Positioning in slowdown, Fed tightening, and inflation regimes

Economics and equity strategy

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Contents

Market cycle

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Slowdown

1

Global tactical asset allocation framework

The US has transitioned from contraction, recovery, and expansion to slowdown. The next contraction appears closer on the horizon, but we’re not there yet.

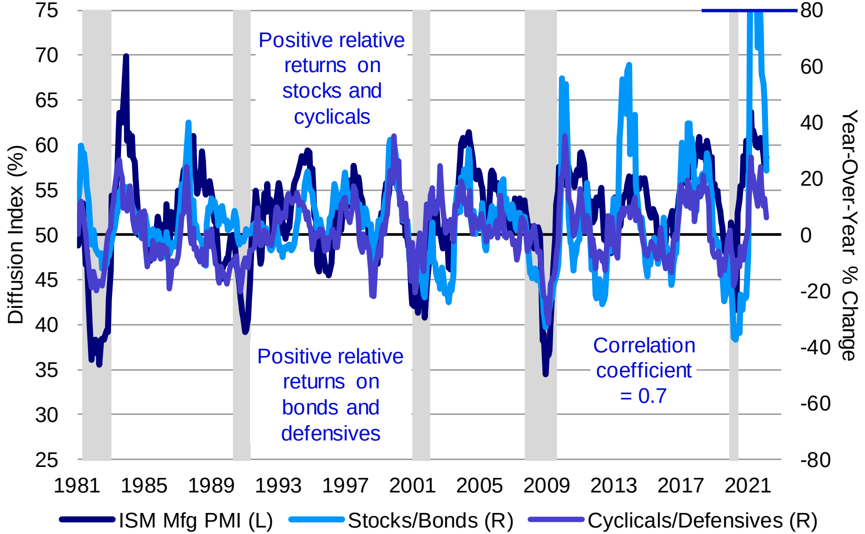
	Recovery	Expansion	Slowdown	Contraction
Macro Regime	Growth ▼ **below** trend & ▲ **accelerating**	Growth ▲ **above** trend & ▲ **accelerating**	Growth ▲ **above** trend & ▼ **decelerating**	Growth ▼ **below** trend & ▼ **decelerating**
Monetary Regime	Still Easy	Tightening	Tight	Easing
	~ 15% of the business cycle	~ 35% of the business cycle	~ 35% of the business cycle	~ 15% of the business cycle
Market Regime (Ranked by expected outperformance)	**Risky Credit** • High Yield, Bank Loans • EM Local Debt	**Equities** • Cyclicals, Growth/Value	**Equities** • Cyclicals, Growth, Large	**Government Bonds** • Long Duration • Nominal Bonds
	Equities • Cyclicals, Value, Small • Emerging Markets	**Risky Credit** • High Yield, Bank Loans • EM Hard Currency	**Government Bonds** • Long Duration • Nominal Bonds	**High Quality Credit** • IG Corporate
	High Quality Credit • IG Corporate	**High Quality Credit** • IG Corporate	**High Quality Credit** • IG Corporate	**Risky Credit** • High Yield, Bank Loans • EM Hard Currency
	Government Bonds • Intermediate Duration • Nominal Bonds	**Government Bonds** • Short Duration • Inflation-Linked Bonds	**Risky Credit** • High Yield, Bank Loans • EM Hard Currency	**Equities** • Defensives, High Quality • Low Volatility

Notes: For illustrative purposes only. Economies can move backwards and forwards in this framework. Based on historical excess returns across asset classes. We define policy easing as the Federal Reserve (Fed) lowering interest rates and/or expanding its balance sheet. Still easy suggests the Fed is maintaining its lower interest rate policy and/or continuing its bond-buying program. Tightening suggests the Fed is tapering asset purchases and/or beginning to raise interest rates. Tight policy suggests the Fed is raising rates to contain inflation. EM = Emerging markets. IG = Investment grade.

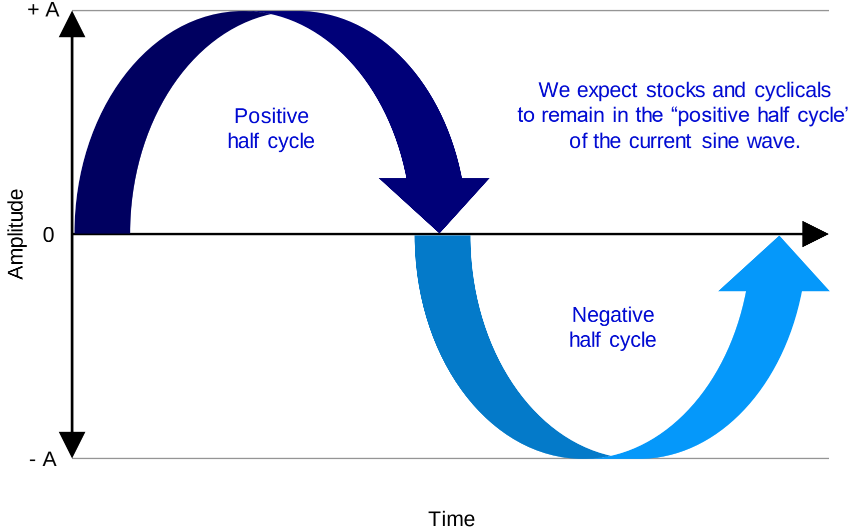
Where are we in the US market cycle?

Sine wave analysis helps inform the tactical outlook. The natural laws suggest decelerating but positive returns on stocks, specifically cyclicals this year.

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



A geometric waveform oscillating above (dark blue) and below (light blue) zero across time

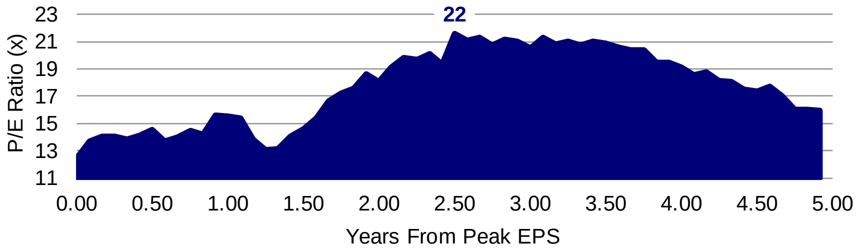


Sources: Bloomberg L.P., Standard & Poor's, Invesco, 2/28/22. **Notes:** The Institute for Supply Management (ISM) Manufacturing Purchasing Managers Index (PMI) is a direct measure of expectations captured by business surveys of production and the general economic climate. Diffusion indices have the 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 34 for index definitions. **Past performance does not guarantee future results.**

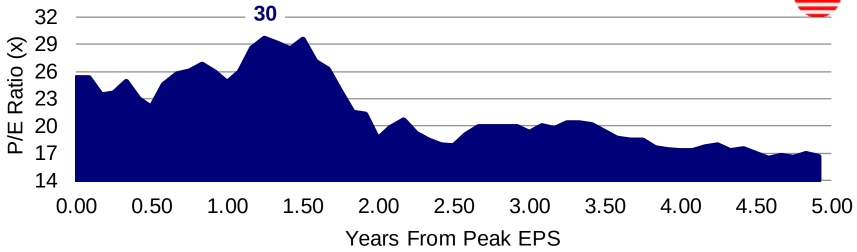
Aren't stocks expensive?

Stocks have grown into their multiples, as they've done after each recession since the early 1990s.

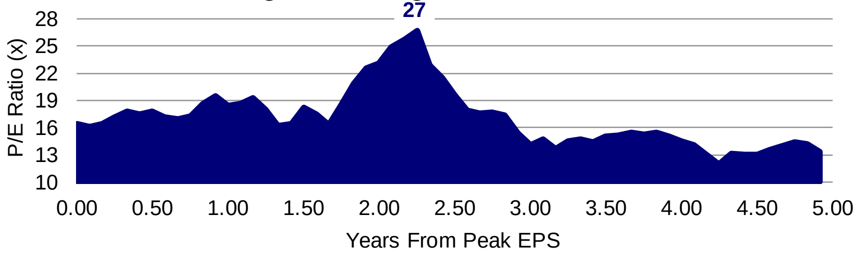
S&P 500 P/E* entering and exiting: The early 1990s recession



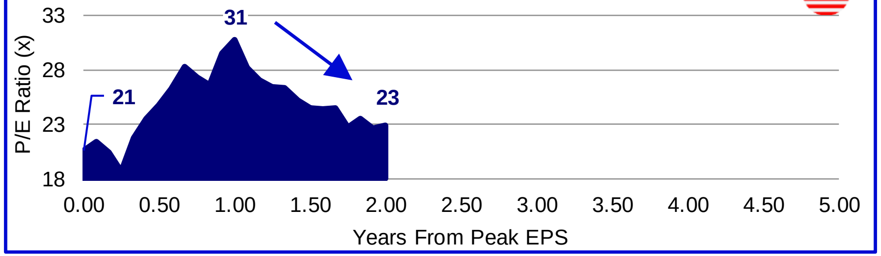
S&P 500 P/E* entering and exiting: The early 2000s recession



S&P 500 P/E* entering and exiting: The late 2000s recession



S&P 500 P/E* entering and exiting: The 2020 recession

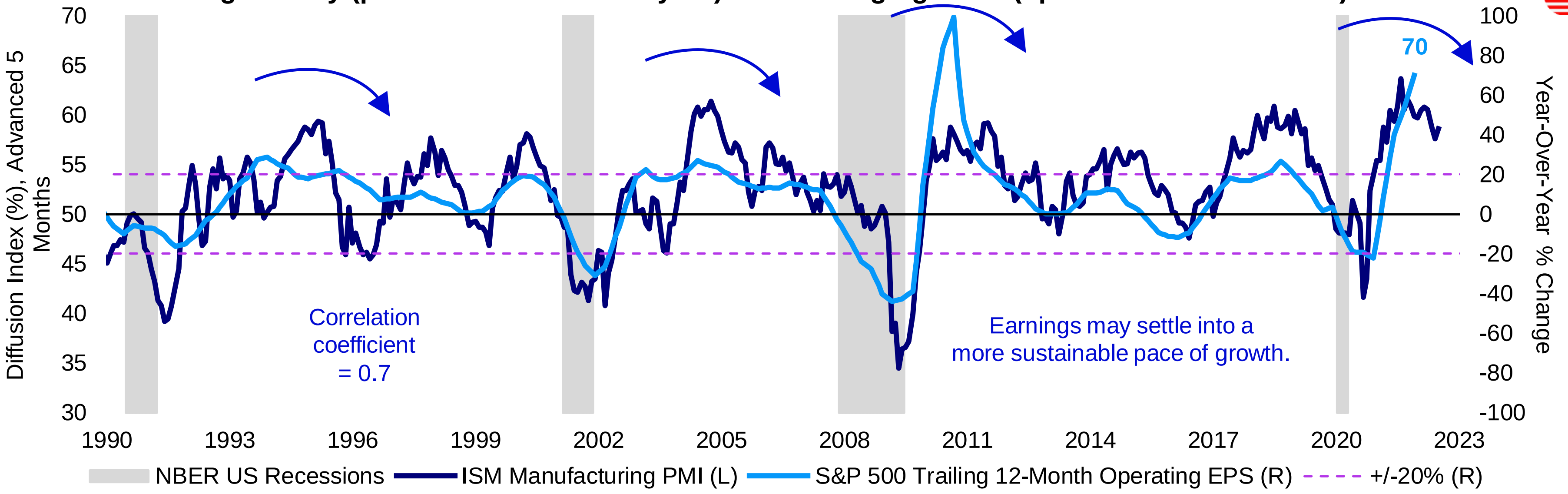


Sources: Bloomberg L.P., Standard & Poor's, Invesco, 12/31/21. **Notes:** EPS = Earnings per share on a trailing 12-month operating basis. An investment cannot be made in an index. **Past performance does not guarantee future results.**

Where are we in the corporate profit cycle?

