



August 15th, 2022

Are Things Really That Good?

- **Better than expected US inflation precipitates another leg of an equity market rebound**
- **Underlying US inflation picture still a concern for economists**
- **Much lower growth and higher inflation still point to a very challenging environment ahead**
- **It's too easily forgotten that the Ukraine war is ongoing and its impact could worsen as we move into the winter**
- **We retain our caution. Preferring tactically credit over equities for new cash deployment**

Judging by the performance of the US equity markets over the past ten days, I'm sure many investors are questioning the rationale behind the surge. Given the difficult macroeconomic background, it's indeed intriguing how markets can stage such a sharp rally.

Interestingly, a very recent AAll survey shows individual US investors are in quite a quandary about the market's future direction – the survey shows 32.2% of the investors are bullish, 31.2% neutral, and 36.7% negative about the market's direction over the next six months.

It's time for a bit of a medium-term perspective and some sober thoughts.

We have put together a dataset to show the contrast between where we were about eight months ago and where we are today (Table 1). Put simply, the prospect of growth is much more dismal today than what was forecast earlier – for much higher interest rates. Let's also not forget the significant geopolitical disruption caused by the Ukraine war and the recent sabre-rattling over Taiwan that has reversed globalisation.

Table 1: What's changed? – Quite a lot!

	31 st Dec 2021	12 th Aug 2022	Change
US Inflation	7.0%	8.5%	+150bps
US 10-year	1.51%	3.28%	+177bps
US 2-year	0.73%	3.24%	+251bps
Brent (\$bbl)	\$77.1	\$98.2	+27.4%
Global High Yield (YTW)	4.85%	8.11%	+326bps (-11.7%*)
S&P500	4766	4280	-10.2%
MSCI World (\$) Index			-11.4%
ISM Manufacturing (Index)	58.8	52.8	-6.0
ISM Services (Index)	62.3	56.7	-5.6bps
US unemployment	4.23%	3.60%	-0.63bps
US 30-year mortgage rate	3.27%	5.53%	+69%
Consensus US GDP forecast 2022	3.90%	1.10%	-280bps
Consensus US GDP forecast 2023	2.50%	1.10%	-140bps

Source: Bloomberg

* year-to-date return

US inflation was already hovering near 7% at the end of 2021, but the bond market didn't want to believe it would persist, let alone go higher. After last week's better-than-expected inflation data, US inflation is only 150bps higher than the level at the start of the year. However, it just shows how much investor perspective has changed recently. Two or three years ago, a 150bps increase in inflation would have been seen as a significant achievement to pull the US out of a risk of deflation. Today, even though the last US inflation data surprised on the downside, it is still at a highly elevated level compared with history, and that's worrying the Fed.

Despite better-than-expected inflation news from the US last week, the consensus view from economists afterwards was that we shouldn't read too much into it. While noisier items in the inflation basket such as gas and airfares ticked down, other stickier core parts of the basket remained uncomfortably high. Moreover, other indicators of future inflation are also worrying for the Fed. The Atlanta Fed wage tracker still shows implied wage growth of 7%. Producer price inflation is running at 11.3%, pressuring corporate margins.

The bond market initially ignored the inflation threat that built up slowly last year. However, bond yields have risen significantly higher since. While yields have come back from their rather low levels, but as a measure of the risk of higher inflation and the damage it could do to the global economy, global high yield bond yields have risen over 300bps.

From the equity market peak in December 2021, the consensus US GDP forecast for 2022 has fallen 2.8 percentage points. The current growth forecast of just 1.7% looks miserable compared with the vibrant economy implied by the growth estimates of 3.9% at the start of the year. Consensus growth forecasts for 2023 haven't witnessed an equally dismal fall, but they are still near the 1.1% level for the year.

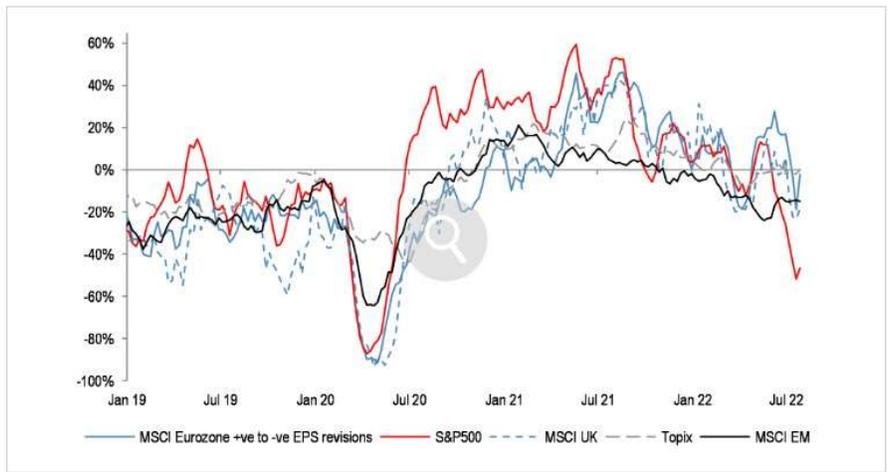
Chart 1: Consensus US GDP Forecasts on the slide



Source: Bloomberg

With such tepid prospects for growth, how can corporate earnings still be holding up? To be honest, the headline that US corporate earnings held up well in the first quarter was a bit of a misrepresentation of facts. While the energy sector accounted for much of the surprise, other sectors were not so vibrant. Indeed, although the aggregate US quarterly earnings beat expectations (as they always do), analysts have been busy cutting their earnings forecasts for 2022. The US indicator of the ratio of upgrades to downgrades for the S&P500 companies' earnings has fallen sharply. The positive-to-negative EPS revisions ratio has fallen to -50% from +40% at the start of the year.

