



NOVEMBER 22, 2022

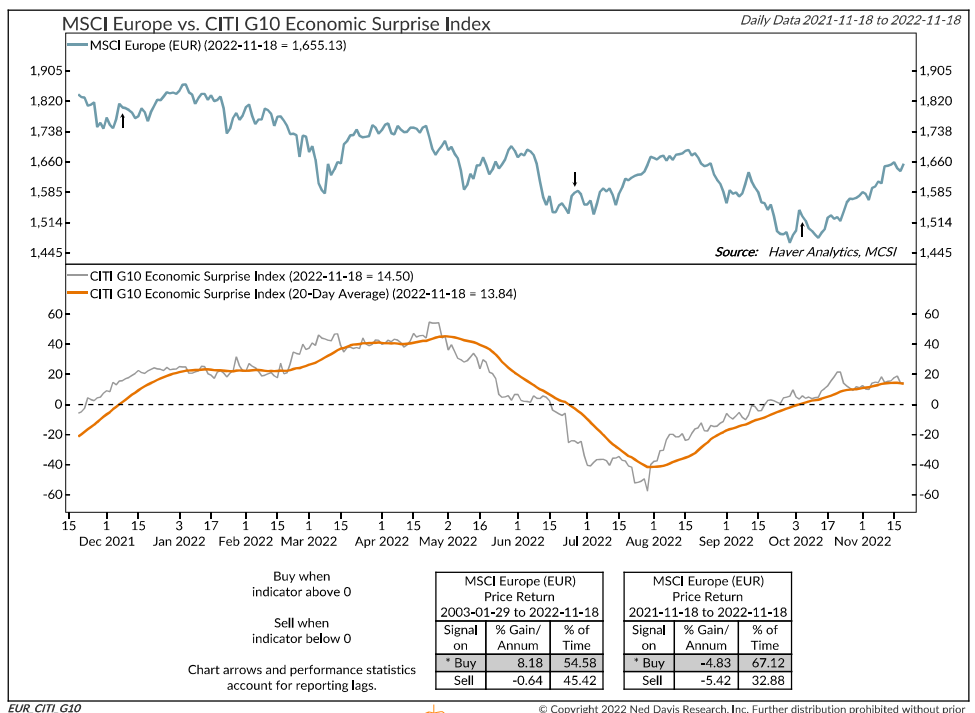
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European economists getting less gloomy

Key Takeaways

- Economists are gloomy as to the outlook for the eurozone economy, but less so than last month, bullish for equities.
- After adjusting for inflation, the 2022 drawdown in European equities is comparable with the 2011 recessionary bear market.
- However, given inflation has yet to peak and the ECB is still tightening, the macro environment still poses risks for equities.

Economic data still surprising positively



Economic recovery in sight

A bleak outlook for European economies driven by record inflation, in part due to spiralling energy and food inflation as a result of Russia's war in Ukraine, is not a new story.

Earlier this month the European Commission published its Autumn [outlook](#). The strong growth in the first two quarters of this year had slowed last quarter, and now the EC is forecasting a contraction in both the EU and euro area this quarter and the first quarter of next year.

This is in-line with our eurozone recession watch [report](#), where all eight indicators are signalling a recession warning.

The unleashing of pent-up demand combined with high levels of savings, after covid restrictions were eased at the start of the year, drove economic activity. But looking forward, household purchasing power will be further eroded by inflation and tighter financial conditions, and increased uncertainty will limit discretionary spending.

And the EC expects inflation to be persistently high across the euro area at 6% for 2023, pointing to a challenging outlook for European equities.

Nevertheless, last [week](#) we noted that technical indicators had become bullish, as a series of trend, rally, and breadth indicators turned positive, signalling further upside in European equities.

While these bullish technical signals were tempered by the prospect of falling economic growth and earnings downgrades, we also recognized that the market has historically tended to lead even forward looking economic and fundamental indicators.

In-line with the renewed equity market optimism, the outlook from the EC, while gloomy is not as dire as some of the worst-case scenarios outlined in recent months. That is, while the EC is predicting a recession, it expects any recession to be relatively shallow and short-lived and forecasts a turning point in the second quarter of next year.

With record low unemployment rates, the EC expects only a marginal increase in unemployment in 2023 across the eurozone to limit the severity of a recession.

Further, inflationary pressures from energy and food have receded. Wholesale energy prices have fallen significantly due to better-than-expected gas storage, and a reduction in demand helped by prices, policy, and mild temperatures. The price of

EU natural gas is now a third of its high in August.

Of course, there are many caveats, but the base case scenario might be considered relatively positive.

Below we review recent updates to our key economic indicators and build on our previous analysis of recessionary bear [markets](#), to assess the case for European equities.

