Thoughts on the Market: The Fog of War

10th March 2022

Introduction

2022 is not very old and already it has seen a stock market correction, a 50bp flattening of the US yield curve and a major geopolitical crisis in Europe. Investors are contemplating the potential consequences of the Russian invasion of Ukraine, and the direct economic impacts here are minor as the world's trade and financial linkages with Eastern Europe are very low. However, the indirect impact through higher commodity prices (energy, metals, and food) to consumer's purchasing power is far more significant and simply adds more impulse to already well-established upward trend in global inflation, as well as downside risks to growth.

Consensus began 2022 with expectations of +4% global GDP growth, but this outlook appears quite dated with growth more likely be around a full percentage point lower, which suggests two changes ahead for markets – futures market pricing of six rate hikes in the UK, Canada and Australia and three in Europe, appear too hawkish, and secondly the odds are high that the street's estimate of +8% global EPS growth in 2022 will have sizable downgrades ahead due to sustained pressure on margins (from both weaker revenue growth and higher input costs). The challenge for policy makers is sizable as central banks are raising rates when economic risks are to the downside and real wages growth is deeply negative in all key regions. This is a backdrop for policy tightening not seen in four decades, which shortens the runway to engineer a soft landing in 2023. The broad issues for traditional portfolios are also complicated in that equities are likely to see rising discount rates, slowing earnings growth and lower valuations, and bond yields are already very low and offer modest diversification, at best.

Two shocks in two years …

Cov-19 was one of the most transformational shocks in the past three decades and all shocks have short-term and long-term consequences. The 2020 pandemic-induced global growth shock was much larger than was the case in 2008 when the global financial system went through an existential crisis, but the post-pandemic recovery has been robust with household income surging, business investment booming and labour markets quickly recovering. This sparked a second shock in 2021 as core inflation doubled both central bank targets and pre-pandemic levels in many key regions (Chart 1).

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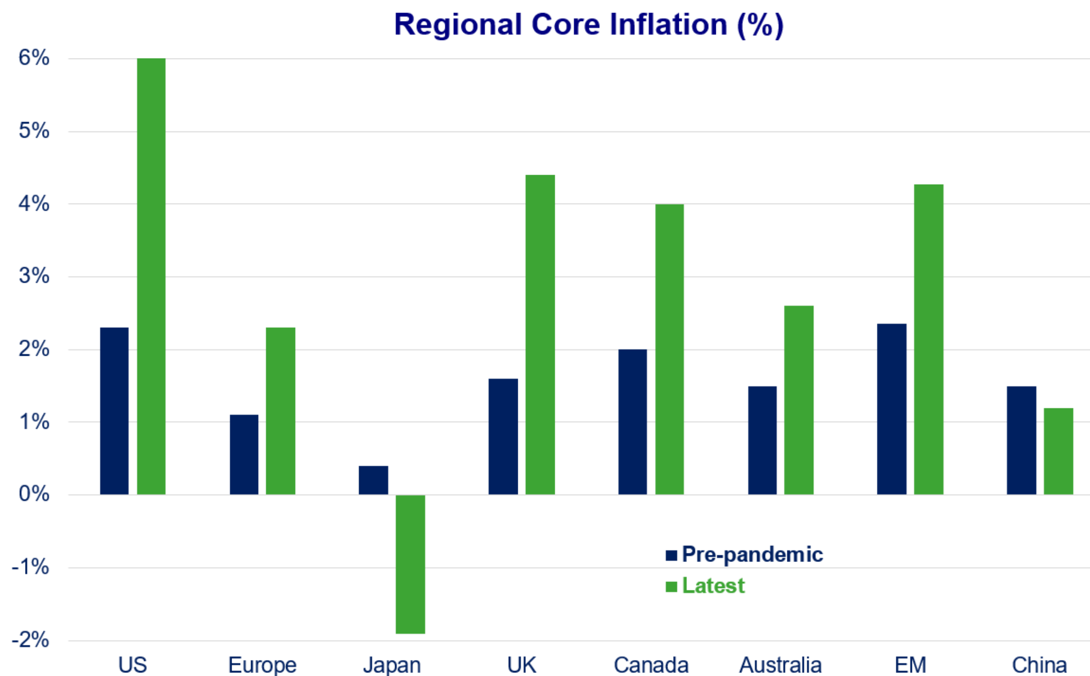
Chart 1: Annual core inflation has doubled in most key economies



