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ARE WE THERE YET?

How much further could the equity market correction extend?

By Michael Sager[1]
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Introduction

Equity markets have fallen hard in 2022. And yet the magnitude of the current correction in the S&P/TSX Composite Index remains below the average of all large drawdowns since 1956, particularly those experienced during periods of economic recession (Table 1). The same is true of a 60/40 equity/bond balanced portfolio.

[1] Michael Sager, Ph.D., is Executive Director, Multi-Asset & Currency Management, CIBC Asset Management.

Table 1 – Historical equity and balanced portfolio drawdowns

Start date	Trough date	Drawdown duration	Peak-to-trough CAD equity	Peak-to-trough balanced
Jul-56	Nov-56	10	-14.4%	-9.3%
May-57	Dec-57	22	-26.9%	-15.0%
Jul-59	Jul-60	18	-14.6%	-7.2%
Dec-61	Jun-62	15	-17.0%	-10.6%
Jan-66	Sep-66	14	-15.1%	-8.8%
May-69	Jun-70	32	-25.4%	-14.3%
Oct-73	Sep-74	63	-37.3%	-26.0%
Feb-80	Mar-80	5	-17.6%	-11.1%
Jun-81	Jun-82	22	-39.1%	-22.2%
Dec-83	Jul-84	13	-14.4%	-8.6%
Jul-87	Nov-87	24	-25.4%	-14.4%
Dec-89	Oct-90	39	-20.1%	-11.5%
Jan-94	Jun-94	16	-10.6%	-10.8%
Apr-98	Aug-98	19	-27.5%	-17.1%
Aug-00	Oct-02	59	-42.5%	-22.3%
May-08	Feb-09	32	-43.3%	-27.2%
Mar-11	Sep-11	31	-16.6%	-7.4%
Aug-14	Jan-16	24	-14.3%	-8.3%
Jul-18	Dec-18	8	-11.6%	-6.5%
Jan-20	Mar-20	9	-22.3%	-14.1%
Mar-22	N/A	N/A	-14.4%	-9.7%

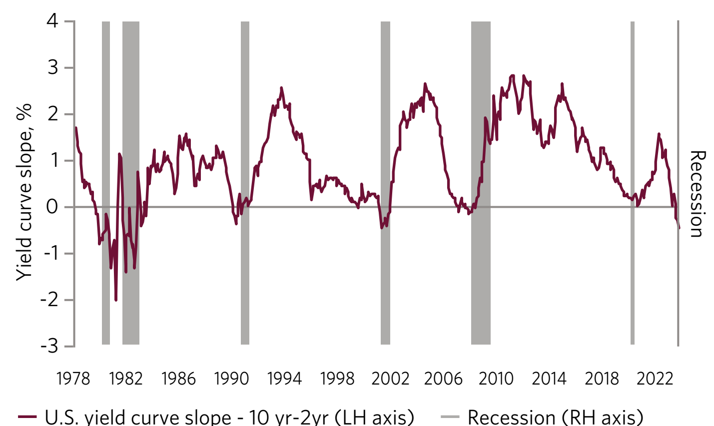
Summary	Peak-to-trough CAD equity	Peak-to-trough balanced
Average	-22.4%	-13.4%
Maximum drawdown (months)	63	53
Average drawdown (during recessions)	-27.6%	-16.2%
Average drawdown (excluding recessions)	-16.7%	-10.2%

This information was prepared by CIBC Asset Management Inc. using the following third-party service provider's data: Bloomberg. Sample is July 1956 to September 2022.

The risk remains for a further market correction lower in the near term. Three factors appear particularly relevant.

- First, central bank policy. A lot of rate increases have been factored into market prices, and financial conditions are now relatively tight. The slope of the yield curve—traditionally a reliable indicator of recession—is inverted, meaning that shorter-maturity interest rates have risen above longer-maturity rates (Chart 1). But the risk remains that further policy tightening will be required if inflation remains more persistent than expected. And once the peak in the U.S. Federal Reserve's (Fed) policy rate is achieved, we expect financial conditions to remain relatively tight for several quarters as the Fed squeezes inflation out of the system. Persistently tight financial conditions likely mean no quick, sustained recovery for equities.

