3,100	3,338	3,577	3,815	4,054	4,292	4,531
Index	-10%	**226**	2,711	2,937	3,163	3,389	3,614	3,840	4,066	4,292
EPS	-15%	**213**	2,560	2,774	2,987	3,200	3,414	3,627	3,840	4,054
	-20%	**201**	2,410	2,610	2,811	3,012	3,213	3,414	3,614	3,815
	-25%	**188**	2,259	2,447	2,636	2,824	3,012	3,200	3,389	3,577
	-30%	**176**	2,108	2,284	2,460	2,636	2,811	2,987	3,163	3,338

Source: Refinitiv. For illustration purposes only.

Past performance is not an indication of future results.

Economy: a short and shallow slowdown

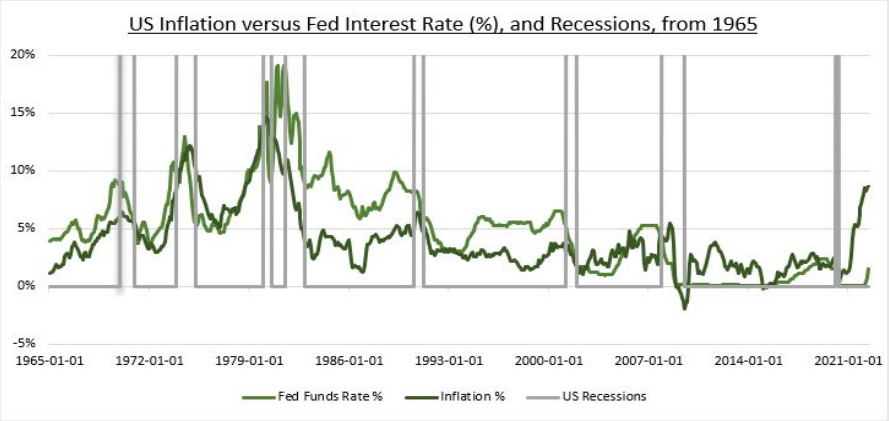
Differences with the 1970's

- Central Banks getting on **inflation-fighting front-foot**, with Fed's 0.75% hike and Bank of England hiking for 5th straight time. Amidst many real parallels with 'stagflationary' 1970's, there are 2 **big differences that give hope today.**
  - Central bank **credibility**, implicit in market reactions to every Fed utterance and its forward guidance.
  - Resulting **anchoring** of long term inflation expectations. Are a little over 2% in the US today versus inflation of 8.6%.

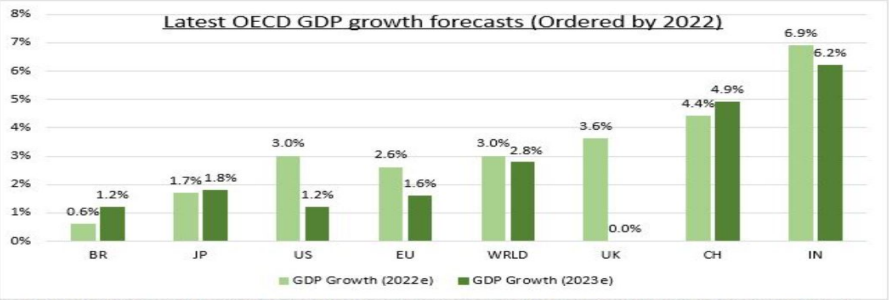
A positive, implying shorter, sharper cycle than lost-decade of the 1970's.

Anatomy of the growth slowdown

- Rich-country OECD club latest to cut global economic outlook. With slower 3% GDP growth, down 1.5 pts from December, but **not a recession**, and sticky 'high-for-longer' inflation.
- With large variation, from **reopening China to stagflationary UK**
- Reinforces **new investment world**, of less growth and returns, and more inflation, interest rates, volatility.



Source: Fred



Source: OECD, Refinitiv. BR=Brazil. JP=Japan. US=United States. EU=EuroArea. WRLD=World. UK=United Kingdom. CH=China. IN=India

Past performance is not an indication of future results.