… has become four shocks in three years

The inflation shock was overlooked by markets in 2021, but it has quickly evolved into a third shock this year as central banks finally concluded that 40-yr highs in inflation and 40-yr lows in unemployment meant emergency policy settings were no longer appropriate. Since the turn of the year, inflationary pressures have continued to build through both higher commodity prices (both food and energy) and tight labour markets (which has added to wages growth). The latter is now at levels which if left unchecked would reinforce above-target inflation as US unit labour costs (+4% y/y) is double to level which is consistent with +2% core PCE inflation. However, in terms of the economic expansion, higher supply side inflation acts like a tax on discretionary spending and is therefore associated with waning growth prospects (albeit from a high base), especially with wages growth entrenched deep in negative territory. Consequently, policy makers are in a highly undesirable situation in that inflationary pressures are mounting at a time that downside risks to growth are intensifying.

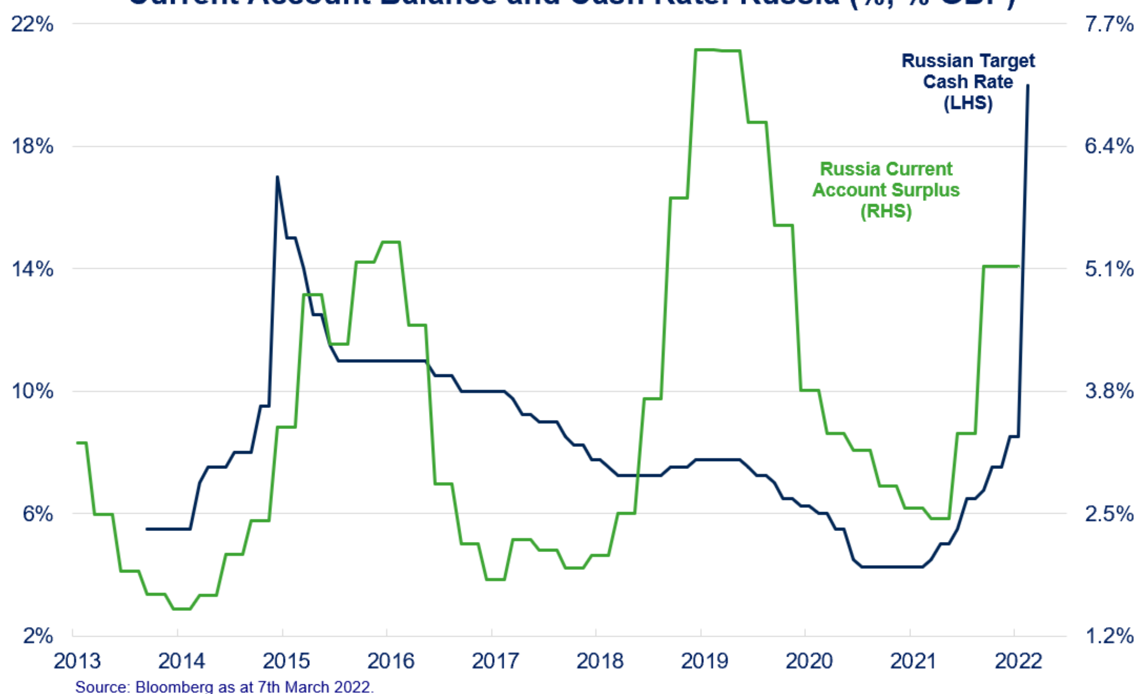
Western sanctions are hitting their mark

A fourth shock came in late February with Russia's invasion of Ukraine and while the dust has not fully settled and investors have no clear line of sight of the global investment terrain ahead, the primary impact, so far, has been through commodity prices and higher risk premiums. Meanwhile, the US and European sanctions imposed in March were designed to inflict significant damage on the Russian economy while maintaining the flow of Russian raw material exports which comprise around 85% of total Russian exports. Recent US banning of Russian oil exports will only have a marginal impact as 92% of US energy is supply either internally or from their allies.

Elsewhere, sanctions on the Russian Central Bank which limits its ability to use its $640 billion of foreign exchange reserves to defend the Ruble, indicates that the allies are utilising the plumbing of the Dollar-dominated global financial system to inflict more domestic harm on the Russian economy, as the Russian Central Bank's cash rate has more than doubled to 20% (Chart 2) to defend the currency. Accordingly, the sanctions are likely to see the Russian economy record not only a very deep recession (-12.5% from peak to trough in 2022) and also a larger economic dislocation than that recorded during the 2020 pandemic (-10%).

The recession would be even deeper if Russia energy exports were banned/lessened by Europe, but this to date is a risk case rather than a base case.

