Rising tail risks: From risk-off to risk-on and back again?

Equity Strategy Special Edition

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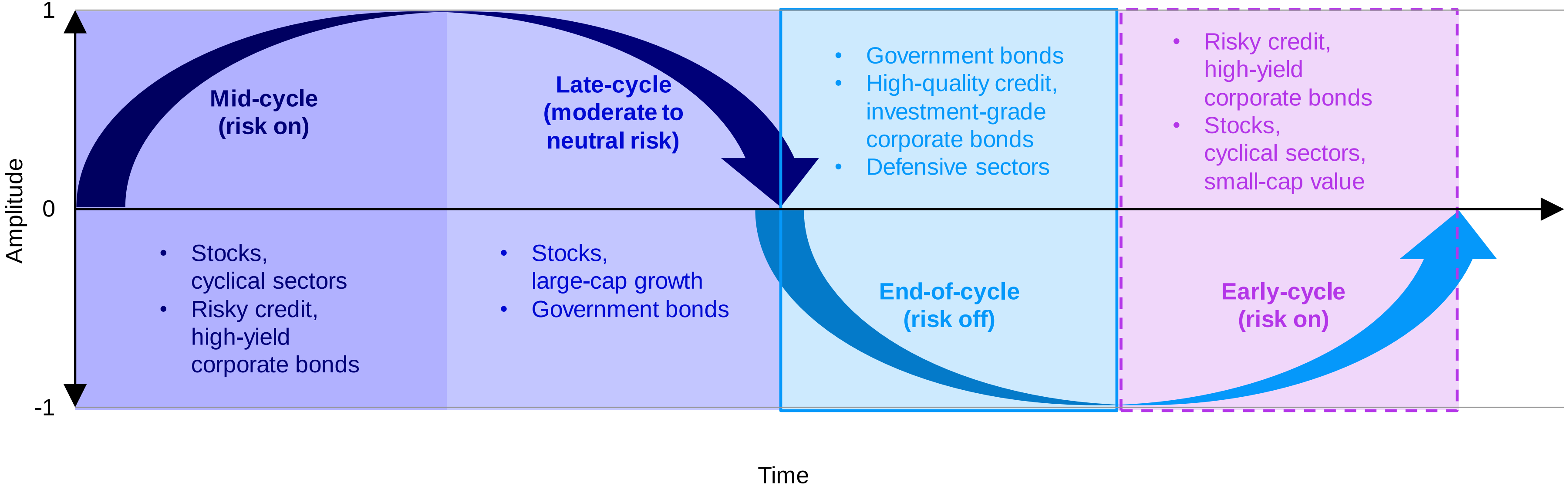
How did we get here?

1. Inflation broadened
2. The Russian invasion of Ukraine and related food and energy supply disruptions exacerbated white-hot inflation
3. The Federal Reserve (Fed) got behind the curve with its interest rate hikes
4. Financial conditions tightened and restricted activity
5. Real economic growth stagnated

A stylized framework for risk appetite and portfolio positioning

US markets have done a roundtrip from risk-off (2020) to risk-on (2021) and back again (2022).