Chart 2: Earnings revisions by region – US on the slide



Source: IBES and JPMorgan

It is important to bear in mind that inflation can severely distort the apparent financial health of companies. Higher inflation levels can also lead to the illusion of strong profit growth. It is the phenomenon of stock profits. As inflation picks up, companies react by increasing prices. Companies benefit by buying inventory cheaply and selling at inflated prices. If we go back to the 1970s, the UK accounting standards board was set to introduce SSAP16 to account for inflation so that companies would not overstate their profits (See Exhibit 1). However the moderation of inflation led to the mothballing of the accounting standard shortly after.

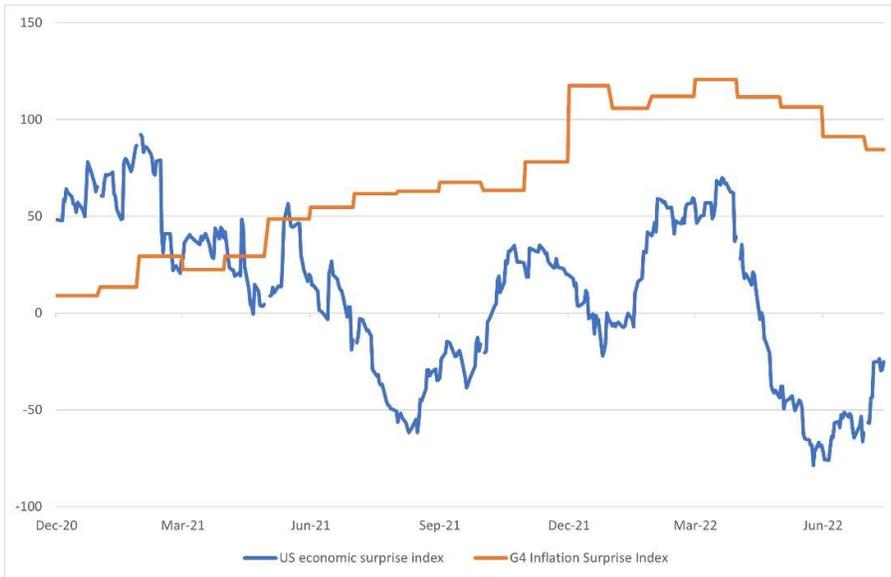
Exhibit 1: A Snapshot of UK Accounting Standard for inflation (Proposed late circa 1970's)

SSAP16 requires physical assets to be revalued, generally to current cost, in the balance sheet, while the profit and loss account is to include:

- a charge for depreciation based on the current replacement cost of fixed assets;
- cost of sales at the current value of goods consumed;
- provision for the additional funds needed to finance the increase in the net trade debtors of the business arising from inflation (or the corresponding gain where the business is a net recipient of trade credit);
- a gearing adjustment to reflect realised gains arising from inflation made by the equity shareholders of the company at the expense of lenders [specifically, that proportion of the total of inflation adjustments for depreciation, cost of sales, and net trade debt (credit), which the net borrowing represents of the net operating assets at current cost].

So, when we reflect on the market backdrop, we must ask ourselves if that squares with the 15% rally in the markets, leaving equities down only about 10% for the year? It's worth recalling that the S&P500 rallied by close to 15% between March and June 2008 before witnessing that dramatic plunge. Having said that, the **momentum of news flow has improved of late**. The US economic surprise index bottomed at a level of -79 and has since recovered to -25. The G4 inflation surprise index that was at +120 has 'recovered' to +84. The momentum of news flow does have an impact on markets over short time frames. We would also reiterate here that we are just over six months into the Ukraine war that disrupted the global economy. Therefore, it is still far too early to say that we have seen the full impact of the war on global growth and inflation. Europe, for instance, is still waiting with trepidation to see what the energy situation will be in the winter, with the prospect of significant disruption to energy supply and a further increase in energy prices looming large. Also, the impact of higher interest rates will build only slowly. No one could argue that the nearly 70% increase in the US mortgage rate will not significantly impact the housing market there.

Chart 3: US economic growth and G4 Inflation surprise indices



Source: Bloomberg

We retain our cautious stance. An equity market rally does not change the market fundamentals. Investors that need to commit capital market should look tactically to credit markets rather than equities at this juncture.

Gary Dugan
Johan Jooste (Consultant)
Bill O'Neill (Consultant)