Manufacturing activity suggests peak earnings growth is likely behind us. Looking ahead, softer output points to slower but still robust earnings growth in 2022.

US manufacturing activity (pushed forward half a year) and earnings growth (up/downside thresholds) since 1990

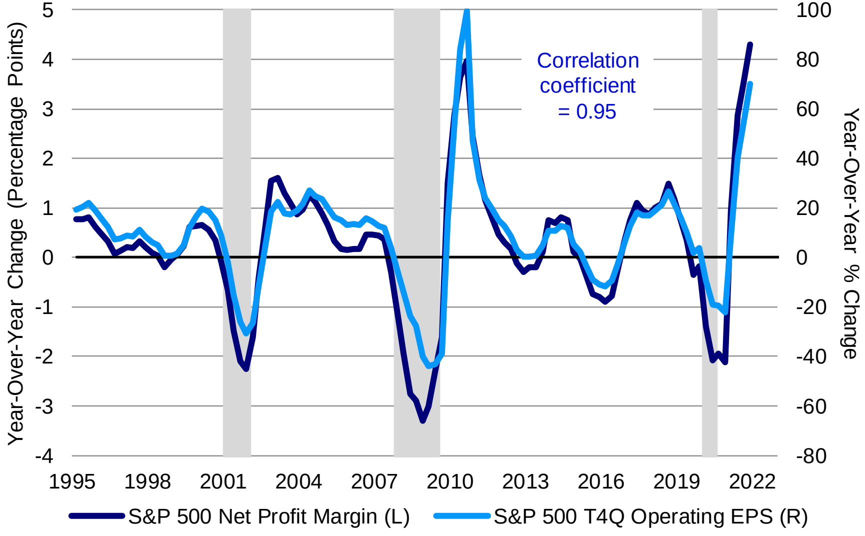


Sources: Bloomberg, Institute for Supply Management, Standard & Poor's, Invesco, 3/1/22. **Notes:** PMI = Purchasing Managers Index. EPS = Earnings per share. NBER = National Bureau of Economic Research. Shaded areas represent NBER-defined US economic recessions. There is no guarantee the forecast will come to pass. An investment cannot be made in an index. **Past performance does not guarantee future results.**

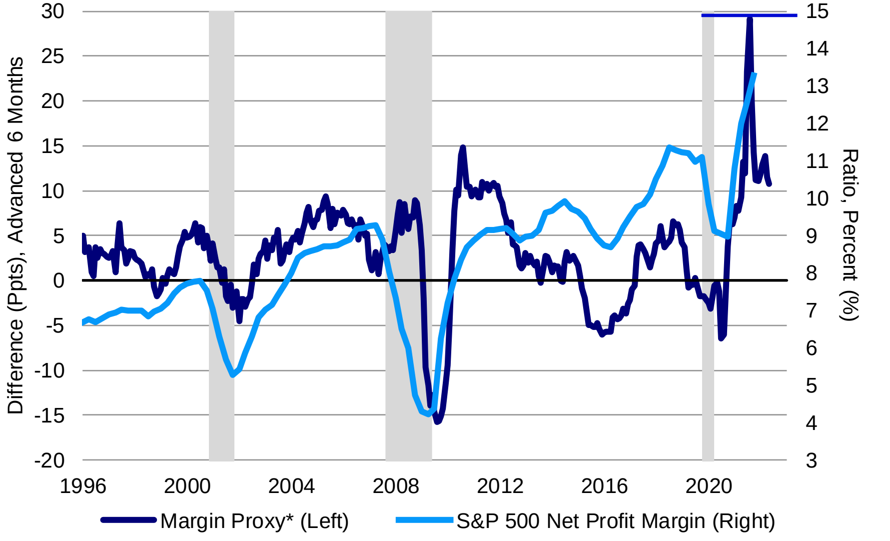
Aren't profit margins at a record high?

Yes, they've soared. However, this directional leading indicator points to a peak in margins – a process that may take over a year to complete.

US profit margin changes (dark blue) and earnings growth (light blue) since 1995



Leading margin indicator (dark blue, pushed forward) and profit margin (light blue) since 1996

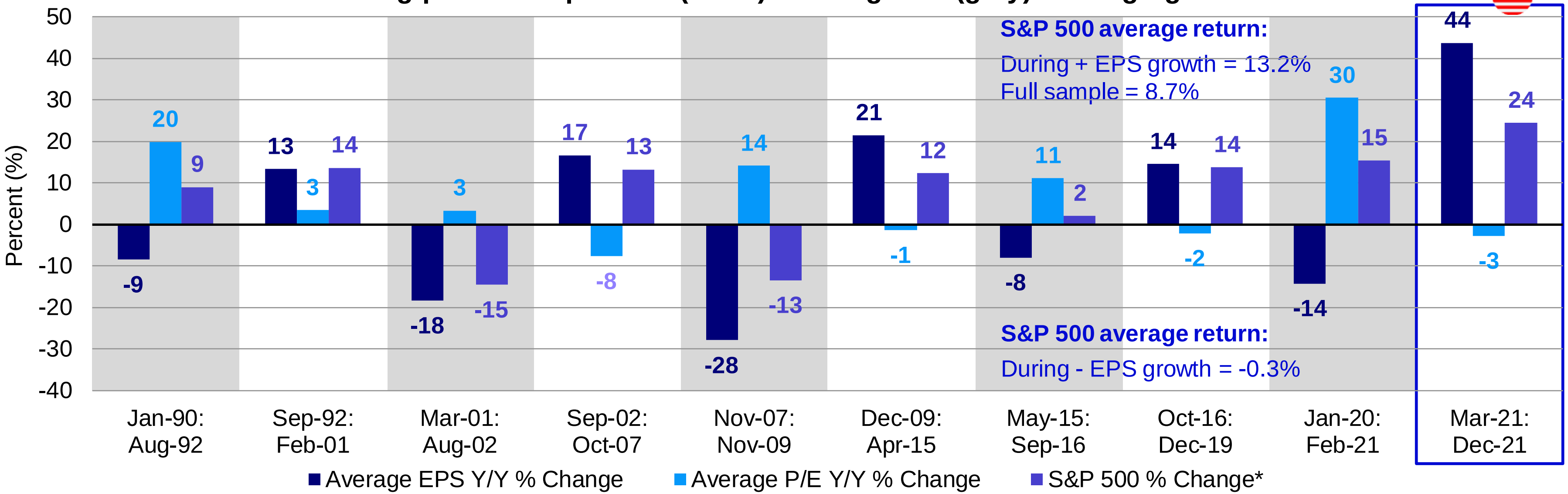


Sources: Bureau of Labor Statistics, FRED, Standard & Poor's, Invesco, 3/16/22. **Notes:** T4Q = Trailing four-quarter. Operating EPS = Income from products (goods and services), excluding corporate (M&A, financing, layoffs), and unusual items. *Margin proxy = Total business sales (year-over-year % change) minus total nonfarm payrolls (year-over-year % change). Shaded areas represent NBER-defined US economic recessions. There is no guarantee the forecast will come to pass. An investment cannot be made in an index. **Past performance does not guarantee future results.**

What's better for stocks? Multiple expansion or earnings growth?

Multiple expansion helps, but stocks did best during periods of positive earnings growth, regardless of what multiples did.

US stock market returns during periods of positive (white) and negative (gray) earnings growth since 1990

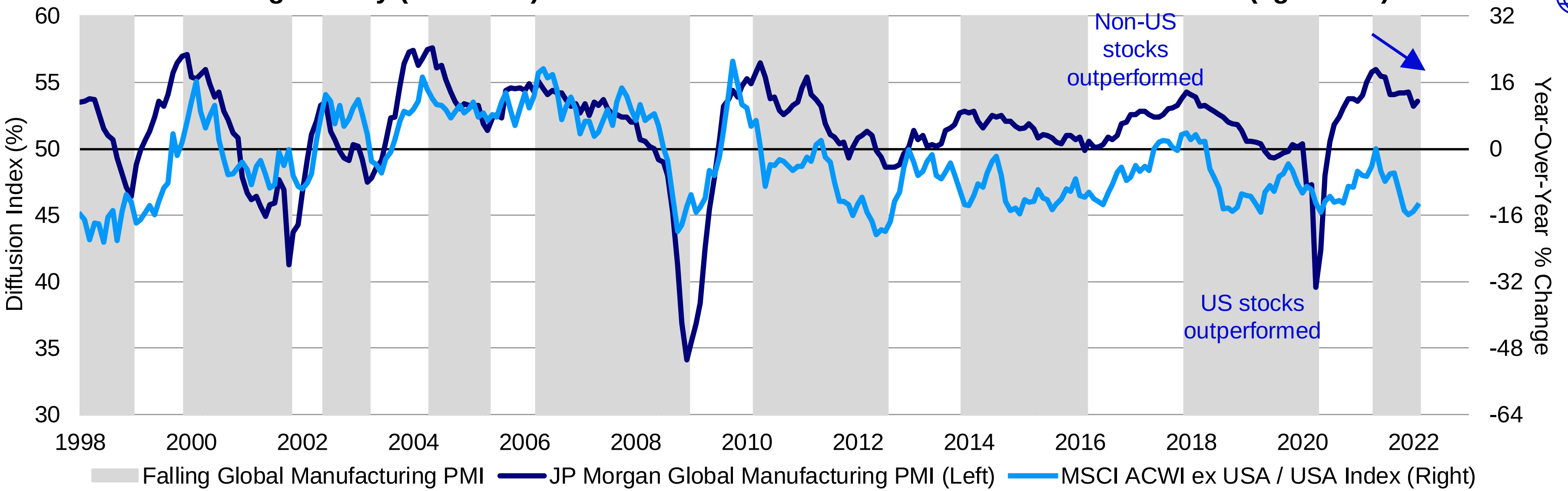


Sources: Bloomberg L.P., Standard & Poor's, Invesco, 12/31/21. **Notes:** Y/Y = Year-over-year. *S&P 500 % change = Compound annual growth rate (CAGR). Shaded areas represent periods of negative earnings growth. White areas represent periods of positive earnings growth. An investment cannot be made in an index. **Past performance does not guarantee future results.**

Where are we in the global market cycle?