Asset class preferences at each stage of the market cycle

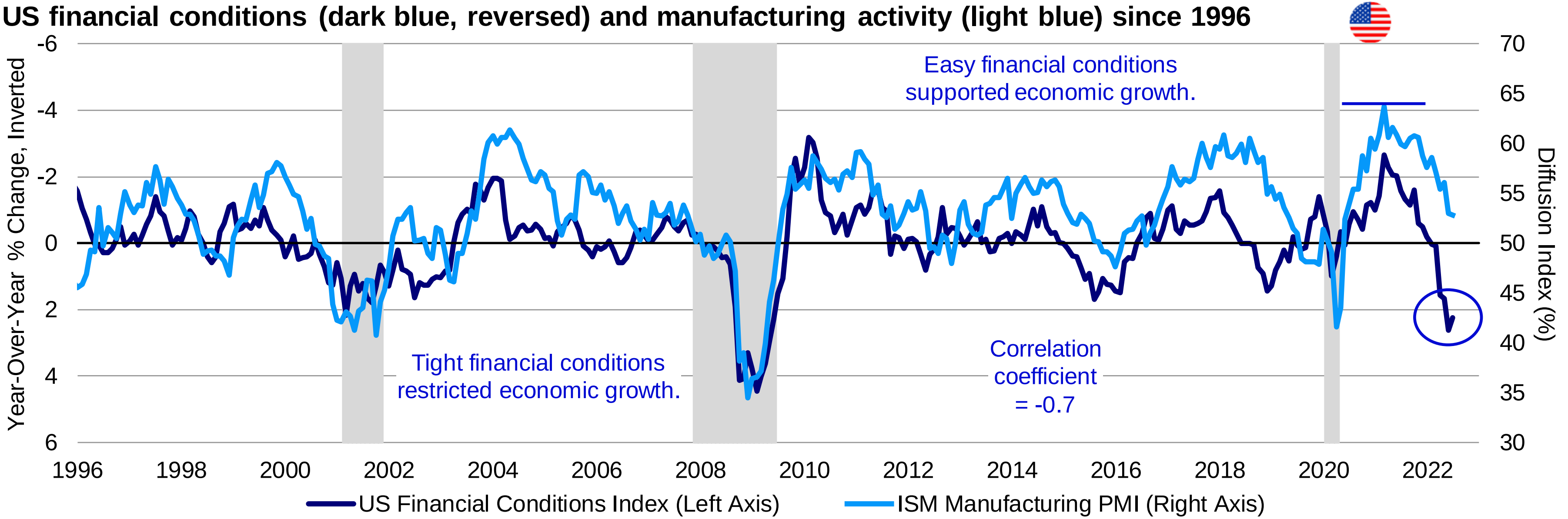


Sources: Invesco, 8/1/22. **Notes:** For illustrative purposes only.

Is the Fed inducing a contraction?

US policymakers are intentionally causing pain to restrain an overheating economy. Financial conditions have tightened sharply.

US financial conditions (dark blue, reversed) and manufacturing activity (light blue) since 1996

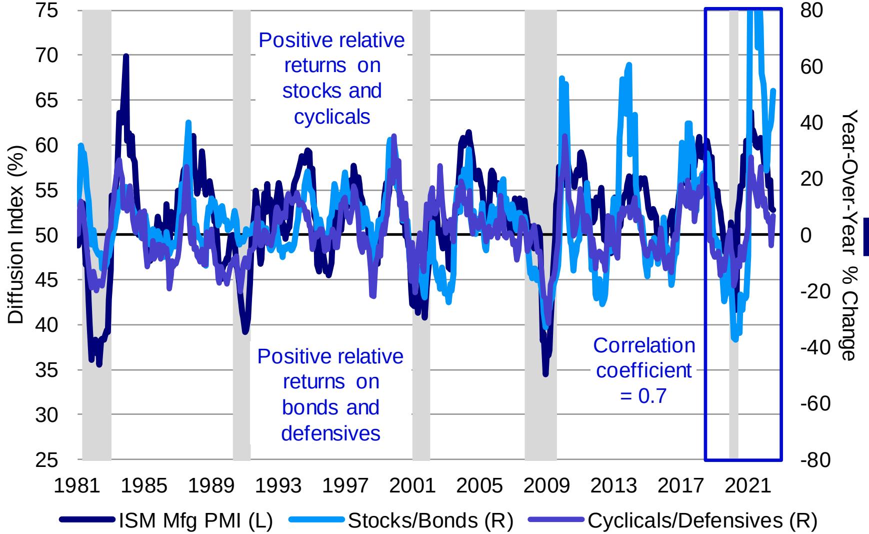


Sources: Bloomberg L.P., Goldman Sachs, Macrobond, Invesco, 8/1/22. **Notes:** The US Financial Conditions Index includes the federal funds rate, 10-year Treasury bond yield, BBB corporate bond spread, S&P 500 and US dollar. ISM = Institute for Supply Management. PMI = Purchasing Managers Index. NBER = National Bureau of Economic Research. Shaded areas denote NBER-defined US recessions. An investment cannot be made in an index. See page 15 for index definitions. **Past performance does not guarantee future results.**