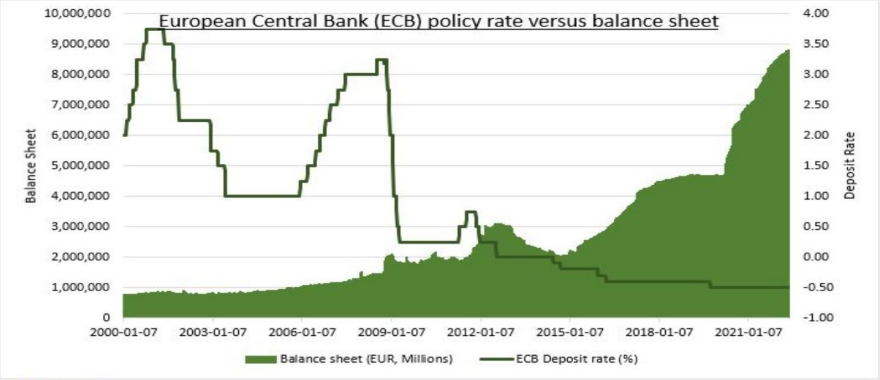
Issues: ECB struggles and petrol 'demand destruction'

ECB between rock and a hard place

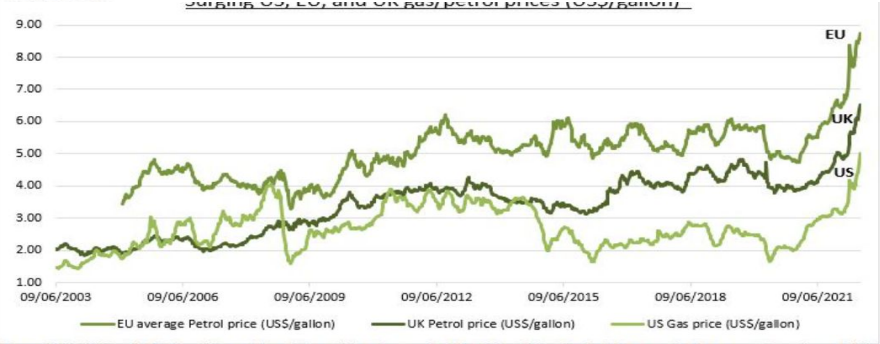
- European Central Bank (ECB) close to raising interest rates for first time in decade as faces **yawning disconnect** of 8% inflation and -0.5% rates.
- **Riskier than seems,** and likely means less-hikes than expected. 1) Europe is closer to recession than most, 2) supply-side inflation more intractable, 3) ECB' $9.3 trillion balance sheet bigger and equals 66% GDP, 4) **fragmentation risk high,** with widely different national debt and bond yield levels. Seen big impact here.

The surging petrol/gas price tax

- Petrol (gas) prices **surging globally** on pent-up travel demand and refining limits. Complicates lives of consumers, central bankers, politicians. It's a tax on consumption, diverts spending from other areas, and boosts inflation.
- Petrol prices **outpaced oil** given a shortage of refining capacity and China' export controls. May worsen, with forecasts for big US hurricane season, and half US refining capacity on gulf coast.
- Winners are the **oil refiners** from Marathon (MPC) to Valero (VLO).



Source: ECB, FRED



Source: FRED, UK Dept for Business, European Commission. * US regular gas price/gallon. UK and EU retail unleaded average price/litre converted to gallons and US$

Past performance is not an indication of future results.

Earnings: the corporate ‘anchor’ set to crack

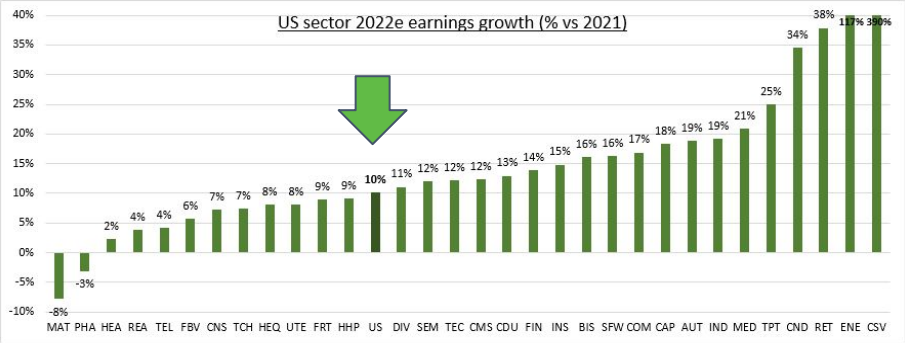
Earnings are the key market anchor to watch

