January 2022

2022: is monetary policy normalisation really on the cards?

Overview

2021 featured a shift in US monetary policy. All year, the world's financial markets kept a close watch on Federal Reserve boss Jerome Powell, whose commentary gradually moved in favour of the end of a highly accommodating stance, with asset purchases amounting to $120 billion per month right up to the autumn. But at that point the Fed started to voice concern that at more than 5% year-on-year for some months, inflation could be both higher and more persistent than it first thought. In November, consumer prices were up 6.8% on the year before, while producer prices climbed no less than 13.6% over the same period! Tapering started in Q4 2021 with an initial reduction of around $15 billion per month in asset purchases. That reduction is set to be doubled from this month onwards, which would halt the expansion in the Fed's balance sheet by the end of Q1 and pave the way to a rise in interest rates... if all goes well.

Eurozone inflation was below its 2% target until the summer of last year, which greatly helped Christine Lagarde's policy position. But consumer prices started to accelerate significantly from September onwards, generating an inflation rate of 4.8% in November. This may have been the highest level recorded ever since the creation of the European Monetary Union, and producer prices had jumped 21.9% the month before. This situation has left the ECB in a more difficult situation, especially as the Fed had announced a change to its own policy. Even so, Ms Lagarde has remained pretty much unmoved, as retail sales are still sluggish (up 0.9% in the year to October).

In China, problems among real estate developers continue to unnerve economy-watchers. In 2021, investors heavily sanctioned the main listed Chinese groups on the grounds of their excessive debt: the share prices of Evergrande, Kaisa and Shimao slumped by 89.3%, 75.3% and 76.7%, respectively, over the course of the year. These corrections were far greater than those suffered by their benchmark indices: MSCI China dropped 23.5% and the Hang Seng 11.7%. This risk factor is additional to a worsening imbalance in the economy's fundamentals, where faltering domestic demand contrasts with extremely buoyant international trade.

Fortunately for China, its exports surged 30% last year, which helped offset some of the sluggishness of domestic demand. But this also leaves the country more dependent on good relations with trade partners at a time of strained international politics. It means that Xi Jinping will have the difficult task of perhaps moderating his public utterances on such matters as world leadership and Taiwan if he is to keep China's economic model on track. If he does opt for sweeter trade relations, it would amount to a fundamental contradiction with the government's 'Made in China 2025' self-sufficiency objective, which sits within its 'common prosperity' concept. All in all, Chinese policy begs a number of questions for 2022, and the country's role as the world economy's engine of growth for almost 20 years is not nearly as obvious as it was.

At a microeconomic level, 2021 will go down as a great year. Ahead of the Q4 results season, S&P 500 earnings growth for the year is estimated at 45.1%, which would be the highest figure ever recorded since FactSet started publishing this data back in 2008 (the previous record was 39.6% in 2010, just after the subprime crisis). Similarly, S&P firms' aggregate revenues climbed an estimated 15.8%, compared with the previous high of 10.6% growth in 2011.

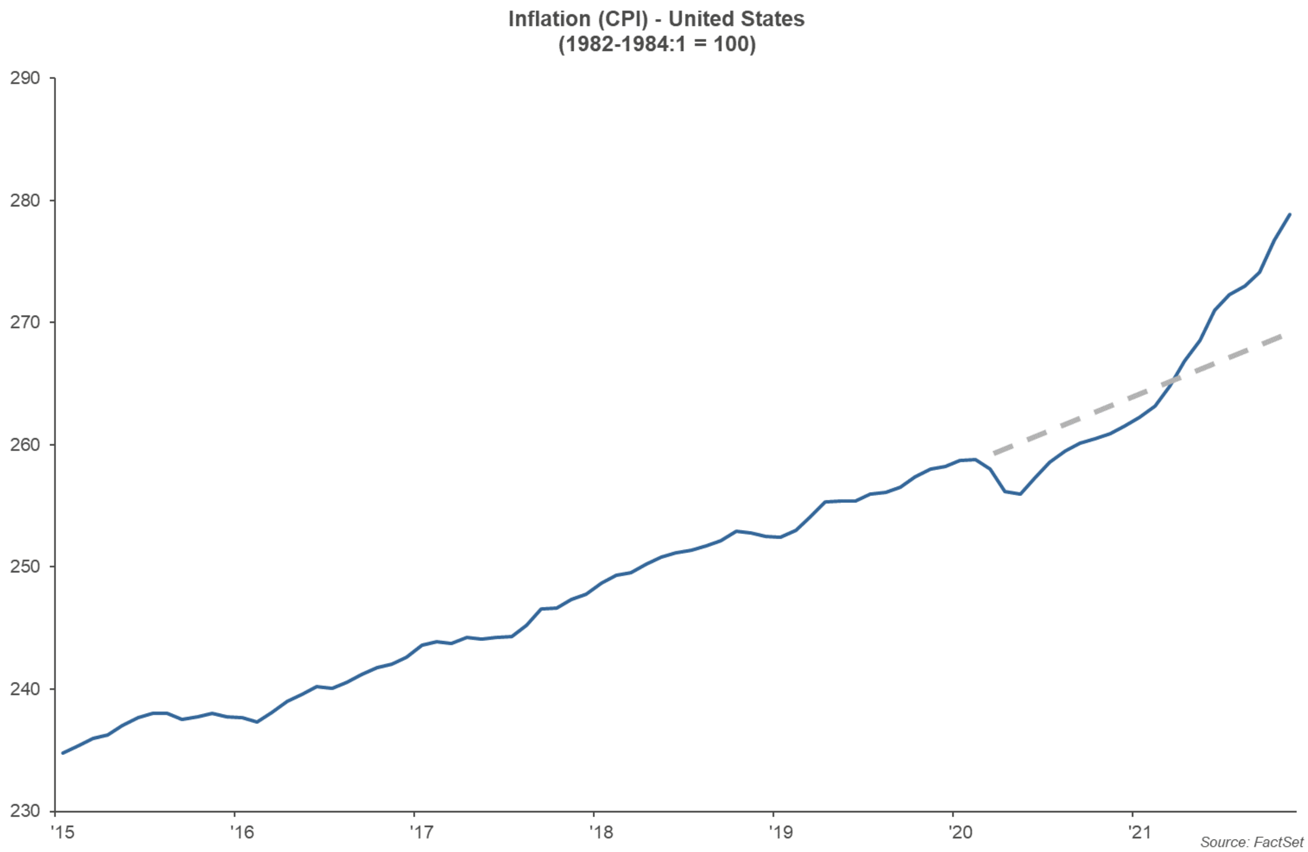
Now that Covid-related base effects have disappeared, we are likely to see more normal earnings growth rates this year, with less systematic good surprises. Our valuation model indicates that Wall Street is more or less fair value but that European equities are underpriced to a degree that depends on changes in interest rates (in the event of a slow recovery, rates would inevitably sink towards zero). The market's 7-15% appreciation potential is valid for all scenarios.

Michaël Sellam

USA: is tighter monetary policy a realistic long-term prospect?

2021 featured a shift in US monetary policy. All year, the world's financial markets kept a close watch on Federal Reserve boss Jerome Powell, whose commentary gradually moved in favour of the end of a highly accommodating stance, with asset purchases amounting to $120 billion per month right up to the autumn. But at that point the Fed started to voice concern that at more than 5% year-on-year for some months, inflation could be both higher and more persistent than it first thought. In November, consumer prices were up 6.8% on the year before, while producer prices climbed no less than 13.6% over the same period. Tapering started in Q4 2021 with an initial reduction of around $15 billion per month in asset purchases. That reduction is set to be doubled from this month onwards, which would halt the expansion in the Fed's balance sheet by the end of Q1 and pave the way to a rise in interest rates... if all goes well.