Bad, but not that bad

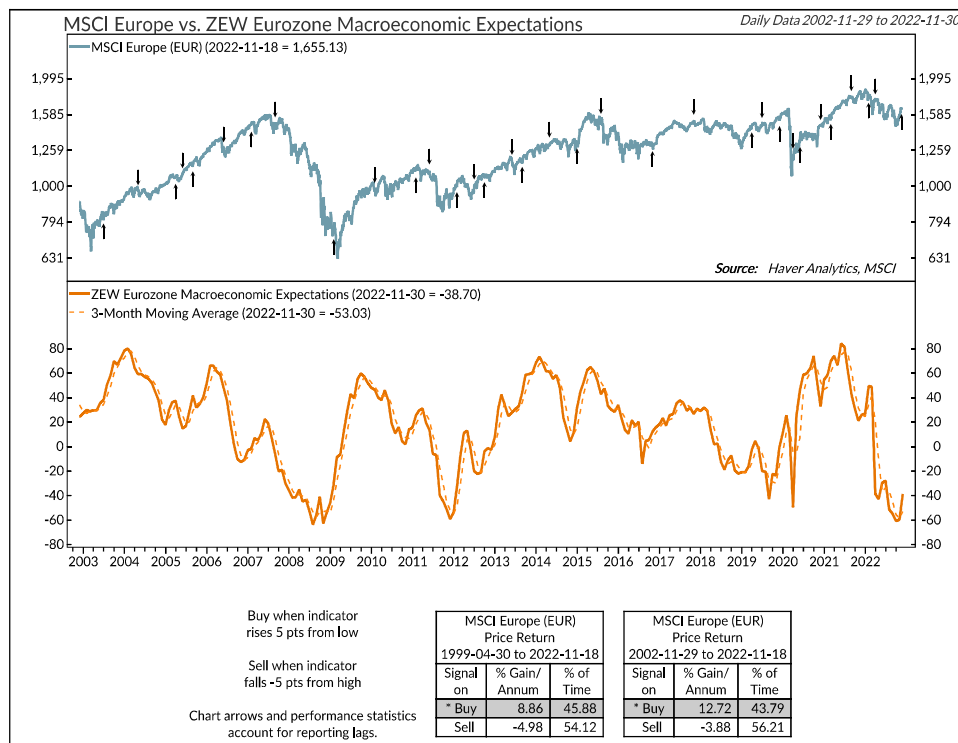
Last [month](#), we highlighted that the Citi euro economic surprise index had been trending higher since end of July, implying that economists had become overly pessimistic. That is, economic data while bad, was surprising to the upside providing support for equities. The latest reading suggests this still to be the case (chart on

page 1).

We also highlighted that the ZEW eurozone macroeconomic expectations survey was excessively pessimistic in October and at levels comparable with the latter stages of the global financial crisis. We wrote that an improvement in this indicator, would be positive for equities.

Last week's reading for November showed that financial experts had become significantly less bearish in aggregate, with "only" a net 38% bearish on the outlook for the eurozone economy, producing a bullish signal as the three-month average rose (chart below).

Eurozone outlook bad but less bad



Customized version of EUR_ZEW1



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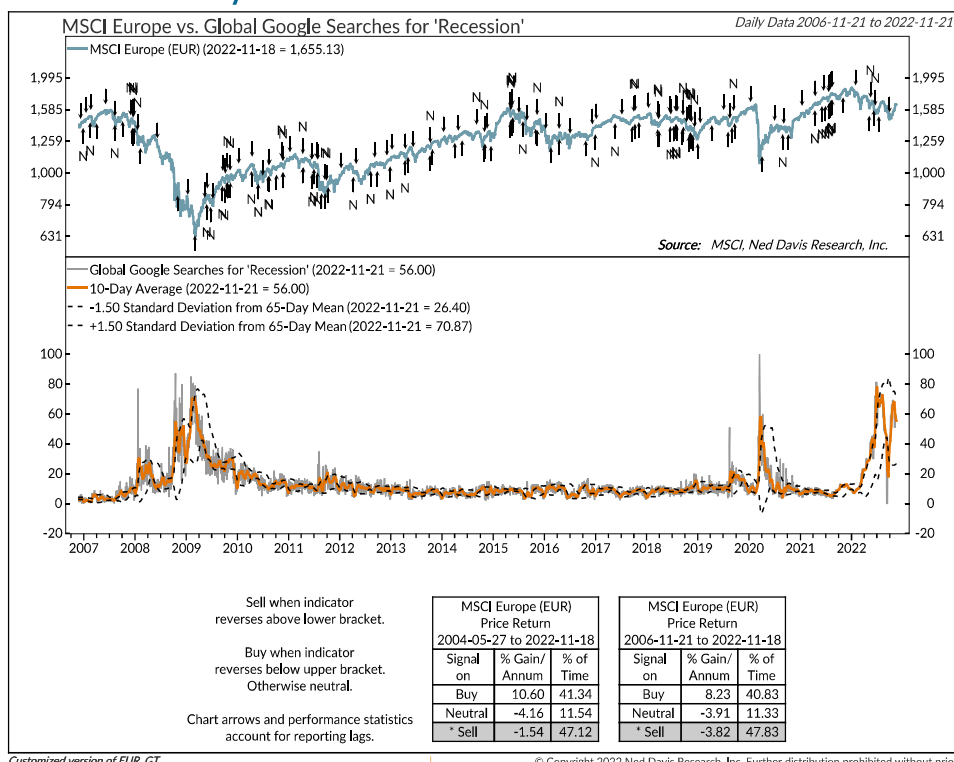


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Google recession searches also point to a fading of recession fears since mid-October, when there was an extreme preoccupation with recession globally (chart right)..