- Broad **rise in US recession risks** and retail stocks sell-off stoked concern that resilient corporate earnings could decline.
- So-far the **opposite has been the case**, with US and European profit margins near record, and profits growth expectations rising.
- Earnings **momentum will decline**, but will be focused on discretionary and goods, with services and staples resilient.
- Is key, as expectations have been rising, versus a **20%+ average decline** during a recession

Outlook remains resilient for now

- US **earnings** rose 10% in Q1, and over 40% in Europe
- Corporate profit **margins** are near record highs, as able to pass through cost increases so far
- **Capex** plans are rising at double digit rates as confidence remains high, and partly investing to offset costs (automation)
- **M&A** activity also more resilient than stock markets. See big deals from Altria/Swedish Match to Broadcom/VMWare

Source: Refinitiv, IBES



Source: Refinitiv. AUT=Autos. BIS=Banks. CAP=Capital Goods. CDU=Consumer Durables. CND=Consumer Discretionary. COM=Communications.CMS=Commercial Services. CNS=Consumer Staples. CSV=Consumer Services. DIV=Diversified Financials. ENE=Energy.FBV=Food & Beverage. FIN=Financials. FRT=Food Retail & Tobacco. HEA=Healthcare. HEQ=Healthcare Equipment. HHP=Household Products. IND=Industrials. INS=Insurance. MAT=Materials. MED=Media. PHA=Phamaceuticals. REA=Real Estate. RET=Retail. SEM=Semiconductors. SFW=Software. TCH=Tech Hardware. TEC=Information Technology. TEL=Telecoms. TPT=Transport. US=S&P 500. UTE=Utilities.

Past performance is not an indication of future results.

Valuation: now back to ‘fair value’ territory

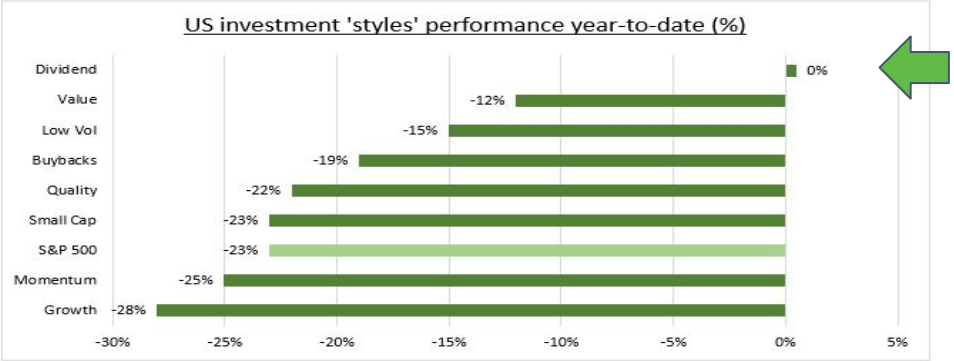
Valuation risks have been falling, helping to reduce risks

- Surging bond yields **slashed the value of future cash flows** and drove the stampede from expensive stocks, like tech.
- **Valuation risks now easing** as
  - bond yields may have **peaked**, as recession risks mount
  - US equities fell to 10-year average P/E valuation, and
  - Earnings forecasts stayed resilient (so far)
- Our **‘fair value’ P/E model is now in-line with current** levels. Each 0.5% to bond yields cuts fair value c10%.

Investment styles - Dividends now; small caps later

- Getting the investment **‘style’ right matters**, by 29% this year (gap between ‘best’ and ‘worst’, and is never easier (with cheap ETFs).
- **High dividends** (@DividendGrowth) led pack, and our ‘U-shaped’ recovery focus. Momentum (MTUM) and ‘quality’ (QUAL) have lagged, but outlook is now better.
- Small caps (IWM) is the next focus, for the brave, when macro risks ease. We are **focused on Value** (IWD) over tech-heavy Growth (IWF).