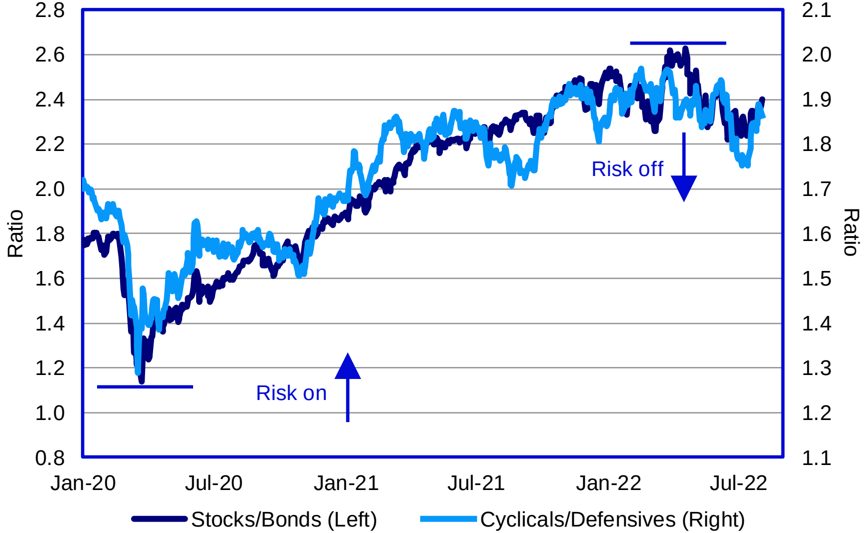
Where are we in the market cycle?

Economic gravity and the natural laws have taken hold. We're seeing signs of a rotation from stocks and cyclicals to bonds and defensives.

US manufacturing activity (dark blue), stocks relative to bonds (light blue), and cyclicals relative to defensives (purple) since 1981



Performance of US stocks relative to bonds (dark blue) and cyclicals relative to defensives (light blue) since 2020