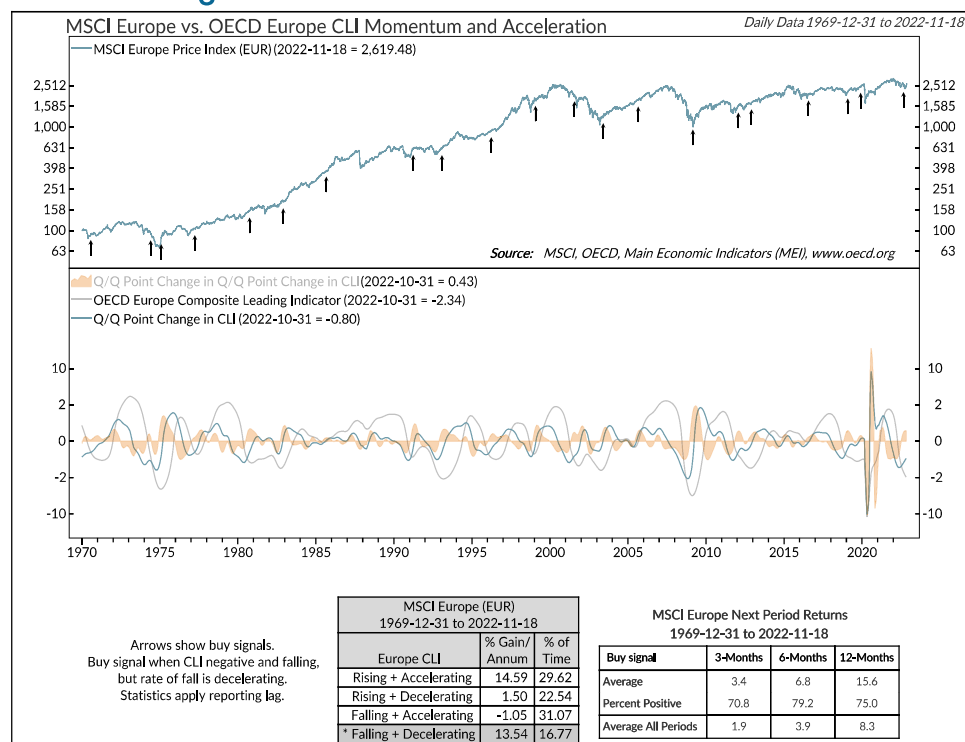
Finally, the week before last, the OECD updated its European composite leading indicator, which again pointed to further deterioration in the economic outlook. But the rate of decline continued to decelerate (chart below).

Recession story baked-in



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Fall in leading indicators decelerates



EUR_CLI2



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The deceleration points to a possible trough in the CLI in the next few months, at which point the outlook for the eurozone economy will start to improve. Taken together with our technical indicators, this suggests **investors are looking beyond the eurozone economic contraction and focussing on the economic recovery, bullish for European equities.**

Market getting ahead of itself?

Hence, forward-looking economic indicators suggest a nadir in economic growth is in sight, consistent with the EC's prediction of positive, albeit marginal growth, later in 2023.

Clearly, investors will price in an economic recovery several months in advance. The table on page 5 shows that in all previous eurozone recessions since 1970, the market bottom occurred before the end of the recession. On average equities bottomed eight months before the recession end, rising an average of 32%.

But while equities will lead the economy, equity market recoveries can also provide false signals. Equity investors can anticipate an economic recovery only for it to fail to materialize or disappoint.

In [July](#) we highlighted the high risk of a eurozone recession, noting that historically, recessionary bear markets had on average lasted more than a year and the drawdown had been over 40%.

With the MSCI Europe currently standing at 10% below its all-time high and a peak to trough decline of 21% from January to September, this would be the shallowest recessionary bear market since our data begins in 1970.

However, this is in nominal terms. If we adjust for inflation the 2022 bear market looks significantly worse, with a maximum drawdown and year-to-date loss of 27% and 19%, respectively.

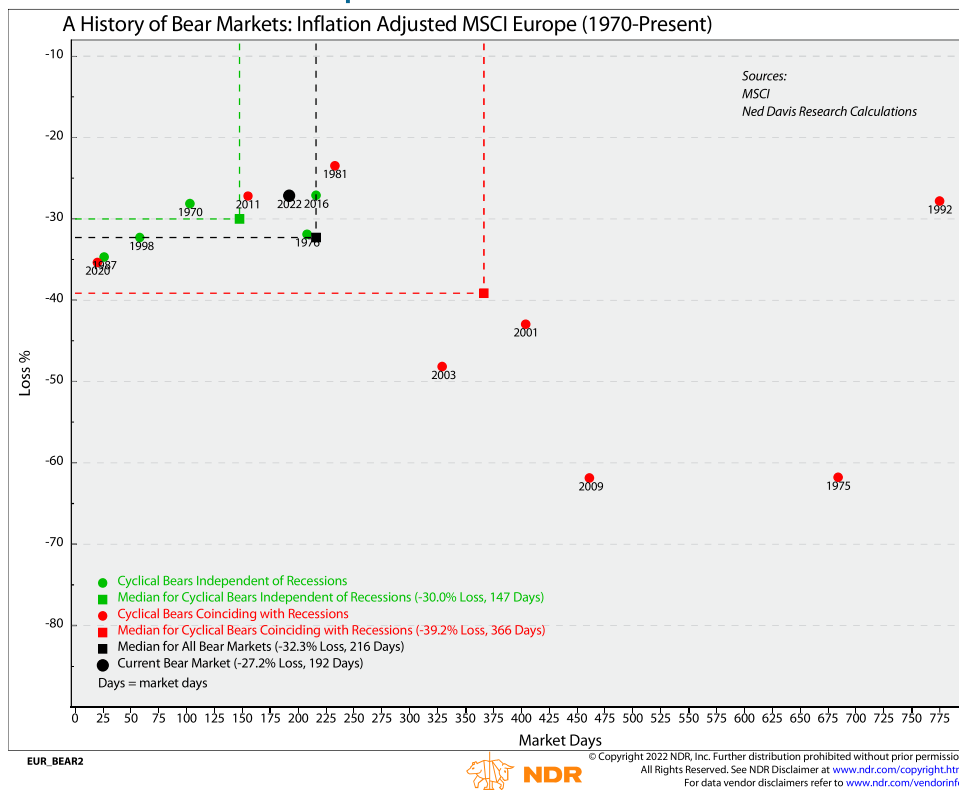
Therefore, given the current record level of inflation, we re-run our original bear market analysis, but after adjusting the MSCI

