

# The Archetypical Equity Cycle and the Anatomy of a Bear Market

As the Fed transitions toward tightening, it will be increasingly important for investors to understand the drivers of a bear market in equities and the approaches to managing through it.

JANUARY 12, 2022

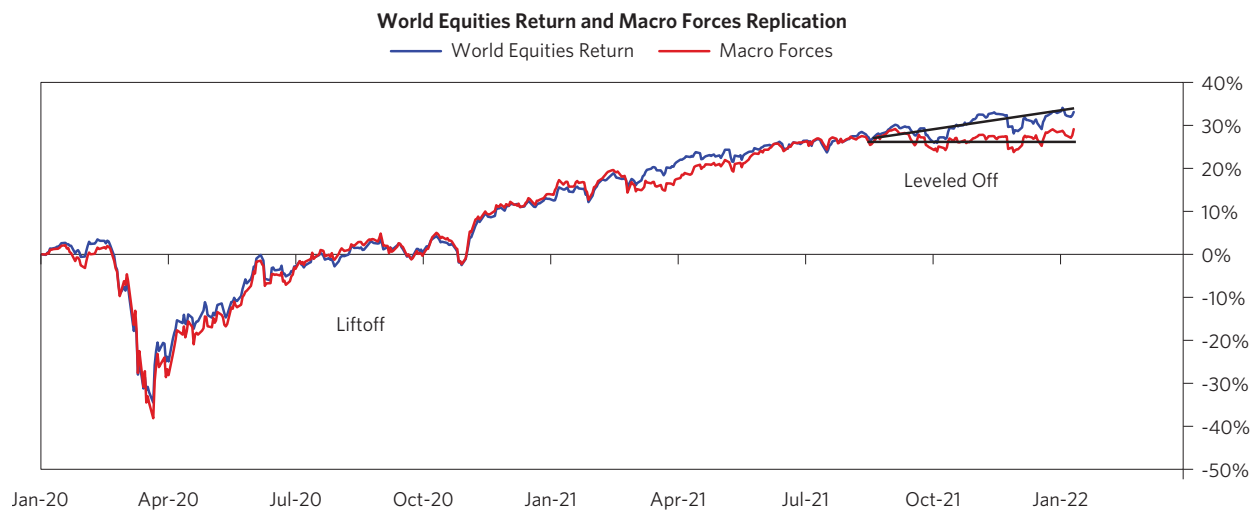
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While the most all-encompassing perspective of an equity market is from the bottom up, i.e., an aggregation of companies, the top-down influence accounts for a substantial portion of what drives equity markets, and, according to our measures, the top-down forces have been fading and are in the process of rolling over. Given this leveling off and the approaching transitions in monetary policies, this is a good time to review the equity cycle, the anatomy of a bear market, and approaches to managing through it.

## Viewing the Equity Cycle Through an All Weather Lens

We make the above observation based on a view of markets that we refer to as an All Weather Lens. This perspective views the pricing of assets as discounting future economic conditions and the returns of assets as driven by how conditions transpire in relation to what is discounted. Viewed through this lens, four major forces account for a substantial portion of what drives equity returns: changes in discounted growth, discounted inflation, discount rates, and risk premiums. Monetary policy and liquidity conditions are an important influence on these conditions.

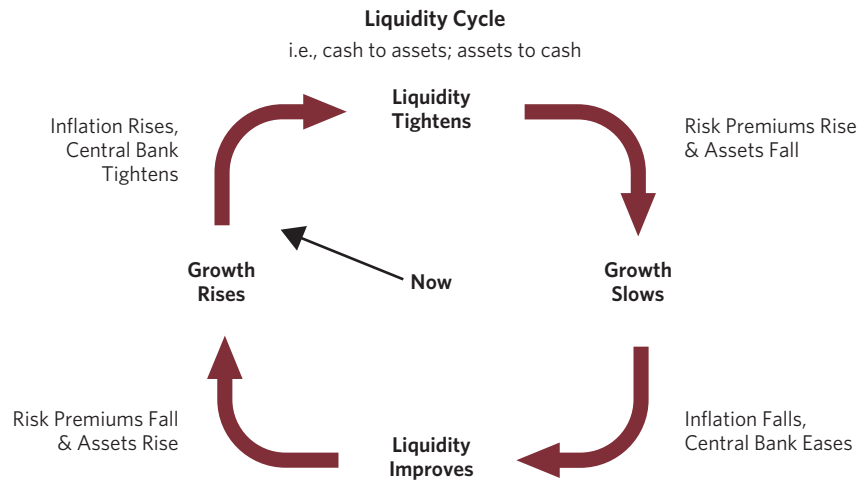
The equity market and nearly all markets have relatively stable betas to these four forces and their returns reasonably track the beta-weighted sum of these forces. For example, below we show the return of world equities (blue) compared to what you would expect based on the beta-weighted sum of what has been going on with these four forces since early 2020 (red). Up until recently, prices tracked macro conditions closely. In recent months, the fundamental macro pressures have leveled off while equity prices have continued to gradually rise.