International stocks usually underperformed US stocks when global manufacturing activity was trending down, as has been the case since May 2021.

Global manufacturing activity (dark blue) and international relative to US stock market returns (light blue) since 1998

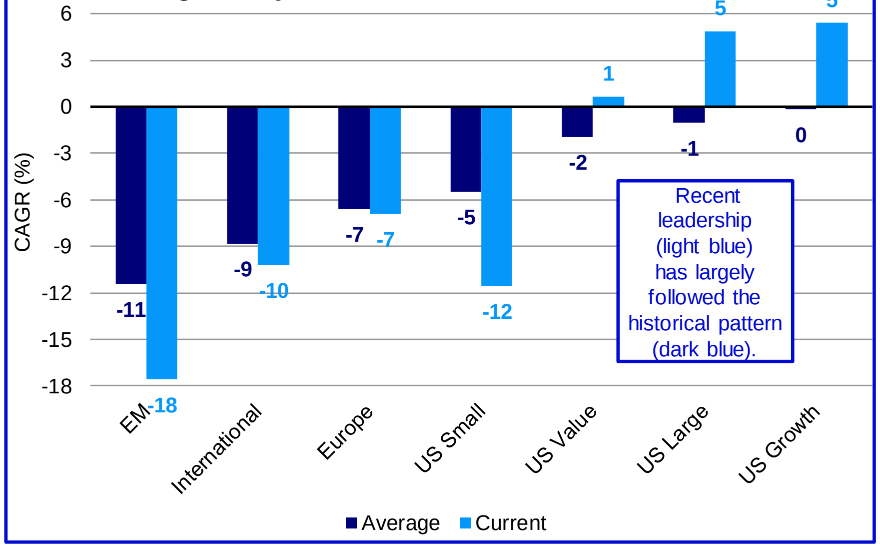


Source: Bloomberg L.P., Invesco, 3/1/22. **Notes:** ACWI = All Country World Index. MSCI ACWI ex USA price index in US dollars. Shaded areas denote a falling global manufacturing PMI. White areas denote a rising global manufacturing PMI. An investment cannot be made directly in an index. **Past performance does not guarantee future results.**

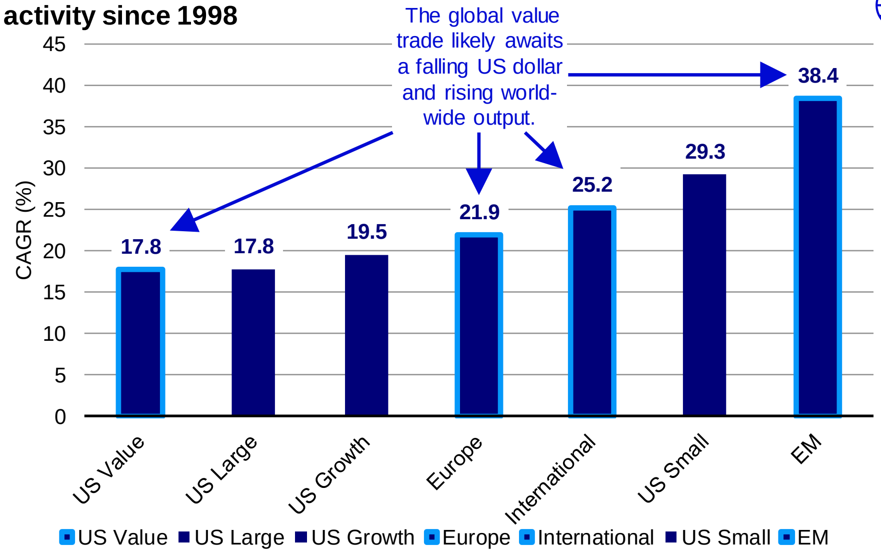
How did global equities perform in past slowdowns?

Emerging markets and European stocks typically struggled in periods of easing global manufacturing activity, whereas US stocks generally did better.

Global equity performance in periods of falling global manufacturing activity since 1998



Global equity performance in periods of rising global manufacturing activity since 1998

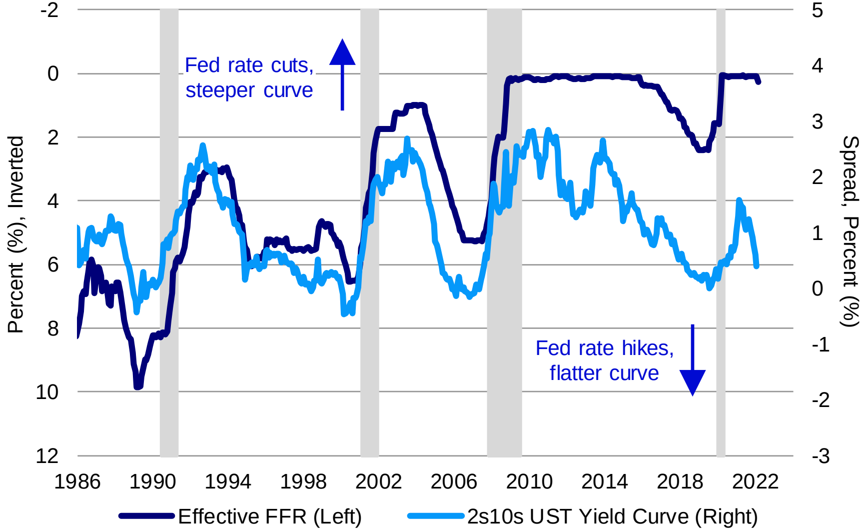


Sources: Bloomberg L.P., Invesco, 2/28/22. **Notes:** EM = MSCI Emerging Markets Index. International = MSCI ACWI ex USA. US growth = Russell 1000 Growth. Europe = MSCI Europe Index. US large = S&P 500. US small = Russell 2000. US value = Russell 1000 Value. Price returns in US dollars. See page 34 for index definitions. An investment cannot be made into an index. **Past performance does not guarantee future results.**

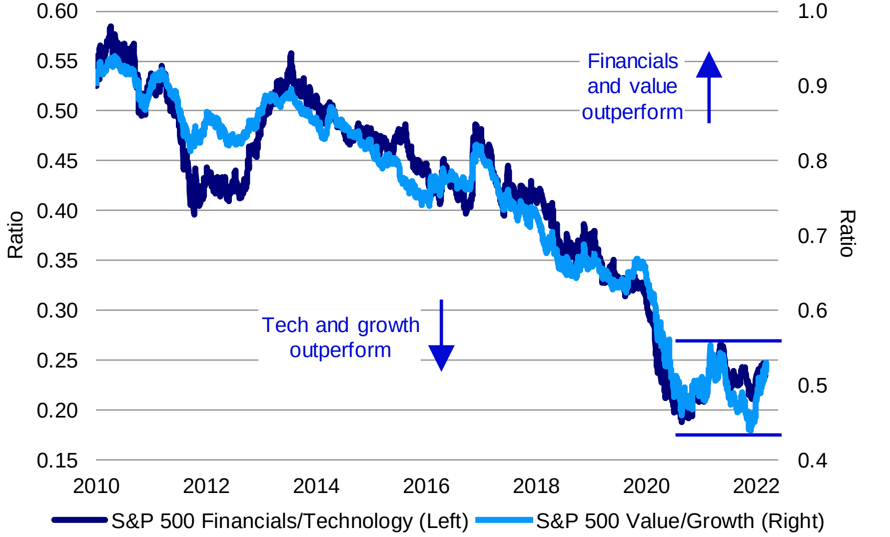
Where are we in the style cycle?

The Fed is guiding short interest rates higher to flatten the curve and cool down an overheating economy. Such an environment has typically favored growth over value.

Federal funds rate (dark blue, reversed) and 10-year minus 2-year US government bond yield (light blue) since 1986



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



Sources: FRED, Standard & Poor's, Invesco, 3/16/22. **Notes:** FFR = Federal funds rate. 2s10s UST yield curve = 10-year minus 2-year US Treasury bond yield. Shaded areas represent NBER-defined US economic recessions. An investment cannot be made in an index. **Past performance does not guarantee future results.**

Fed reaction

Back

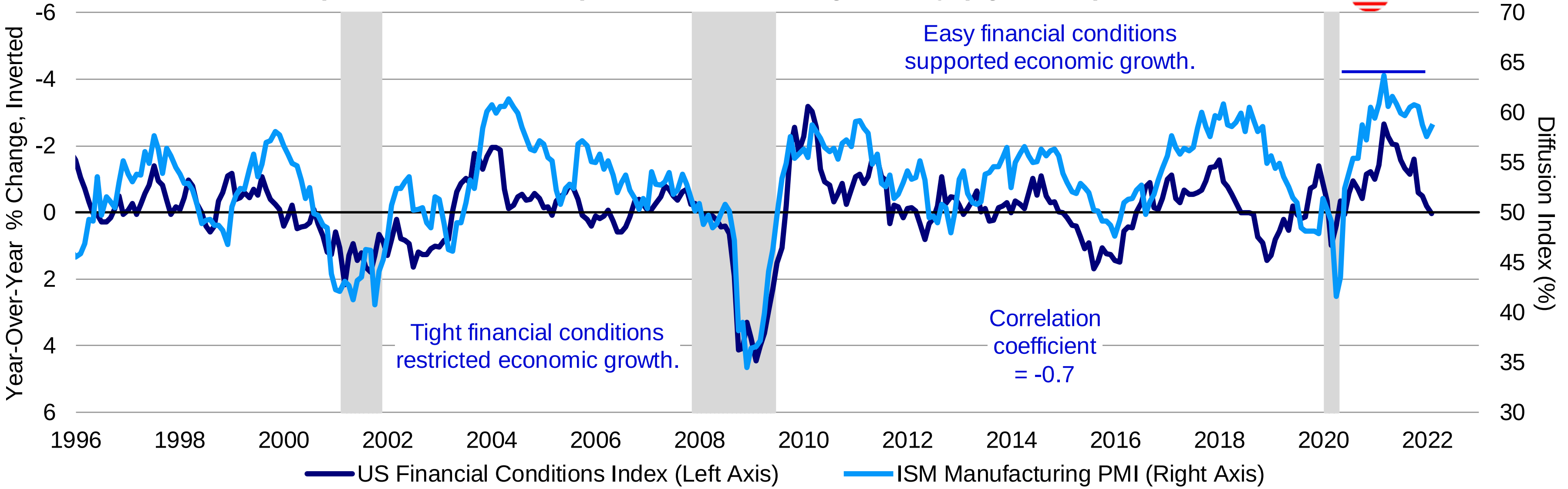
Don’t fight the Fed

2

How's the Fed reacting to inflation and a tight labor market?

