October 10th, 2022

We Just Don't Trust It

- **Equities closed higher on the week despite evidence pointing to challenging times ahead**
- **The Fed is unlikely to ease up – why should it really?**
- **The dollar's rise presents a serious headwind to US corporate profit forecasts**
- **Japan opens to foreign tourists adding to the slew of better news of late**
- **China's Communist Party Congress could be a once-in-a-five-year opportunity to save the equity market**

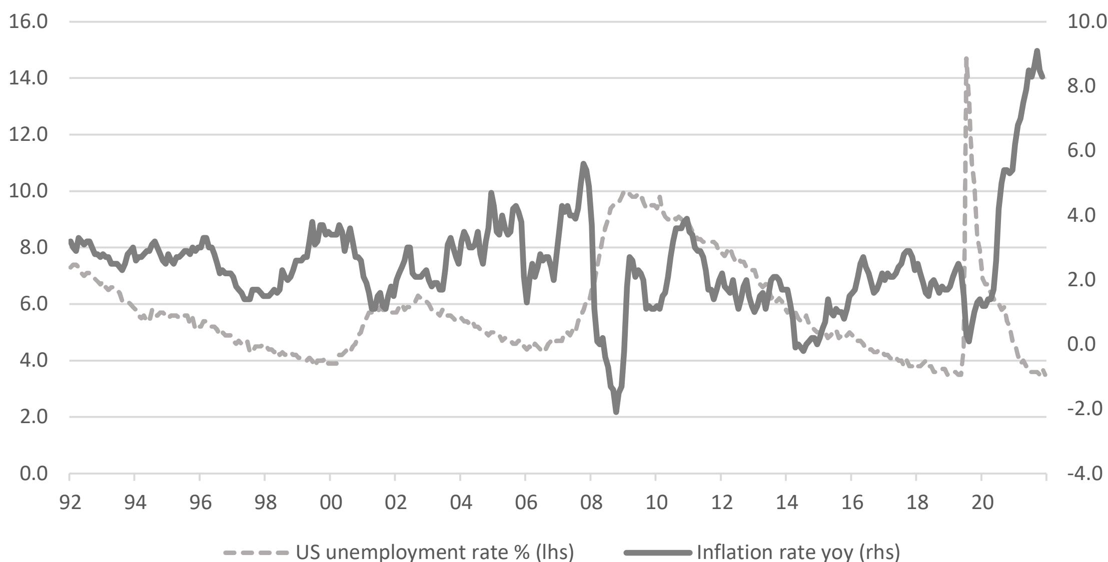
Different asset classes had a somewhat mixed performance last week. While the US 10-year government bond yield finished at its weekly high of 3.88%, up 24bps on the week, surprisingly, equities managed to eke out positive returns almost worldwide. Asian markets, in particular, had a substantial improvement after their recent precipitous fall. Stronger equities helped high-yield bonds post 0.5% to 1.0% gains on the week, which was quite a feat given the higher government bond yields.

Bond markets continue to be led by Fed speak. While there has been a growing chorus of calls for the Fed to slow down the pace of its interest rate increases, there is little sign that Fed members see much merit in such a strategy shift at this stage. Last week, Fed member John Williams said he saw Fed policy as still not restrictive and had ways to go. Williams was of the view that the rates would need to rise to "somewhere around 4.5% over time". Fed member Thomas Barkin tipped his hat in favour of those who worry that higher US interest rates will strengthen the dollar and cause problems in other parts of the world. However, he concluded that at the end of the day, it is the mandate of the Fed to control the US economy. Fed member Neel Kashkari said the Fed is "quite a ways away" from pausing the rate hikes.

Market participants will be closely watching US inflation data due out this week. Wednesday (12th October) sees the release of producer price inflation, with the core measure expected to remain unchanged month-on-month at 7.3%. The following day the market expects consumer price inflation data to show the core inflation excluding energy, drifting higher for the month – to 6.5% from 6.3%. Headline inflation is expected to drop to 8.1% from 8.3%. The same day the minutes from the FOMC's September 21 meeting minutes will help market participants gauge just how hawkish Fed thinking has been.

Prospects of a further 75bps increase in the US Fed funds rate look even more emphatic after last week's stronger-than-expected employment report. US nonfarm payroll data was marginally stronger than expected, with 263,000 new jobs created. However, the fall in the unemployment rate to 3.5% from 3.7%, caught the market's attention with average hourly earnings faring in line with expectations at 5% year-on-year. Hence, even if this week's inflation data is a little better than expected, the unemployment rate and the prospect of further strong wage inflation will continue to concern Fed officials.