The analysis in the above chart is based on the All Weather Lens, which is an analytical approach to assess the behavior of the major drivers of asset performance and their impact on markets during any given period, based on Bridgewater's understanding of global financial markets. Information shown is the result of analyses of actual and simulated market data. Please review the "Important Disclosures and Other Information" located at the end of this research paper.

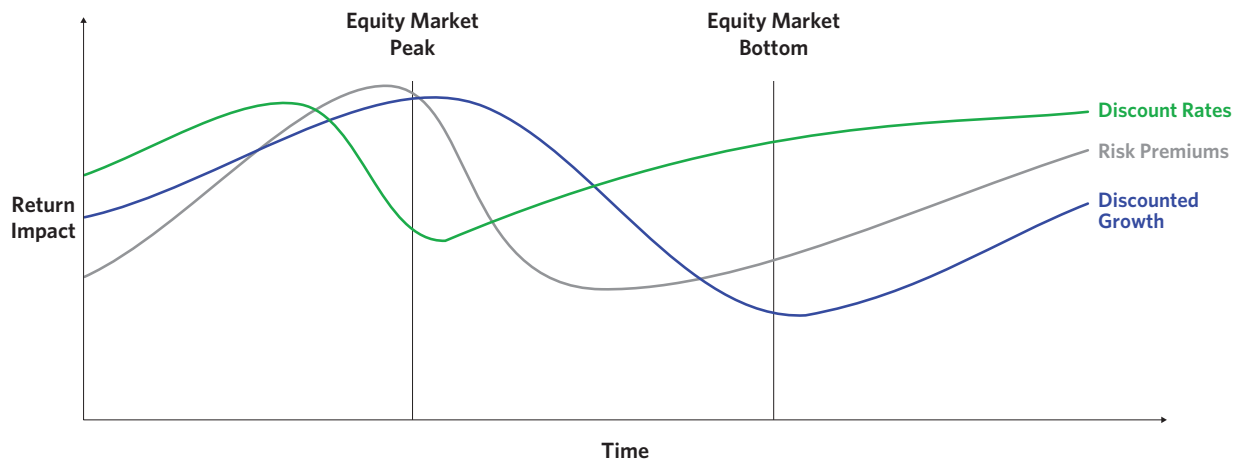
# The Influence of the Liquidity Cycle

A key driving force of these conditions is the liquidity cycle, and in particular whether money is moving from cash to assets, in which case it's also moving from cash to spending, or from assets to cash, in which case spending falls. This is primarily under the control of the central bank, though the financial system also plays a role. As illustrated below, in the current cycle, we've transitioned from the stage where massive stimulation pushes risk premiums down and assets and growth up to the stage where growth is now pushing inflation higher. When central banks determine that inflation is a problem, you get a tightening, which reverses the flow of money from assets to cash, pushing risk premiums up and assets down, ultimately slowing growth until inflation is no longer a problem.