US policymakers are starting to remove monetary support to cool down an overheating economy. Financial conditions are tightening.

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

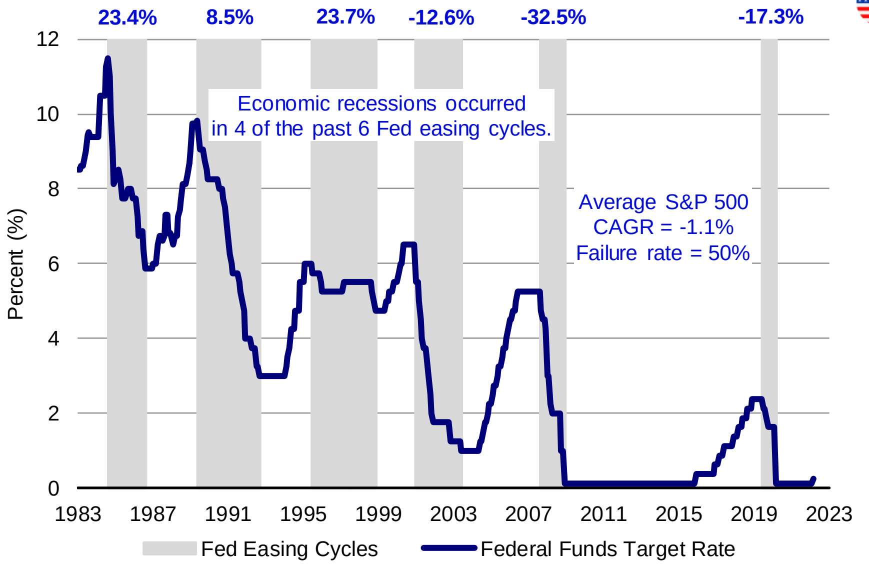


Sources: Bloomberg L.P., Goldman Sachs, Macrobond, Invesco, 3/1/22. **Notes:** The US Financial Conditions Index includes the federal funds rate, 10-year Treasury bond yield, BBB corporate bond spread, S&P 500 and US dollar. ISM = Institute for Supply Management. PMI = Purchasing Managers Index. NBER = National Bureau of Economic Research. Shaded areas denote NBER-defined US recessions. An investment cannot be made in an index. See page 34 for index definitions. **Past performance does not guarantee future results.**

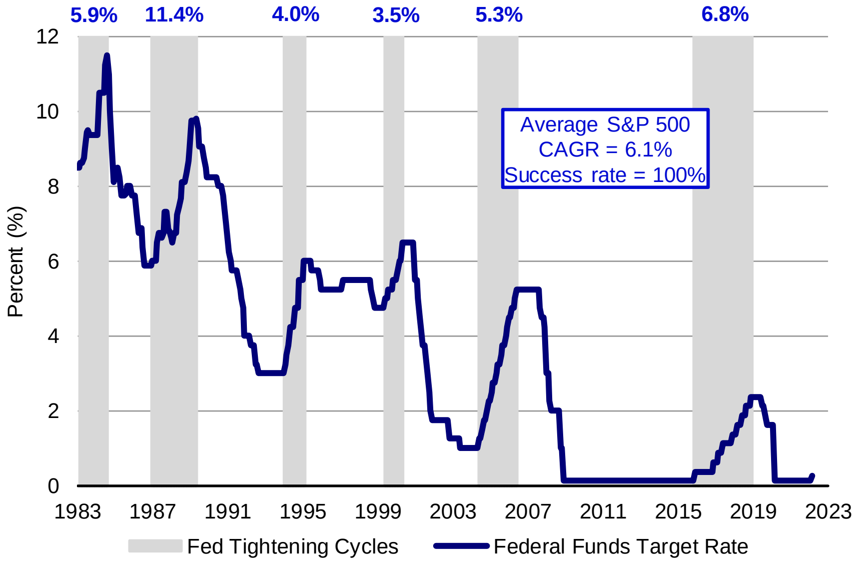
How did US stocks perform in past Fed tightening cycles?

Fortunately, the US stock market generally did better during Fed tightening cycles, which occurred in the second half of business cycles 67% of the time.

US equity performance (%) during Fed easing cycles since 1983



US equity performance (%) during Fed tightening cycles since 1983

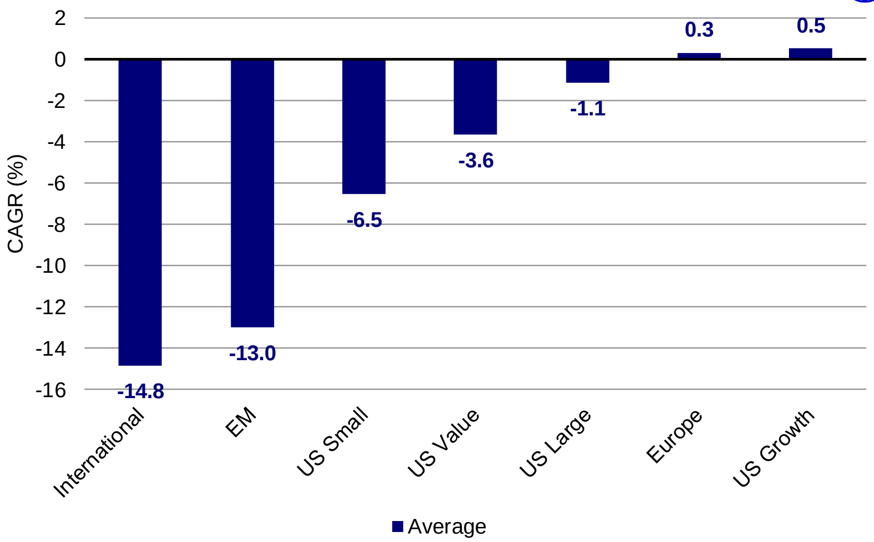


Sources: Bloomberg L.P., Invesco, 3/16/22. **Notes:** In the right chart, shaded areas denote Fed tightening cycles from first to last hike (1983-1984, 1987-1989, 1994-1995, 1999-2000, 2004-2006, and 2015-2018). In the left chart, shaded areas denote Fed easing cycles from first to last cut (1984-1986, 1989-1992, 1995-1998, 2001-2003, 2007-2008, and 2019-2020). CAGR = Compound annual growth rate. US stocks = S&P 500. Price returns in US dollars. See page 34 for index definitions. An investment cannot be made into an index. **Past performance does not guarantee future results.**

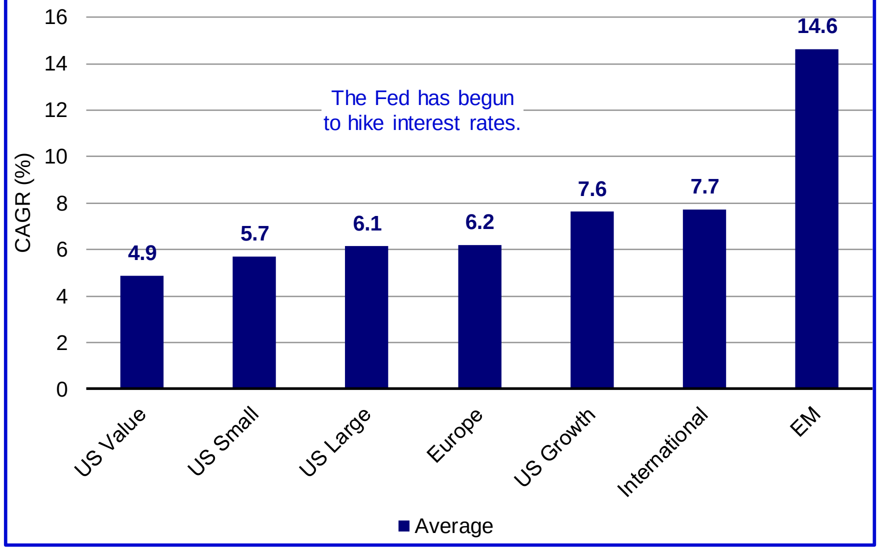
What about global equities?

Similarly, global equities generally did better when the Fed was raising interest rates.

