**MORNING BRIEFING**
**May 24, 2022**

## Bear Anatomy

*Check out the accompanying chart collection.*

**Executive Summary:** History and data offer perspective into what a prospective bear market in the S&P 500 may mean for investors. Today, we examine the past two bear markets' longevity, quantify the index's valuation slide to date from its peak, compare component indexes' performances, and see how much better global stock markets have been faring. … Also: Rapidly rising rent inflation will offset some of the improvement we expect in several other categories of consumer prices. Perversely, the Fed is putting upward pressure on rents by reducing the affordability of buying homes.

**Strategy I: After the Long Good Buy.** The S&P 500 dipped into bear-market territory on Friday. It was down 20.5% on an intra-day basis from its record high at the close of trading on January 3. It recovered near the close to actually finish the day higher on Friday and ended with an 18.7% drop from the January 3 peak, keeping it in correction territory (*Fig. 1*). Let's have a closer look at the current selloff that was teetering on the edge of a bear market on Friday:

(1) The decline in stock prices since January 3 has lasted for 136 calendar days. That makes it the second-longest correction since the start of the bull market on March 9, 2009. The longest correction so far lasted for 157 days during 2011.

Meanwhile, the S&P 500 was 12.7% below its 200-day moving average on Friday, the most negative reading since the lockdown recession in early 2020 (*Fig. 2*).

(2) This has been the third worst selloff of the current bull market (hey, it ain't over 'til it's over). The S&P 500 fell 19.8% in late 2018 and 19.4% in 2011.

(3) Over the past 136 days, the forward P/E of the S&P 500 has dropped by 510bps from 21.5 to 16.4 (*Fig. 3*). This makes it the steepest 136-day decline since October 2002. Meanwhile, since the end of last year, S&P 500 forward earnings is up 6.5% to a record high during the May 19 week (*Fig. 4*).

(4) Here is the performance derby for the 11 sectors of the S&P 500 from January 3 through Friday's close: Energy (42.0%), Utilities (0.7), Health Care (-7.2), Materials (-8.0),

Consumer Staples (-8.9), Industrials (-14.7), Financials (-17.0), Real Estate (-17.7), S&P 500 (-18.7), Information Technology (-25.9), Communication Services (-28.0), and Consumer Discretionary (-33.6). Two of these S&P 500 sectors remain in bull-market territory, six are in corrections, while three are in bear-market territory.

(5) From January 3 through Friday's close, the S&P 500/400/600 indexes are down 18.7%, 16.4%, and 17.3% (*Fig. 5*). Over this same period, the S&P 500 Growth stock price index is down 27.0%, while the S&P 500 Value index is down 9.3% (*Fig. 6*). The market capitalization of the S&P 500 Growth's MegaCap-8 stocks (eight of the highest-cap stocks) has dropped 32.1% since January 3 through Friday's close. These eight stocks have had a significant impact on driving the outperformance of LargeCaps versus SMidCaps and Growth versus Value in recent years. Now their underperformance is weighing on LargeCaps relative to SMidCaps and Growth relative to Value (*Fig. 7* and *Fig. 8*).

(6) The MegaCap-8 stocks also have contributed to the outperformance of the US MSCI relative to the All Country World (ACW) ex-US MSCI, both in local currencies and in US dollars, since the start of the bull market (*Fig. 9*). That may no longer be the case this year as a result of the stock-market selloff in the US led by the MegaCap-8. That's because there has been less air in valuation multiples overseas than in the US (*Fig. 10*).

Here is the performance derby of the major global market indexes from January 3 through Friday in local currencies: UK (2.3%), Japan (-6.3), ACW ex-US (-10.2), Emerging Markets (-13.2), EMU (-15.4), ACW (-16.1), and US (-19.7).

Here is the same performance derby in US dollars: UK (-5.1%), ACW ex-US (-14.9), Japan (-15.6), Emerging Markets (-16.1), ACW (-17.8), US (-19.7), and EMU (-20.9).

(7) The rest of the world's valuation multiples remain well below the one for the US. Here are the forward P/Es for the major MSCI composites around the world through the May 12 week: US (17.0), Japan (12.5), ACW ex-US (11.9), EMU (11.7), Emerging Markets (10.9), and UK (10.1) (*Fig. 11*).

**Strategy II: How Much Longer?** Let's say that the S&P 500 fell into a bear market on Friday, at least on an intra-day basis. That means it's been in a bear market for 136 days, not just for one day on Friday. I asked Joe to have a look at how many days it took for the S&P 500 to fall 20% during the previous two bear markets:

(1) During the previous bear market, the S&P 500 took 274 days to fall by 20% from

October 9, 2007 through July 9, 2008. That was just before Lehman collapsed, which caused the S&P 500 to plunge by another 45.6% over the next 243 days through March 9, 2009. The bear market lasted 517 days altogether, with the S&P 500 falling 56.8%.

(2) During the bear market that started March 24, 2000, the S&P 500 took 353 days to fall by 20% through March 12, 2001. It then fell another 34.1% over the next 576 days through October 9, 2002. The bear market lasted 929 days with the S&P 500 falling by 49.1%.