Source: Refinitiv, eToro calculations



Source: Refinitiv. Tickers: IWF, MTUM, IWM, QUAL, USMV, SPBUYUP, IWD, HDV. For illustration purposes only. Year to June 17, 2022

Past performance is not an indication of future results.

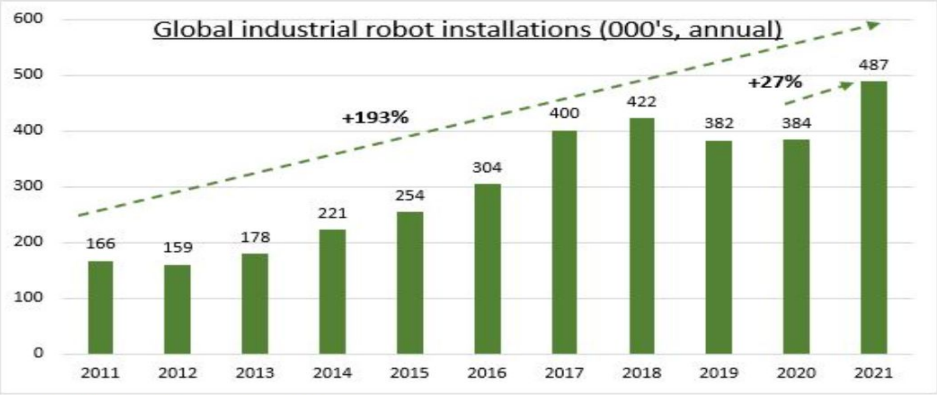
Themes: automation 'silver-lining' and housing risks

Using robots to beat inflation

- Lack of workers and rising wages boost **growth of automation** and robotics to boost productivity. Driver of investment spending, with offshoring more difficult, as seek to defend profit margins.
- Industrial robot installations tripled the past decade, grew 27% last year, and in US by 28% in Q1. Automation, robotics, AI industries another segment seeing a silver lining of current macro pressures, like renewables and EV's, despite the tech valuation collapse.
- @5GRevolution enabler tech or Japan (EWJ), China (CQQQ) chain.

Housing to lead the slowdown

- Global housing, and related equities, in spotlight as Central Banks **push mortgage rates**. US 30-yr mortgage rates highest in 15-yrs, our housing misery index at 40-yr highs, and home sales plunging.
- US may lead global housing slowdown, but **others are more exposed**, with floating-rate mortgages, high debt-service ratios.
- Many equity markets have **long 'supply chains'** of exposed sector stocks. But is a cyclical not structural issue for most, unlike 2007, with household balance sheets secure and mortgage rates fixed.
- See **chain** from materials (VMC, MLM), to homebuilders (DHI, LEN).



Source: International Federation of Robotics

Source: OECD. FR=France. US=USA. HU=Hungary. UK=United Kingdom. GE=Germany. DE=Denmark. CZ=Czech. HO=Holland. CA=Canada. IT=Italy. SP=Spain. SW=Sweden. JP=Japan. PR=Portugal. GR=Greece. RO=Romania. AU=Australia. FI=Finland. NO=Norway. PO=Poland

Past performance is not an indication of future results.

Commodities: energy sell-off opportunities?

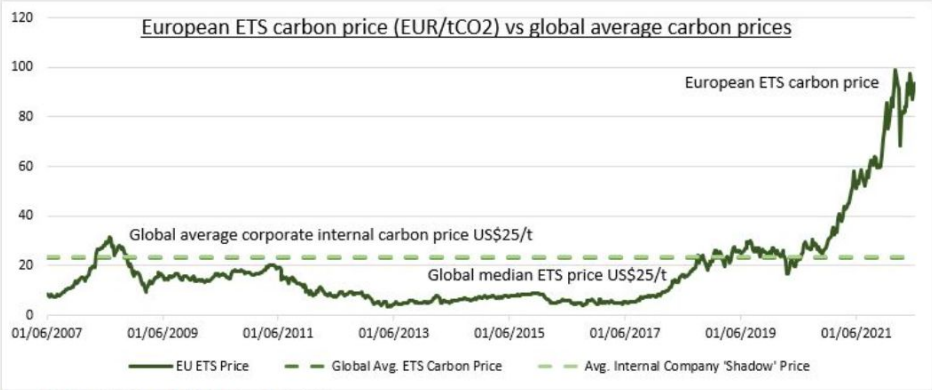
Resilient to the global growth sell-off on China and supply