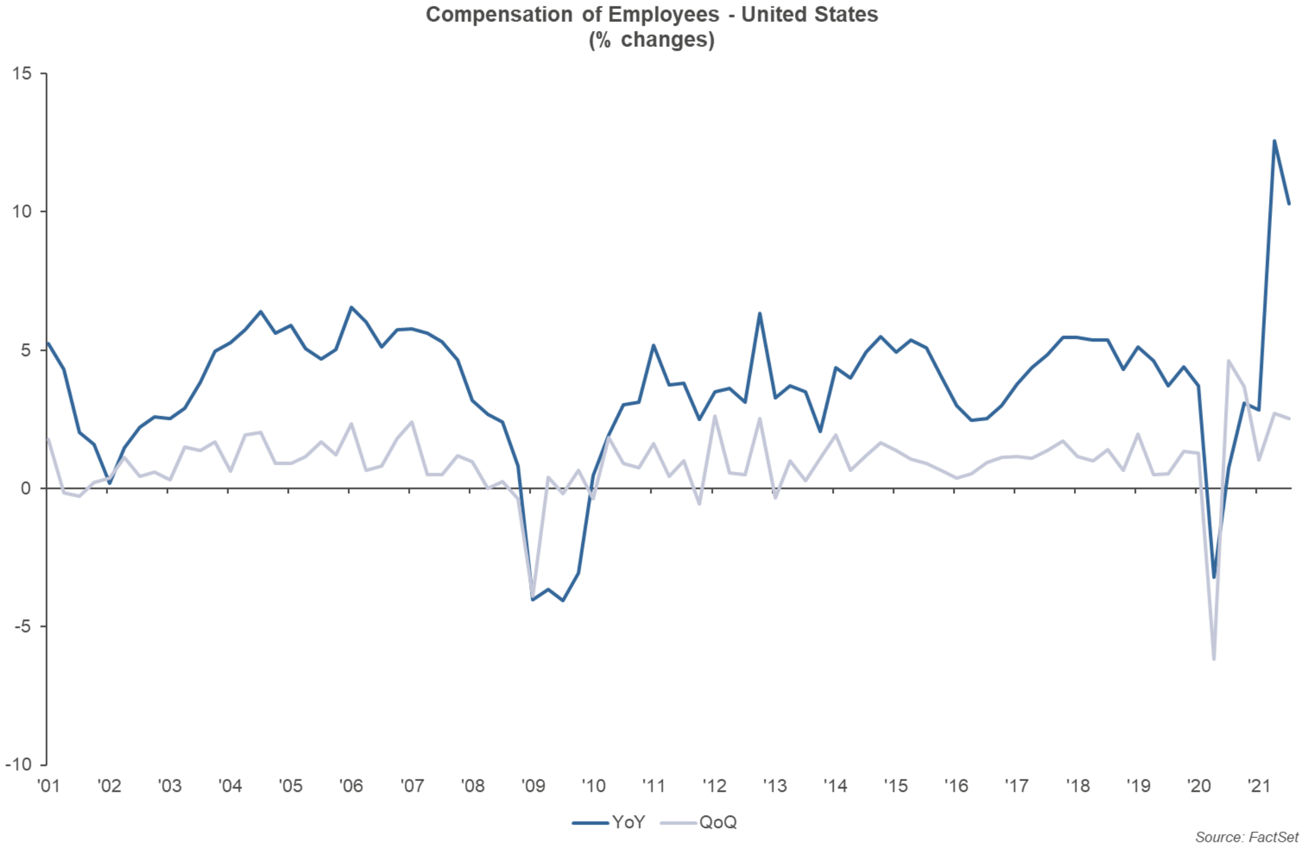
Erratic inflation has finally persuaded the Fed to end its asset purchase programme



Although inflation is higher than it has been for years, we continue to believe that current price pressures are temporary as final demand is still incapable of playing a part in any inflationary spiral. A close examination of the figures lends credibility to our view. Most pressures are associated with a few specific sectors: car prices are rising by 19.2% per year, for example, with used car prices up 31.4% over the same period. Although core inflation (i.e. excluding food and energy) is a very relevant and useful indicator and is running at a relatively 4.9% per year, the more structural components of inflation are far tamer than many observers allow.

The main impediment to surging inflation is America's ageing population. One corollary of this structural development is a far slower increase in the size of the labour force relative to the past. This means that wage inflation (which we could refer to as micro inflation) does not necessarily mean an increase in the total employment income paid across the whole economy (i.e. wages paid multiplied by the number of waged employees). And this is precisely what we are seeing now, with total employment income rising by far less than monthly inflation (see chart). Moreover, we estimate that employment income probably peaked at $12.7 trillion in Q3 2021. We should therefore put the low US unemployment rate (4.2%) in perspective, particularly with regard to the low participation rate (61.8%).

US employment income may well have peaked already

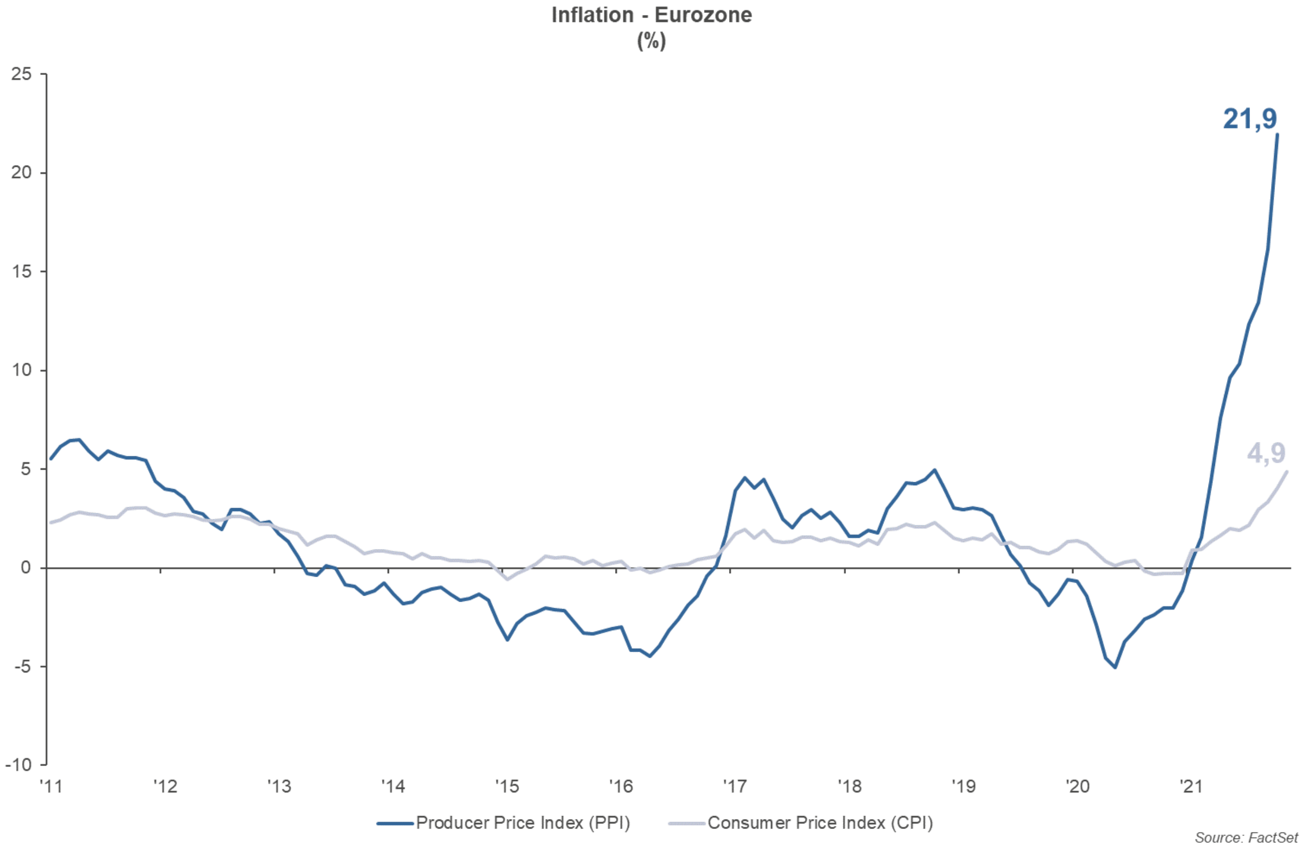


For these reasons, we suggest that investors do not put too high a probability on a sharp reversal of the Fed's monetary policy, despite upbeat GDP growth forecasts (4.1% in 2022, according to the FactSet consensus) and recent commentary from Jerome Powell. This seems to be the market's own assumption, given that long rates are still very low (around 1.5% in the 10-year maturity, for example). Given that budgetary stimulus is unlikely to be as great as had been hoped, we would not expect the Fed to try and shrink its balance sheet just yet or even to raise its key interest rates significantly in 2022, as either could throw the economy into reverse just as we approach the politically risky midterm elections. The upshot is that real interest rates should stay very accommodating and the sectors most sensitive to borrowing costs will continue to perform well, IT above all.

Euro zone: between bolstering the economy and price stability, the ECB has made its choice

Eurozone inflation was below its 2% target until the summer of last year, which greatly helped Christine Lagarde's policy position. But consumer prices started to accelerate significantly from September onwards, generating an inflation rate of 4.8%[1] in November. This may have been the highest level recorded ever since the creation of the European Monetary Union, and producer prices had jumped 21.9% the month before. This situation has left the ECB in a more difficult situation, especially as the Fed had announced a change to its own policy. Even so, Ms Lagarde has remained pretty much unmoved, as retail sales are still sluggish (up 0.9% in the year to October).