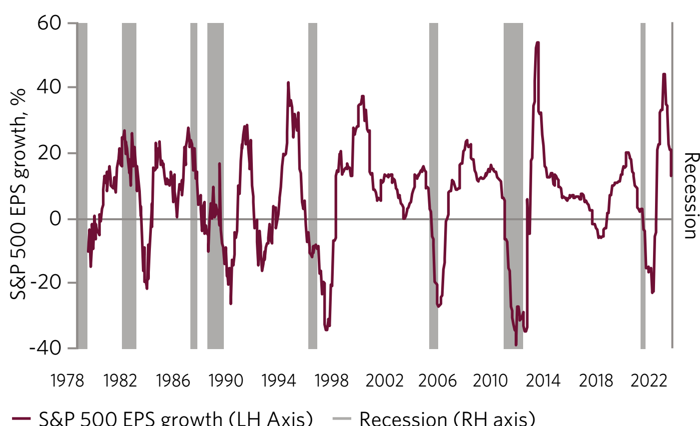
Chart 1 – Inversion of the U.S. yield curve slope has traditionally been a reliable lead indicator of recession
Yield curve data advanced 12 months



The information was prepared by CIBC Asset Management Inc. using the following third-party service provider's data: Bloomberg. Data as at September 23, 2022.

- Second, long-term equity valuations. These have improved as a result of this year's correction. But many markets still appear expensive, including as a result of relatively high inflation. This is particularly the case in the United States. More progress is required to bring valuations down to levels that appear attractive from a long-term perspective. To achieve this progress, prices will have to do the heavy lifting, due to the outlook for earnings.
- Third, earnings. Every recession during the past 50 years has been associated with a decline in the level of S&P 500 earnings. Currently, earning growth is slowing but remains positive (Chart 2). The market consensus expects further earnings growth through 2023. This appears too optimistic. Even if the U.S., and global, economy avoids a recession, earnings expectations will likely have to correct lower. This makes equity markets vulnerable.

Chart 2 – S&P 500 earnings growth typically turns negative around economic recessions



The information was prepared by CIBC Asset Management Inc. using the following third-party service provider's data: Bloomberg. Sample is December 1969 to September 2022.

Gauging when the turn in equity markets will come

Every market drawdown and subsequent recovery is different. This makes it difficult to identify a precise set of conditions that will signal a persistent bounce in markets. But we can draw on experience to provide at least a loose guide.

First, equity market indexes have historically responded positively once central banks signal a peak in policy rates (Table 2). In most episodes, both the S&P/TSX and S&P 500 were meaningfully higher one year after the peak in policy rates.

Table 2 – Equity markets have typically recovered once policy interest rates peak

Interest rate peak	Peak rate	S&P/TSX after 1 year from peak	S&P/TSX after 2 years from peak	S&P 500 after 1 year from peak	S&P 500 after 2 years from peak
Jun-1974	11.9%	-32.6%	-15.6%	-29.7%	4.5%
Mar-1980	17.2%	22.8%	0.4%	30.6%	23.3%
Jun-1981	19.1%	-14.3%	-18.1%	-3.5%	16.5%
Aug-1984	11.6%	18.5%	27.2%	21.9%	48.7%
Mar-1989	9.9%	6.1%	3.7%	14.9%	24.9%
Feb-1995	6.1%	20.8%	43.5%	27.6%	48.8%
May-2000	6.5%	-14.1%	-16.1%	-9.2%	-20.7%
Jun-2006	5.3%	21.3%	28.4%	16.4%	2.3%
Jan-2019	2.4%	11.8%	16.0%	17.7%	31.5%
Average		**4.5%**	**7.7%**	**9.6%**	**20.0%**

Periods of stagflation · Period of high equity valuations

This information was prepared by CIBC Asset Management Inc. using the following third-party service provider's data: Bloomberg. Data accessed as at September 23, 2022. Stagflation is defined as a period when growth is weak or negative and inflation is high.