Europe index for inflation.

In our updated analysis below, we evaluate the assumption that the 2022 bear market ended on September 29. We also assume that the eurozone entered a recession at the start of this quarter and the ECB will raise rates by 50 bps in December, then 25 bps in February at which point they will reach their terminal rate.

The chart below highlights, as with our original analysis, even in inflation adjusted terms, the current drawdown would be relatively short, and shallow compared to other recessionary bear markets.

2022 bear market comparable to 1911



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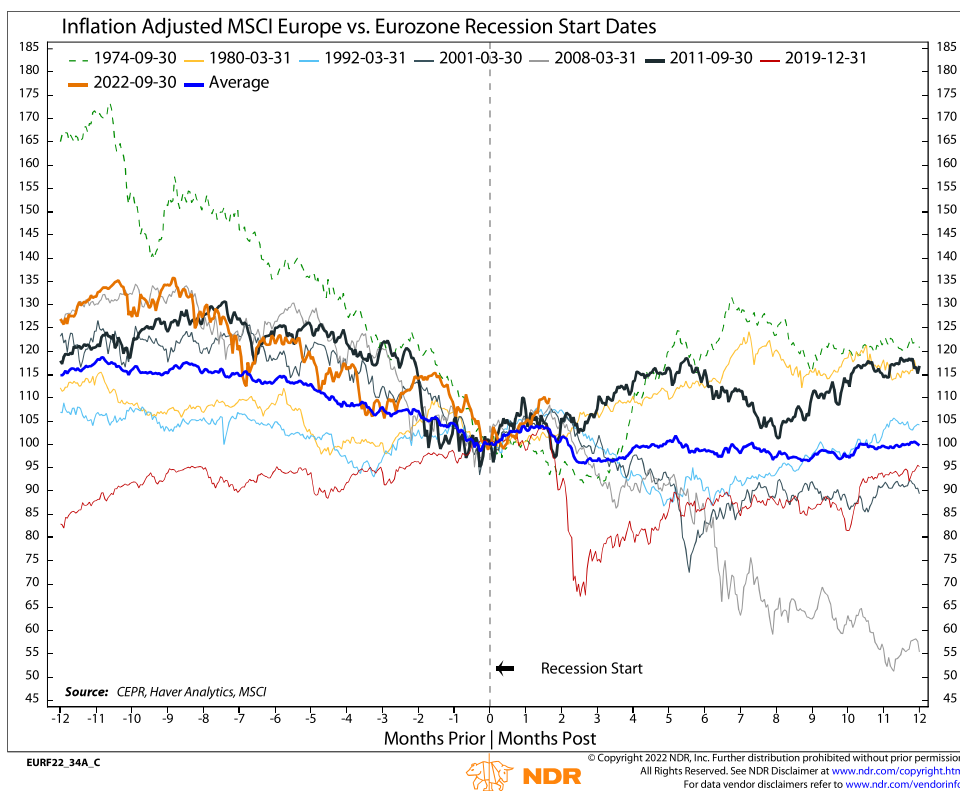


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But it also shows that the current drawdown and duration is now comparable with that during the eurozone sovereign debt crisis, when the market bottomed just as an 18-month recession got underway.

Moreover, once we look at inflation adjusted drawdowns, we identify recessionary bear markets in 1981 and 1992, when inflation was significantly higher than the post-GFC era.

Flat and volatile returns



Bear market ends after recession starts

MSCI Europe Market Inflation Adjusted Performance During Recessions

Recession Start	Recession Length in Months	Market Bottom	# Months Recession Start to Market Bottom	# Months Market Bottom to Recession End	Decline Recession Start to Market Bottom (Real)	Gain Market Bottom to Recession End (Real)
1974-09-30	6	1975-01-02	3.1	2.9	-8.3	30.5
1980-03-31	30	1981-09-28	18.0	12.1	-4.9	12.2
1992-03-31	18	1992-08-25	4.8	13.2	-13.3	34.8
2001-03-30	9	2001-09-21	5.8	3.3	-27.5	26.1
2008-03-31	15	2009-03-09	11.3	3.7	-48.7	29.9
2011-09-30	18	2011-09-22	-0.3	18.3	5.1	31.2
2019-12-31	6	2020-03-18	2.6	3.4	-32.7	28.0
2022-09-30		2022-09-29	0.0		1.1	
Average	15		6.5	8.1	-18.6	27.5

Source: MSCI, Haver Analytics

Performance based on inflation adjusted MSCI Europe index in euros

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Market bottoms and recessions

In July, we showed that equities typically fall leading up to the recession start date. As the recession starts, price returns on average tend to be flat, though volatile. We find something similar when including the two additional recessionary bear markets from our inflation adjusted bear market analysis (chart above).