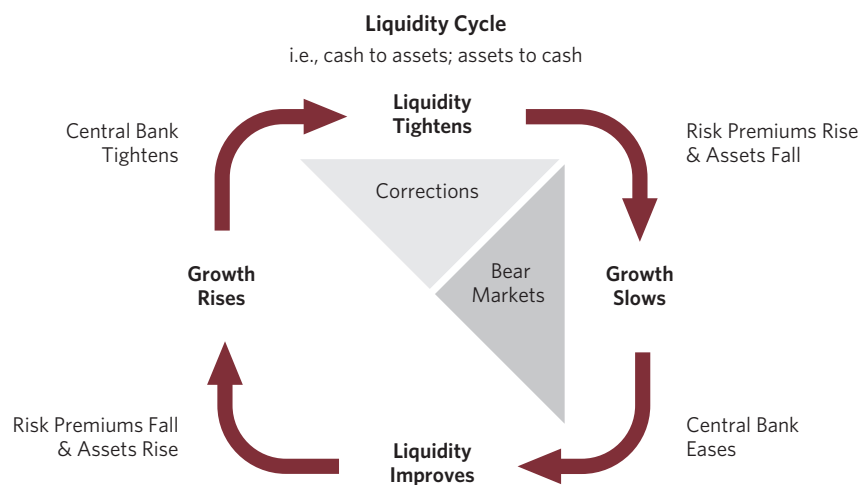
# The Anatomy of a Bear Market

The equity market has a relatively stable beta to each of the four key macro conditions across all stages of the cycle. Starting from roughly where we are now, a rise in inflation is a moderate drag. What typically follows is a rise in discount rates from the tightening, which is an additional drag. When the tightening is aggressive enough, you get the rise in risk premiums, which is another incremental drag. And when that causes a credit contraction and downturn in growth, further downward pressure is added. The sum of the forces roughly equates to the size and direction of the equity move. Furthermore, each of these conditions is an influence on the next, such that they tend to unfold in roughly that order. We illustrate the archetypical bear market below. The tipping point will be around the time that the weight of the forces rolls over, though sentiment and flows obviously play a role regarding timing.



This sequence of events means that hedging a bear market or profiting from it is best achieved across the full cycle, from the rise in inflation (breakeven inflation, commodities) and interest rates (short rates, yield curve, long rates) leading into the peak, to the spike in risk premiums (credit spreads, implied volatility), to the decline in discounted growth (stocks versus bonds, cyclicals versus stables, strong versus weak balance sheets), to the eventual decline in inflation (breakeven inflation, commodities) and monetary easing (short rates, yield curve, long rates). In other words, by positioning for each of the forces that cause a bear market, there is a series of opportunities across a diversified set of positions prior to, during, and after the price decline. In fact, because an equity market is a singular package of forces, there is more opportunity for positioning in the pieces than in the package.

The depth of a price decline will depend on the degree of the beta-weighted sum of these forces. But by and large, the difference between a correction (e.g., 10–20% decline) and a bear market (e.g., a greater than 20% decline) is the extent to which the contraction in liquidity and rise in risk premiums passes through to an economic contraction and a collapse in earnings.



You see this in the data shown below, covering 41 bear markets and 30 corrections over the past 100 years in the four largest developed world markets. In corrections of 10–20%, the price decline is mainly comprised of a rise in risk premiums and fall in P/Es, and the change in earnings and economic growth is not much. In bear market declines of 20% or more, the price impact of the earnings decline is much bigger than the impact of risk premiums due to a deeper contraction in the economy.

**Average During Equity Market Drawdowns**

	Equity Drawdown	Impact of P/Es	Δ in Earnings	Δ in Real Economy (vs Potential)
<b>Corrections (10–20%)</b>	-15%	-13%	-2%	-1%
<b>Bear Markets (&gt;20%)</b>	-37%	-13%	-28%	-5%

Going to the individual cases, the following table shows the beta-weighted influence of inflation, discount rates, risk premiums, and discounted growth in the year leading up to the top, the move from the peak to the bottom, and the year after the bottom for all of the equity bear markets (defined as a decline of more than 20%) across five major economies since 1900. What you see is that in the year leading into the peak, discount rates are generally a negative influence as monetary policy is beginning to tighten, typically due to rising inflation, which is also a drag, but risk premiums and growth are still a favorable influence as the tightening has not yet begun to bite. From peak to trough, you see that rising risk premiums and falling growth are almost always big negative influences, discount rates have become a positive as central banks ease, and typically inflation remains a drag but with variations depending on the nature of the inflation cycle. In the year following the trough, discount rates remain a positive influence, with that easing passing through to a decline in risk premiums and eventually to a pickup in discounted growth.