Global equity performance during Fed easing cycles since 1983



Global equity performance during Fed tightening cycles since 1983

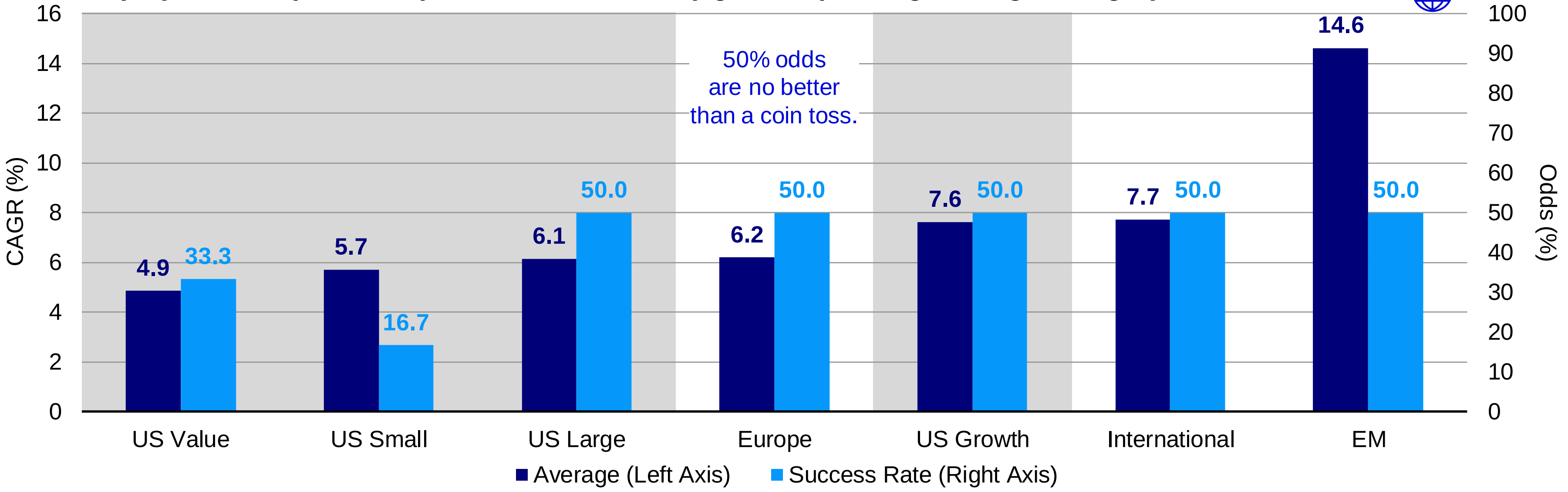


Sources: Bloomberg L.P., Invesco, 2/28/22. **Notes:** EM = MSCI Emerging Markets Index. International = MSCI ACWI ex USA. US growth = Russell 1000 Growth. Europe = MSCI Europe Index. US large = S&P 500. US small = Russell 2000. US value = Russell 1000 Value. Price returns in US dollars. See page 34 for index definitions. An investment cannot be made into an index. **Past performance does not guarantee future results.**

Was leadership consistent across categories?

On average, non-US stocks outperformed US stocks in Fed tightening cycles. However, no single category ranked in the top three more than 50% of the time!

Global equity returns (dark blue) and success rates (light blue) during Fed tightening cycles since 1983

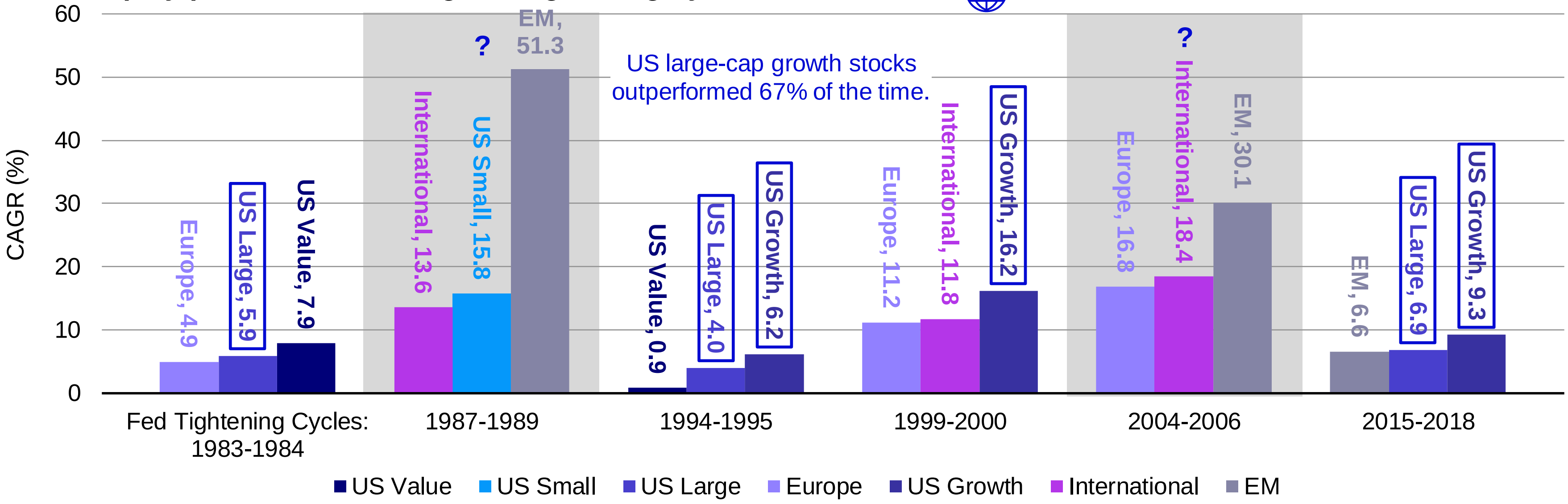


Sources: Bloomberg L.P., Invesco, 2/28/22. **Notes:** Success rate = Number of times each category ranked in the top three across six tightening cycles. Shaded areas denote US stocks. White areas denote non-US stocks. See page 34 for index definitions. An investment cannot be made into an index. **Past performance does not guarantee future results.**

How should investors position themselves in this Fed tightening cycle?

Change was constant across tightening cycles. But we expect US large-cap growth to resurface, given tighter fiscal and monetary policy coupled with slower activity.

Global equity performance during Fed tightening cycles since 1983

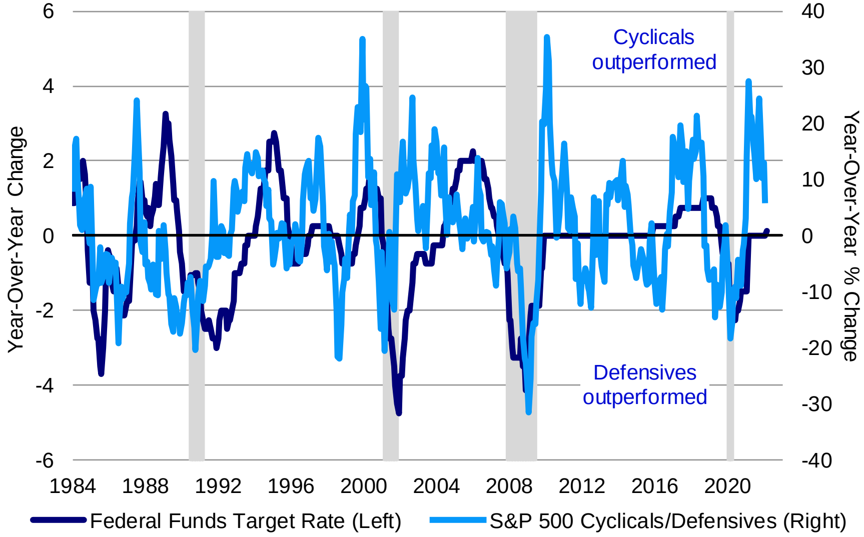


Sources: Bloomberg L.P., Invesco, 2/28/22. **Notes:** Shaded areas denote episodes when US large-cap growth underperformed. White areas denote episodes when US large-cap growth outperformed. See page 34 for index definitions. An investment cannot be made into an index. **Past performance does not guarantee future results.** These comments should not be construed as recommendations but as an illustration of broader themes.

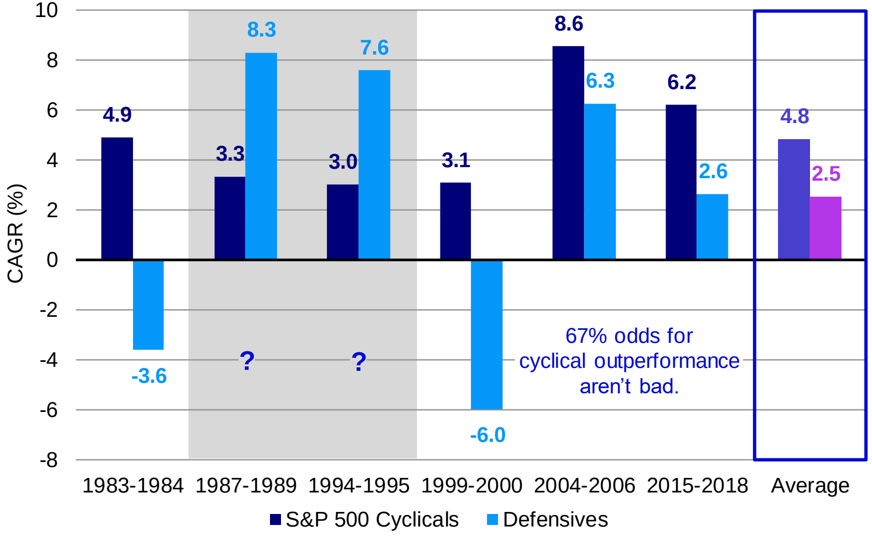
What about sectors?

US cyclical sectors outperformed their defensive counterparts in four of the last six Fed tightening cycles.