Chart 2: Russian rates are at record highs, where global rates are at record lows

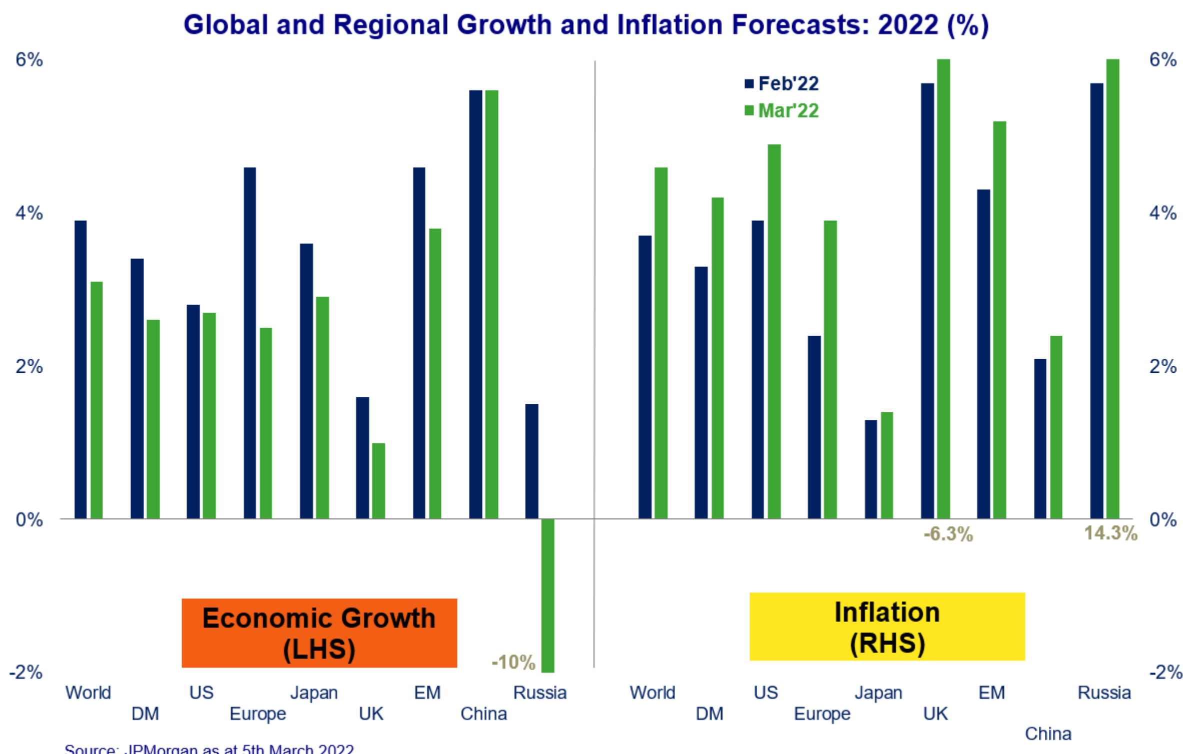


… the 2022 outlook is dented, but not derailed…. yet

Higher commodity prices are set to spark growth downgrades and inflation upgrades in H1'22 in all regions, but some regions are more exposed than others. Last week JPMorgan upgraded 2022 global inflation +0.9% to +4.6% and downgraded global growth by the same amount to +3.1% Q4/Q4.

The risks to growth here are not uniform but in essence there will be a large income transfer from energy consumers to energy producers – which will improve their terms of trade and national income and should lift their currencies. The most resilient country in terms of growth is the US who's 2022 growth outlook was cut by only -0.1% to +2.7% Q4/Q4 (Chart 3) as they are energy self-sufficient, have high income growth and energy purchases are only +6.5% of disposable income (which will rise to about +9% when you factor in a $130 WTI) which I would argue will be absorbed by a lower savings rate in coming months.

Chart 3: Growth downgrades and inflation upgrades in every region



Net energy importers will be the worst off

In contrast to the US, the biggest growth losers are Europe (-2.1% to 2.5%, and which is at the epicentre of the crisis), Japan (-0.7% to 2.9%) and the UK (-0.6% to +1.0%) who are all large net energy importers and the impact here is amplified by a typical exchange rate depreciation. Meanwhile, the growth hit to EM (-0.8%) is concentrated in EE (-5.8%) whereas Asia (-0.1%) and LATAM (-0.2%) have a minor downgrade like the US. The growth downgrade would have been larger had it not been for the dissipating Omicron drag, as the global economy was in a fairly good position before the invasion given solid rises in the February global PMI report (with gains in both manufacturing and services) and robust labour market reports in the US and Europe which saw unemployment decline in both regions to levels rarely seen in the past 50 years. That said, risks to the baseline view mentioned about remains skewed to the downside as the assumption here is a WTI price of $110 per barrel and the growth and inflation estimates have made no allowance for food price inflation which could be impacted as higher gas prices is making it cost-prohibitive to produce ammonia, and 33% of global supply of potash exports come from Russia and Belarus – these two commodities are essential ingredients to fertilizers which risks the volume of 2022 global food production.