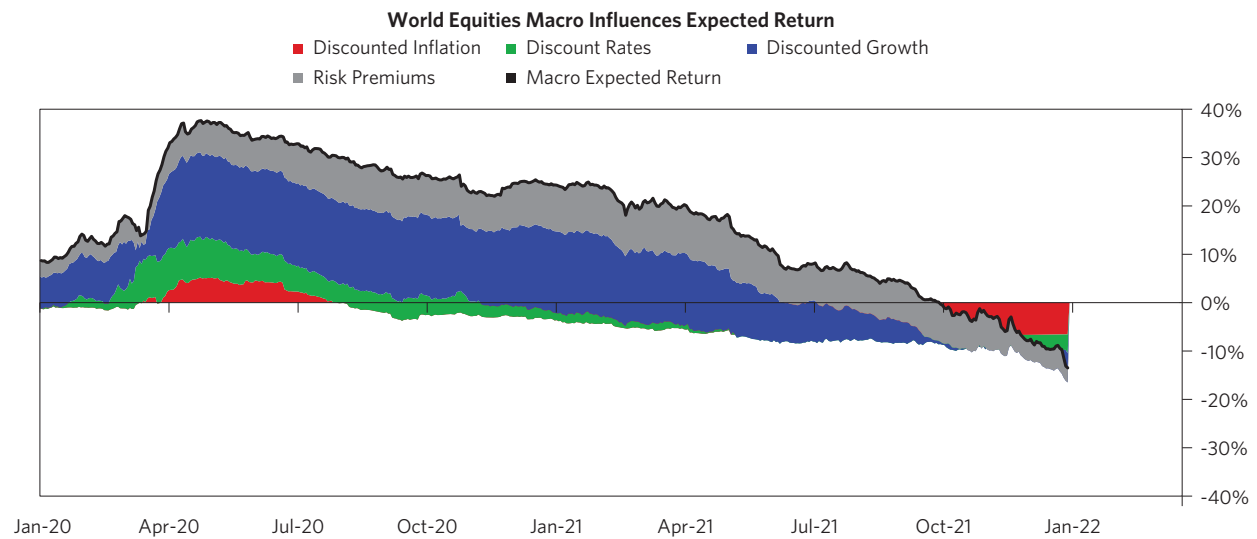
## Equities Bear Market Cases

	During Year Prior to Peak					Peak to Bottom					During Year After Bottom				
	Equities	Disc Inflation	Disc Rates	Disc Growth	Risk Prem	Equities	Disc Inflation	Disc Rates	Disc Growth	Risk Prem	Equities	Disc Inflation	Disc Rates	Disc Growth	Risk Prem
USA 1906-1907	6%	-15%	-1%	3%	5%	-39%	-18%	-5%	-26%	-20%	25%	9%	20%	9%	-22%
USA 1912-1914	14%	2%	-11%	10%	19%	-31%	-9%	-3%	-20%	-20%	25%	-6%	20%	11%	-5%
USA 1916-1917	12%	-21%	0%	-2%	25%	-26%	-39%	-9%	-41%	16%	14%	-16%	1%	-12%	14%
USA 1919-1921	23%	-8%	8%	-5%	4%	-22%	3%	-14%	-5%	-25%	26%	24%	6%	17%	2%
USA 1929-1932	36%	3%	0%	28%	7%	-139%	38%	19%	-59%	-138%	51%	17%	0%	18%	8%
USA 1937-1938	23%	-7%	-2%	3%	14%	-36%	1%	0%	-15%	-16%	21%	7%	0%	2%	0%
USA 1946-1946	29%	0%	2%	3%	7%	-20%	-22%	5%	-14%	7%	9%	-17%	1%	-4%	17%
USA 1968-1970	8%	-5%	11%	-5%	-6%	-34%	-37%	6%	11%	-41%	25%	8%	3%	-12%	24%
USA 1973-1974	10%	-8%	-5%	9%	9%	-54%	-68%	1%	-10%	-2%	19%	-6%	4%	-6%	7%
USA 1980-1982	23%	-7%	-29%	23%	24%	-24%	15%	-23%	3%	-36%	43%	16%	22%	1%	5%
USA 2000-2002	13%	-7%	-8%	10%	15%	-42%	-4%	40%	-45%	-47%	12%	-5%	2%	2%	9%
USA 2007-2009	9%	-2%	5%	2%	-1%	-54%	10%	17%	-36%	-43%	31%	-5%	5%	6%	12%
EUR 1960-1967	35%	9%	-14%	22%	33%	-28%	-11%	-7%	-50%	-1%	22%	4%	1%	3%	17%
EUR 1969-1971	18%	-8%	-8%	20%	11%	-29%	-16%	11%	-22%	-42%	15%	-2%	7%	-13%	23%
EUR 1973-1978	12%	-19%	-1%	3%	21%	-60%	-45%	12%	-35%	-44%	13%	1%	-12%	-3%	16%
EUR 1986-1988	34%	19%	3%	3%	1%	-32%	-1%	7%	-3%	-31%	25%	-3%	3%	10%	13%
EUR 1990-1992	12%	6%	-5%	17%	-13%	-41%	10%	-13%	-11%	-28%	28%	6%	26%	-3%	-10%
EUR 2000-2003	39%	-6%	-11%	26%	28%	-80%	-10%	24%	-50%	-42%	35%	1%	0%	8%	10%
EUR 2007-2009	23%	3%	-7%	11%	5%	-59%	1%	15%	-29%	-40%	30%	0%	1%	6%	11%
JPN 1957-1957	22%	10%	-15%	18%	5%	-20%	-3%	-2%	11%	-14%	22%	28%	8%	-2%	-5%
JPN 1960-1965	20%	-5%	-5%	16%	0%	-22%	-2%	9%	-34%	-17%	29%	-7%	7%	2%	4%
JPN 1972-1975	66%	-2%	8%	11%	18%	-38%	-99%	-13%	-1%	12%	11%	9%	13%	-4%	-13%
JPN 1989-1992	17%	-2%	-18%	15%	22%	-95%	-11%	17%	-40%	-62%	23%	14%	7%	-3%	-6%
JPN 2000-2003	18%	-3%	0%	7%	9%	-74%	-28%	23%	-45%	-29%	44%	-3%	2%	25%	19%
JPN 2007-2009	15%	2%	-7%	8%	11%	-65%	24%	-21%	-33%	-52%	23%	-11%	29%	4%	-2%