Federal funds target rate (dark blue) and the performance of US cyclicals relative to defensives (light blue) since 1984



US sector performance during Fed tightening cycles since 1983

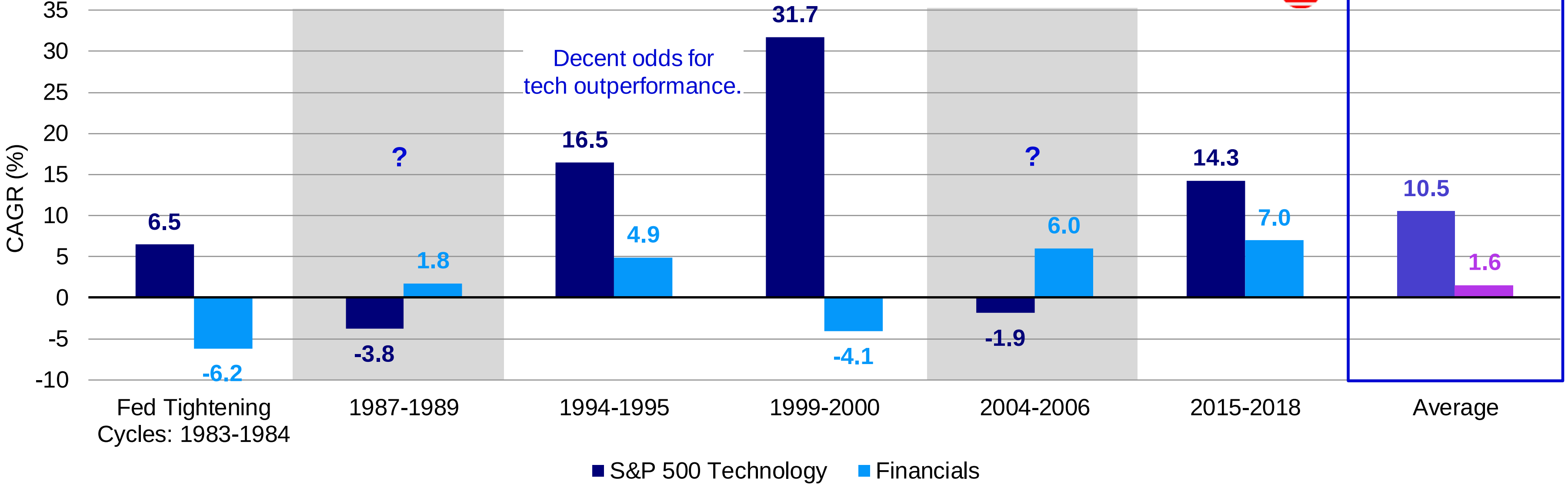


Sources: Bloomberg L.P., Invesco, 3/16/22. **Notes:** Cyclicals = S&P 500 consumer discretionary, energy, financials, industrials, information technology, and materials indices. Defensives = S&P 500 consumer staples, health care, telecommunication services, and utilities indices. In the left chart, shaded areas denote NBER-defined US economic recessions. In the right chart, shaded areas denote episodes when cyclicals underperformed defensives. White areas denote episodes when cyclicals outperformed defensives. See page 34 for index definitions. An investment cannot be made into an index. **Past performance does not guarantee future results.**

Within cyclicals, what should investors favor?

In Fed tightening cycles, tech (growth) outperformed financials (value) most of the time.

Tech (dark blue) and financial (light blue) performance during Fed tightening cycles since 1983



Sources: Bloomberg L.P., Invesco, 2/28/22. **Notes:** Shaded areas denote episodes when technology underperformed financials. White areas denote episodes when technology outperformed financials. See page 34 for index definitions. An investment cannot be made into an index. **Past performance does not guarantee future results.** These comments should not be construed as recommendations but as an illustration of broader themes.

Inflation cycle

Back

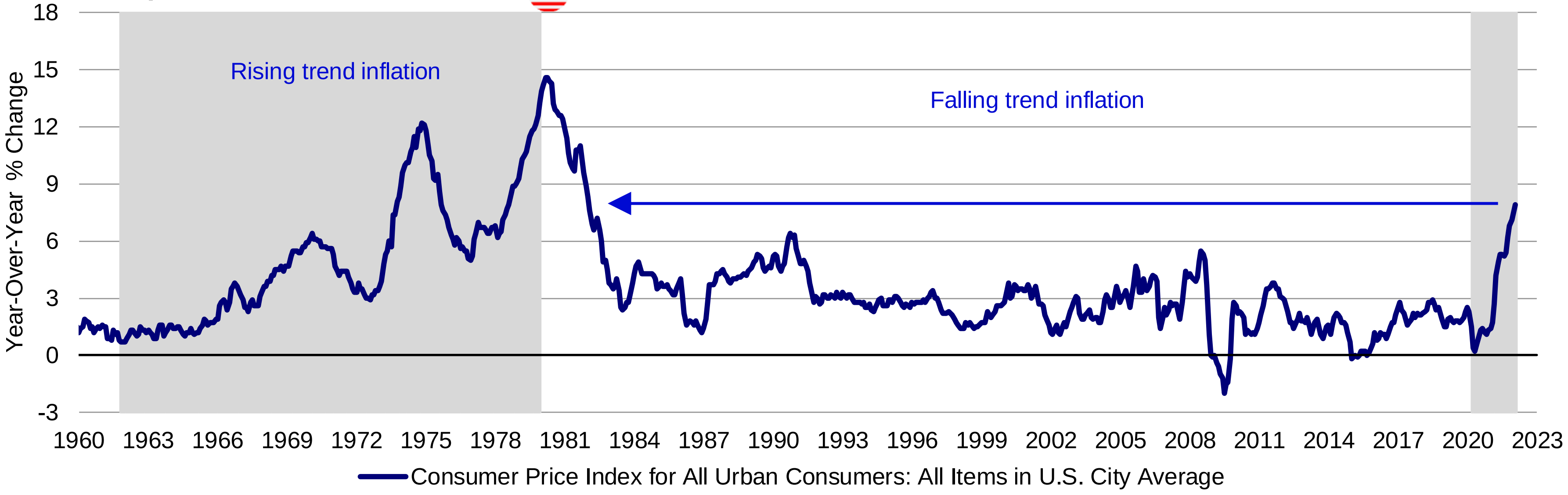
Signs of hope

3

Where are we in the inflation cycle?

In less than two years, inflation has accelerated to the fastest pace since the early 1980s.

Consumer price inflation since 1960

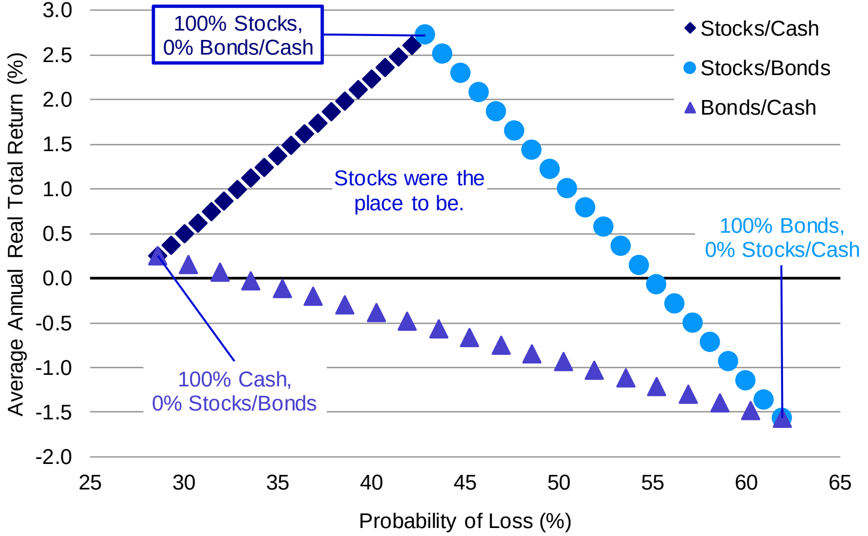


Sources: FRED, Invesco, 2/28/22. **Notes:** Shaded areas denote rising trend inflation. An investment cannot be made in an index. See page 34 for index definitions. **Past performance does not guarantee future results.**

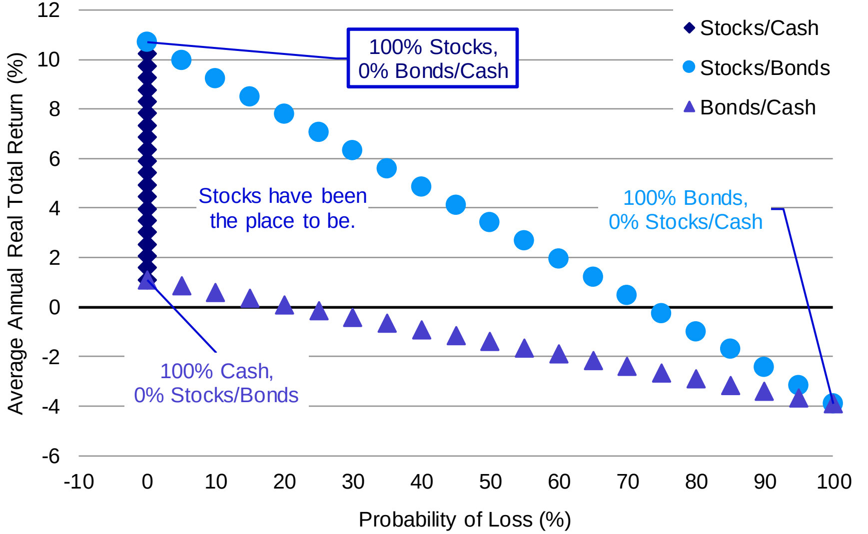
How can investors potentially protect themselves from inflation?

From 1960 to 1980, stocks were the place to be and may still provide some relative comfort to investors who are concerned about runaway inflation now.

Impact of consumer price inflation on stock, bond, and cash risk (x axis) and return (y axis) combinations from 1960-1980



Impact of consumer price inflation on stock, bond, and cash risk (x axis) and return (y axis) combinations in 2020

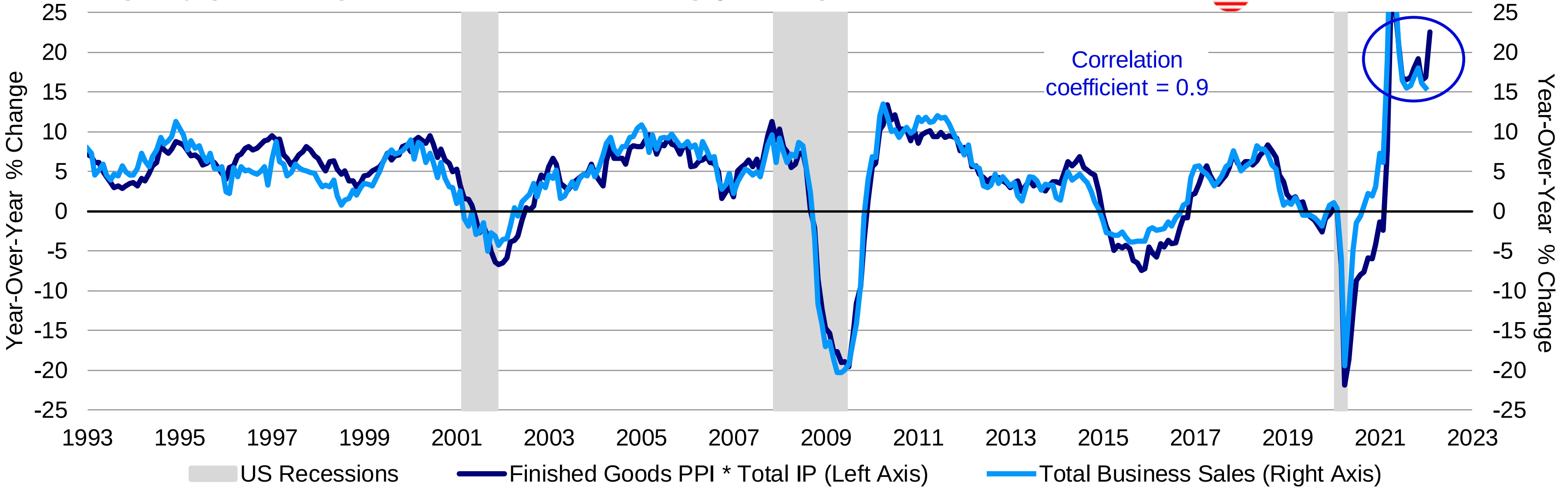


Sources: Barclays, CRSP, Invesco, 2/28/22. **Notes:** Horizontal axis – For a given unit of risk (loss), stocks provided better returns. Vertical axis – For a given return, stocks experienced fewer losses (less risk). An investment cannot be made in an index. **Past performance does not guarantee future results.**

Isn't inflation bad?