Household savings buy consumers limited time…

The primary channel of growth risks is through softer consumer spending which has eased back in recent months as the Omicron drag and rising inflation weighed on real wages and confidence. Lower household saving rates cushioned this blow, but real US wages growth of -2.5%, if sustained, will be tough to overcome especially given household savings are already -2% below pre-pandemic levels and currently sitting at an 8-year low (Chart 4). At the current rate of decline, the US household savings rate will be fully depleted by mid-year. Meanwhile, the broad acceleration of inflation will take consumer price growth up to fresh 40-yr highs. There is no doubt that headline inflation is noisy which is why central bank's target annual core inflation, but headline inflation is what matters to consumers.

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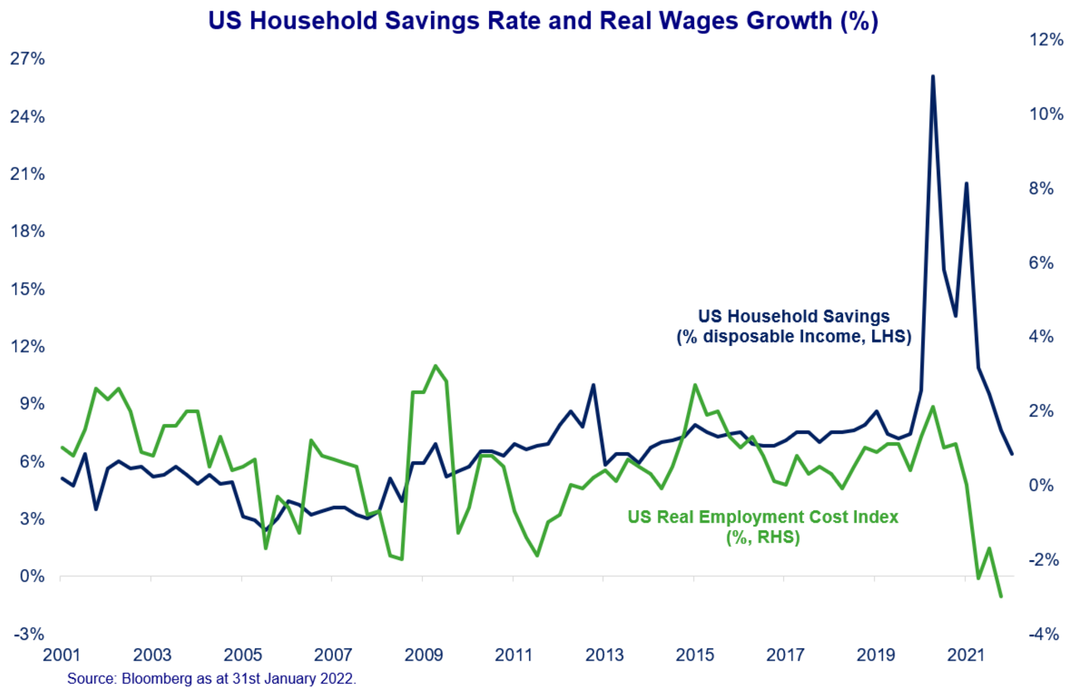
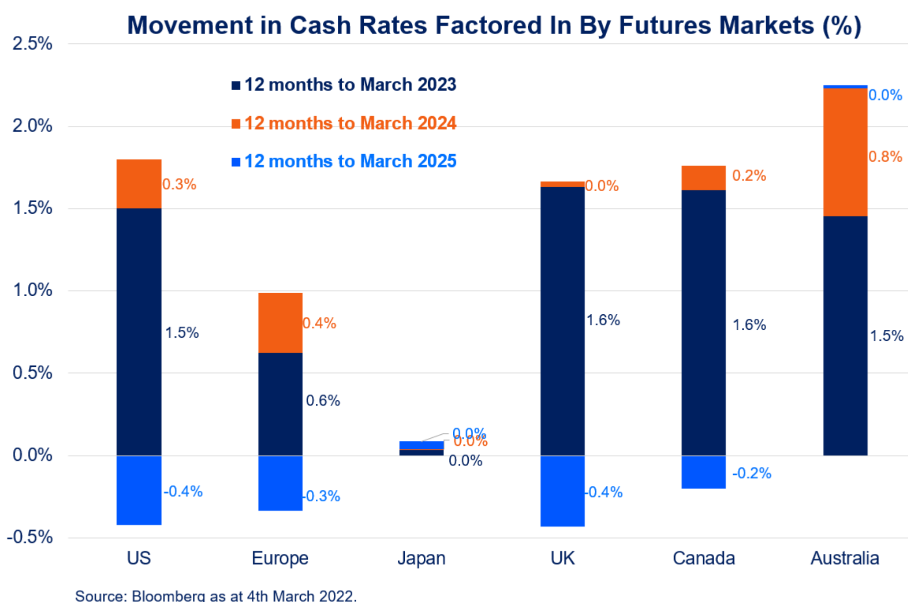
Chart 4: US household savings - a limited cushion for negative real wages growth