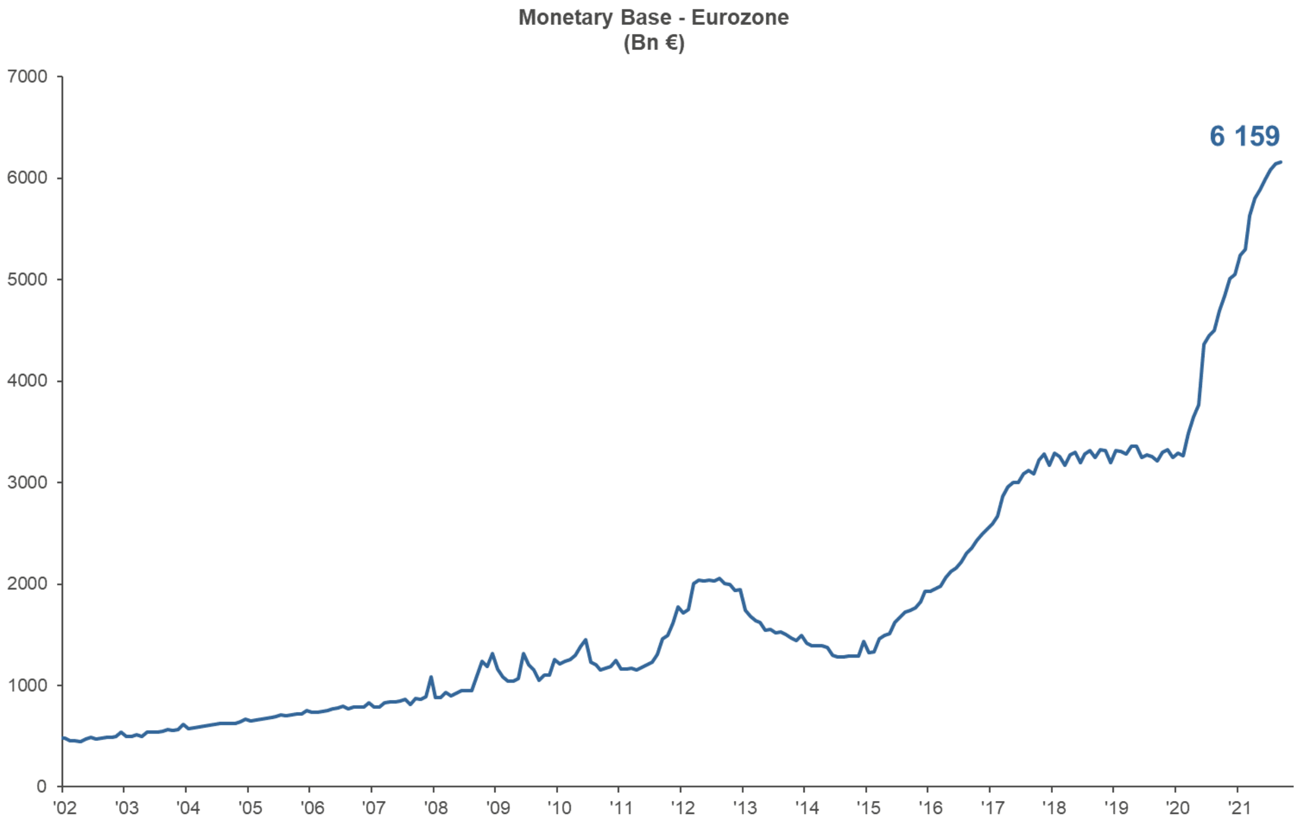
Eurozone inflation accelerated relatively late but at an unprecedented pace



The ECB will clearly be more accommodating than the Fed in 2022. This stance is consistent with the desynchronisation of the two economies on the economic cycle, with the US economy (unemployment rate: 4.2%) taking a significant lead over Europe early in the pandemic. Indeed, the euro zone is still sluggish and well short of full employment (unemployment rate: 7.3%). It is also consistent with fears that EU budgetary stimulus will not materialise: bad memories of the Greek debt crisis have had a lasting impact on European institutions, which are fearful of repeating the errors of the past. In short, the ECB has made a conscious choice to buoy the economy to the detriment of price stability, and this has been by no means a passive strategy. As the chart below shows, the euro zone's monetary base has soared since the start of the pandemic. So far, this expansionary policy has had only one truly negative consequence: a rise in the prices of assets such as real estate and equities, to the point where some investors fear overheating or even a bubble. The ECB prefers to run this risk rather than stifle a still fragile recovery, especially in a perilous political context.

[1] Even so, eurozone inflation was overstated in H2 2021. Because of the pandemic, Germany reduced its standard rate of VAT from 19% to 16% and its lower rate from 7% to 5% between 1 July and 31 December 2020. This created a base effect that automatically raised Germany's inflation rate in Q3 and Q4 2021, which in turn fed through to a higher eurozone figure (the 'error' could be worth a percentage point or so).

ECB liquidity injections have been so large since the start of the pandemic that the monetary base (M0) has almost doubled



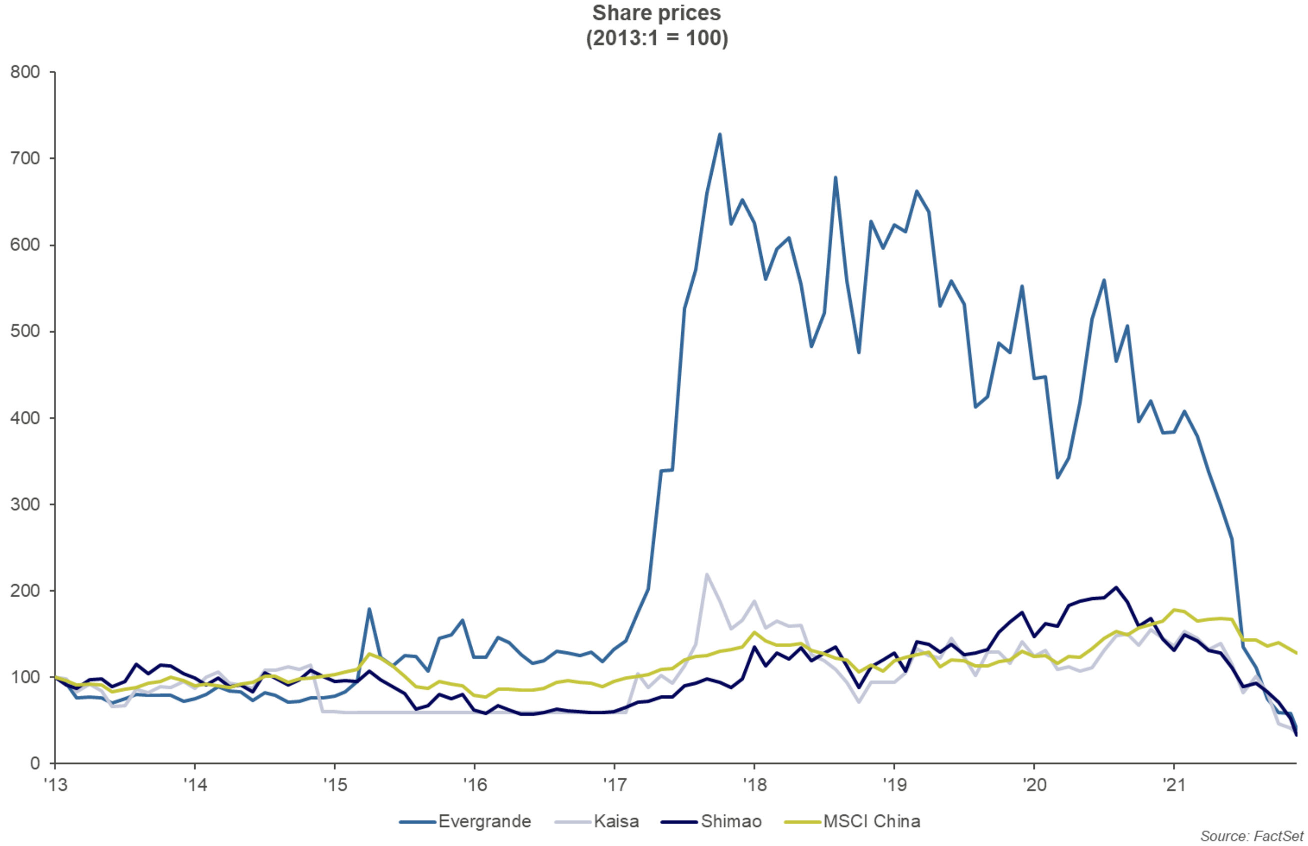
Source: FactSet

More specifically, the ECB will start by drawing its emergency Covid programme to a close. In December 2021, the ECB Governing Council decided on a gradual reduction in the Pandemic Emergency Purchase Programme (PEPP), worth a total €1,850 billion, leading to its complete end in March. A temporary increase in its Asset Purchase Programme (APP) to €40 billion in Q2 will take up part of the slack; it will then decline to €30 billion per month in Q3 and back to its previous €20 billion per month in Q4. The ECB will not be looking for a rate hike, either. According to Ms Lagarde, its key rates will remain unchanged until the autumn at least. In this largely accommodating context, the euro zone could post swift GDP growth in 2022, and perhaps faster than that of the USA (4.4% against 4.1%, according to the FactSet consensus).