In five of seven cases, the market rose in the first one to two months of the recession, only to fall to a new low three to four months from the recession start date. The two exceptions were in 1980 and in 1992.

If we assume a eurozone recession started at end of September, then the current rally is in-line with the short-term rallies at the start of past recessions. But if history is a guide, then we might expect the market to at least retest the September low before a sustained recovery.

The table on page 5 shows that on average the market has bottomed around six months after the start of the recession. Although there are significant divergences. Again, the 1980 and 2011 cases stand out.

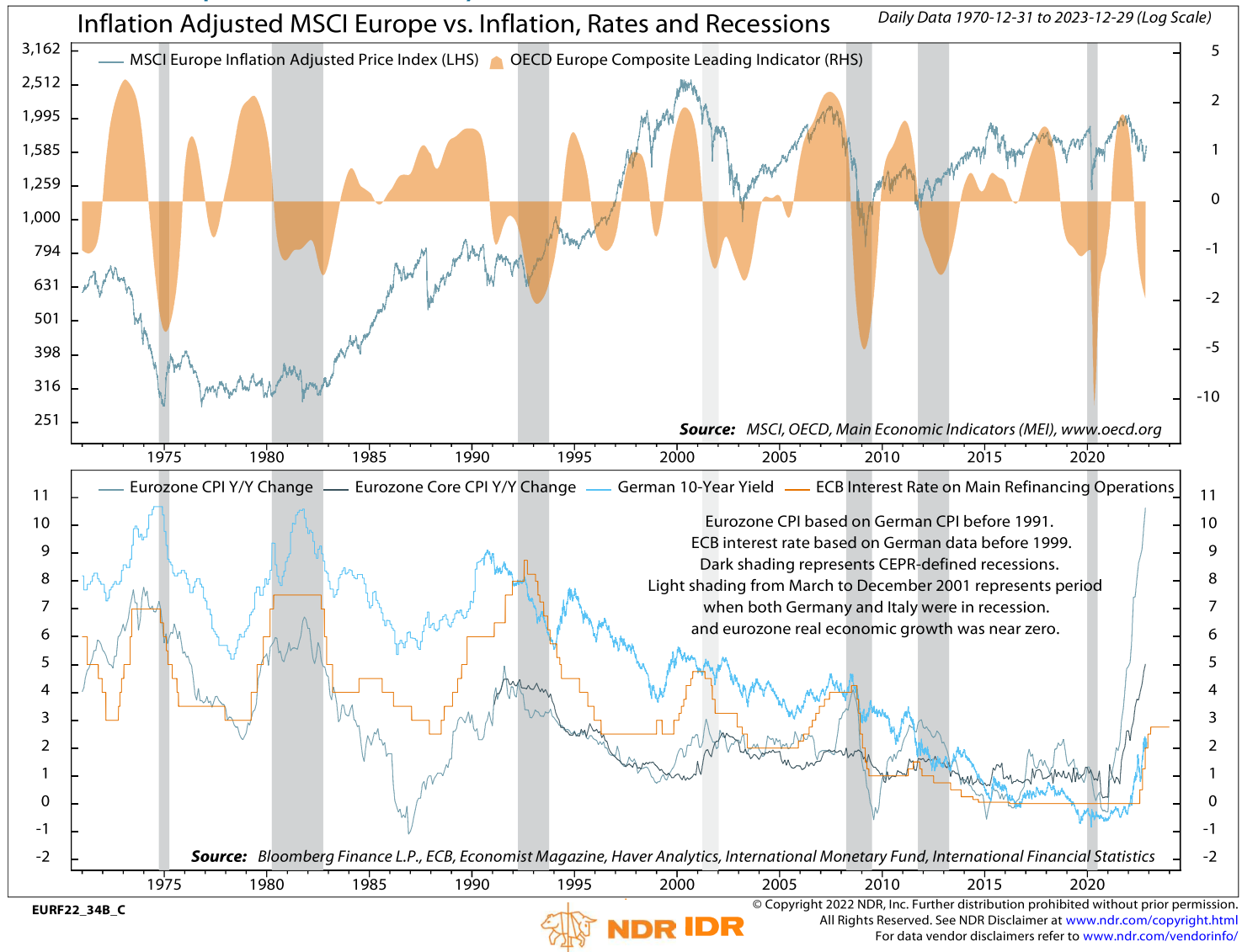
In 1980, the market recovered strongly for six months as the recession started, driven higher by a fall in inflation and yields, and evidence that the outlook for the economy had become less bad. But as these tailwinds reversed the market faltered and made a new low in inflation adjusted terms (chart below).

In 2011, the market troughed a week before the recession start date. But during the 18-month recession that followed, European equities gained at an annualized rate of 18% in price terms.

The 2011 is the only one of the previous seven cases when the market troughed in real terms before the recession started. The question then is whether the bear market that started in January will be the exception or the norm.