GBR 1937-1940	6%	-9%	2%	3%	7%	-28%	-17%	4%	-55%	-2%	12%	-13%	3%	-16%	17%
GBR 1961-1962	18%	-4%	12%	12%	-2%	-25%	-4%	7%	-22%	-24%	12%	4%	-5%	-8%	22%
GBR 1969-1970	31%	-10%	11%	14%	-2%	-33%	-14%	7%	-12%	-23%	20%	-3%	28%	-8%	-6%
GBR 1972-1974	38%	13%	17%	-15%	23%	-112%	-132%	-7%	-11%	-41%	86%	7%	3%	-5%	47%
GBR 1987-1987	35%	6%	-7%	17%	10%	-24%	3%	5%	-9%	-14%	4%	-6%	3%	-3%	0%
GBR 1999-2003	12%	-9%	-20%	11%	22%	-47%	-4%	22%	-17%	-40%	15%	-5%	0%	6%	5%
GBR 2007-2009	8%	-1%	1%	7%	-4%	-40%	-1%	24%	-21%	-36%	28%	-3%	2%	5%	10%
AUS 1951-1952	31%	-18%	29%	3%	18%	-28%	-12%	-1%	-28%	-18%	1%	-2%	-45%	-5%	15%
AUS 1969-1974	10%	-8%	-8%	12%	2%	-58%	-102%	-13%	-23%	-18%	18%	-11%	50%	-7%	-26%
AUS 1980-1982	45%	-1%	-28%	34%	15%	-54%	-7%	-37%	10%	-44%	19%	0%	41%	-7%	-23%
AUS 1987-1990	48%	6%	14%	11%	-9%	-64%	1%	-3%	-11%	-26%	15%	15%	13%	-5%	-15%
AUS 2007-2009	23%	3%	-3%	12%	2%	-60%	1%	13%	-34%	-27%	29%	2%	-9%	14%	9%
<b>Average</b>	<b>23%</b>	<b>-3%</b>	<b>-2%</b>	<b>10%</b>	<b>10%</b>	<b>-47%</b>	<b>-16%</b>	<b>3%</b>	<b>-23%</b>	<b>-29%</b>	<b>24%</b>	<b>1%</b>	<b>7%</b>	<b>1%</b>	<b>5%</b>
<b>% in Expected Direction</b>	<b>--</b>	<b>68%</b>	<b>59%</b>	<b>89%</b>	<b>78%</b>	<b>--</b>	<b>70%</b>	<b>57%</b>	<b>89%</b>	<b>92%</b>	<b>--</b>	<b>49%</b>	<b>89%</b>	<b>49%</b>	<b>68%</b>

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# On a Forward-Looking Basis, Macro Influences Are Continuing to Roll Over

The following chart shows our forward-looking estimates of these macro conditions and their estimated beta-weighted impact on global equities. As shown, during the early phase of the liftoff, forward-looking pressures were positive from all four influences. Over time, leading indicators of these macro influences have gradually waned and are now on balance moderately negative globally. Of course, flows, sentiment, and the circumstances of companies are required for a holistic view of equity markets and are not reflected in this chart. And there are differences across countries. But what it does convey is that the macro environment that we are headed into is far less supportive than what has existed over the past couple of years.



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