China at the crossroads?

In China, problems among real estate developers continue to unnerve economy-watchers. In 2021, investors heavily sanctioned the main listed Chinese groups on the grounds of their excessive debt: the share prices of Evergrande, Kaisa and Shimao slumped by 89.3%, 75.3% and 76.7%, respectively, over the course of the year. These corrections were far greater than those suffered by their benchmark indices: MSCI China dropped 23.5% and the Hang Seng 11.7% (see chart). This risk factor is additional to a worsening imbalance in the economy's fundamentals, where faltering domestic demand contrasts with extremely buoyant international trade.

The markets severely sanctioned China's high-debt real estate developers in 2021

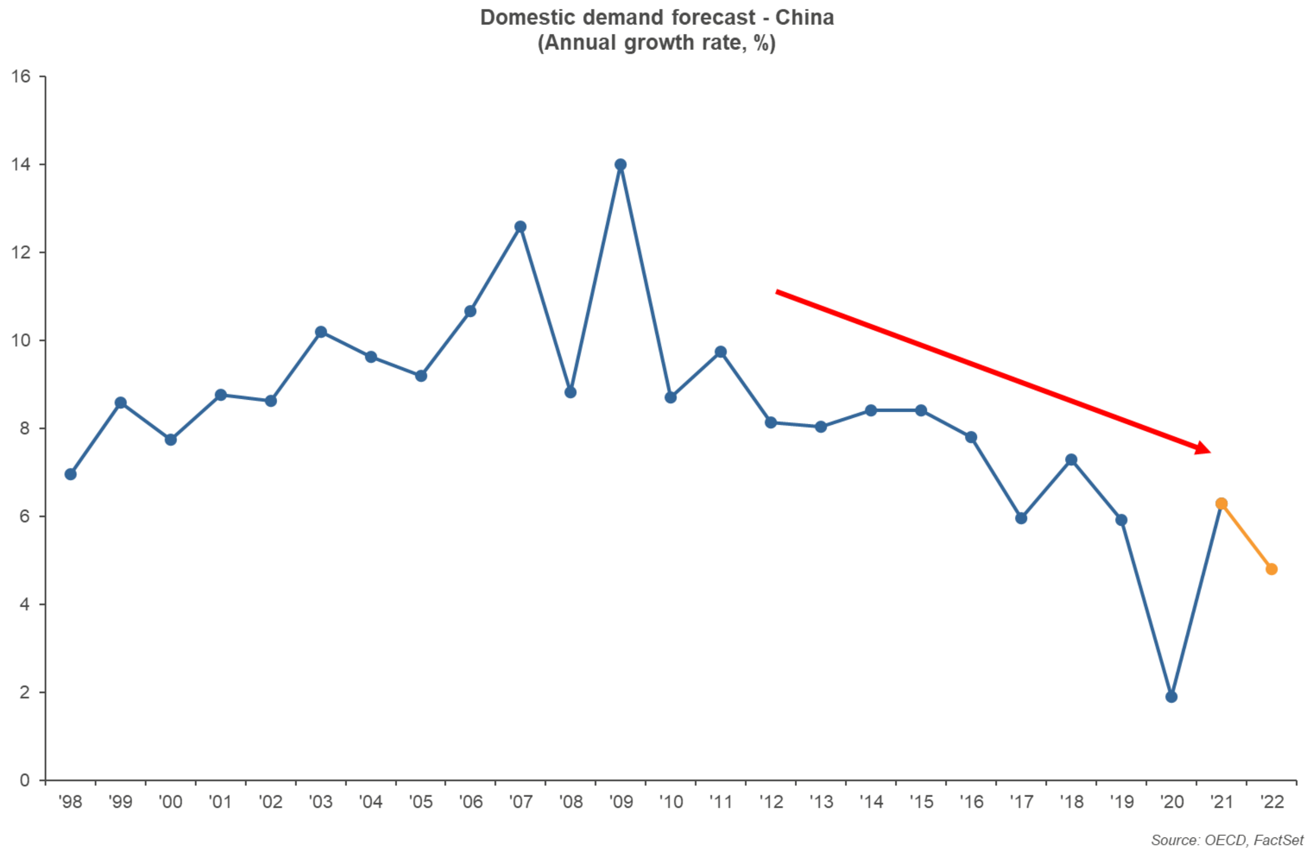


Source: FactSet

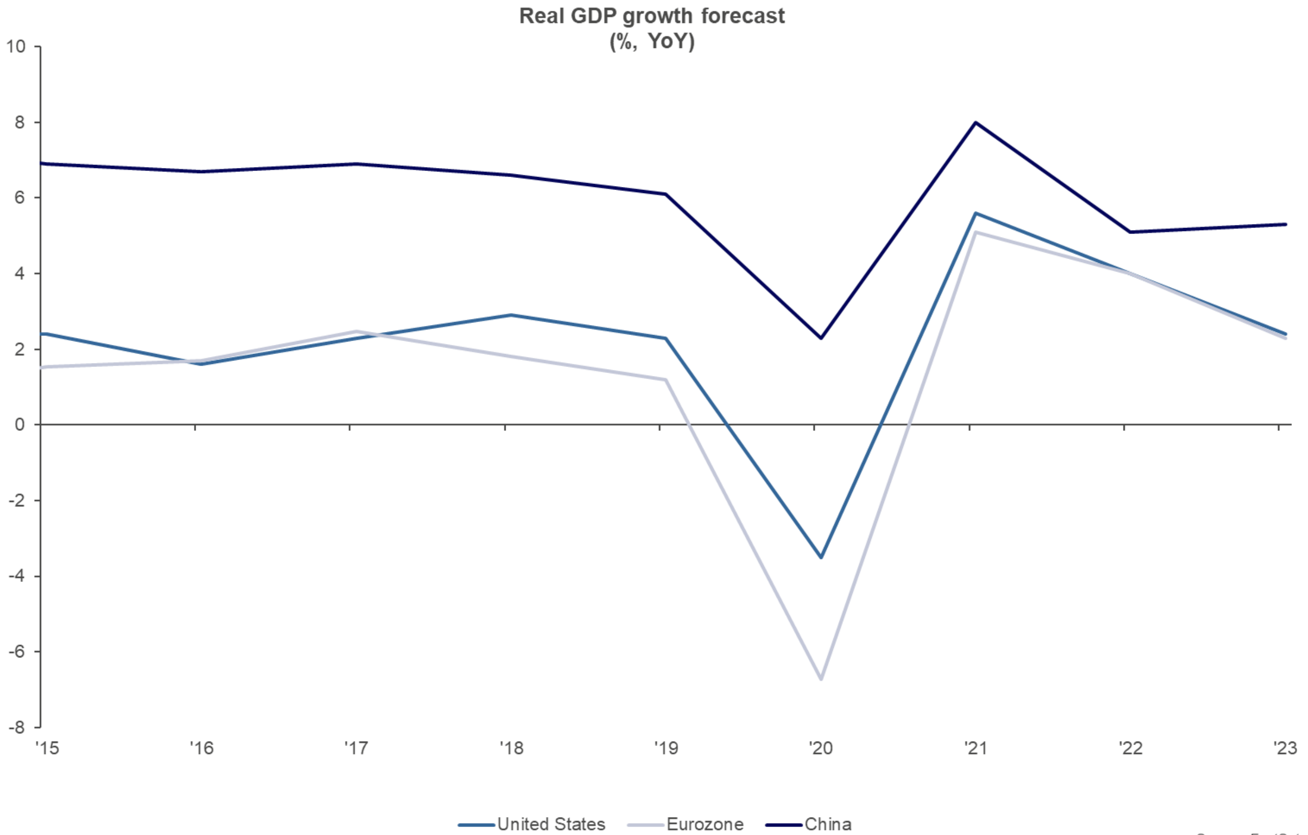
Apart from cyclical challenges, weaker domestic demand is durably undermining China's potential growth rate (see chart below). According to forecasters, the world's second-largest economy will grow by just 4.8% in 2022, not much better than the USA (4.1%) or the euro zone (4.4%). Domestic demand growth has been falling slowly but surely for the past decade, partly because of the combination of an ageing population and an underdeveloped pensions regime. The purchasing power of a growing proportion of the population is declining in a situation where shares of value added are too imbalanced to give any real benefit to the middle class. It is hardly surprising that consumer price inflation is relatively limited in China (an annual 2.3% in November 2021), especially given stiff domestic competition, and even though producer prices (although levelling off) are still up sharply (12.9%).

