Sept 26th, 2022

The Great Reckoning

- **Central bank meetings highlight their determination to raise rates substantially to control inflation risk**
- **Bond market repricing to catch up with central bank aggressiveness**
- **Equities have still to price the recession risk and the likely persistence of higher interest rates**
- **Worst case scenario – S&P500 plunging 25% from here**

Gone is the bravado of the equity market that was often characterised by investors' 'buy the dip' mentality; gone is the Fed put. Markets are now at the mercy of the fundamentals, which don't look pretty.

Policymakers are all at sea: Central bankers are no longer your friend—if you considered them one. The Fed is determined in its resolve to control inflation, even if that means pushing the US economy into a recession. The conclusion from last week's Fed meeting is that we are staring at the prospect of a possible fed funds rate of 5%.

The Bank of England's policy-making committee, already grappling with the task of controlling massively high inflation, is now staring at a profligate government policy. The UK government's most significant economic experiment in 30 years appears to be devoid of any economic sense. The market expects UK rates to rise to 5.5% by the middle of next year.

The Bank of Japan (BoJ) is doing nothing but leaving rates at zero and the yen to the wolves. The bank's attempt last week at currency intervention to stabilise the yen was too late and, frankly, lacked global coordination or conviction.

Back in Europe, the European Central Bank is employing a rear-guard effort to tame inflation with relatively blunt tools amidst significant geopolitical challenges. The market expects ECB rates to rise to 3% by the middle of next year.

Governments can't stop racking up debt without risking their credibility
Funding higher government deficits is no easy task, particularly if central banks stop quantitative easing or put it into the reverse with quantitative tightening. A country's cost of financing debt has risen significantly with the substantial rise in long-term interest rates. When sovereign debt is redeemed and refinanced at these higher interest rates, the total interest outlay of the country shoots up. For example, the US 10-year government bond yield is currently 70% higher than where it has been on average over the past ten years. According to the latest baseline of the Congressional Budget Office, the federal government will spend $400 billion on interest payments on the national debt this fiscal year. That's equivalent to over 8% of all federal revenue collections and roughly $3,055 per household.

By and large, we do not expect governments to deliberately expand fiscal policy to support their economies—unless it is the UK government, which last week announced the most significant budgetary experiment in three decades. As former US Treasury Secretary Larry Summers put it, the UK government's budget is "naïve wishful thinking".

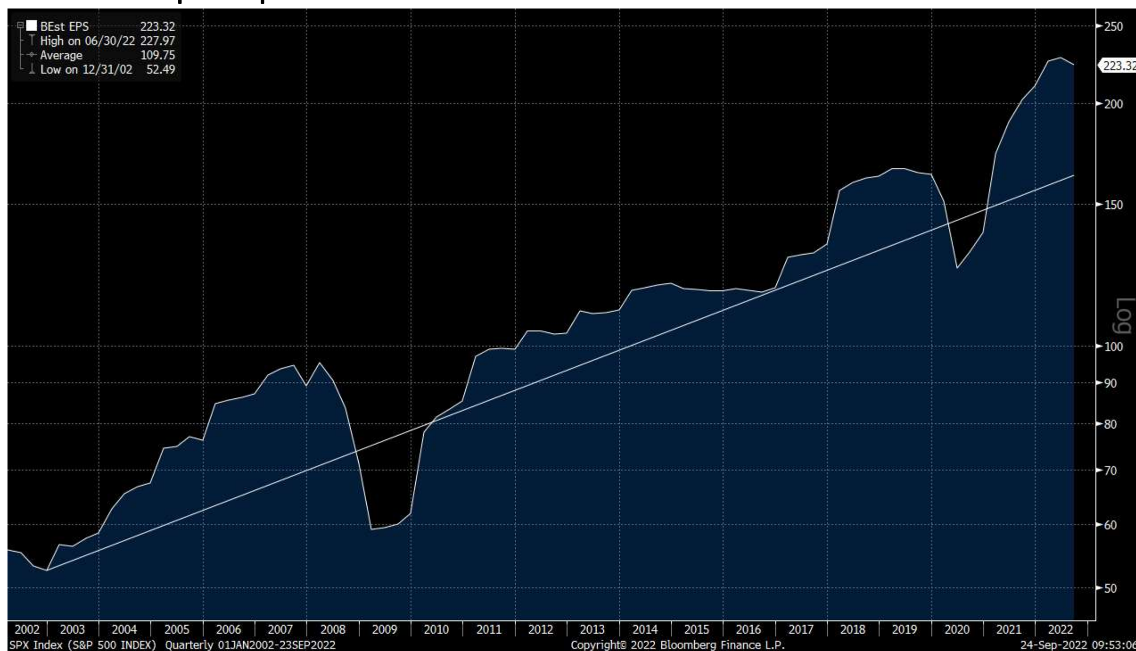
In the US, President Biden's Inflation Reduction Act aims to reduce government spending by $300bn. Although, within a few weeks of the act being signed into law, President Biden introduced a student debt forgiveness programme that cost the exchequer $500bn. Despite these measures though, the idea that the US will indulge in a relief budget looks far-fetched.

Past equity and bond market performance was built on sand

The markets appear on course to a repricing back to fair value. During this period and in the absence of fire breaks, resetting economies and markets will be painful. We need to take the readers back to fundamentals or issues we have been worried about for the past three years.

