



August 1st, 2022

Trying to Keep an Open Mind

- **Equity market rally discounts a re-run of the Goldilocks scenario**
- **We accept the idea that US inflation may be peaking but we fear it will be sticky at around 5%.**
- **We struggle with market's pricing that the Fed funds rate will peak at the turn of the year**
- **US corporate earnings are OK but with weak momentum. Later quarters will be much more challenging**
- **Global credit market rally mirrors equities and carries the same downside risk**

The past two weeks have seen a sharp surge in equities with investors taking the view that bad macroeconomic news is good news for markets. That view is built on the premise that if growth data is poor, the Fed will back off from raising interest rates. While we take exception to such a view, we also understand that it's wrong to outrightly dismiss this notion when it has served investors well in the past.

The global growth backdrop to markets remains weak and market movements of late have often reflected the investors' predicament. In fact, last week appeared to be a microcosm of recent years. Last week the US reported its second consecutive quarter of negative GDP growth, implying a technical recession. However, we tend to take the early estimates of GDP growth with a pinch of salt as they are often subject to revisions. Moreover, technical indicators aside, it doesn't look like the US economy was facing recessionary pressures in the first half of the year. But there's no denying the fact that there are headwinds. Latest data for capital investment, for instance, was particularly weak in the second quarter, reinforcing the view that companies continue to remain cautious. Corporates are facing an acceleration in employment costs with the employment cost index up above expectations at a 6% annualised rate.

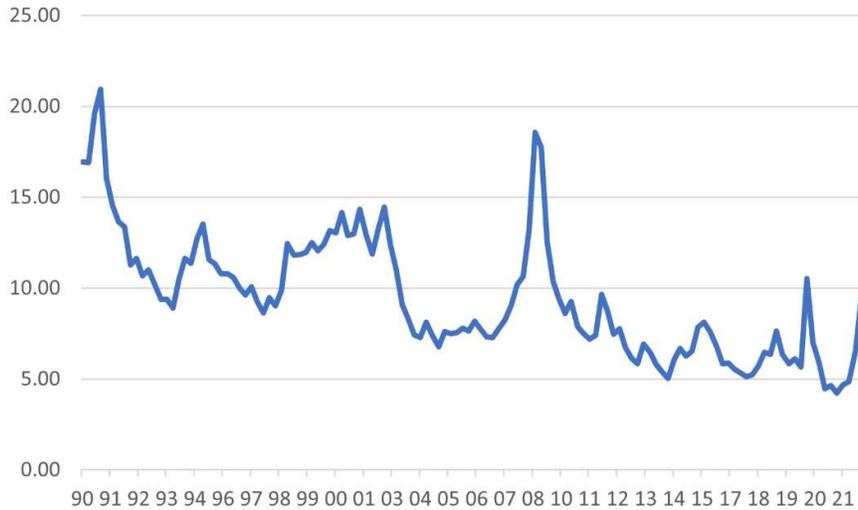
In our view, the downside to maintaining a tactically cautious stance on risk assets is that inflation abates in the coming months – as it is almost certain, too – and the market interprets it as giving the Fed an opportunity to pull back from further meaningful tightening. However, it is worth emphasising at this point that while there is significant support for the notion that inflation will indeed abate, there is also a strong body of economists expecting US inflation to remain sticky at around the 5-7% level. If US inflation indeed hovers around even 5%, it is difficult to see the US Fed funds rate peaking at just 3.5%.

US corporate earnings reports are also open to interpretation. They can be best summarised as better than feared but with weak momentum. Approximately half of the S&P 500 companies have already reported earnings, with 67% of them beating second-quarter earnings projections. However, this compares with an average of 79% of companies that have typically beaten earnings estimates in the previous four quarters. At just 0.8%, the scale of the earnings beat this time is starkly more modest than the normal average of 11.2% seen over the previous four quarters. The positive surprises are also concentrated in a handful of sectors such as staples, energy and healthcare.

The better-than-expected US corporate profits have also not led to upgrades to full-year profit forecasts. Indeed, aggregate earnings forecasts for the full year are down 0.65% and estimates for 2023 have fallen 1.2%.

After the Fed increased interest rates by 75bps, it seems quite extraordinary that US 10-year yields that have fallen as low as 2.60% level. We still worry that the Fed may have much more work to do than is implied in market pricing of future level of Fed policy rates. The market expects the Fed to be cutting interest rates through much of 2023. A peak in policy rates at around 3.5% and then declines to 2.5% by the end of 2023 represent a very benign perspective of how the inflation story will work out. In particular we don't see how a 2.60% 10-year bond yield represents value if inflation hangs around the 5% level.

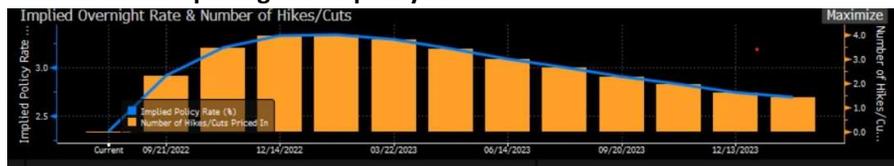
Chart 1: Global High Yield Bonds Yield to Worse



Source: Bloomberg

The rally in the credit markets is also challenging to square with the likely risk of defaults in the coming year. However, we also understand why investors were tempted to buy global high yield at around 9%, even optically, such a yield level looked attractive. But, the difficulties in the global economy have barely started, and defaults will surely rise. The real trouble in global high yield sees yields up to 18% (Global Financial Crisis) and 14% (Global economic demise in 2000-2002). It goes back to how this cycle will play out. If it's 'normal' with policymakers supportive and in control, then yields approaching 10% would be attractive. However, the word normal doesn't seem to ring true when you see inflation at close to double-digit around the world, fiscal policy tightening and central banks cutting quantitative easing and raising interest rates.

Chart 2: Market pricing of Fed policy rates



Source: Bloomberg

Gary Dugan
Johan Jooste
Bill O'Neill (Consultant)