Fortunately for China, its exports surged 30% last year, which helped offset some of the sluggishness of domestic demand. But this also leaves the country more dependent on good relations with trade partners at a time of strained international politics. It means that Xi Jinping will have the difficult task of perhaps moderating his public utterances on such matters as world leadership and Taiwan if he is to keep China's economic model on track. If he does opt for sweeter trade relations, it would amount to a fundamental contradiction with the government's 'Made in China 2025' self-sufficiency objective, which sits within its 'common prosperity' concept. All in all, Chinese policy begs a number of questions for 2022, and the country's role as the world economy's engine of growth for almost 20 years is not nearly as obvious as it was. This is especially true in the light of a looming debt issue: Chinese corporate debt was almost 160% of GDP in mid-2021, compared with 51.1% in the USA and 64.7% in the euro zone. Even in Japan, notorious for its debt levels, corporate debt amounts to 102.6% of GDP… this says a great deal about the scale of China's problem! The possibility of default in the Chinese real estate sector could be just the tip of an iceberg. And any domino effect running through Chinese firms would inevitably spread to the rest of the world.

Chinese domestic demand has been softening on trend over the past decade



Growth rates converge among the world's biggest economies

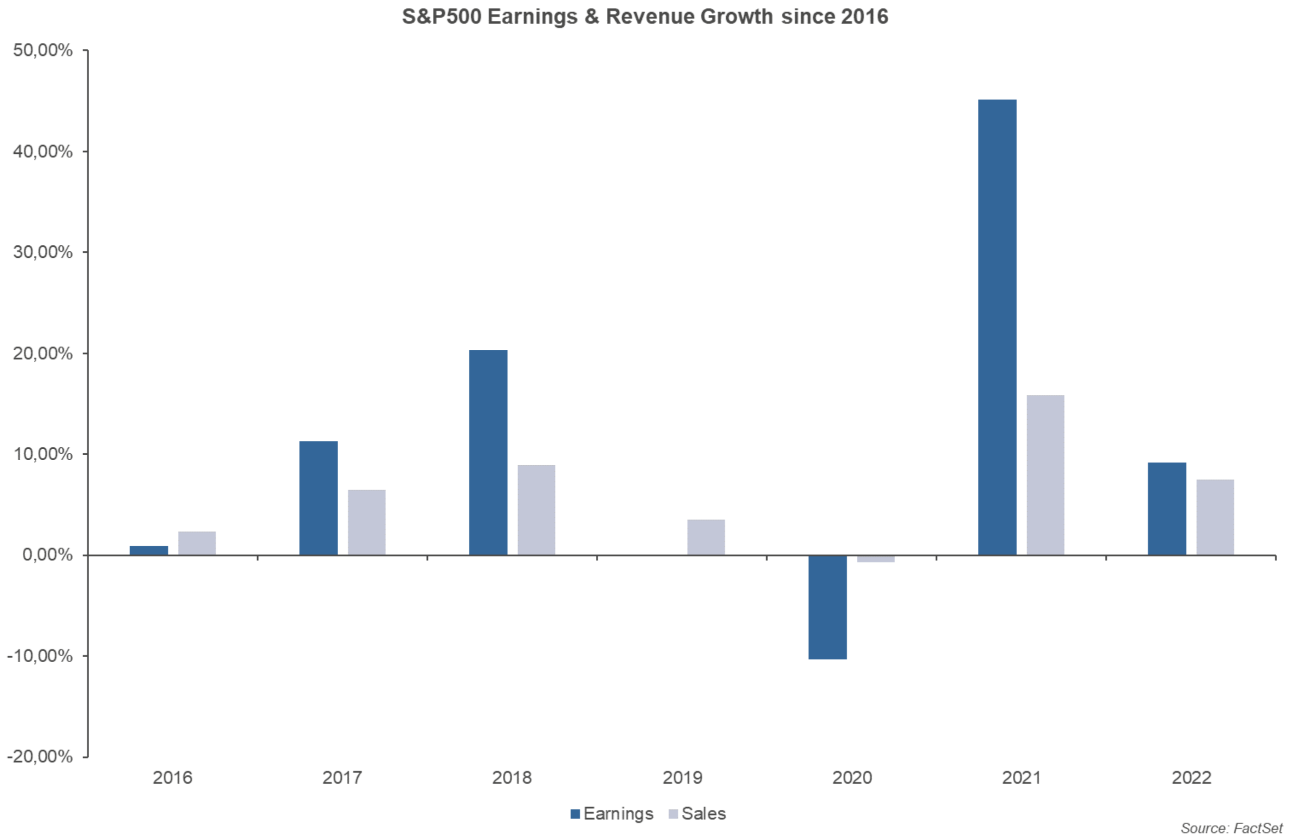


Source: FactSet

2021: a record year for corporates

At a microeconomic level, 2021 will go down as a great year. Ahead of the Q4 results season, S&P 500 earnings growth for the year is estimated at 45.1%, which would be the highest figure ever recorded since FactSet started publishing this data back in 2008 (the previous record was 39.6% in 2010, just after the subprime crisis). Similarly, S&P firms' aggregate revenues climbed an estimated 15.8%, compared with the previous high of 10.6% growth in 2011.

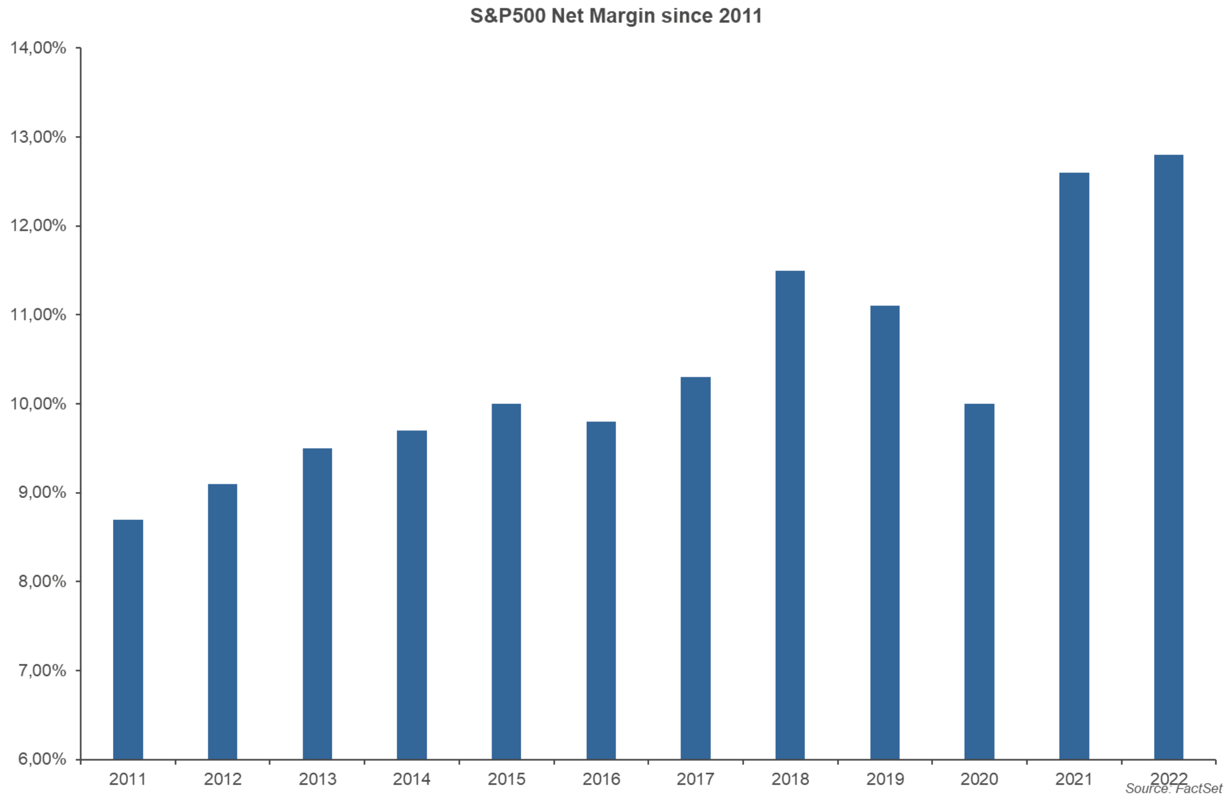
A great year for corporate America



Source: FactSet

We should not forget net profit margins, either, which also hit record highs despite a whole range of challenges that firms had to grapple with, from higher inflation to supply chain breakdowns, labour shortages and higher wages in some sectors. In 2021, aggregate net margin for S&P 500 companies hit 12.6%, well above the previous record of 11.5% set in 2018 in the aftermath of the Trump tax reforms.

