

Markets could be reaching a capitulation point... and regaining a sense of normalcy

Fear of inflation, which has driven stocks and bonds down in tandem year to date, is expanding to fear of a growth slowdown, potentially leading to a capitulation point. If this shift takes hold, and stagflation risk has been priced in to reach a new equilibrium, it could restore the normal relationship between stocks and bonds.

Highlights

- Traditional “risk-off” positioning in asset allocation hasn’t worked well this year. Generally, when markets fear slowing growth, bonds can offer respite from falling stock prices. That relationship has been disrupted by fear of inflation.
- The U.S. Federal Reserve now finds itself forced to confront stubbornly high inflation with aggressive monetary policy, raising the risk that a policy overshoot will trigger an economic contraction.
- So long as monetary policy remains incrementally restrictive, the bearish outlook for equities is likely to persist. If the 10-year U.S. Treasury yield approaches 3.5%, however, the stock–bond relationship could revert to normal.
- We see signs that markets are nearing a capitulation point: financial conditions have tightened; hedge funds are backing away from long-held, high-growth equity positions; rate volatility remains intense, but is mostly evident among longer maturities.

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Risk-off positioning falters

Shifting to a “risk-off” stance in asset allocation typically means going long bonds and yen, short stocks and oil. Such positioning hasn’t worked this year, because the normal relationship between bonds and risk assets has been disrupted by fear of inflation.

The first four months of 2022 have seen major shifts in the geopolitical/economic landscape and asset prices. Russia’s invasion of Ukraine has cast a shadow of uncertainty over Europe and exacerbated existing risks. Disruptions to energy supplies have made it more difficult for policymakers to quell inflation. As a result, the Fed has set a more hawkish tone in recent communications and left investors wondering how aggressive it will be.

The situation has been unfavorable for most financial assets (Figure 1). In the United States, larger-capitalization, more value-oriented stocks have outperformed smaller, growth-oriented stocks. Overseas, countries most exposed to the war, either geographically or economically, have struggled. What has made this a particularly painful period, however, has been the lack of refuge generally offered by bonds. Rising rates and low starting yields, along with wider yield spreads across the quality and product spectrum, have caused core bonds to underperform stocks during a risk-off period, which is highly unusual.

Figure 1. Most financial assets have pulled back under geopolitical and inflationary stress

Month-end and year-to-date percent total returns, as of 04/30/22

Index	Jan 22	Feb 22	Mar 22	Apr 22	YTD 22
S&P 500	-5.17	-2.99	3.71	-8.72	-12.92
Russell 1000	-5.64	-2.74	3.37	-8.91	-13.59
Russell 1000 Growth	-8.58	-4.25	3.91	-12.08	-20.03
Russell 1000 Value	-2.33	-1.16	2.82	-5.64	-6.34
Russell 2000	-9.63	1.07	1.24	-9.91	-16.69
MSCI EAFE	-4.82	-1.76	0.76	-6.38	-11.80
MSCI Emerging Markets Free Total	-1.89	-2.98	-2.22	-5.55	-12.09
Bloomberg Global Aggregate Bond	-2.05	-1.19	-3.05	-5.48	-11.30
Bloomberg U.S. Aggregate Bond	-2.15	-1.12	-2.78	-3.79	-9.50
Bloomberg Commodity	8.78	6.23	8.65	4.14	30.75

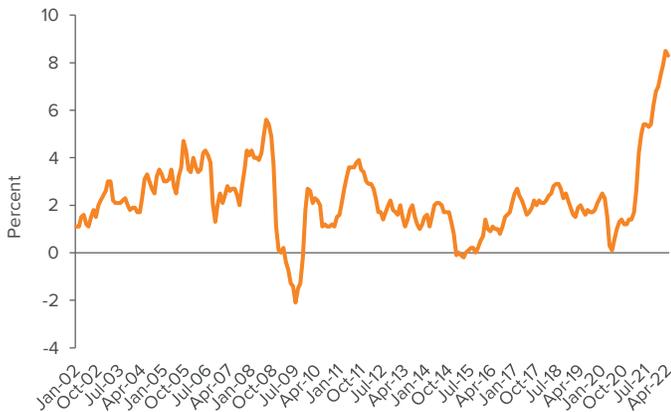
Source: Voya Investment Management; data are sourced from third-party providers that Voya considers to be reliable, though Voya cannot guarantee the accuracy of third-party data. **Past performance is no guarantee of future results. Investors cannot invest directly in an index.**

When markets fear slowing growth, bonds can offer respite from falling stock prices. By contrast, when markets fear inflation, bonds and stocks suffer simultaneously. Though April CPI eased from March (Figure 2), the initial market reaction was negative — investors were looking for a somewhat softer report to reinforce the “peak inflation” narrative. The Federal Open Market Committee (FOMC) raised the fed funds rate by 50 basis points (bp) at its May meeting,

and bond markets are pricing in 50 bp rate hikes at the June and July meetings. The April inflation reading probably wasn't enough to convince the Fed to moderate its hawkish policy stance, however, and Federal Reserve Chairman Jerome Powell won't rule out the possibility of a 75 bp hike at the next meeting.