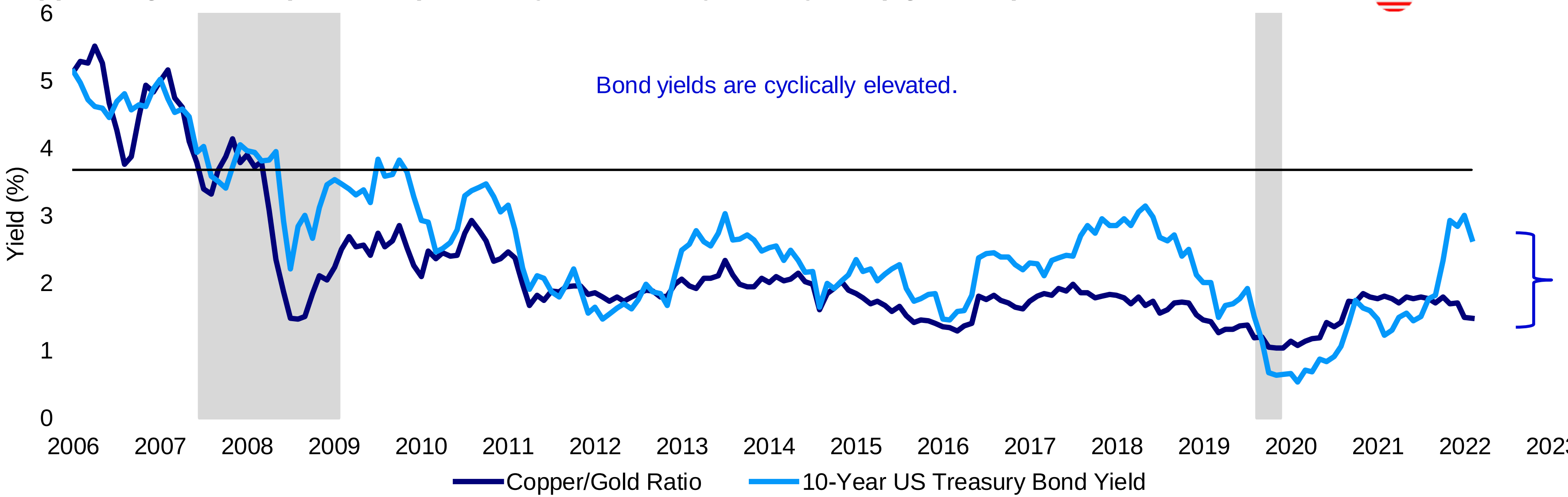


Sources: Bloomberg L.P., Standard & Poor's, Invesco, 8/3/22. **Notes:** The Institute for Supply Management (ISM) Manufacturing Purchasing Managers Index (PMI) is a direct measure of expectations captured by business surveys of production and the general economic climate. Diffusion indices have the properties of leading indicators and are convenient summary measures showing the prevailing direction and scope of change. Cyclicals = Consumer Discretionary, Energy, Financials, Industrials, Information Technology, and Materials. Defensives = Consumer Staples, Health Care, Telecommunication Services, and Utilities. A correlation coefficient measures the strength of the relationship between the relative movements of two variables. The values range between -1 and 1. A perfect positive correlation is 1, and a perfect negative correlation is -1. Amplitude is the maximum departure of the value of an alternating current or wave from the average value. For illustrative purposes only. An investment cannot be made in an index. See page 15 for index definitions. **Past performance does not guarantee future results.**

Are bond yields too high?

The copper-to-gold ratio, another barometer of investor risk appetite, suggests the bond selloff may be overdone in the near term.

Copper-to-gold ratio (dark blue) and 10-year Treasury bond yield (light blue) since 2006

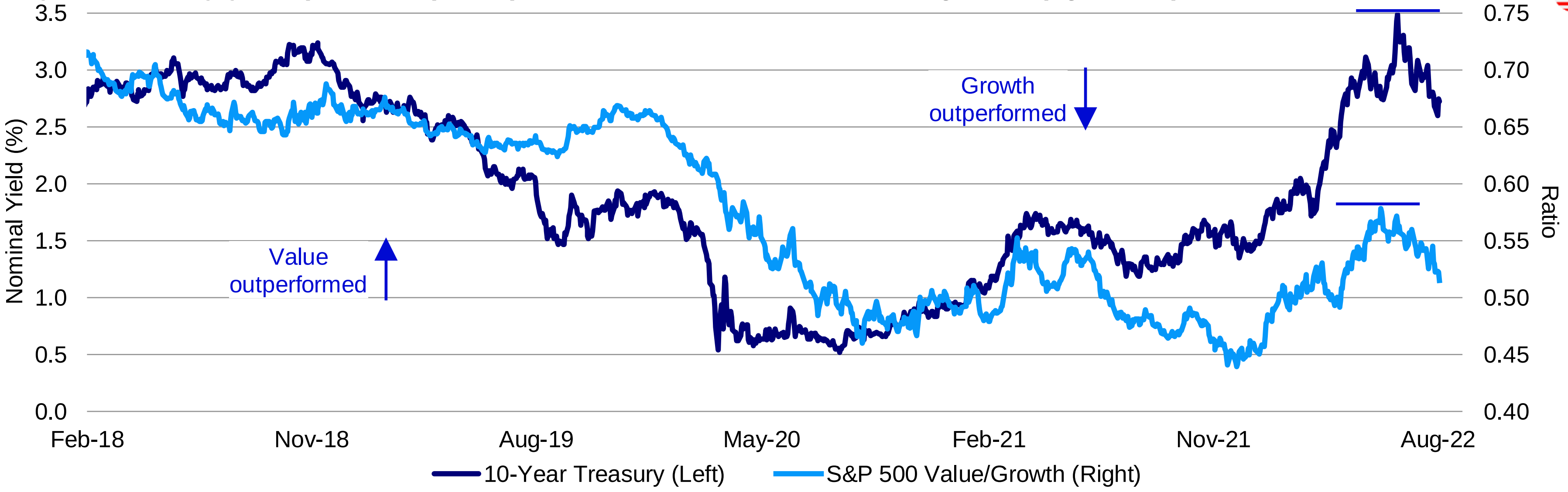


Sources: Bloomberg L.P., Invesco, 8/1/22. **Notes:** GDP = Gross domestic production. GDP growth = Year-over-year % change. The horizontal black line is the 10-year average of nominal GDP. NBER = National Bureau of Economic Research. Shaded areas represent NBER-defined US economic recessions. An investment cannot be made in an index. **Past performance does not guarantee future results.**

Are large-cap growth stocks oversold?

Growth stocks have borne the brunt of the adjustment to higher bond yields. Symmetrically, they could be amongst the first to stabilize.