US firms shrug off acknowledged problems to post record margins

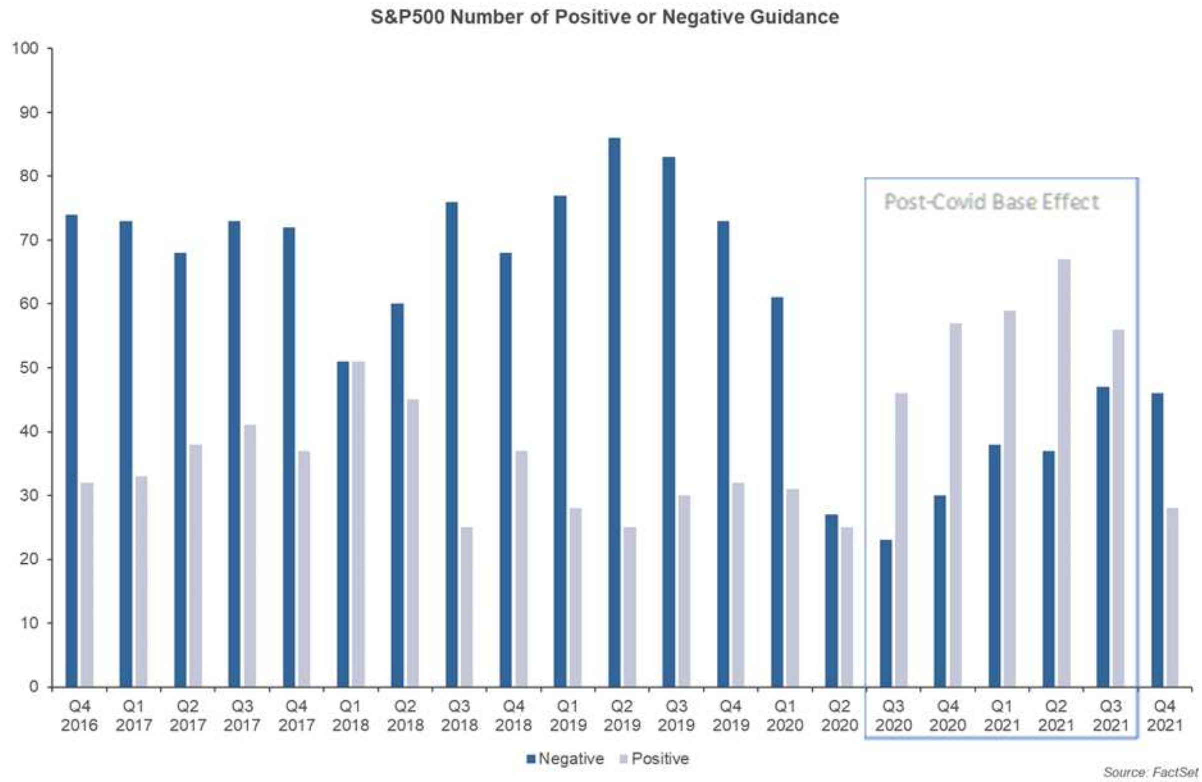


A strong Q4 2021 even without the momentum behind upward revisions seen in preceding quarters

S&P 500 earnings are expected to have risen 21.3% in the year to Q4, and this will be the fourth quarter in a row to post EPS growth above the symbolic 20% level. That said, the trend towards upward revisions to estimates that we saw in each of the first three quarters of the year has disappeared. At the end of September, analysts estimated a 20.9% gain for Q4, a number that has clearly changed little since; in the previous four quarters the average upward revision in each quarter was 4.7%. The flat estimates over Q4 therefore reveals less optimism and reflects the gradual weakening of the base effect inherited from pandemic-related damage (see chart).

For the first time since Q2 2020, more S&P 500 firms issued negative guidance for Q4 than those issuing positive guidance for the period. The negative guidance percentage is now 60%, which corresponds to the historical average for the past five years.

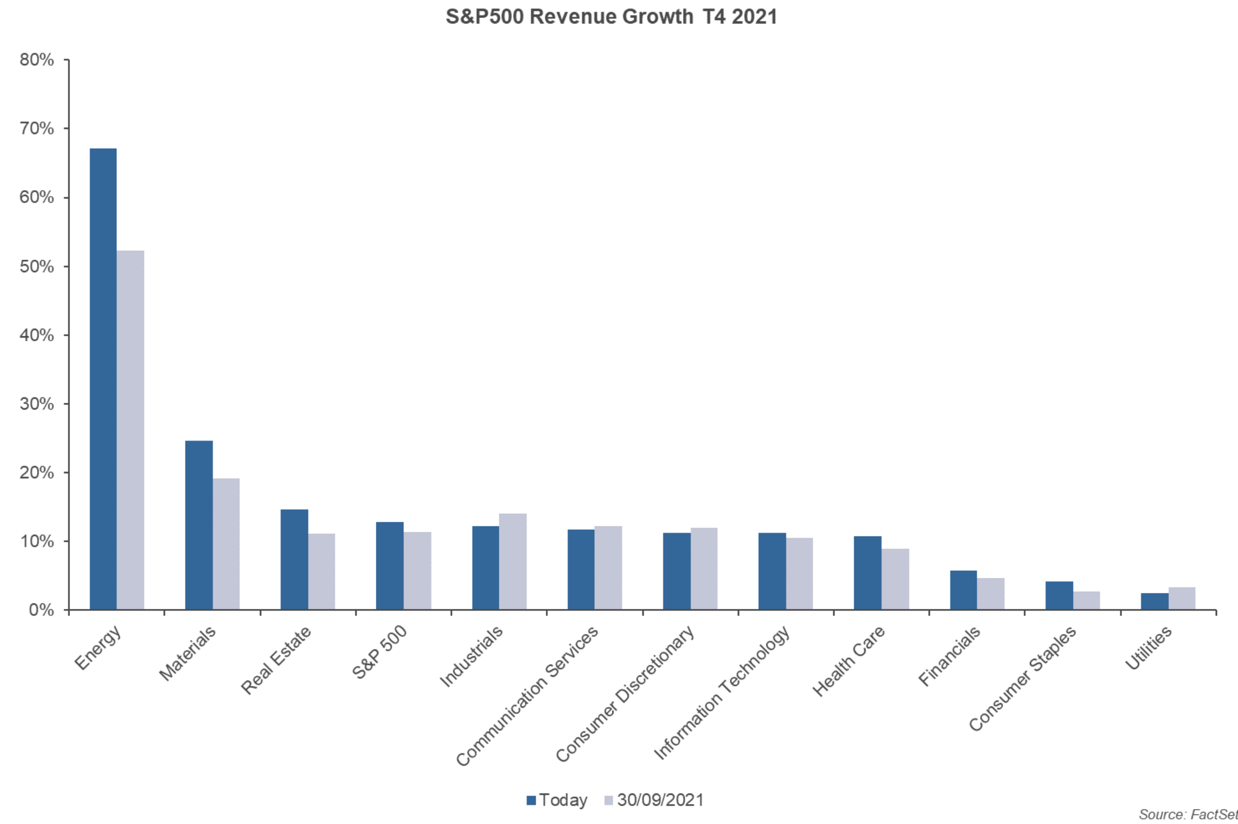
Dwindling euphoria from post-Covid base effects



As far as revenues are concerned, analysts are looking for 12.8% annual growth in Q4, which would be the third-fastest growth rate since FactSet started publishing these data in 2008. It compares with an average 6.5% for the past five years.

All S&P 500 sectors are set to post positive revenue growth in Q4. Readers will not be surprised to find the energy and basic materials sectors at the top of this league table, as they were in the preceding quarter and as we discussed in our letters at the time.