Can central banks hikes live up to expectations?

Taking a step back, one of the many challenges for markets is the starting point – we have zero cash rates around the world, despite 40-yr highs in inflation and 40-yr lows in unemployment. Yet tightening into a slowing economy with negative real wages growth is a backdrop most regional central banks have not faced in over 40 years. At present, futures markets have considerable tightening priced in this year and next, but they seem to be painting most countries with the same brush. Given recent comments from US Fed Chair Powell, the FOMC is set to hike rates in March and will continue throughout the year, but current expectation of six +0.25% Fed rate hikes to March 2023 (Chart 5) could be challenged if oil price-induce inflation keeps US real wages growth negative and recession signs emerge. It's a much higher hurdle for the RBA to meet market expectations as Australia's inflation performance is very different from that of the US, as our core inflation rate (+2.6% y/y) remains in the middle of the 2%-3% target band whereas the US is triple their target (+6.0% vs +2.0% y/y).

Chart 5: The US Fed will lead the pace of 2022 policy tightening



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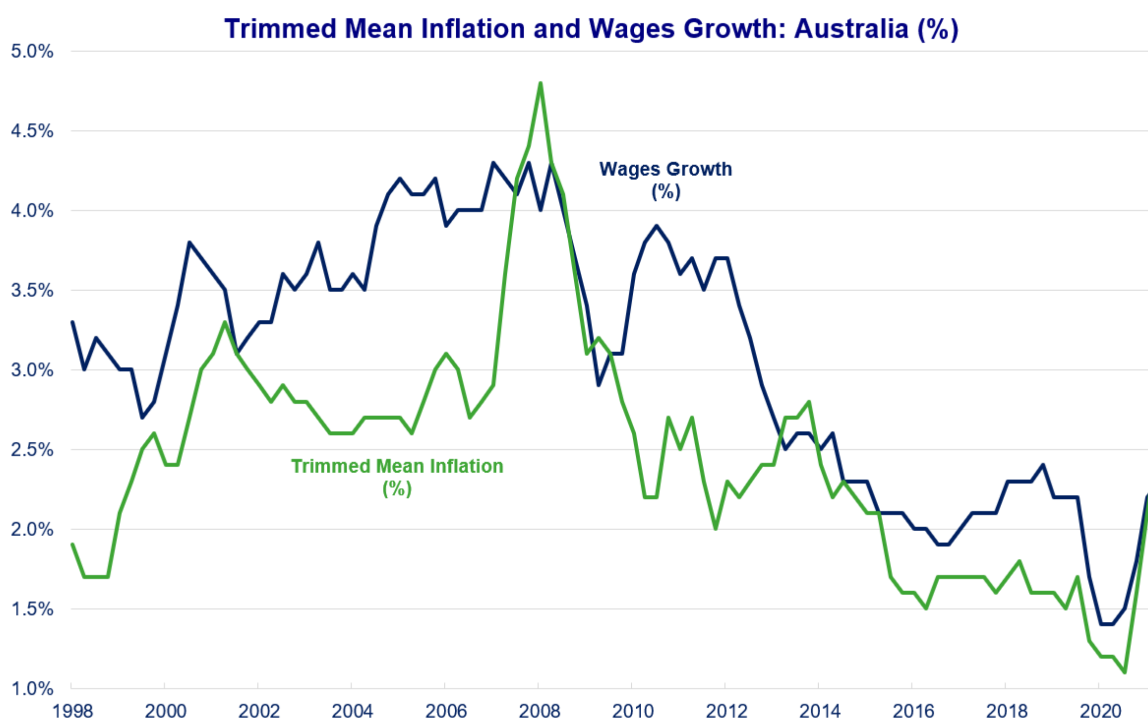
Australian wages to remain anchored low