10-year Treasury yield (dark blue) and performance of value relative to growth (light blue) since 2018

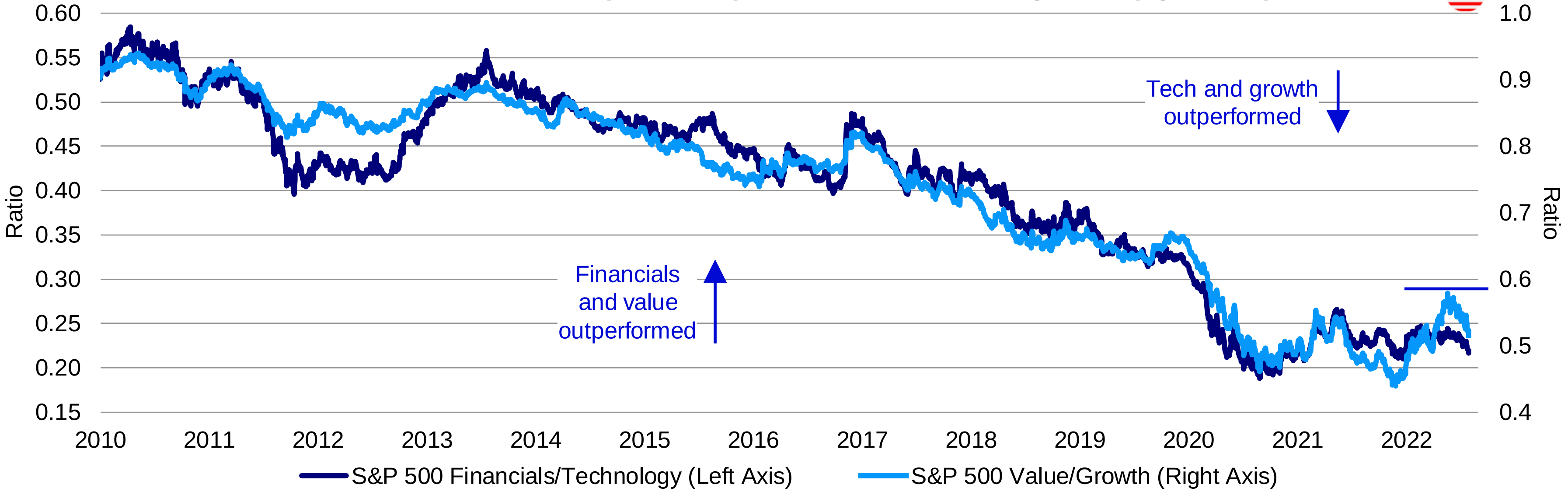


Sources: Bloomberg L.P., FRED, Standard & Poor's, Invesco, 8/3/22. **Notes:** An investment cannot be made in an index. **Past performance does not guarantee future results.**

Polar opposites – What about financial and tech stocks?

Running for cover in the deep-value financial sector seems counterintuitive amidst sharply tighter financial conditions.

Performance of US financials relative to tech (dark blue) and value relative to growth (light blue) since 2010

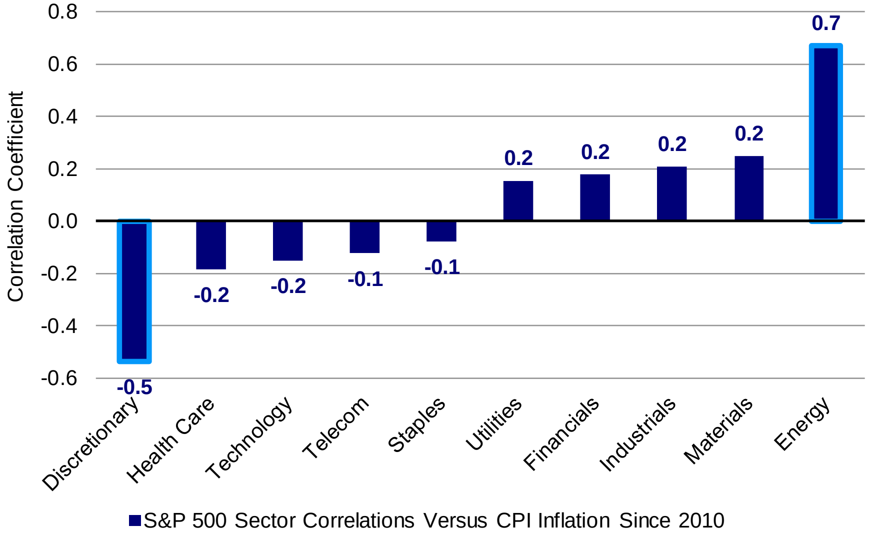


Sources: Bloomberg L.P., FRED, Standard & Poor's, Invesco, 8/3/22. **Notes:** FFR = Federal funds rate. Yield curve = 10-year Treasury yield minus FFR. Shaded areas represent NBER-defined US economic recessions. An investment cannot be made in an index. **Past performance does not guarantee future results.**