Revenue growth for all S&P 500 sectors in Q4 2021



Source: FactSet

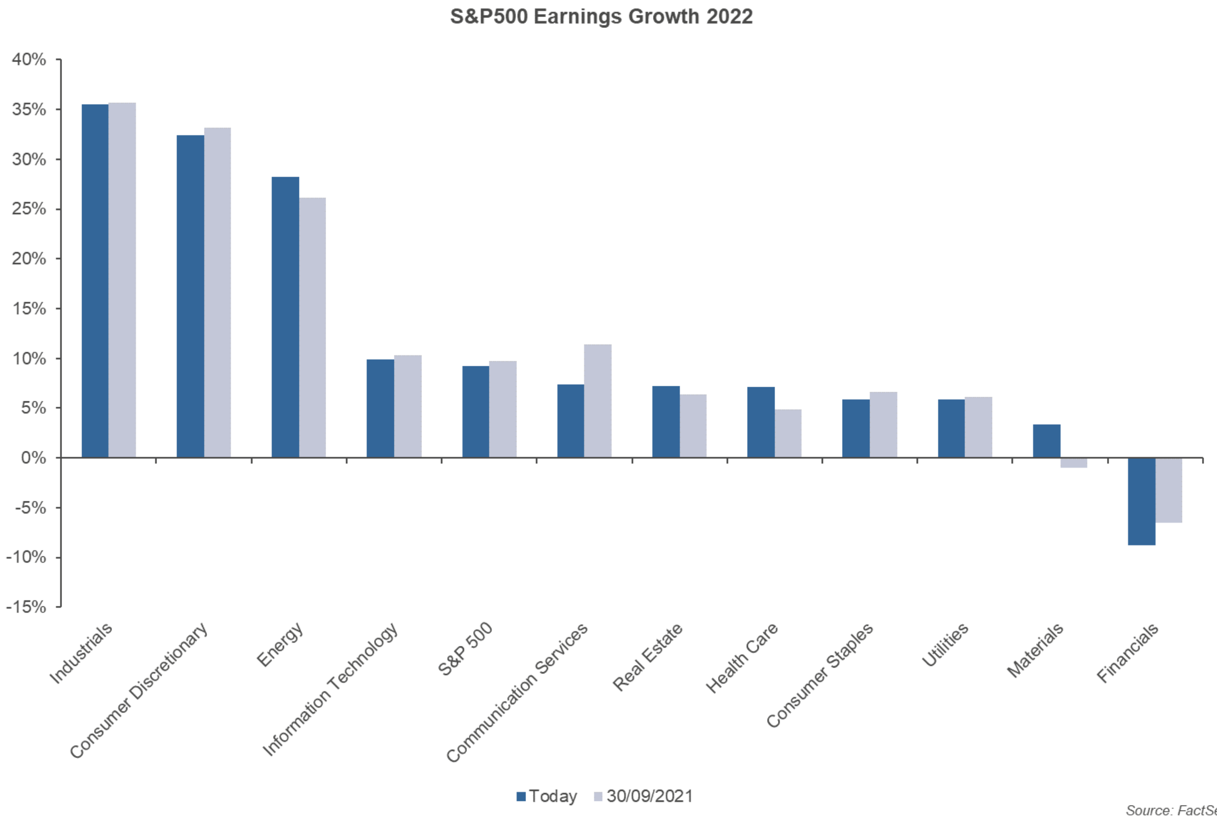
Profit margins are still looking robust for Q4, despite the persistence of the issues already mentioned. Analysts expect an aggregate net margin of 11.8%, which although down on Q2 (13.1%) and Q3 (12.9%) is still historically high and would be the fifth-largest margin ever recorded since FactSet started publishing this series in 2008.

The outlook for 2022

The challenges facing US firms could yet trip them up. As we have mentioned before, S&P 500 companies are increasingly likely to cite such terms as 'inflation' or 'supply chain' in their results announcements, and we do not expect that trend to reverse with respect either to Q4 2021 or to the first quarters of this year.

On a like-for-like basis, therefore, investors should not expect profits announcements to be as upbeat as they were in 2021. It follows that the market impact of those announcements will not be the same either. This does not mean that the microeconomic news will be bad, although we remain convinced that analysts' expectations for EPS growth in the years ahead are too aggressive, particularly in the USA. They are currently projecting 9.2% EPS growth in 2022, down from 9.7% at end-September, and revenue growth of 7.5%. The year should therefore correspond to the normalisation of profits along a pre-Covid trend. Only the financial sector is expected to show a drop in EPS next year, but that reflects a base effect stemming from provisioning among banks (which affect earnings but not revenues). Banks set aside huge sums in 2020 when the pandemic hit the economy, and the disappearance of the base effect that ensued in 2021 will disappear this year, 'artificially' penalising their results.

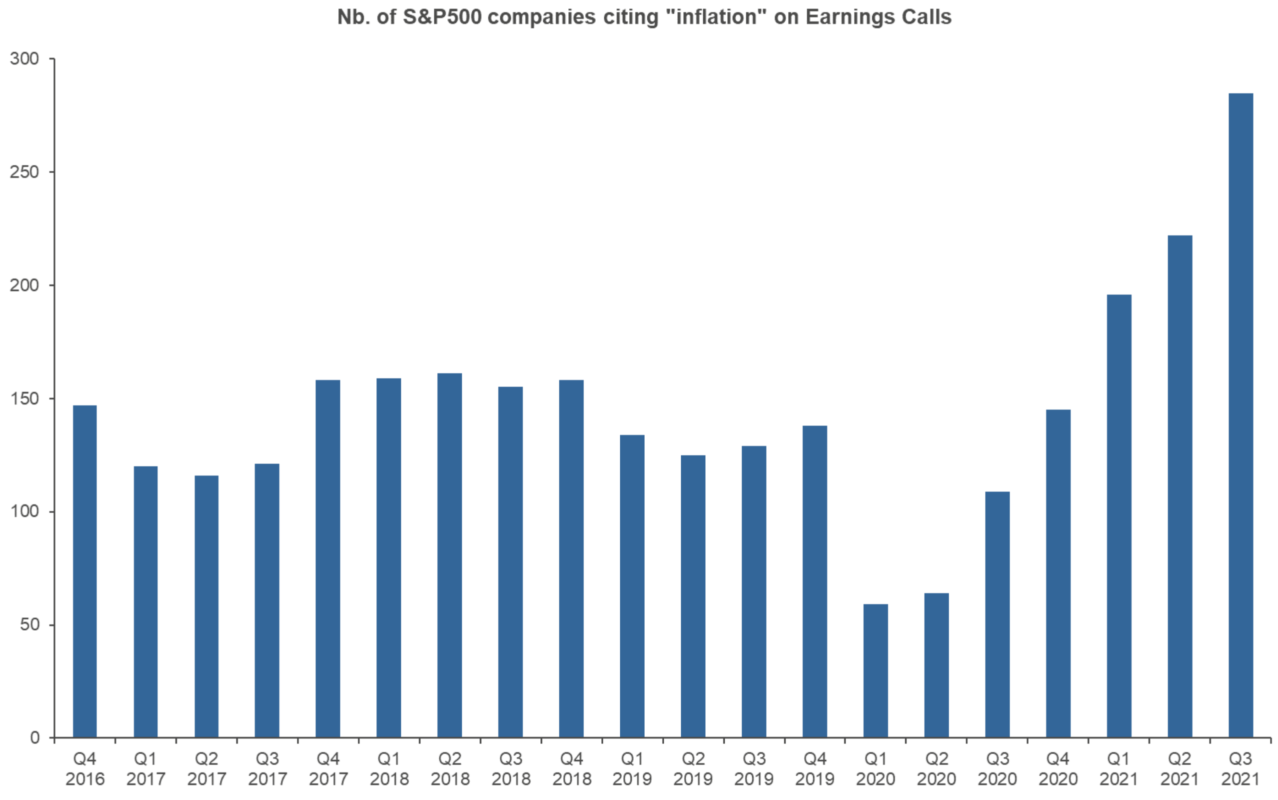
Apart from financials, the outlook for 2022 remains generally positive



Source: FactSet

It will be worth keeping a close watch on profit margins, which could struggle to stay as high as they are against a backdrop of inflation that has slipped out of the Fed's control and the higher tax burden in prospect from 2023 onwards. The start of this year will reveal the ability of American firms to continue with their current performance trends, and avoiding disappointment on current projections will be an unenviable task.

Inflation will continue to haunt firms in the quarters ahead



Source: FactSet

Valuation model: we still favour European equity markets

US equity indices rebounded smartly in December (the S&P 500 gained 4.4%), as did European markets (the Euro Stoxx progressed 4.9%). Over the past three weeks investors have drawn comfort from research suggesting that the Omicron variant will be less harmful than its predecessors. 30-year yields have rebounded 20bp in the USA and 15bp in Europe, reflecting hints from central banks such as the Fed around gradual rate hikes later this year.