- Commodities down on rising global recession risks and strong USD. 'Safe haven' **gold** hurt by competition from US bond yields.
- **Natgas** volatility on Freeport LNG and Nord Stream I disruptions. Both imperil efforts to build EU inventories ahead of winter.
- China-centric commodities, like copper and aluminium, were boosted by **'less-bad'** Chinese May industrial production and auto sales data as economy starts reopening from covid lockdowns.
- Possible energy equity opportunity (XLE) given sharp sell off and high-for-longer **'sweet spot'** on tight supply side, China recovery, and inflation-hedge demand offsetting global growth slowdown.

The spreading price of carbon

- Carbon **prices consolidating** after 2021 surge, but development is accelerating under surface, with bigger ETS plans having global implications. Adoption building globally, but still a long way to go.
- Costing carbon will **continue to broaden and rise**, pressuring polluters (XLE) in long term, whilst boosting structural outlook for renewables (@RenewableEnergy). '**KRBN**' alternative commodity ETF tracks European and North American carbon markets. It is flat this year, lagging commodities but besting all other assets.

Source: Refinitiv



Source: Refinitiv, World Bank. * ETS=Emissions Trading System

Currencies: the twin drivers of the US dollar rally

USD rallies further as Fed accelerates and 'risk-off' sentiment builds

- DXY index **new highs** as Fed rate expectations surge, and 'safer haven' bid returns. USD rally, at 20% since 2021 rivals 2014 surge.
- **JPY bore brunt** as BoJ recommitted to -0.1% rates and 0.25% 10-year 'yield curve control' (YCC) policy.

Impacts of the rampaging USD

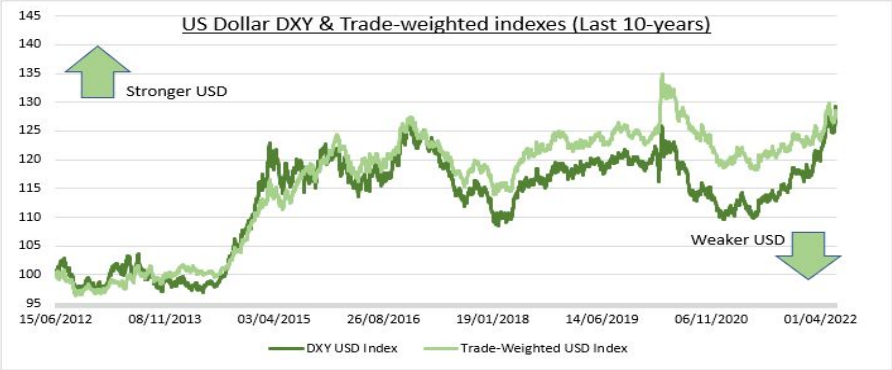
(-) Emerging Markets: Hurts emerging markets (EEM), by raising USD financing pressures. The more local currency a country needs to repay.

(-) Commodities: Makes commodities (DJP), which are priced in USD, pricier for foreign buyers. Commodities would ben even stronger without USD rally.

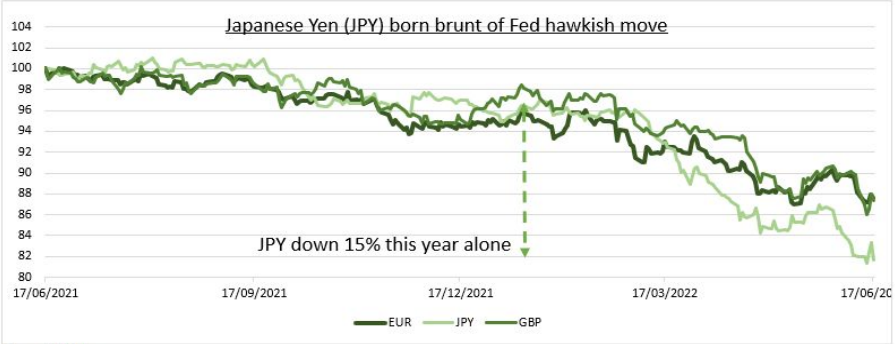
(-) US tech: The 60% US tech sector sales from abroad now less competitive with a strong US dollar. By contrast, utilities (XLU) is most domestic sector.