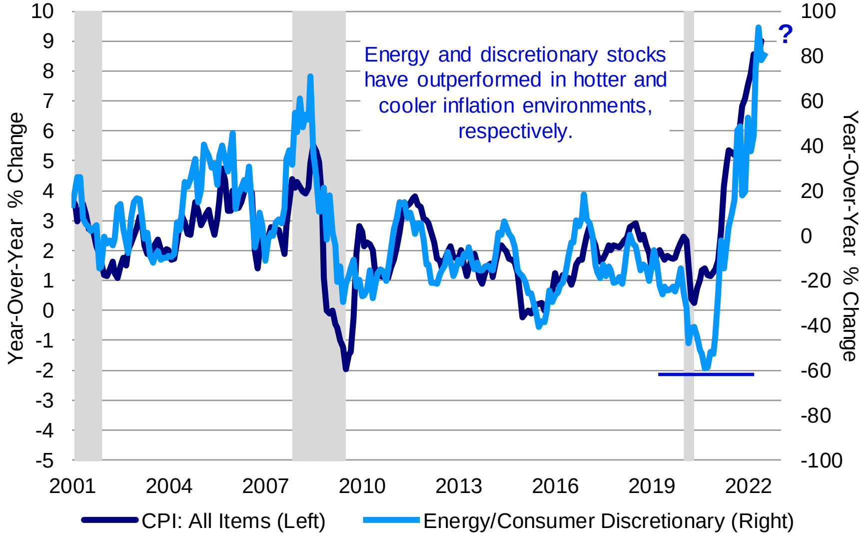
Polar opposites – What about energy and consumer discretionary stocks?

Energy stocks have benefited from war, related oil price shocks, and broader inflationary pressures. But don't overstay your welcome in the sector.

Relationship between consumer price inflation and relative sector returns since 2001



Consumer price inflation (dark blue) and performance of energy relative to consumer discretionary stocks (light blue) since 2001