**US Economy: The Rent Is Too D@mn High!** The most persistent source of upward inflationary pressure in measures of consumer prices over the rest of this year through next year is likely to be rent. That's because rental rates on new leases have soared by over 10% y/y since the start of this year. Rapidly rising home prices and mortgage rates have forced many would-be first-time homebuyers to rent instead. The median existing single-family home price is up 14.8% over the past 12 months and 36.4% over the past 24 months through April.

This year's jump in rental rates will boost the tenant rent components of the CPI and PCED in the months ahead (*Fig. 12*). That could contribute to the wage-price-rent spiral, offsetting some of the likely improvement in several categories of consumer prices, especially the prices of consumer durable goods.

The problem is that rent inflation tends to be exaggerated in both the CPI and the PCED because, in addition to tenant rent, both indexes include owners' equivalent rent (OER) (*Fig. 13*). OER is a bizarre concept reflecting how much homeowners would have to pay themselves in rent if they were their own landlords. Here's more:

(1) The current weights of the OER and tenant rent components of the headline CPI are 24% and 7%, respectively, and those of the headline PCED are 11% and 4%. The combined weights for tenant rent and OER are unrealistically high in the CPI at 31% but about right in the PCED at 15%.

(2) During Q1-2022, 34.6% of households rented their homes (*Fig. 14*). The number of renters increased 1.9 million over the past four quarters through Q1 compared to the previous four quarters (*Fig. 15*). Over this same period, the number of households owning their homes decreased by 1.1 million.

(3) The Fed's tightening of credit conditions has led to a sharp increase in mortgage rates from 3.32% at the start of this year to 5.47% currently (*Fig. 16*). Applications to purchase

homes are down 19% since the start of this year through the May 13 week (*Fig. 17*).

While home prices might start to fall, the inventories of both new and existing homes remain very low. The falling affordability of buying a home and the shortage of inventories are likely to keep the upward pressure on rents. History shows that the one sure way for the Fed to bring rent inflation down rapidly has been to cause a recession that puts downward pressure on wages. While the stock market is teetering on the edge of a bear market, we are teetering on the edge of raising our odds of a recession, currently at 30%.

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## Calendars

**US: Tues:** M-PMI & NM-PMI Flash Estimates 57.9/55.4; New Home Sales 750k; Richmond Fed Manufacturing Index; Powell. **Wed:** Durable Goods Orders Total, Core, and Core Nondefense Capital Goods 0.6%/0.6%/0.5%; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; FOMC Meeting Minutes; Brainard. (Bloomberg estimates)

**Global: Tues:** Eurozone, Germany, and France C-PMI Flash Estimates 55.3/54.0/57.3; Eurozone, Germany, and France M-PMI Flash Estimates 54.9/54.0/55.1; Eurozone, Germany, and France NM-PMI Flash Estimates 57.5/57.2/58.6; UK C-PMI, M-PMI & NM-PMI Flash Estimates; World Economic Forum Annual Meetings; Lagarde; Tenreyro; Ellis; Woods. **Wed:** Germany GDP 0.2%q/q/4.0%y/y; Germany Gfk Consumer Climate -26.0; France Consumer Confidence 89; Japan Leading & Coincident Indicators 0.9%/-0.1%; ECB Financial Stability Review; World Economic Forum Annual Meetings; Lagarde; Lane; Panetta; Beermann; Kuroda. (Bloomberg estimates)

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## Strategy Indicators

**S&P 500/400/600 Forward Earnings** (*link*): All three of these indexes had forward earnings at a record high last week. LargeCap's was at a record high for a second week after falling 0.2% below the week before that for the first time in 19 weeks due to Amazon's Q1 earnings miss and lowered future guidance. MidCap's was at a record high for a 24th straight week. SmallCap's rose for the ninth time in 10 weeks, and was at a record high for a fourth week. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward

earnings has risen during 99 of the past 104 weeks, with the down weeks due to Tesla's addition to the index in December 2020, Amazon's earnings misses for Q1-2022 and Q2-2021, and index changes last September and December. MidCap's forward earnings is up in 98 of the past 102 weeks, and SmallCap's posted 94 gains in the past 103 weeks. SmallCap had been steadily making new highs each week until mid-December, but then dropped 1.4% below its record by early March. Forward earnings for these indexes had been on an uptrend from November 2019 until February 2020, before tumbling to a bottom by June 2020 due to the Covid-19 economic shutdown. LargeCap's forward earnings has risen 68.5% from its lowest level since August 2017; MidCap's is now up 139.8% from its lowest level since May 2015; and SmallCap's has soared 199.8% from its lowest point since August 2013. In the latest week, the yearly rate of change in LargeCap's forward earnings weakened to a 25-month low of 20.1% y/y from 20.3%; that's down from a record-high 42.2% at the end of July and up from -19.3% in May 2020, which was the lowest since October 2009. The yearly rate of change in MidCap's forward earnings rose to 35.3% y/y from a 25-month low of 34.6%. That's down from a record high of 78.8% at the end of May and compares to a record low of -32.7% in May 2020. SmallCap's rate tumbled to a 25-month low of 35.6% y/y from 43.3%. It's down from a record high of 124.2% in late June and up from a record low of -41.5% in June 2020. Companies have been beating consensus estimates quite handily since the Q2-2020 earnings season, causing analysts' consensus earnings forecasts for 2021 and 2022 to improve instead of decline as is typical. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (10.0%, 9.9%), MidCap (14.9, 6.6), and SmallCap (13.7, 11.4).

