THE GLOBAL CIO OFFICE

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Growth Challenges the Markets

- **US economic data shows much more strength in growth than previously thought**
- **Inflation data has been at the lower end of expectations, but may re-accelerate**
- **A US 10-year bond yield of 4% is a challenge for US equity valuations**
- **European equities look better value after the 10% relative correction**
- **The Bank of Japan finally signals a shift in policy even if it is dressed up as temporary**

There were a number of themes to digest last week, but we have some better clarity.
The US is not on the cusp of a recession, far from it. Hence equity markets may still have some momentum. Central Bankers in the US, Europe and Japan delivered their different forms of tightening, but future policy shifts seem very data dependent. Equities look like they may continue to make progress until the growth at hand, notably out of the US, soaks up resources leading to potential inflation pressures.

Last week's US second-quarter GDP report, labour market data and consumer confidence surveys were all strong. The data reinforces our previous GCIO weekly message that US economic growth is much more robust than the market had forecast.

- Q2 GDP was materially stronger than expected at 2.4% compared to the consensus expectation of 1.8%
- Durable goods orders hit 4.7% versus market expectations of 1.3%
- Initial jobless claims fell to 221k versus market expectations of 235k

The market believes the data releases fit the soft-landing scenario where growth remains robust but inflation abates. Last week's PCE inflation data was better than expected at 3.8%, although still way ahead of the Fed's target inflation of 2.0%. The stronger-than-expected growth data pushed the US 10-year government bond yield to 4.0%. Those forecasters who expect the 10-year government bond yield to drop back through the balance of the year predicate their forecast on a view that the US economy will slip into a mild recession in the coming months. But the data still show strong US growth soaking up spare resources.

Economists have underestimated the impact of President Biden's fiscal boost. GDP growth is being supported by strong government spending growth and the support for the government initiative of re-shoring manufacturing. Private investment is strong – business investment was up 7.7% in Q2, the most robust pace of growth since Q1'21. As mentioned earlier, durable goods orders in June were well ahead of expectations.

However, we remain concerned that the re-acceleration of growth threatens to create higher inflation. The market was pleased with lower-than-expected core PCE inflation, and the employment cost index showed further moderation in employment costs. But basic economics tells us that growth eats up the create

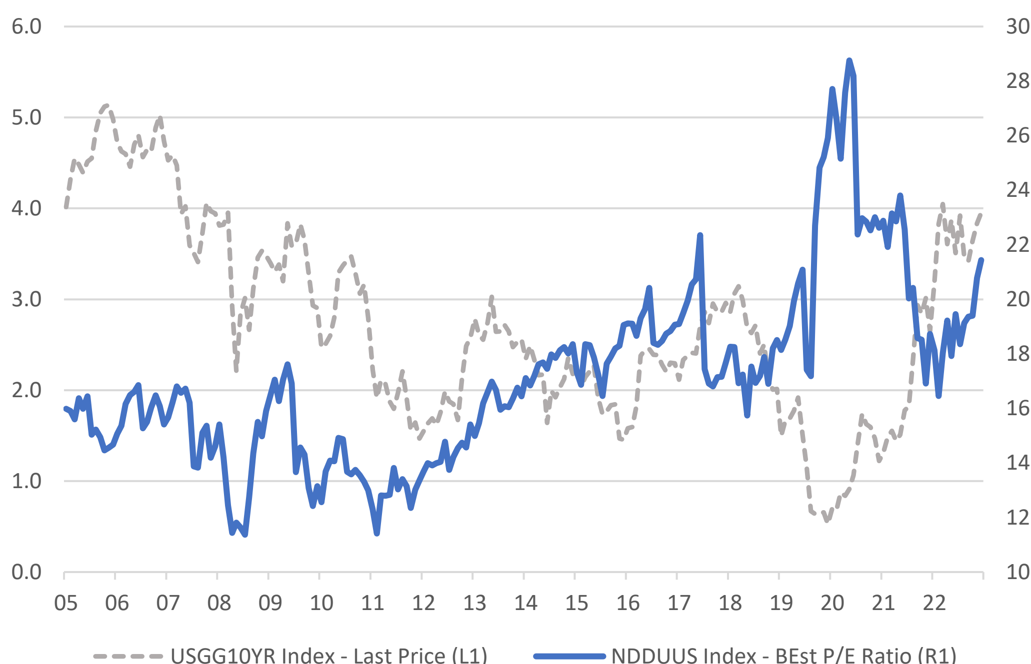
economy's resources and eventually generates inflation. The US economy continues to inch towards full capacity.

A word of warning – Biden's fiscal looseness is undermining the impact of rate rises. If inflation re-accelerates only monetary policy can bring it under control. In the build up to the US Presidential election we will not able to rely on US government prudence to rein in growth. Just consider in the back of your mind how a 6% Fed funds rate might feel!

Asset market consequences

The number that shines bright on the market data sheet now is the 10-year yield that has climbed back to 4.0%. For the equity market, the good economic news will help sentiment, but the higher government bond yields will constrain PE valuations. High PE multiples cannot ordinarily persist if bond yields are rising. Chart 1 gives some insight into the relationship between the US government bond yield and the PE of the S&P 500. The link is multi-faceted, but the rule of thumb is that higher bond yields mean lower valuation for equities. The current PE multiple for the S&P 500 of 21.7x, a level that is typical with bond yields of 3%, not 4%. If the US 10-year yield stays at around 4%, it lends itself, based on history, to PE multiples closer to 17x. That would imply the equity market would have to fall 20% to bring it to fair value. The only way the market can solve this conundrum is if we see significant upgrades to corporate profit forecasts.

Chart 1: S&P500 actual PE and the US 10-year government bond yield



Source:

Elements of the European economy are weaker than thought but it's probably already in equity prices

A slew of industrial confidence surveys suggests very downbeat economic activity in the euro area at present. That being said, the 10% relative under performance of the European equity markets against global markets since the middle of April appears to already discount the poor economic news. If anything, there was a silver lining to last week's weak economic data in that the ECB was less emphatic about following up on last week's rate hike with a further rate hike in September. Also, this week's euro zone retail sales growth data may show that consumer spending may be regaining some momentum.

Chart 2: Europe versus global equities ex Europe

Source: Bloomberg

Japan has moved along the long path towards policy normalisation

To be fair Governor Ueda was carful not to recognise the near-term tightening of monetary policy as akin to normalisation. However, this is probably the closest we have been to policy normalisation in many years. The shift in policy reflects the increased risk of inflation becoming re-established – all of which would be a positive for the economy. The new world is however very challenging for the JGB market that is having to contemplate a level for the 10-year yield of around 1.0% - the highest in a decade.

The BoJ while leaving the policy framework largely in place, they have lifted the upper limit for the 10-year JGB to 1.0%. The policy shift allows the BoJ to step back from some of its regular intervention and allow JGB yields to rise over time.

Chart 3: 10-year JGB yields potentially moving back to the highest in decade

Source: Bloomberg

The headlines from the BoJ meeting give the impression of being Yen positive, however given that despite increasing their near-term inflation forecast the BoJ cut their longer-term inflation forecast the Yen weakened against the dollar.

Chart 4: Yen dollar weakens after BoJ cuts its longer-term inflation forecast

Source: Bloomberg