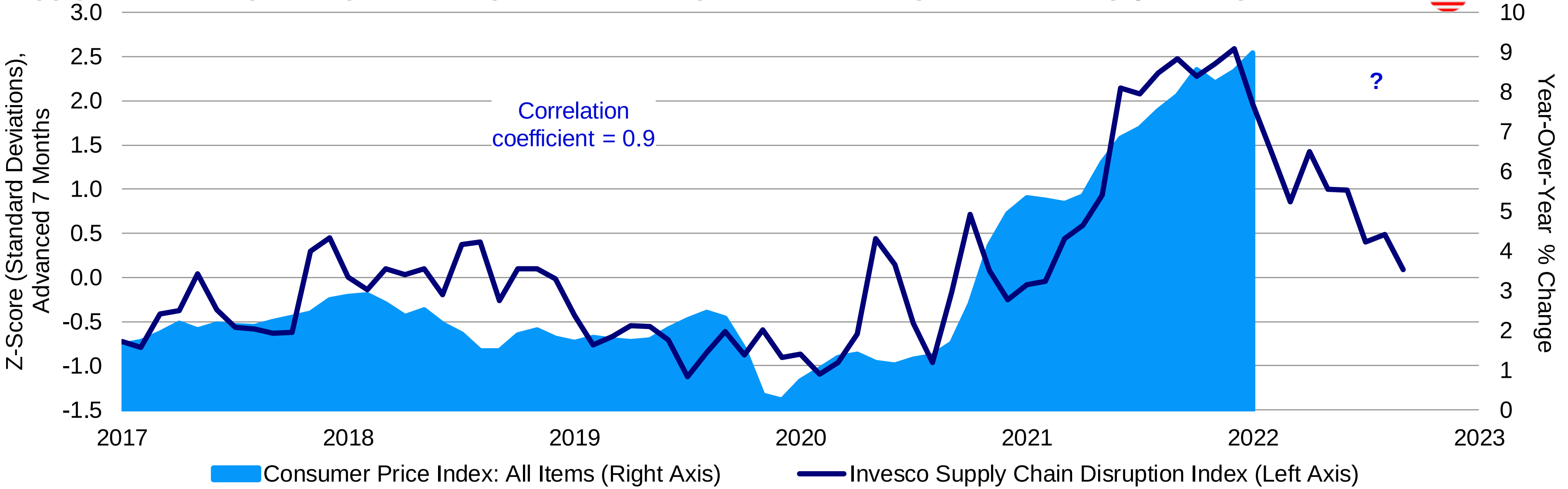


Sources: Bloomberg L.P., Bureau of Labor Statistics, FRED, Standard & Poor's, Invesco, 8/1/22. **Notes:** When the CPI accelerated / rose, the S&P 500 Energy sector outperformed. When the CPI decelerated / fell, the S&P 500 Consumer Discretionary sector outperformed. An investment cannot be made in an index. **Past performance does not guarantee future results.**

Are inflationary pressures getting better or worse?

Pandemic-related supply chain disruptions seem to be easing, which suggests inflation may peak by H2 2022. Is it time for consumer discretionary stocks to shine?

Supply chain disruptions (dark blue, pushed forward) and consumer price inflation (light blue) since 2017



Sources: Bloomberg, L.P., Bureau of Labor Statistics, FRED, Invesco, 8/3/22. **Notes:** Our Supply Chain Disruption Index (SDI) includes the Institute for Supply Management (ISM) manufacturing and services supplier deliveries, backlog of orders, and inventories (inverted); the Baltic Exchange Baltic Dry Index (BDI) which is a composite of the dry bulk time-charter averages; inSpectrum Tech Inc DRAM spot prices (DDR4 4Gb 512Mx8 2133/2400 MHz); and the Drewry Hong Kong-Los Angeles Container Rate per 40-foot box. An investment cannot be made in an index. **Past performance does not guarantee future results.**

Is there a way out?

1. Moderating economic activity – check
2. Lower oil prices – check (at least they're down from peak)
3. Easing supply chain disruptions – signs of hope
4. Peaking inflation – maybe (both core CPI and PCE inflation have eased y/y)
5. Maximum Fed hawkishness – ?

Looking for signs of a bottom in stocks

A list of classic tactical indicators
– 2 out of 8 signals have been triggered, but there’s still more work to do.

1. **American Association of Individual Investors (AAII) Sentiment Survey – Extremely negative**
   (-43% YTD minimum on 4/28/22 < -30% signal)
2. **Chicago Board Options Exchange (CBOE) Volatility Index (VIX) – Elevated but not extreme**
   (36% YTD maximum on 3/7/22 < 40% signal)
3. **CBOE Equity Put/Call Ratio – Rising but not extreme**
   (0.89 YTD maximum on 6/10/22 < 1.0 signal)
4. **Percentage of NYSE stocks above their 200-day moving average – Falling but not extreme**
   (15% YTD minimum on 6/20/22 > 0% signal)
5. **S&P 500 Index’s deviation from its 200-day moving average – Low but not extreme**
   (-17% YTD minimum on 6/16/22 > -20% signal)
6. **US Economic Policy Uncertainty Index – High enough**
   (508 YTD maximum on 1/16/22 > 500 signal)
7. **Bloomberg US Corporate High Yield Average OAS – Widening but not extreme**
   (5.8% YTD maximum on 7/5/22 < 7% signal)
8. **NYSE Composite Advance/Decline Ratio – Perking up but unimpressive**
   (9 YTD maximum on 5/13/22 < 10 signal)

Sources: Bloomberg, L.P., FRED, Invesco, 8/3/22. **Notes:** OAS = Option adjusted spread. See page 15 for index definitions. An investment cannot be made in an index. **Past performance does not guarantee future results.**

Global Thought Leadership

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Talley Léger is the Senior Investment Strategist for the Global Thought Leadership team. In this role, he is responsible for formulating and communicating macro and investment insights, with a focus on equities. Mr. Léger is involved in macro research, cross-market strategy, and equity strategy.