There are some similarities in terms of 2011. In both instances, economic sentiment had become very bearish coinciding with a sharp deterioration in leading indicators. But the key difference is that in 2011 yields had fallen significantly prior to the market bottom (chart below).

Recessions – equities, inflation, and yields

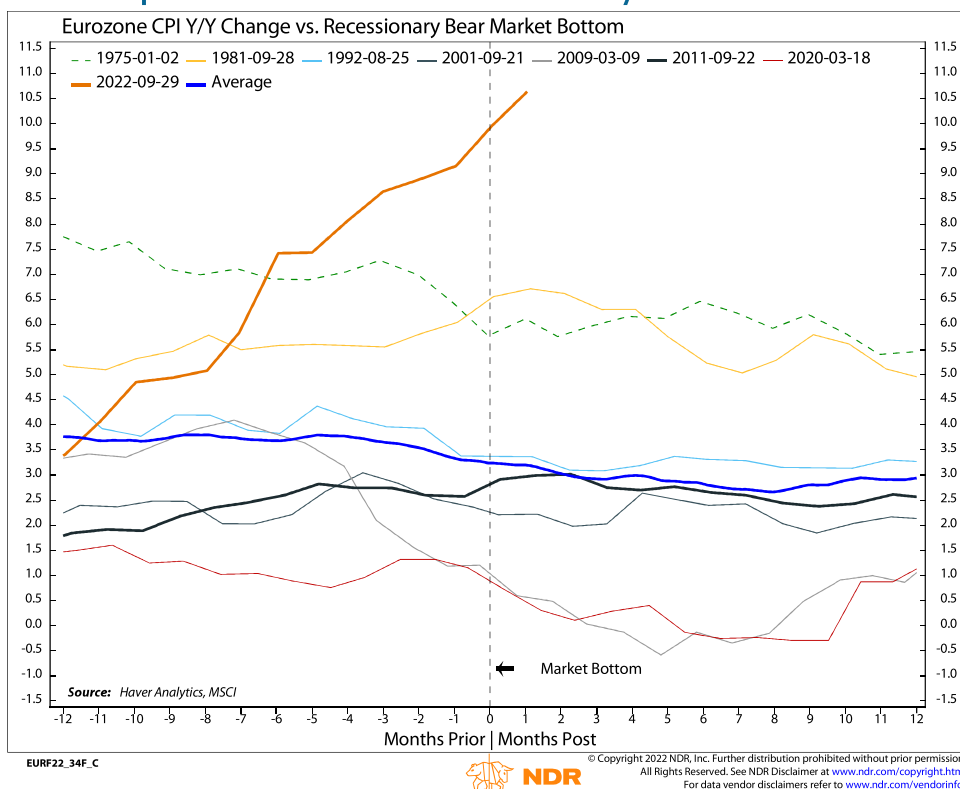


Inflation

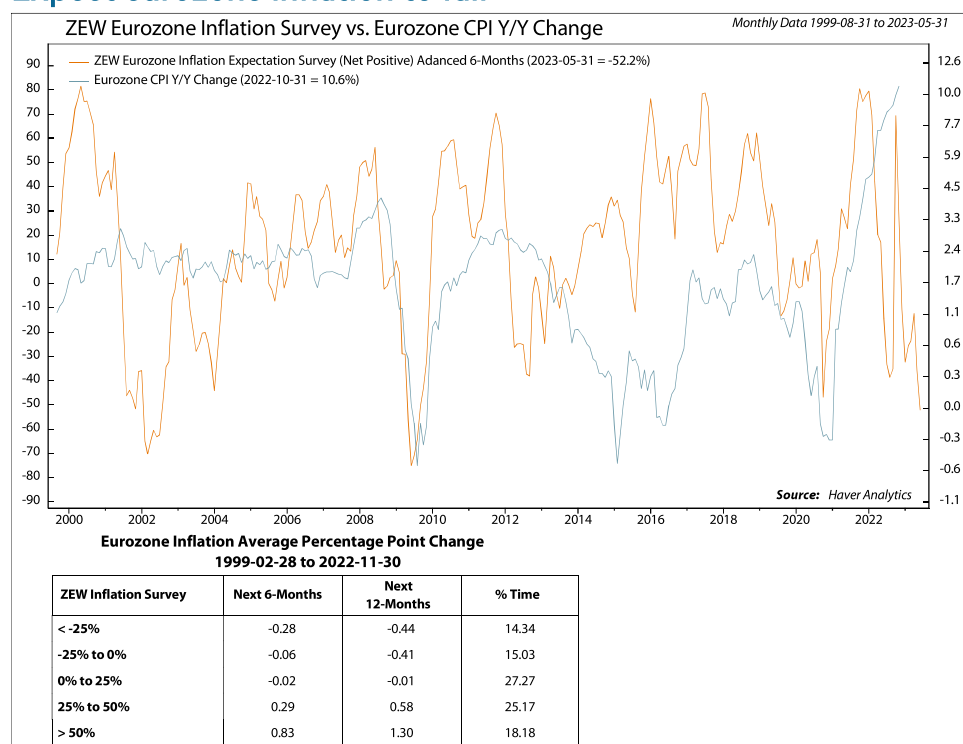
There are other concerns in becoming overly bullish following the recovery in equities since end of September. Firstly, inflation has historically tended to peak prior to a bear market bottom. Again 1981 and 2011 are the exceptions, when inflation peaked one to two months after the bottom (chart right).