As with any analysis, there are important exceptions to this broad conclusion. In this case, there have been three in the past 50 years. Two were periods of stagflation, when inflation remains high during a period of weak or negative growth (blue shaded rows in Table 2). The other, during the 2000s was characterized by a period of excessive equity valuations. In all three periods, market recoveries took longer to emerge. These periods may be relevant this time around. Inflation is currently high and may take time to diminish. And in the U.S. at least, the valuation of large-cap equity in aggregate remains unattractive. Both features suggest a slower, less vigorous equity market recovery in response to a peak in policy rates.

This does not preclude individual sectors, or other markets, delivering more vigorous recoveries than the United States. For instance, in Canada large-cap valuation already looks relatively attractive (Chart 3).

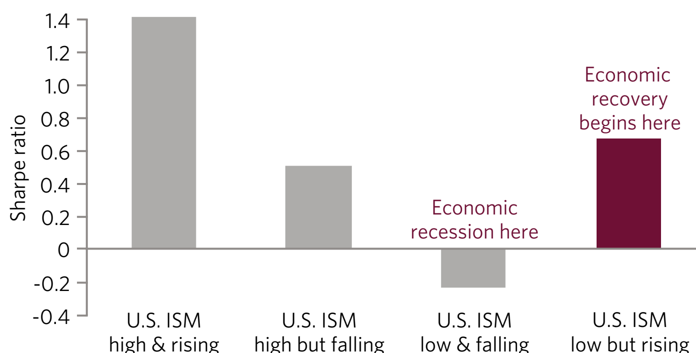
Chart 3 – Canada large-cap equity valuation has corrected to a level that appears relatively attractive from a long-term perspective

The information was prepared by CIBC Asset Management Inc. using the following third-party service provider's data: Bloomberg. Sample is January 2002 to September 2022.

Second, an analysis of reliable economic lead indicators can also help gauge the likely timing of a sustained recovery in equity markets. An important driver of equity, and other, market returns is the strength of the economy (Chart 4). Leading indicators provide insight into economic conditions well before official data print. Currently, the global economy appears to be slipping towards recession. These periods are challenging for equity markets. However, once lead indicators begin to turn persistently higher (the red bar in Chart 4), signaling the onset of economic recovery, equity market returns have historically responded positively.

Chart 4 – A sustained improvement in lead indicators of economic activity has proven adept at signaling a recovery in equity markets

Risk-adjusted returns to S&P/TSX during different macro environments



The information was prepared by CIBC Asset Management Inc. using the following third-party service provider's data: Bloomberg. Sample March 1989 – August 2022. High (Low) = U.S. ISM Survey of Manufacturing Index above (below) its full sample average. Rising (Falling) = latest observation of ISM above (below) 4-month trailing average.

Conclusion

We expect a further correction lower in equity markets before we reach the ultimate bottom in this cycle. Identifying the timing of the subsequent recovery is difficult. But we can look to history and a set of lead indicators to provide insight. They suggest a sustained bounce in equity markets will have to wait at least until policy makers—and particularly the Fed—signal a pivot in policy away from the current emphasis on maintaining tight financial conditions.

In the meantime, we place an emphasis on maximizing portfolio diversification, as well as identifying investment opportunities that have demonstrated an ability to mitigate either capital drawdown risks or the impact of inflation on portfolio performance. Examples include real assets, dividend equity strategies, and diversifying alternatives.

Let's connect

Should you have any questions about this report or anything else, please do not hesitate to connect:

Michael Sager, Ph.D.
Executive Director, Multi-Asset and Currency
CIBC Asset Management
michael.sager@cibc.com

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