September 20th, 2022

Sapping Confidence

- **US inflation stronger at the core and widespread**
- **Equities and bonds vulnerable to breaking into new weaker territory**
- **First signs for the US corporate results season unnerve the market**
- **Fed and Bank of England look set for 75bps rise in policy rates**

Last week's equity market action made it amply evident that investor confidence continues to be on the wane. In these troubling times, when equities have struggled to find a bottom, we doubt 'the Federal Reserve meeting scheduled this week will provide any respite – or a decisive direction – to the markets.

FedEx failed to deliver hopes…

If there were hopes that the economic challenges facing the market will blow over sooner rather than later, FedEx's results last week served as an important wake-up call that the challenges are here to persist. FedEx, a bellwether of global economic health, announced a profit warning for its quarterly results. The company pointed to particular weakness relative to its targets in Asia and Europe and said that it was seeing an overall decrease in shipping volumes. Analysts were quick to cut their estimates on the company aggressively, with consensus earnings forecasts plummeting around 45% based on the company's revenue and profits guidance.

…but all's not lost

A bit of good news here. While one may feel inclined to take a pessimistic view post FedEx's warning, some other global logistics companies have not had such a bad story to tell, at least until recently. Market commentators cite the case of UPS and DHL, both of which have seen their businesses hold up relatively well, at least to date. While FedEx's business model may have made it more susceptible to a global slowdown, the company may ultimately end up proving to be an early signal of a challenging third-quarter corporate results season.

We have said in recent weeks that the US equity market was already creaking under the weight of a higher discount rate marked by the increase in both short- and long-term interest rates. At 3.47%, the US 10-year yield is back towards the top end of the range. On the other hand the consensus forecast for S&P500 corporate earnings has held up relatively well with the forecast for the current year only down 1-2% from mid-July's peak estimates.

Flow of economic data taking a breather

The recent flow of economic data has not been as bad as FedEx points out, although a loss of momentum in financial data takes a month or two to reflect clearly in the data releases. Indicators in the US and Europe that had been on an improving trend have hit the pause button since. Nevertheless, we also know that it is not just about revenue growth (represented by the growth indicators) but the pressure on margins resulting from input cost inflation. The real challenge to corporate profits will be how companies deal with this cost inflation, something that economic data doesn't have a reliable indicator for.

Inflation better at the headline but worse at the (crucial) core

While there are some signs that global headline inflation is abating, core inflation is surprising to the upside. Economists are increasingly concerned with the stickiness of inflation. Inflation that hangs around and gets reinforced in the psychology of participants in an economy is more problematic for a central bank and more difficult to bring under control. The increasing fear in the market is that central bankers will have to push their respective economies into a recession to meet their long-term inflation targets.

Last week's US inflation report was a case in point. Headline inflation beat expectations, but **the big surprise was core inflation coming in at a pace of twice market expectations.** While headline inflation was up just 0.1% for the month, core inflation rose 0.6% month-on-month and surprised to the upside in a broad range of products and services. The inflation surprise shook the bond market.

Too many market participants have experience of just the past thirty years of disinflation and have still to recognise that inflation is an entirely different animal. You can't just wish inflation away when it takes hold in an economy. Central bankers must be aggressive and patient. Policy rates must be maintained at a high enough level for long enough to be effective. Economists have continued to push their policy rate forecasts higher over recent weeks. We are now facing peak rates of 4-5% in the major developed economies (save for Japan) in the coming quarters.

75 or 100?

The financial market is betting that the Federal Reserve will raise the rate by 75bps this week, with an outside chance of a 100bps increase. By Q1 2023, the market sees the federal funds rate at 4.5%. By that logic, **the Bank of England should raise rates by 75bps to 2.50%.** The Bank of England will still have much work to do, with rates likely to rise to 4.0% from the current 1.75% by Q1 2023.

At this point, in our view, the economists and central bankers are struggling to gauge the likely speed of rate increases and the scale of impact they will have on activity and inflation. The increase in the Fed funds rate has already led to a near-doubling of the average 30-year mortgage rate to 6.3%.

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