True, it is likely that inflation will peak in the coming months. For example, a net 52% of financial experts surveyed by ZEW expect inflation to fall, which has typically led falls in inflation and is the highest level since 2009 (chart below).

Inflation peaks before end of recessionary bear



Expect eurozone inflation to fall



But even if inflation peaks within the next two months, it will still stand out as unusual should September 29 be confirmed as the end of 2022 bear market.

Interest rates

Secondly, prior to all previous bear market bottoms, the central bank had either stopped raising or started cutting interest rates. Never has a bear market bottomed when the central bank has been tightening (chart top of page 8).

The ECB is expected to deliver two more rate hikes in its coming meetings. Therefore, if September 29 was indeed the end of the bear market, this would imply that the market bottomed around five months before the end of the tightening cycle. This would be unprecedented.

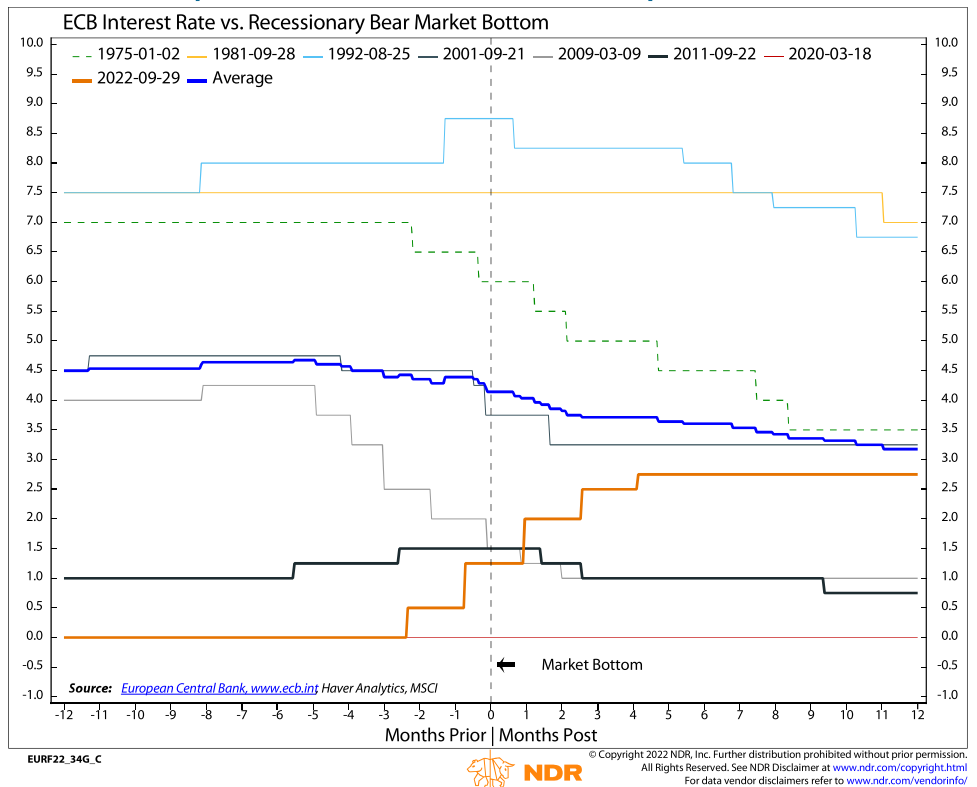
Yields

Finally, we showed in [September](#) that yields will typically fall preceding an equity market recovery. The chart below shows the trajectory of the 10-year German yield around recessionary bear market bottoms using the inflation adjusted MSCI Europe index.

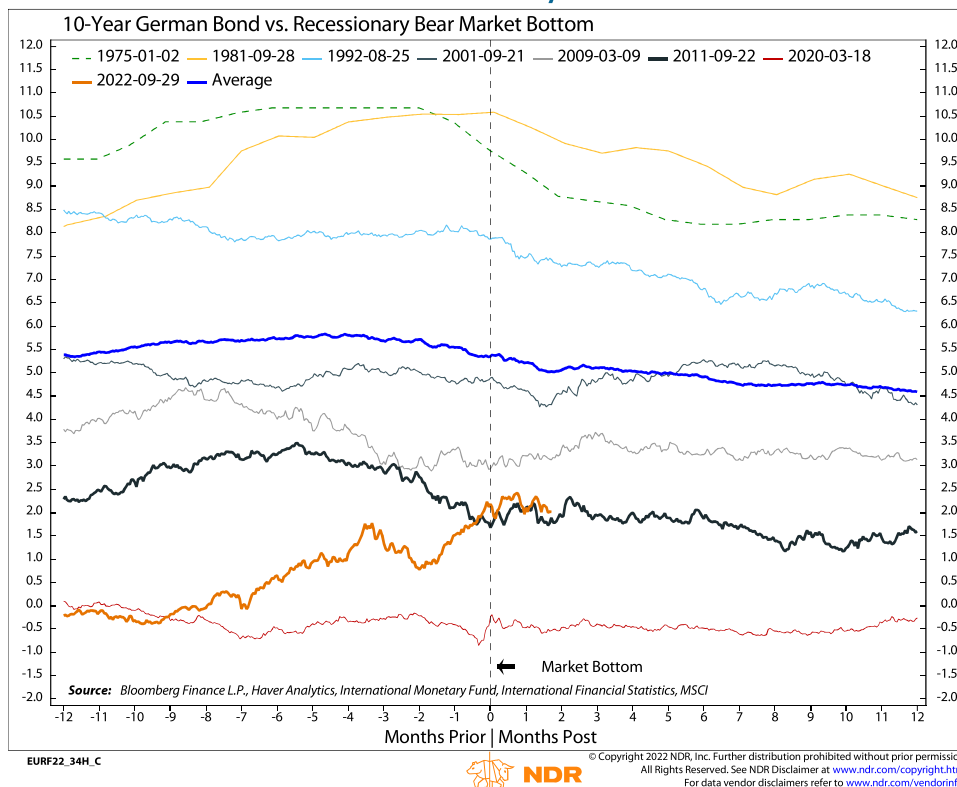
Certainly, there is some evidence that the 10-year yield has found a range somewhere between 1.8% and 2.4%.