Chart 1: Sky-high US inflation and rock-bottom unemployment rate



Our most pressing concern with the equity markets is that the US corporate profits could take a severe hit in the coming months. The domestic economy is slowing, although the evidence is still mixed as to the pace of the decline. However, we are more concerned with other aspects of the inputs driving corporate profit growth. Take the dollar for example. A stronger dollar will have helped mitigate some of the input cost pressures; however, at the same time, the dollar's strength will have pared overseas earnings sharply. The US dollar was stronger by an average of 16.7% through the quarter. The mechanical translation of overseas profits back into dollars will have taken a severe YoY hit.

There were plenty of headwinds that the corporate sector has had to deal with in the just-concluded quarter that may not only have affected the third-quarter numbers but also the future profit growth.

Chart 2: YoY increase in the value of dollar presents a serious headwind to profit growth

Source: Bloomberg

To us, the slow pace of the decline in corporate profit forecasts doesn't align with the fundamentals. The consensus forecast for S&P500 corporate earnings for 2022, derived from individual estimates of company profits, has fallen just 2.2% from the peak in June.

Chart 3: Estimates of US corporate profit for 2022 (S&P500)

US corporate profits (index point)

Source: Bloomberg

Two events in the coming week could be helpful to the markets, although they have long been anticipated.

Japan opens to tourism

On October 10, Japan finally opens its borders to foreigners. It will not be as profound as the events of 1853, but it has been anticipated for some time now and marks another stage in Japan's post-COVID re-opening. Foreigners accounted for about 20% of Japanese domestic tourism in 2019. Tourist arrivals this August were down 93% from the levels of 2019. Also, anyone working with Asian businesses will know that personal contact is a crucial element of doing business. Hence, commercial relationships will have waned somewhat during the lockdown. The pace of recovery will be measured at least partly because 40% of inward tourism spending came from China, and their citizens are still not free to travel abroad.

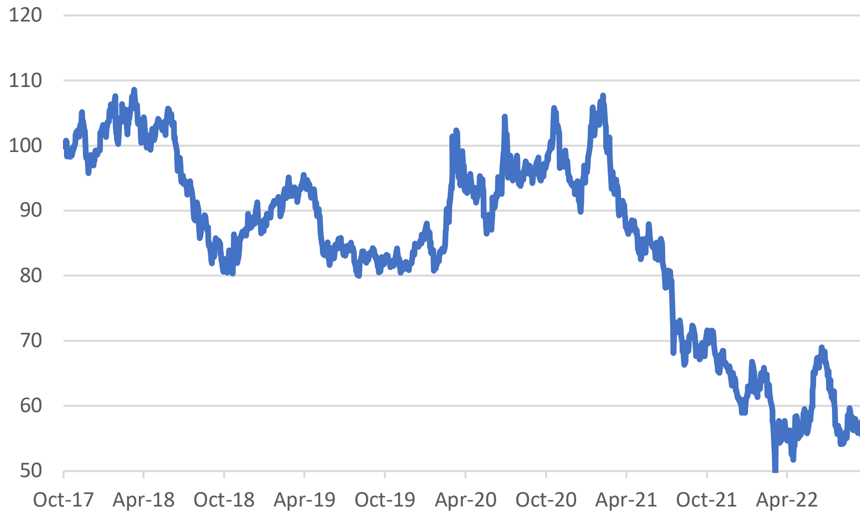
China's Communist Party Congress

The almost certain crowning of Xi Jinping as the leader for a third time next Sunday, October 16, is unlikely to come as a surprise. However, the markets will look to his speeches for signs of any shift in thinking in the wake of the prevailing serious economic challenges. Analysts will tell you that the equity market normally has a good time post the Congress, in part because the government typically, after the meeting, provides a stimulus for the economy. There are some concerns that this time will be different. Firstly, there are no easy routes out of the current economic challenges. In attempting to stop the previous economic excesses, President Jinping has done little to fill the GDP gap and hence the stress in the Chinese asset markets over the past 18 months. Secondly, global restraints stop China from quickly expanding its international reach and growth.

For equity investors, there will be a significant temptation to buy back into Chinese equities. The sharp underperformance of the Chinese equities over the past 18 months places the market on the list of assets that are probably on many buy lists, if only the investors could see a catalyst. The party congress has often been the catalyst for a period of good performance, and it may well be the case this time, too, irrespective of analysts' concerns that this time could be different.

Chart 4: Relative performance of MSCI China versus MSCI World

MSCI China Index relative to MSCOI World (rebased to October '17=100)



Source: Bloomberg

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