In addition, Australian wages are not responding in the same way to labour market tightness relative to other regions. Despite local unemployment being close to a 40-yr low Australian wages growth is just +2.3%y/y and has not been above the 3.0% since 2013 which is a level which has been singled out by RBA Governor Lowe as a key hurdle for any normalisation in the Target Cash Rate. In contrast, US wages (as represented by average weekly earnings) are currently at +5.4% y/y which is aligned with the post-pandemic average. The US has lost several million workers from the pandemic, which has force firms to push up labour rates to attract workers, whereas in Australia wages growth is harder to raise as enterprise bargaining agreements are multi-year, public services wages are limited to the inflation rate target and the Morrison Government is set to increase labour supply through its population strategy.

This suggests it will be very difficult to get Australian wages growth sustained above +3% in 2022 (Chart 6), which will keep monetary policy extremely easy despite rising cost pressures. Unless the RBA changes its forward guidance (which is always possible), it is hard to envisage any more than one hike by the RBA this year. Similarly, market prices for three hikes in Europe in 2022 also seems excessive as that region is at the epicentre of geopolitical, energy supply and growth risks. So overall the regional policy tightening cycle will be more synchronised that it was after the GFC, however, in terms of the impact on the economy and spending, the direction of rates is much less important than their level, and the number of hikes this year will vary greatly from region to region.

Chart 6: Australian Wages Growth above +3% is consistent with 2%-3% core inflation



The Fed cannot stall on rate increases

Some commentators have asked if the US Fed could hold off on tightening given the clouded growth outlook, but core inflation has been well above target for upwards of a year and that may remain the case to the end of 2023. Meanwhile, the Ukraine situation has ramped up inflation risks at a time when markets were expecting consumer price to begin declining. The vast bulk of the 2022 decline was from base effects which are strongest in the June 2022 quarter – if that time-specific decline does not eventuate, or is less than expected, then there is a risk that we have another year of elevated inflation, which runs the risk (whether its high or low) of inflation expectations becoming unanchored. As such, the Fed can't sit on their hands any longer with rates

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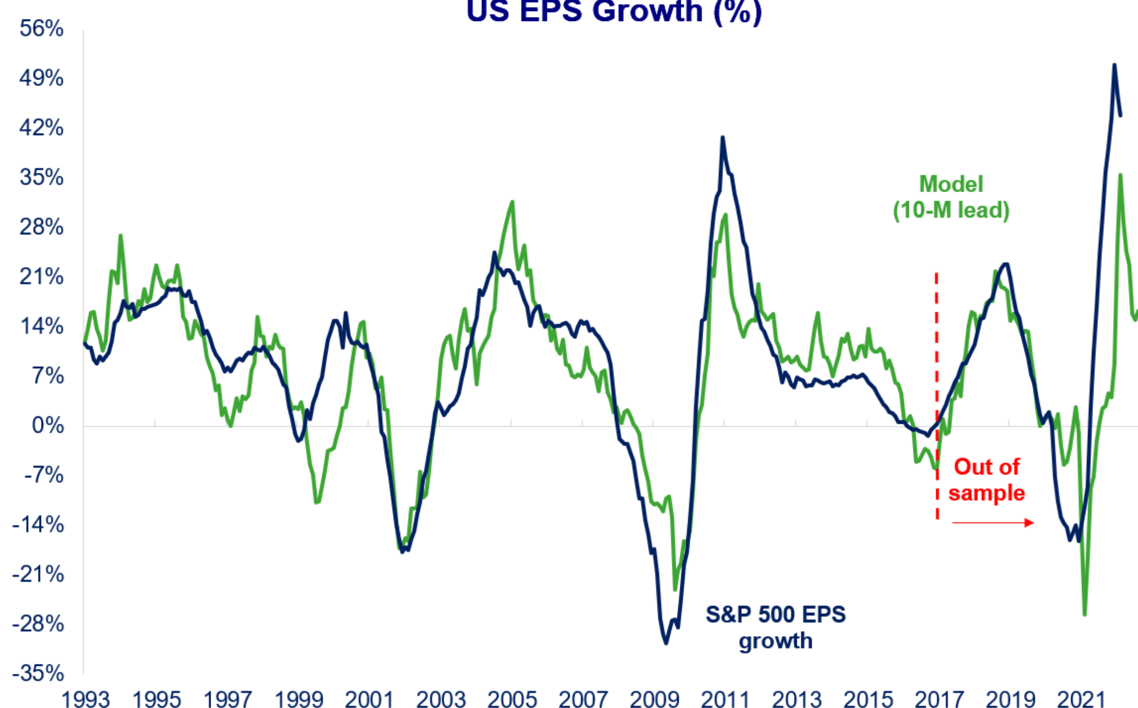
to be lifted this year, and quantitative tightening will also get underway as one of the Fed's largest policy errors in the past two years was not realising that QE money would flow through to the real economy, unlike after the GFC. Accordingly, the key question for investors is "how much are things going to tighten" and they should be mindful that the Fed has not administered tough love to the markets, and US economy, since 1994.