But given inflation is at a record peak and the end of the tightening cycle is months ahead, an imminent sharp decline in yields is unlikely. And if yields rise again, this would be negative for European equities at this stage of the economic cycle.

Recessionary bears end after interest rate peak



Yields fall before end of recessionary bear



The bottom line

The bottom line is that several of our economic indicators have become more positive. This combined with more bullish technical indicators points to an inflexion point in the economic cycle in 2023, broadly consistent with the recent Autumn outlook from the EC.

However, given eurozone inflation may not have peaked, and the ECB remains in tightening mode, there is still significant macro risk for European equities. In addition, our analysis of the earnings [cycle](#) suggests that future earnings downgrades could weigh on equities.



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EQUITIES

NDR HOUSE VIEWS (Updated November 17, 2022)

For global asset allocation, NDR recommends marketweight allocation to stocks, bonds, and cash. We are in line with our Global Balanced Account Model estimate.

Equity Allocation

U.S. | We have a modest underweight to stocks in our asset allocation recommendation but are neutral on an absolute basis. The hawkish Fed has overwhelmed the positive tape development in the summer, but sentiment is extremely pessimistic. We favor small-caps over large-caps and Value over Growth.

INTERNATIONAL | We are overweight Europe ex. U.K. and marketweight on all other regions.

Macro

ECONOMY | The global economy is in a sustained slowdown due to waning monetary and fiscal support, stubbornly high inflation, and rising geopolitical risk. While the slowdown remains moderate, the risk of severe recession increases in 2023. Global inflation pressures are easing but will remain historically elevated in the foreseeable future.

FIXED INCOME | We raised our bond exposure to 100% of benchmark duration and are neutral on the yield curve. We are overweight Treasuries, MBS, and CMBS and underweight high yield and TIPS. We are marketweight everything else.

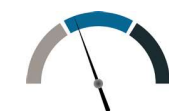
GOLD | We are currently neutral but will be watching our Gold Watch Report for a bullish signal for a potential upgrade.

DOLLAR | We are bearish due to worsening momentum and model readings.

Economic Summary

November 21, 2022

Near term activity: ● Accelerating ● Neutral ● Decelerating



Global Economy
(2.9%)



U.S. Economy
(1.5%-2.0%)



U.S. Inflation
(4.0%-4.5%)

Economic gauges reflect changes in near-term economic activity. Numbers in parenthesis refer to NDR 2022 forecasts.

Global Asset Allocation

● Overweight ● Marketweight ● Underweight



Stocks (55%) | Bonds (35%) | Cash (10%)



Benchmark: Stocks (55%), Bonds (35%), Cash (10%)

Equities — Regional Relative Allocation



Europe ex. U.K. (14%)



U.S. (61%) | Emerging Markets (11%) | Japan (5%) | U.K. (4%) | Pacific ex. Japan (2%) | Canada (3%)



Benchmark – U.S. (61.5%), Europe ex. U.K. (12%), Emerging Markets (11.2%), Japan (5.5%), U.K. (3.8%), Pacific ex. Japan (3%), Canada (3.1%)

Global Bond Allocation



Japan (19%)



U.S. (55%) | Europe (25%)



U.K. (1%)

Benchmark: U.S. (57%), Europe (25%), Japan (15%), U.K. (4%)

U.S. Allocation



Cash (15%) | Small-Cap | Value



Bonds (35%) | Mid-Cap



Stocks (50%) | Large-Cap | Growth

Benchmark: Stocks (55%), Bonds (35%), Cash (10%)

Sectors



Health Care (17%) | Energy (5%) | Materials (4%)



Consumer Discretionary (8%)

Benchmark: Technology (27.4%), Health Care (13.8%), Financials (10.7%), Communication Services (9.3%), Consumer Discretionary (12.1%), Consumer Staples (7.0%), Industrials (7.9%), Energy (4.0%), Utilities (2.7%), Real Estate (2.7%), Materials (2.5%)

U.S. Bonds — 100% of Benchmark Duration

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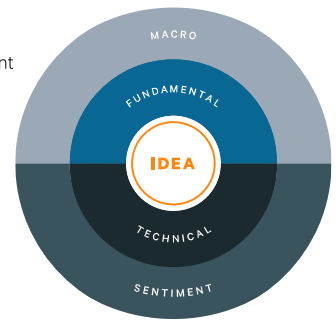
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