Mr. Léger joined Invesco when the firm combined with OppenheimerFunds in 2019. At OppenheimerFunds, he was the equity strategist. Prior to OppenheimerFunds, he was the founder of Macro Vision Research and held strategist roles at Barclays Capital, ISI, Merrill Lynch, RBC Capital Markets, and Brown Brothers Harriman. Mr. Léger has been in the industry since 2000.

He is the co-author of the revised second edition of the book *From Bear to Bull with ETFs*.* Mr. Léger has been a guest columnist for *The Big Picture* and *Data Watch* on *Bloomberg Brief Economics*, as well as a contributing author on Seeking Alpha (seekingalpha.com). He has been quoted in Associated Press, Barron's, Bloomberg, Business Week, Dow Jones Newswires, The Financial Times, MarketWatch, Morningstar Magazine, The New York Times, and The Wall Street Journal. Mr. Léger has appeared on Bloomberg TV, BNN Bloomberg, CNBC, Reuters TV, TD Ameritrade, The Street, and Yahoo! Finance, and has spoken on Bloomberg Radio.

Mr. Léger earned a Master of Science in Financial Economics and a Bachelor of Music from Boston University. He is a member of the Global Interdependence Center (GIC) and holds the General Securities Representative registration.

**From Bear to Bull with ETFs* (2nd ed.), by David R. Kotok and Talley Léger, published by Cumberland Advisors Publishing (2014).

Definitions

The Goldman Sachs US Financial Conditions Index includes the federal funds rate, 10-year Treasury bond yield, BBB corporate bond spread, S&P 500 and US dollar.

The Institute for Supply Management (ISM) Manufacturing Purchasing Managers Index (PMI) is a diffusion index that measures US manufacturing output.

The MSCI Emerging Market Index measures the equity market performance of emerging markets.

The MSCI All-Country World Index (ACWI) measures the equity market performance of developed and emerging markets.

The MSCI ACWI ex USA Index measures the equity market performance of developed and emerging markets, except the US.

The MSCI Europe Index measures the equity market performance of Europe.

The Russell 1000 Growth Index measures the performance of the large-cap growth segment of the US equity universe.

The S&P 500 Index measures the performance of 500 of the largest companies in the US.

The Russell 2000 Index measures the performance of the small-cap segment of the US equity universe.

The Russell 1000 Value Index measures the performance of the large-cap value segment of the US equity universe.

US cyclical sectors include the S&P 500 consumer discretionary, energy, financials, industrials, information technology, and materials indices.

US defensive sectors include the S&P 500 consumer staples, health care, telecommunication services, and utilities indices.

The AAII Bull-Bear Spread is the net percentage of positive (bull) minus negative (bear) survey respondents, where a difference of roughly -30% signals extremely negative investor sentiment.

The VIX or so-called "investor fear gauge" is a weighted, constant, 30-day measure of the expected volatility of the S&P 500, calculated from out-of-the-money SPX options.

The CBOE Equity Put/Call Ratio is a measure of seller (put) relative to buyer (call) positioning derived from the options market, where a ratio greater than 1 signals extremely negative investor sentiment.

The % of NYSE stocks above their respective 200-day moving averages, when it is extremely low, signals weak internal breadth and can reflect an approaching seller climax.

The S&P 500's deviation from its 200-day moving average – calculated as the S&P 500 minus its 200-day moving average as a percentage of its 200-day moving average – when it is extremely low, measures technical damage at the index level.

The daily US News-Based Economic Policy Uncertainty Index utilizes newspaper archives from Access World News' NewsBank service. When extreme uncertainty eases, it helps stocks further along in their bottoming process.

The Bloomberg US Corporate High Yield Average OAS measures the spread of US dollar-denominated, below investment-grade, fixed-rate corporate bonds above their Treasury counterparts. When the spread is wide, investors demand high compensation for taking risk.

The NYSE Composite Advance/Decline Ratio is a breadth indicator that compares the number of advancing stocks to the number of declining stocks within the index. Divergences between the A/D ratio and the index may warn of a coming reversal.

Important Information

Indices are unmanaged and cannot be purchased directly by investors. Index performance is shown for illustrative purposes only and does not predict or depict the performance of any investment. Past performance does not guarantee future results.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Disclosures

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This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

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