Figure 2. Inflation shows signs of easing but remains elevated

Consumer Price Index for all Urban Consumers (CPI-U), monthly year-over-year percent change



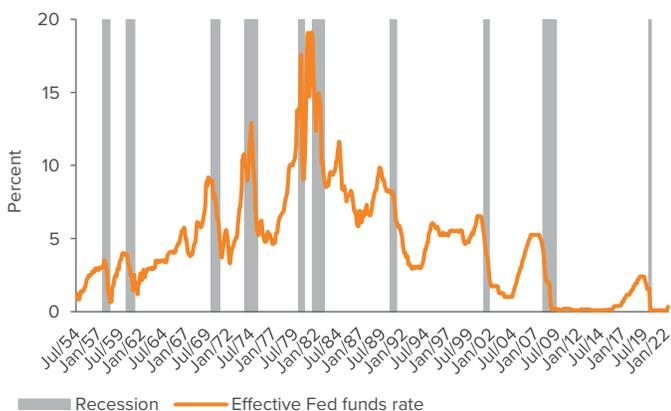
Source: U.S. Department of Labor, Bureau of Labor Statistics.

Fed plays catch-up

As many feared, the Fed now finds itself forced to confront accelerating inflation with aggressive monetary policy, raising the risk that a policy overshoot will trigger an economic contraction. The Fed is likely to keep tightening until there is a significant softening, e.g., in the housing market or the unemployment rate. Comparing the history of the effective federal funds rate with recessionary periods suggests that when the Fed tightens policy, because of lagging effects, it has a tendency to tip the economy into recession (Figure 3).

Figure 3. Federal Reserve policy record points to possibility of overshoot

Effective fed funds rate, 1954–2022



Source: U.S. Federal Reserve, <https://fred.stlouisfed.org>, data as of 4/30/22.

On the other hand, Figure 3 also suggests that since the 1980s, the Fed has become more effective at blunting the impact of recessions — which generally have been less frequent and shorter than in prior decades.

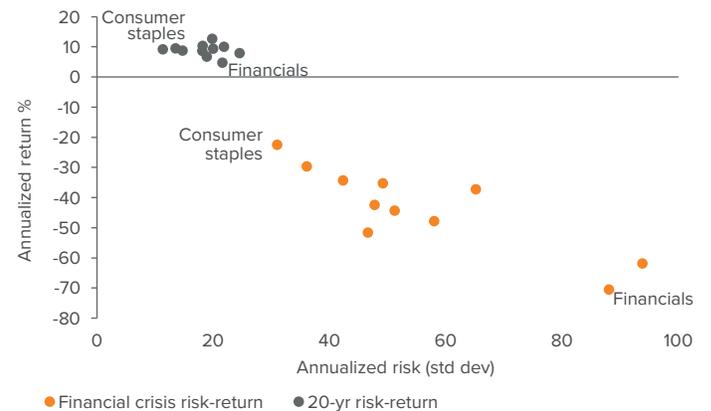
Risk assets hang fire

Bearish themes have featured prominently in recent corporate earnings guidance and commentary, particularly regarding the Fed-led global monetary policy shift. This policy shift has had an outsized impact on the technology, growth and duration market narratives, where concerns about stretched valuations already had been developing. Valuation concerns also seem to fit with views that stocks have not yet seen sufficient capitulation for a credible rebound. While April provided some evidence that inflation may be peaking, it remains elevated, underpinning potential for the fed funds rate to move into restrictive territory. China Covid lockdowns have been another meaningful macroeconomic overhang driving more pessimistic guidance and corporate commentary.

So long as monetary policy remains incrementally restrictive, the bearish outlook for equities is likely to lead to persistent volatility (Figure 4). With stocks down at recent levels, investors are looking for a market bottom and will be likely to overestimate the significance of company news; we therefore expect to see bear market rallies that quickly come and go without altering overall market direction.

Figure 4. S&P 500 sector returns and volatility can become extreme during down markets

S&P 500 sector return/risk during the Great Recession, versus 20 years ended 4/30/2022



Source: Morningstar Direct, data as of 04/30/22. The data comprise the financial crisis period of the Great Recession, from 11/01/07 to 03/05/09. Data consist of the 11 GICS sectors that comprise the S&P 500 index.

Capitulation nearing

At present, market dynamics offer little clarity on whether we're experiencing bear market rallies or are in the early stages of finding a bottom. Bearish signals include recent earnings multiple contraction: according to Refinitiv, as of May 13, 2022, the S&P 500 PE had declined to 16.7; year-over-year earnings growth was 11.1%, ex-energy only 4.9%. Earnings estimates for 2022 and 2023 stood at 9.2% and 9.8%, respectively, making a two-year total of 19.0%, which

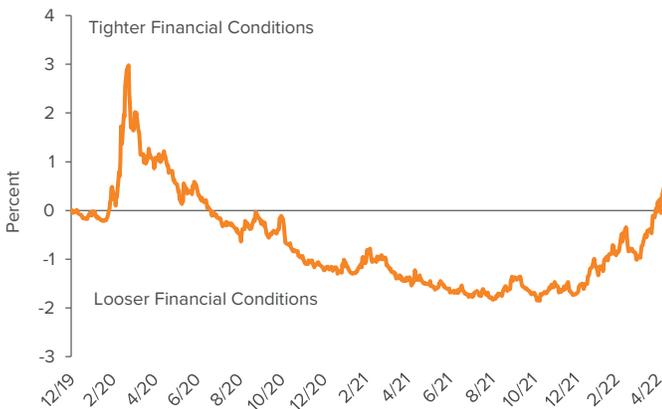
seems too high. Taken together, these points raise the risk of an earnings downgrade.