**S&P 500/400/600 Valuation** (*link*): Valuations mostly ticked lower for these three indexes last week. LargeCap's forward P/E dropped to a 25-month low of 16.4 from 17.0. That's down from a six-month high of 21.5 in early November. LargeCap's forward P/E also compares to a 19-year high of 22.7 in January 2021 and is up from 13.3 in March 2020, which was the lowest since March 2013. MidCap's fell 0.3pts to a 25-month low of 12.0 from 12.3. That's down from a 13-week high of 17.1 in early November and is 9.6pts below its record high of 22.9 in June 2020. SmallCap's fell 0.2pt w/w to a 26-month low of 11.6 from 11.8. That's down from a 13-week high of 16.1 in early November and is now down 15.1pts from its record high of 26.7 in early June 2020 when forward earnings was depressed. During March 2020, MidCap's 10.7 and SmallCap's 11.1 were their lowest readings since March 2009. LargeCap's forward P/E in February 2020—before Covid-19 decimated forward earnings—was 18.9, the highest level since June 2002. Of course, that high was still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's P/E was below LargeCap's P/E yet again last week, as it has been for most of the time since August 2018.

In contrast, it was last solidly above LargeCap's from April 2009 to August 2017; MidCap's current 27% discount to LargeCap is near its biggest since September 2000. SmallCap's P/E was below LargeCap's for a 92nd week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 29% reading is near its biggest discount since February 2001. SmallCap's P/E had been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for a 49th straight week; the current 3% discount is up from a 9% discount in December but remains near its lows during 2000-01.

**S&P 500 Sectors Quarterly Earnings Outlook** (*link*): Since the Q3-2020 earnings season, analysts as a whole have been raising their consensus forecasts for future quarters instead of lowering them as is the norm through the earnings warnings seasons. That six-quarter streak of positive revisions throughout the quarter officially ended with Q1-2022. In the latest week, the Q1-2022 earnings-per-share forecast fell 5 cents w/w to $54.84, but is now 5.0% above its $52.22 forecast at the start of the quarter. Analysts expect S&P 500 earnings growth to weaken substantially to 11.6% y/y on a frozen actual basis and 11.1% on a pro forma basis. That's down from Q4-2021's 26.9% y/y on a frozen actual basis and a 32.1% y/y gain on a pro forma basis. Double-digit growth is expected for seven sectors in Q1-2022, and three are expected to record a y/y decline. That compares to Q4-2021's count of eight sectors with double-digit growth and one sector with a y/y decline. Here are the S&P 500 sectors' latest earnings growth rates for Q1-2022 versus their Q4-2021 growth rates: Energy (268.8% in Q1-2022 versus 12,611.0% in Q4-2021), Materials (46.2, 64.2), Industrials (40.2, 43.8), Real Estate (27.3, 17.6), Utilities (24.7, -1.3), Health Care (18.4, 28.0), Information Technology (13.7, 24.6), S&P 500 (11.1, 32.1), Consumer Staples (7.2, 7.7), Communication Services (-2.8, 16.6), Financials (-17.1, 9.9), and Consumer Discretionary (-28.3, 54.1).

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## Global Economic Indicators

**Germany Ifo Business Climate Index** (*link*): "The German economy has proven itself resilient in the face of inflation concerns, material bottlenecks, and the war in Ukraine," noted Ifo's President Clemens Fuest. "There are currently no observable signs of recession." The business climate index improved for the second month to 93.0 this month, after plunging 7.9 points in March—from 98.7 to a 20-month low of 90.8. The current situation measure climbed 2.4 points (to 99.5 from 97.1) over the two-month period, while the expectations measure rose 2.1 points (86.9 from 84.8). The latter is recovering from a

13.8-point plunge during March. The measure for the manufacturing sector improved for the second month, from -3.6 in March to 2.8 in May, as the expectations component improved 12.7 points (-17.3 from -30.0) over the period. The present situation measure moved up to 25.1 this month—though was below its recent high of 41.8 last July. Confidence within the service sector improved again in May to 8.1 after falling to near zero in March, with companies more optimistic about the current situation (33.1 from 19.5) over the two-month period, though still pessimistic about the future—that reading deteriorated from -11.0 to -14.3 this month. Within the trade sector, the present situation component improved from 13.7 in April to a six-month high of 18.4 this month, while expectations (-36.0) was little changed around recent lows. The business climate (-13.4) within the construction sector remained in a slump, though the current assessment (17.0 from 15.7) was slightly more positive, while expectations (-39.5 from -49.8) was less negative than last month's record low.

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Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-228-9102

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