In these circumstances, our valuation model indicates that US equities are fair value. But our scenario that integrates a rise in taxes in 2023 – which does not appear to have been priced in – shows correction potential of around 10% in the medium term if interest rates stabilise.

S&P 500 - Valuation end 2022 except implied scenario

CAGR Compounded Annual Growth Rate from 2021	**30 Years Gvt bonds**				
	1,50%	**1,75%**	**2,02%**	**2,25%**	**2,50%**
Tax increase to 25% (approx. -5% impact on EPS) - CAGR 3.4%	**4 825**	**4 524**	4 233	4 010	3 789
Implied Scenario CAGR 5.6% over 8 years	5 490	5 137	**4 797**	4 535	4 277
Return to normal: 8.4% in 2022, 8.8% in 2023 - CAGR 4.9%	5 412	**5 073**	**4 746**	**4 495**	4 246
Current Index S&P 500			4 797		

For the euro zone, our model suggests that European equities are fair value to underpriced, depending on how interest rates behave (in the event of a slow recovery, they would tend inevitably towards zero).The market's 7-15% appreciation potential is valid for all the scenarios envisaged. We therefore continue to overweight European equities relative to their American counterparts.

MSCI EMU - Valuation end 2022 except implied scenario

CAGR Compounded Annual Growth Rate from 2021	30 Years Gvt bonds				
	0,00%	0,50%	0,74%	1,00%	1,25%
Slow recovery: 3.8% in 2022, 2.5% in 2023	**183**	**156**	146	136	128
Implied Scenario	195	166	**155**	145	136
Return to normal: 3.8% in 2022	209	178	**166**	**155**	146
Current Index MSCI EMU			**155**		

Main ratios for markets and sectors as of 05/01/2022 (in local currency)

CHAHINE CAPITAL
PERFORMANCE ENGINEERING

Data as of	Weight vs	Perf		Weighted P/E		% Wted EPS Chge			Div Yield	Revision vs M-1%	
01/05/22	World	2022	2021	2022	2021	2022	2021	2020	2021	Fiscal 22	Fiscal 21
World - Developed	**100,0%**	**-0,97%**	**13,18%**	**18,3 x**	**20,2 x**	**10,70%**	**66,97%**	**-19,08%**	**1,8%**	**0,0%**	**0,0%**
United States	56,6%	-1,98%	21,64%	22,2 x	24,8 x	11,86%	63,54%	-15,57%	1,3%	0,4%	0,0%
Japan	7,3%	1,45%	-2,20%	14,7 x	16,7 x	13,31%	35,98%	-8,89%	2,1%	-1,8%	-1,6%
Eurozone	11,0%	1,44%	11,04%	16,2 x	17,6 x	8,77%	100,49%	-38,93%	2,5%	-0,2%	0,0%
Europe	20,5%	1,09%	12,88%	16,3 x	17,7 x	8,97%	87,96%	-35,70%	2,7%	0,6%	1,0%
Austria	0,2%	2,09%	25,54%	11,1 x	11,9 x	6,92%	112,69%	-41,33%	3,0%	-0,5%	-0,7%
Belgium	0,4%	1,95%	5,03%	19,6 x	21,2 x	7,83%	30,41%	-25,07%	2,3%	-0,7%	-0,4%
Denmark	0,7%	-2,00%	13,23%	21,5 x	22,5 x	4,93%	66,14%	-7,16%	1,9%	0,3%	0,3%
Finland	0,4%	1,71%	5,66%	19,0 x	19,7 x	4,00%	38,19%	-13,69%	2,9%	0,6%	-1,8%
France	3,8%	2,15%	19,06%	18,4 x	21,1 x	14,88%	170,11%	-55,00%	2,3%	0,0%	0,1%
Germany	2,8%	1,66%	4,34%	14,2 x	15,3 x	7,77%	78,03%	-20,06%	2,7%	-0,7%	0,6%
United Kingdom	4,1%	1,75%	12,03%	13,6 x	14,8 x	8,38%	94,97%	-40,09%	3,5%	1,6%	3,5%
Ireland	0,1%	3,05%	12,86%	19,7 x	28,9 x	46,42%	5174,06%	-105,07%	1,2%	-1,8%	-0,5%
Italy	0,9%	2,42%	13,37%	12,3 x	13,8 x	11,49%	75,50%	-41,54%	3,6%	-1,2%	-1,6%
Netherlands	1,4%	-1,08%	14,28%	19,9 x	20,6 x	3,54%	94,01%	-27,12%	1,5%	0,3%	-0,1%
Norway	0,5%	2,27%	14,05%	14,7 x	16,5 x	12,49%	243,34%	-55,06%	3,1%	1,8%	2,5%
Spain	0,8%	0,14%	-0,49%	14,4 x	13,6 x	-5,62%	100,09%	-42,81%	3,4%	0,7%	0,0%
Sweden	1,5%	0,22%	21,33%	21,3 x	21,7 x	11,13%	92,13%	-38,43%	2,3%	5,6%	2,1%
Switzerland	2,7%	-0,16%	17,46%	20,3 x	22,4 x	10,70%	22,97%	-7,91%	2,4%	-0,4%	0,0%
Europe / Commercial Services	0,6%	0,14%	9,58%	22,0 x	25,9 x	17,86%	62,92%	-29,26%	1,7%	1,4%	1,8%
Europe / Communications	0,5%	0,10%	0,96%	14,6 x	11,9 x	-18,22%	5,50%	4,86%	4,6%	0,1%	0,7%
Europe / Consumer Durables	0,9%	5,45%	21,32%	9,8 x	10,6 x	7,79%	282,78%	-58,41%	3,2%	-2,3%	0,1%
Europe / Consumer Non-Durable	3,3%	1,71%	13,18%	24,4 x	27,3 x	12,21%	27,12%	-21,01%	1,9%	0,9%	1,0%
Europe / Consumer Services	0,4%	1,93%	4,84%	24,5 x	291,5 x	1190,53%	122,63%	-122,49%	1,4%	-1,6%	-18,1%
Europe / Distribution Services	0,2%	0,87%	20,56%	21,9 x	23,7 x	8,42%	57,59%	-15,04%	1,7%	1,8%	0,5%
Europe / Electronic Technology	1,1%	-0,90%	15,23%	25,5 x	31,2 x	22,25%	139,07%	-51,15%	0,9%	0,0%	0,0%
Europe / Energy Minerals	0,7%	5,26%	21,06%	8,1 x	9,2 x	13,63%	13366,48%	-92,11%	4,5%	1,3%	0,3%
Europe / Finance	3,7%	2,16%	15,23%	11,8 x	11,8 x	0,92%	79,08%	-34,78%	3,8%	1,9%	2,9%
Europe / Health Services	0,2%	-2,26%	20,45%	23,5 x	24,2 x	2,91%	20,78%	-0,81%	1,4%	0,6%	0,5%
Europe / Health Technology	2,3%	-2,53%	15,32%	20,7 x	23,0 x	11,02%	12,65%	-0,94%	2,1%	-1,4%	0,6%
Europe / Industrial Services	0,3%	1,37%	6,82%	15,8 x	21,2 x	34,00%	76,09%	-51,28%	2,8%	0,4%	0,0%
Europe / Miscellaneous	0,0%	-0,81%	35,07%	14,1 x	10,8 x	-23,44%	148,46%	-81,20%	2,9%	0,5%	0,4%
Europe / Non-Energy Minerals	0,7%	3,30%	13,30%	8,5 x	7,2 x	-15,49%	117,04%	27,68%	6,5%	0,5%	0,2%
Europe / Process Industries	0,8%	1,99%	9,77%	19,2 x	19,9 x	3,53%	53,92%	-13,98%	2,5%	1,6%	0,8%
Europe / Producer Manufacturin	1,5%	1,95%	21,04%	21,5 x	26,1 x	21,48%	86,33%	-32,22%	1,9%	0,2%	0,2%
Europe / Retail Trade	0,5%	0,00%	-1,51%	22,1 x	26,5 x	19,51%	86,57%	-24,54%	2,1%	1,0%	3,2%
Europe / Technology Services	1,1%	-1,27%	2,33%	28,3 x	32,4 x	14,46%	28,70%	-5,82%	0,7%	0,5%	-0,8%
Europe / Transportation	0,7%	2,85%	26,29%	13,5 x	27,3 x	103,14%	154,68%	-255,23%	2,9%	1,9%	0,0%
Europe / Utilities	0,9%	-1,08%	-4,61%	16,8 x	17,5 x	3,79%	21,01%	-17,21%	3,8%	-0,7%	-0,9%

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