Financial conditions have been tightening as a result of the market downturns and slowing economic growth. At some point, the Fed will have to make a determination that it has tightened financial conditions sufficiently to restore price stability. Recall, monetary policy affects financial conditions and financial conditions affect the economy. Tighten conditions too much and we go into a recession. But tightening too little could lead to more inflation and a further decline in real incomes.

Have financial conditions tightened enough to permit policy moderation? According to the Goldman Sachs Financial Conditions index (Figure 5), over the last two years they have made a round trip. Tight conditions at the onset of the Covid pandemic gave way to substantial easing of conditions after the Federal Reserve cut interest rates to zero and initiated large-scale asset purchases. The tightness observed year to date has adjusted financial conditions such that an almost \$5 trillion expansion of the Fed’s balance sheet, as well as historical direct fiscal transfers, are a wash.

Figure 5. Financial conditions have tightened after loosening during the Covid pandemic

Cumulative growth in the Goldman Sachs Financial Conditions index



Source: Goldman Sachs, Voya Investment Management, as of 5/10/22. The GS financial conditions index is defined as a weighted average of riskless interest rates, the exchange rate, equity valuations and credit spreads, with weights that correspond to the direct impact of each variable on GDP.

We believe most of the year’s tightening of financial conditions already is in the books. While consumers and corporations face tougher choices ahead given rising interest rates and inflation, from an investor’s perspective, profits have held in and the labor market is strong. What’s more, if the 10-year U.S. Treasury yield approaches 3.5%, we could see the stock–bond relationship revert to normal; i.e., inversely correlated. There are signs that the markets are nearing a capitulation point: hedge funds are beginning to back away from long-held, high-growth equity positions. Rate volatility remains high (Figure 6) but is mostly evident among longer maturities.

Figure 6. Volatility has pressured rates, leaving asset allocators no place to hide from equity volatility

ICE Bank of America Merrill Lynch MOVE Index, daily closing price

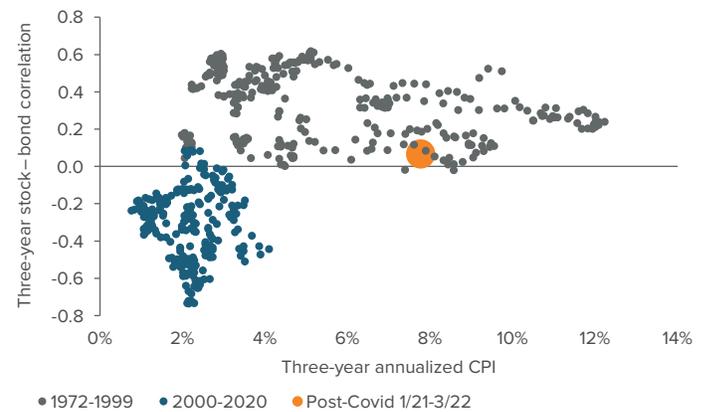


Source: Yahoo! Finance. The MOVE Index is a well-recognized measure of U.S. interest rate volatility that tracks the movement in U.S. Treasury yield volatility implied by current prices of one-month over-the-counter options on two-, five-, ten- and thirty-year U.S. Treasury securities.

The cross-currents of rising inflation and slowing growth make it harder for the Fed to avoid recession and engineer a soft landing. Nonetheless, as signs of economic slowing accumulate, we’re likely to see further easing of inflation pressures, which could shift the stock–bond relationship back toward normal (Figure 7).

Figure 7. As inflation subsides, bonds likely will again offer downside protection

Three-year stock–bond correlation versus three-year annualized inflation (CPI): monthly rolling data, 1972–2022



Source: Bureau of Labor Statistics, Standard & Poor’s, U.S. Federal Reserve and Voya Investment Management. Stocks are represented by the S&P 500 index. Bonds are represented by the 10-year U.S. Treasury note. Three-year annualized CPI is represented by the U.S. CPI Urban Consumers NSA index.

Long bond yields seem to have peaked in early May, suggesting that the bond markets are pricing in the effects of economic slowdown. This recognition is not yet clear in the stock market, though late-cycle dynamics appear to be in play. One clear sign of capitulation that we haven't yet seen is a full-on retail selloff; i.e., heavy outflows from mutual funds. Yet financial conditions have tightened considerably, and the stock market may not need to trade off much more to establish a bottom. Certain corners of the market, e.g., large-cap value stocks, have held in relatively well year to date and could form the basis of a turning point once rate volatility subsides.

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