US corporate profits are well off the trend line and look set to retrace some extraordinary gains. Chart 1 shows the recent trend in corporate profits, and the anticipated level of corporate profits is well off the long-term trend line (note it is a log scale that shows true trend growth). The extraordinary profit growth seen before 2007 was built on heavy bank leverage and a housing boom, which was reversed during the global financial crisis. The surge in 2018-19 was because of an extraordinary tax break gift from President Trump that was never paid for. In early 2020, COVID hit and then there was a further extraordinary fiscal boost that, again, is unsustainable.

Chart 1: **US corporate profits are well above trend and are set to correct**



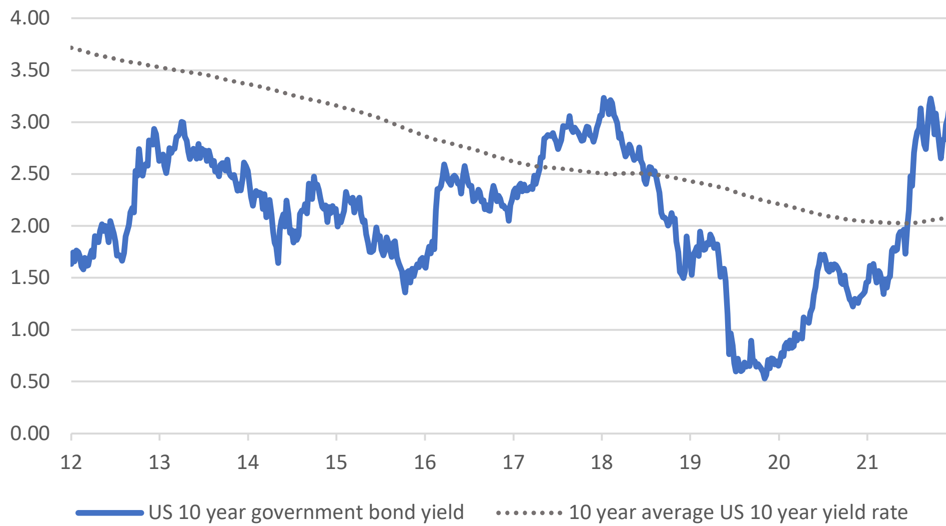
Source: Bloomberg

The US and other major economies face a significant risk of inflation amidst depleted growth prospects, which will inevitably bring corporate profit forecasts down. To date, earnings forecasts in the US have hardly moved despite building in the bad news. Unfortunately, analysts are unlikely to downgrade until companies tell them, which will be too late for investors to respond. Share prices will reprice immediately and potentially violently.

In such a scenario, the risks to the performance of the equity market are two-fold: firstly, corporate profit forecasts will fall and secondly, there will be a sharp rise in the discount rate of corporate profits. Markets witnessed high P/E multiples because of extraordinarily high profits and extremely low interest rates. The US 10-year government bond

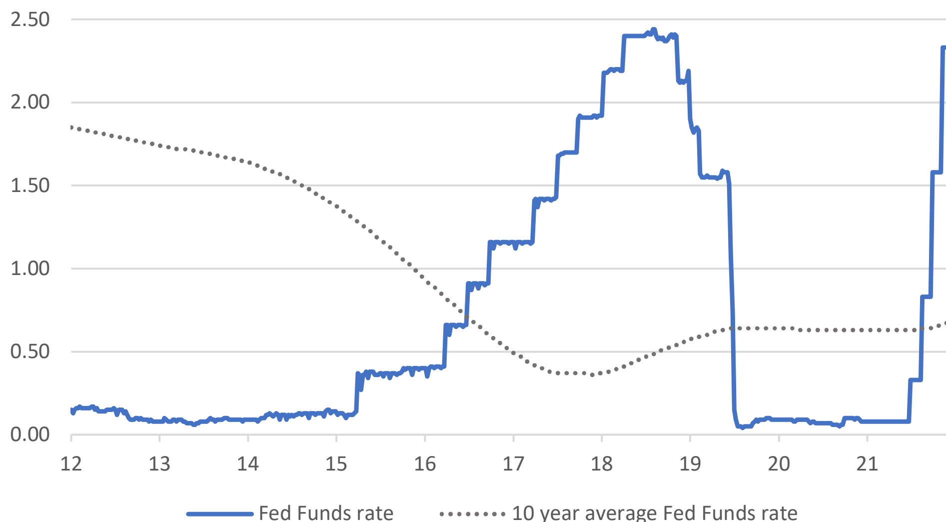
yield has averaged around 2.0% over the past 10 years, but that average is nearing 4.0% at present. The fed funds rate has averaged approximately 0.7% during this period but appears to be settling at about 3.0% into the future.

Chart 2: Challenge to equity market valuation – US 10-year government bond yield is well above the long-term average and likely to stay there for an extended period



Source: Bloomberg

Chart 3: Challenge to equity market valuation – fed funds rate well above the long-term average and likely to stay there for an extended period



Source: Bloomberg

Let’s just make a few assumptions here and start with what we consider to be the Fed's neutral rate, for the Fed funds rate which has been a moving feast anyway. With so much inflation around at present, we believe the rate to be neutral at around the 3.0% level. If we add in a normal risk premium for the 10-year bond yield of 1.5%. Hypothetical we solve for a 4.5% US government bond yield.

A US policy rate of 3.0% and a government bond yield of 4.5% must attract funds away from equities. The P/E multiple of the S&P500 today is 18.1x current earnings. Such a high PE multiple looks unsustainable into a likely recession and some of the highest cash and bond yields seen in some time. We would target a P/E multiple of 15 and a fall of 10% in corporate profits. **This would solve for a further 25% drop in the US equity market to around 2800.** That would take us to levels halfway through the COVID sell-off. We would characterise this as a worse-case outcome.

Chart 4: US S&P500

Source: Bloomberg

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