Silver lining – If it weren't for producer pricing power, total business sales would be advancing at a significantly slower pace.

Revenue proxy (dark blue) and total business sales (light blue) since 1993

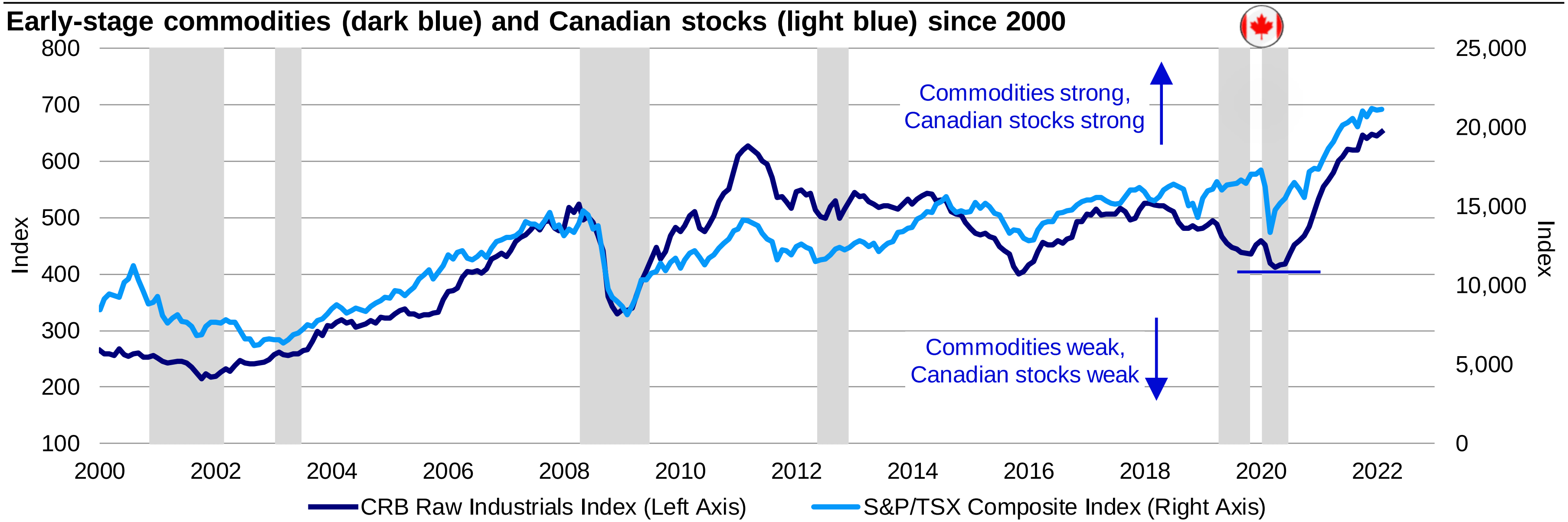


Sources: FRED, Invesco, 3/16/22. **Notes:** PPI = Producer Price Index. IP = Industrial production. Shaded areas denote NBER-defined US economic recessions. An investment cannot be made in an index. **Past performance does not guarantee future results.**

Outside the US, are there any other inflation beneficiaries?

Canadian stocks tend to do better when commodities are rising (one form of inflation), as has been the case since early 2020.

Early-stage commodities (dark blue) and Canadian stocks (light blue) since 2000

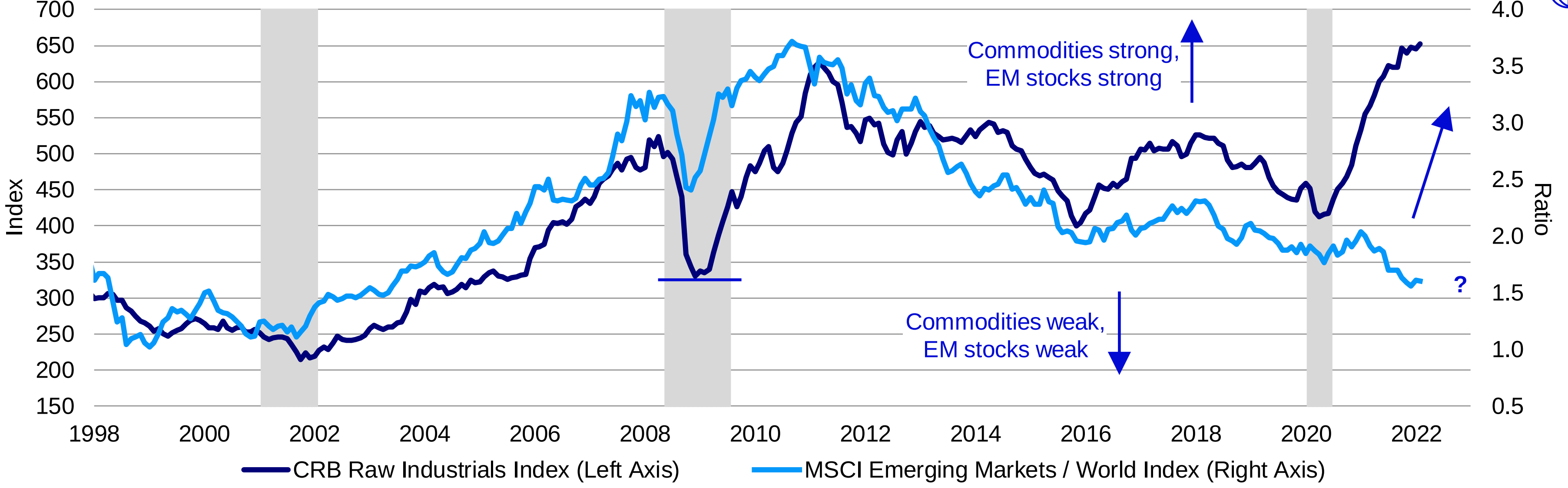


Sources: Bloomberg L.P., Invesco, 2/28/22. **Notes:** CRB = Commodity Research Bureau. S&P/TSX Composite price index in Canadian dollars. Shaded areas denote global manufacturing contractions. See page 34 for index definitions. An investment cannot be made directly in an index. **Past performance does not guarantee future results.**

What about emerging markets?

Emerging markets usually outperformed developed markets when commodity prices were rising. But EM stocks have overreacted and may be poised for a meltup.

Early-stage commodities (dark blue) and emerging relative to developed market stocks (light blue) since 1998

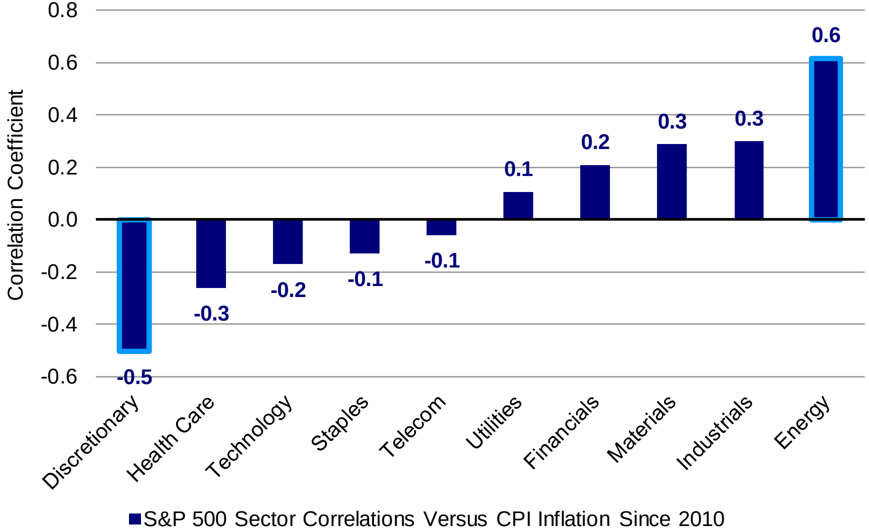


Sources: Bloomberg L.P., FRED, Invesco, 2/28/22. **Notes:** CRB = Commodity Research Bureau. EM = Emerging markets. Developed markets = MSCI World Index. MSCI EM and World price indices in US dollars. Shaded areas denote global all-industry contractions. See page 34 for index definitions. An investment cannot be made directly in an index. **Past performance does not guarantee future results.**

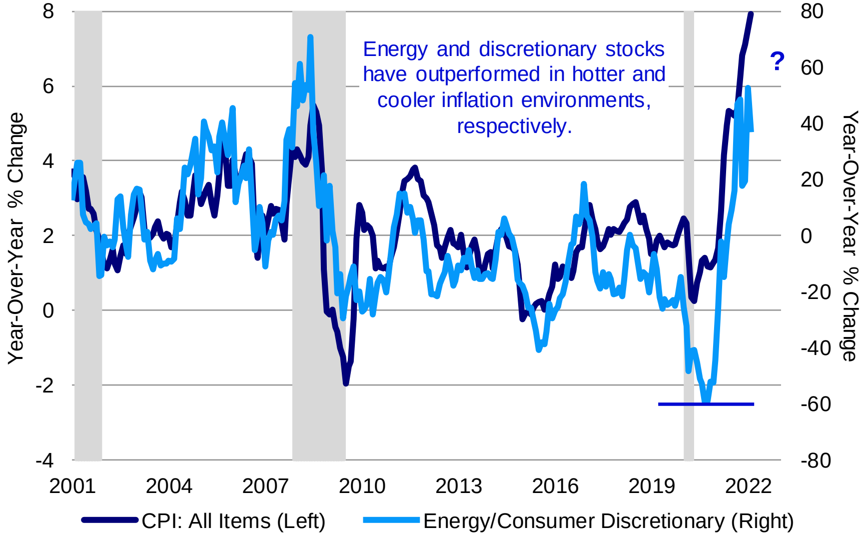
What about sectors?