(+) Europe/Japan: Weaker local FX an important competitiveness 'buffer' for global European (EZU) and Japanese (EWJ) stocks and economies.

(+/-) US economy: Hurt export competitiveness. But cuts imported inflation.



Source: Refinitiv, FRED, eToro calculations. Rebased to 100. for illustration purposes only.



Source: Refinitiv

Past performance is not an indication of future results.

Crypto: led the global markets sell-off

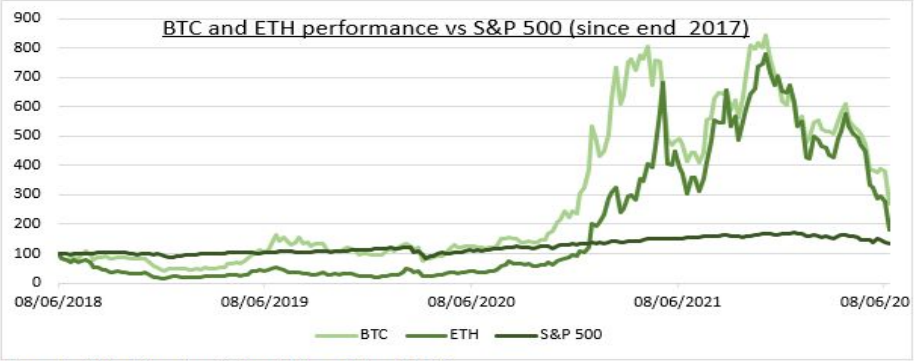
Crypto sell off contagion accelerates, down 30% in one week

- Bitcoin (BTC) dramatically fell to new 18-month low under $20,000, and **1/3 November peak** on 'perfect storm' of equity market falls, US lender Celsius withdrawal halt, and asset class contagion.
- Nearing a complete **unwind** of its 2020-2022 outperformance versus US equities.
- 70%+ Bitcoin (BTC) sell-off is **not unprecedented**, and only the 3rd worst of the last decade (see chart).
- Sell-off **contagion across asset class**. Coinbase (COIN). BlockFi, Crypto.com announced layoffs, MicroStrategy (MSTR) denied a big margin call. Crypto hedge fund Three Arrows funding issues.

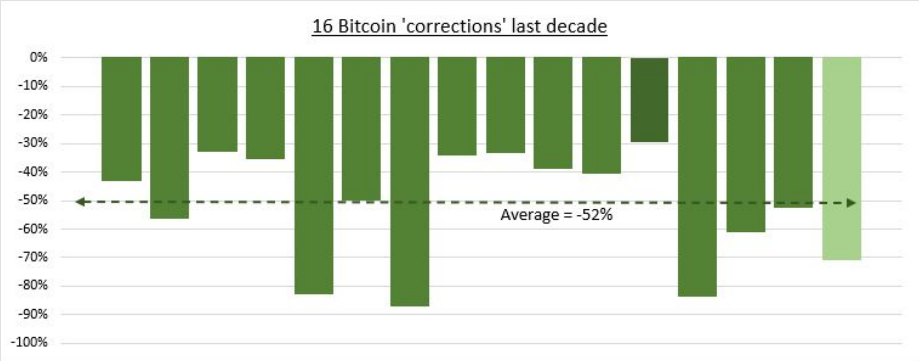
Implications of nearing Ethereum August 'merge'

- Ethereum (ETH) first (2015) and **largest smart contract** platform.
- ETH the native token for this blockchain and takes value from its success. Transition from energy-intensive Proof-of-Work (PoW) to **Proof-of-Stake (PoS)** unprecedented Ethereum 2.0 initiative.
- A successful 'merge' would **boost platform**, and uses.

See related **smart portfolios**: @CryptoPortfolio, @DeFiPortfolio. Many considering 'equity-proxies' like SI, RIOT, MARA, and MSTR



Source: Refinitiv. Rebased to 100 from ETH launch date in 2017.



Source: Refinitiv, etoro calculations

Past performance is not an indication of future results.