Can earnings be resilient enough as higher rates weighs on valuations?

The pace of regional rate hikes will be led by the Fed who are the key central bank for all markets, and the key question for investors is whether earnings growth can offset the impact of any decline in global PE ratios that could emanate from higher discount rates. While 10-yr US Treasury bond yields have declined in recent weeks, on safe haven flows, discount rates would still have risen given an inevitable rise in the equity risk premium. Over the past 18 months global corporations, and the US in particular, have been over-earning and 12M EPS growth recently peaked at +53% and +51% y/y for the MSCI World Index and the S&P 500, respectively. Coming out of the pandemic firms had massive operational leverage where revenue surged due to the potent combination of the vaccines, stimulus and reopening, and costs grew strongly albeit at a slower pace. Moving forward, we are likely to see the opposite side of that trend as revenue growth slows and expenses rise given the sustained tightness in labour markets and commodity markets. Our proprietary earnings model is signalling that US EPS growth is set to head down to just +6.5% by end-22 (the green line in Chart 7).

Chart 7: 2022 will experience a rapid decline in EPS growth



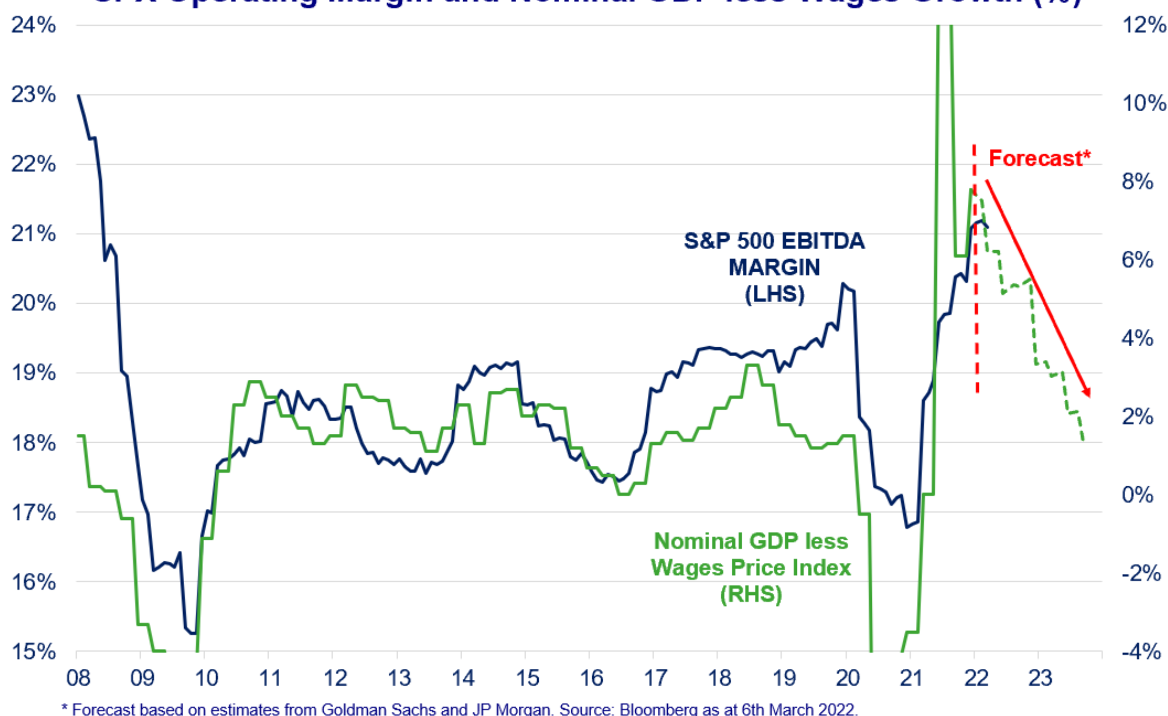
Are corporates set for a period of "under-earning?