Pair trade – Energy stocks have been inflation beneficiaries; consumer discretionary stocks have been inflation sensitive.

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

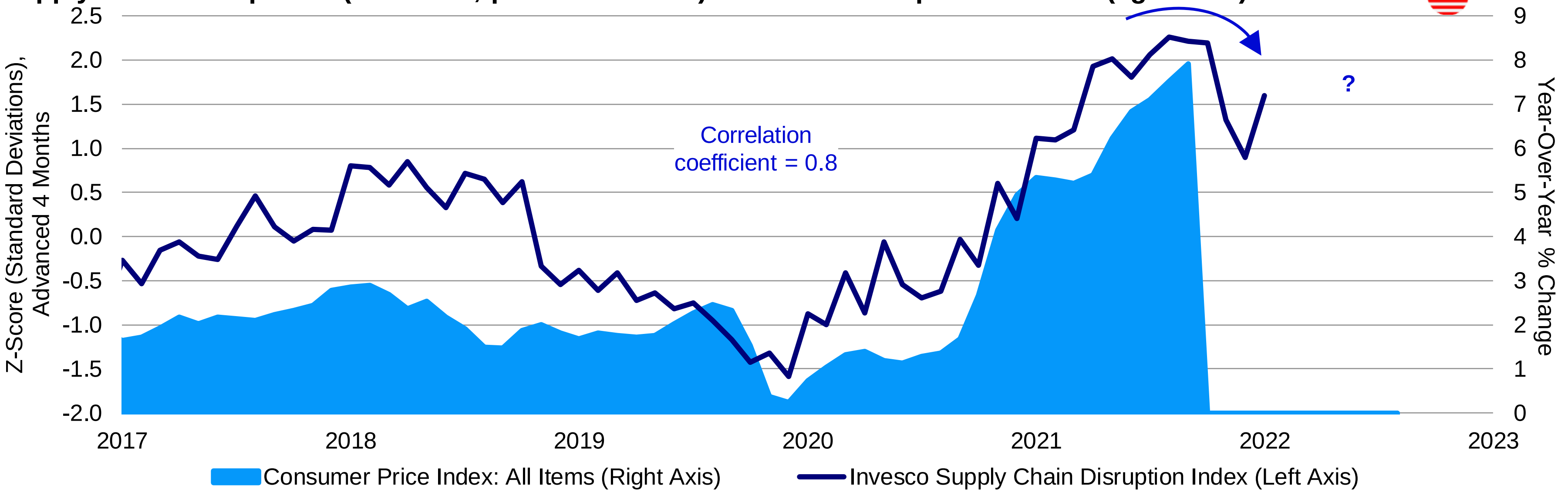


Sources: Bloomberg L.P., Bureau of Labor Statistics, FRED, Standard & Poor's, Invesco, 2/28/22. **Notes:** When the CPI accelerated / rose, the S&P 500 Energy sector outperformed. When the CPI decelerated / fell, the S&P 500 Consumer Discretionary sector outperformed. An investment cannot be made in 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. Don’t overstay you’re welcome in energy stocks.

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, 3/3/22. **Notes:** Our Supply Chain Disruption Index (SDI) includes the Institute for Supply Management (ISM) manufacturing and services supplier deliveries, backlog of orders, and inventories; the Baltic Exchange Baltic Dry Index (BDI) which is a composite of the dry bulk timecharter 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.**

Positioning

Back

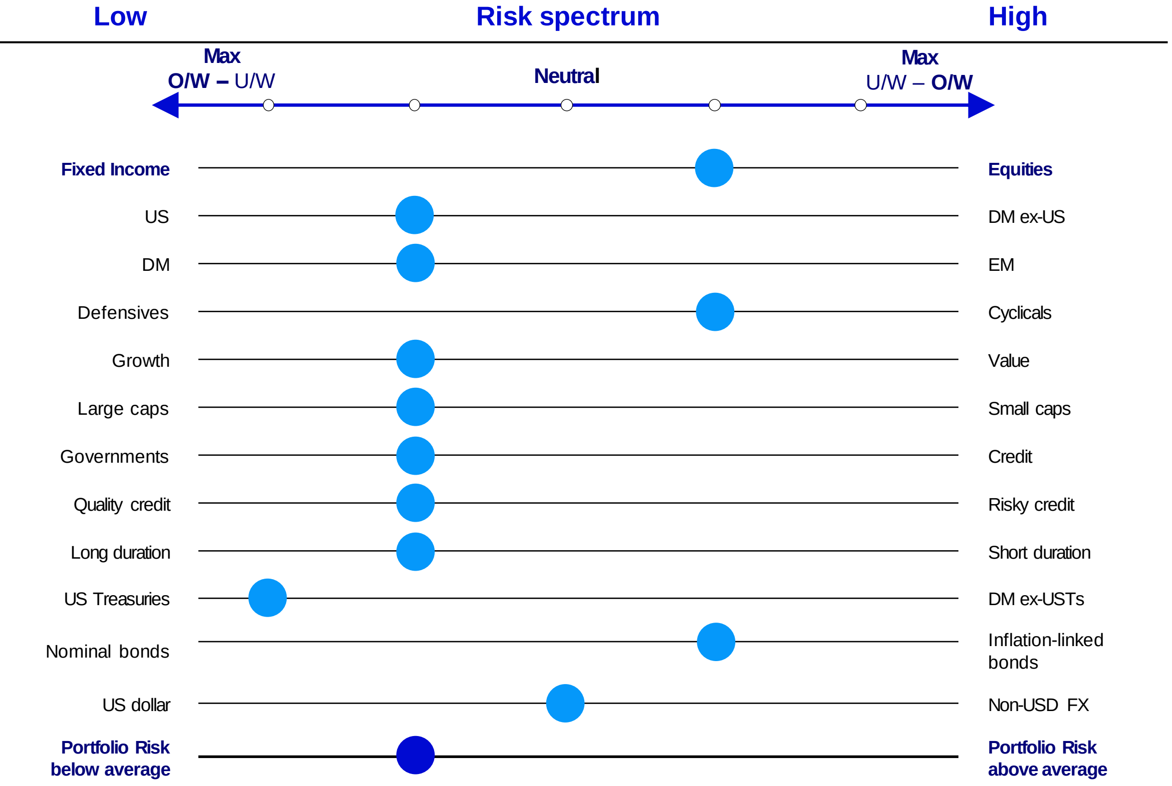
US high-quality, large-cap growth stocks

4

Tactical asset allocation positioning

Reducing risk, with a bias toward US high-quality, large-cap growth stocks

- **Risk:** Reducing portfolio risk while maintaining a modest overweight to equities and cyclical sectors. Amidst slower growth and tighter policy, we expect higher volatility and a convergence of returns across asset classes.
- **Equities:** Favoring the US with a bias toward high-quality large-cap growth, partially owing to stable to lower long-term bond yields.
- **Fixed Income:** Overweighting US Treasuries and duration. We expect higher rates up to intermediate maturities, but stable to lower yields at the long end of the yield curve.
- **FX**: Neutral.



Source: Invesco, 2/28/22. **Note:** For illustrative purposes only.

Addendum: Pandemic

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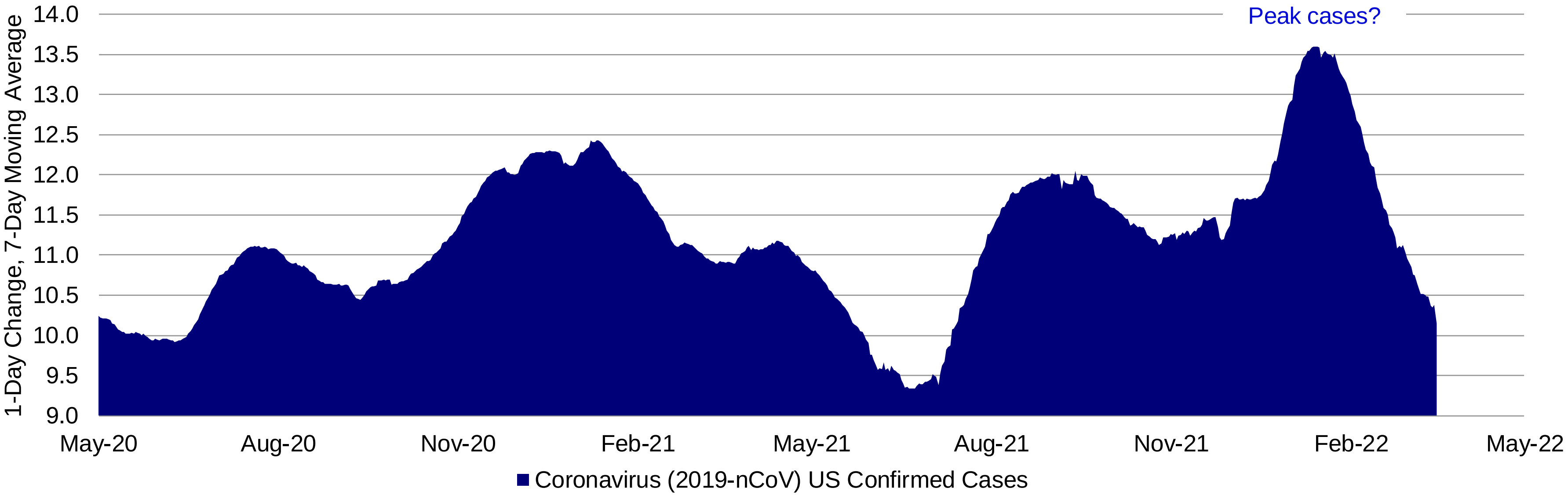
Signs of hope

5

What about the virus?

Despite our worst fears about the omicron variant, coronavirus cases have declined sharply in the US.

US coronavirus cases since 2020



Sources: Bloomberg L.P., Invesco, 3/16/22. **Notes:** Confirmed coronavirus (2019-nCov) case counts compiled by Bloomberg Newsroom. Counts are subject to change as governments survey and confirm cases. Data are based on reported values as of midnight EST. The coincident case count is shown on a natural log scale. See page 34 for index definitions. An investment cannot be made into 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.

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*_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.

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