While the investment terrain is always characterised by uncertainties, today's backdrop seems to have more than normal. In this sort of environment, it can be helpful to examine future trends in factors such as earnings growth, and then determine risks around that estimate. Given the likely moderating revenue growth and rising input cost environment, profit margins are likely to have sustained downside pressure which could spark downside risks to the earnings estimates in Chart 7, especially as analysts have assumed margins remain at elevated levels in the next 18 months.

Elevated geopolitical uncertainty certainly adds more ambiguity in the current cycle, but a simple model for margins based on nominal GDP less wages growth, as proxies for revenue growth and expenses,

respectively, signal that there could be considerable downside risks to margins which could see them return to levels evident for much of the post-GFC cycle (Chart 8). If that proves to be the case, the risk is real that earnings growth is not enough to offset falling valuations in 2022. That said, I would argue that the decline in valuations (-15% since March 2021) is well advanced as the past three investment cycles have recorded an average -20% decline in valuations in years 2 and 3 of the recovery. This suggests that moving ahead earnings growth could be a more important driver of market trends than it has been in recent months.

Chart 8: There appears to be sizable downside risks to US profit margins



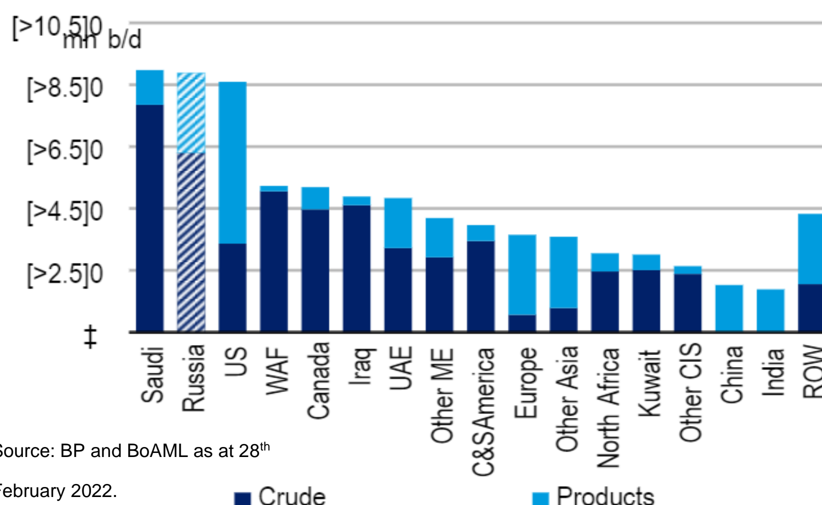
The invasion will also have two key long-term effects

From a long-term economic perspective, the invasion is set to have two key effects – firstly, it is likely to lead to a re-design of European energy policy, and secondly, it could also see key economies begin to extricate themselves from trade dependency with both Russia and China. These two consequences would be yet another inflation shock for this decade which are plentiful given the likely rebirth of local manufacturing, and de-carbonisation from fossil fuels.

The energy challenge for Europe

While the Russian economy will soon be on its knees, one should not underestimate the leverage that Russia has over Europe as they are one of the largest global energy suppliers. In particular, Russia is the world's largest exporter of natural gas (which it sends to both Europe and Asia) and the second largest producer of crude oil and petroleum products behind Saudi Arabia (Chart 9). In the last 20 years EU energy production has fallen by half, and therefore it is simply not possible to address Europe's Russian energy dependency in the near-term, as the process could take upwards of a decade.

Chart 9: Russia is the world's second largest oil produce



Source: BP and BoAML as at 28th February 2022.

Concluding comments

The key thought for investors given the heightened uncertainty around Ukraine and its impact on energy prices, inflation, risk premiums, profit margins, earnings growth, central bank policy, investor sentiment and so on, is how to manage equity market volatility. Australian investors have accomplished this by purchasing government bonds, but the challenge today is that bonds are more expensive than equities, and bond yields tend to rise (and incur capital losses for investors) when the Fed hikes interest rates and inflation is rising. Nevertheless, there are numerous portfolio strategies which can help to diversify equity risk – focusing on companies which are more resilient to economic slowdowns and higher interest rates because they have robust operating models and strong balance sheets, identifying stocks, sectors, and regions with less valuation risk, and finally considering what is an appropriate asset allocation to risk markets in the current environment. The fog of war makes the current investment terrain very challenging, but focusing on valuations, earnings delivery and balance sheets can help to determine your risk budget and where to deploy your capital.

Yours sincerely,

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