April 2022

Are central banks about to start a new currency war?

Overview

The war between Russian and Ukraine has overshadowed a major financial development since the start of the year: the decision on the part of several major central banks to adopt a significantly less accommodating monetary policy. Following a 25 basis-point hike by the Bank of England on 3 February, from 0.25% to 0.5%, the Federal Reserve did exactly the same thing (and to the same level) in mid-March. Fed Chairman Jerome Powell said on that occasion that future hikes could be bigger and that the Fed would intervene as often as necessary, as the origins of US inflation were endogenous enough to trigger higher interest rates.

In the meantime, the war in Ukraine has fundamentally altered the nature of inflation in continental Europe. We have shifted abruptly from expensive energy (cyclical inflation) to energy scarcity (structural inflation), reflecting the fact that we will lose Russian supply in the short and medium term at least. We recall that Russian oil and gas accounts for 16% and 19%, respectively, of EU consumption. The European Central Bank's 2% inflation target has already been overshot for the past nine months, precisely because of higher energy prices. Year-on-year consumer price inflation hit 5.9% in February and the problem is bound to worsen. The ECB's own scenarios give us inflation rates of between 5.1% and 7.1% for 2022 as a whole and it has reduced its eurozone growth forecast for this year from 4.2% to 3.7%. Given that the war appears to be nowhere near ending, growth forecasts will inevitably be reduced further in the months ahead.

At the same time, divergent central bank approaches will have a real impact on the currency markets, injecting more volatility to international asset prices.

The best example is that of Japan, where the yen has depreciated 6% since the start of the year and 17% since the beginning of 2021, leaving it at its lows of 2015 and 2007. The reason is evident: the Bank of Japan's clear desire to persist with unconditional support for the economy in general and government in particular via market intervention and extremely low interest rates. The resulting interest-rate differential with respect to other currencies has pushed international investors out of yen and into the UK, for example, and especially the USA. Both have made tackling inflation a priority and have unambiguously initiated tightening cycles.

At micro level, the American Q4 2021 results season ended on a strong note. S&P 500 earnings per share increased 31.5% over the year before, compared with a consensus forecast at end-December of 21.2% (source: FactSet). This made it the fourth consecutive quarter of 30%-plus earnings growth, a phenomenon that we have not seen since Q3 2010. That said, Q4 2021 saw the consensus outstripped by only 8.2% overall, compared with an average 8.6% over the past five years. We believe this signals the end of a trend of large flows of positive surprises over the past few quarters.

Against a backdrop of a widening GDP growth gap between the USA and Europe, with a healthier corporate sector in the former and a more helpful dollar exchange rate, we would argue that conditions have now been met for US equities to outperform their European equivalents once again in the short and medium term.

Michaël Sellam

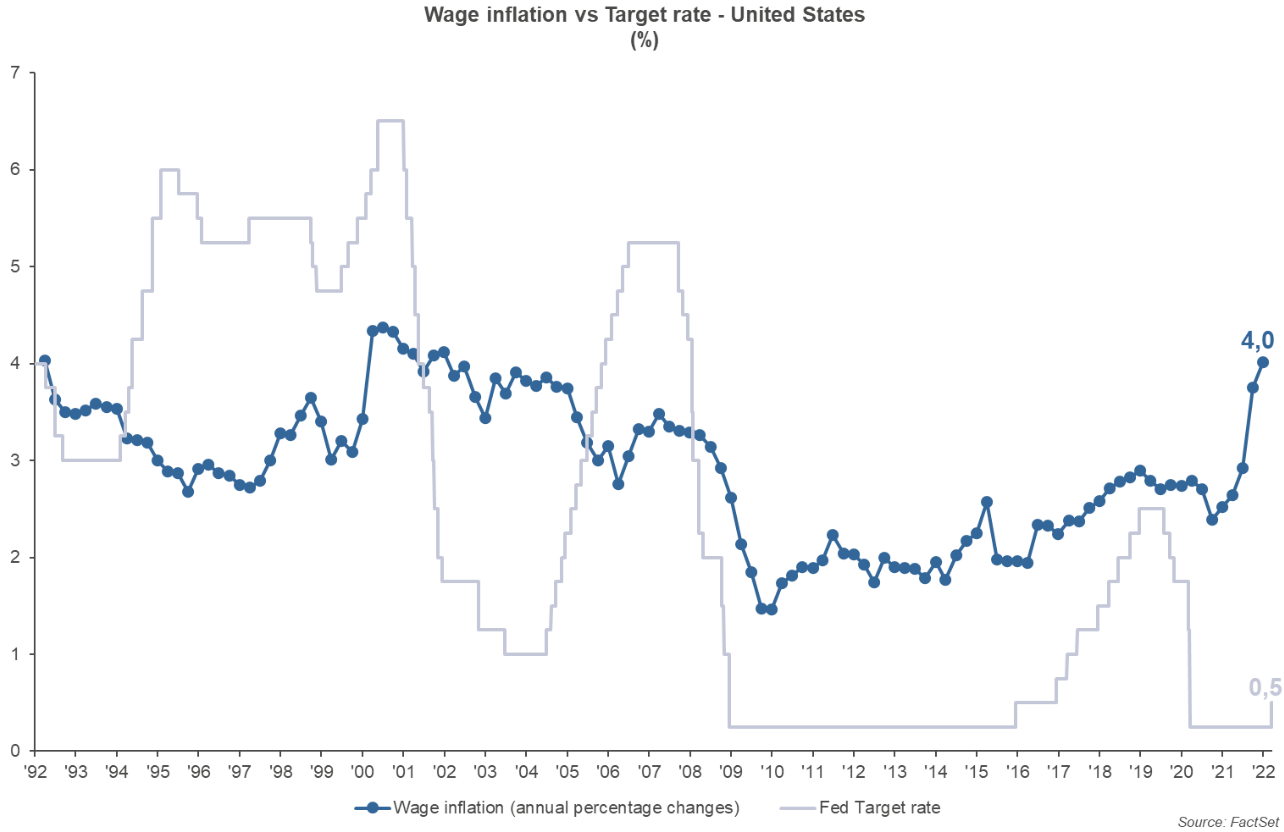
First the Bank of England, then the Fed

The war between Russian and Ukraine has overshadowed a major financial development since the start of the year: the decision on the part of several major central banks to adopt a significantly less accommodating monetary policy. Following a 25 basis-point hike by the Bank of England on 3 February, from 0.25% to 0.5%, the Federal Reserve did exactly the same thing (and to the same level) in mid-March. Fed Chairman Jerome Powell said on that occasion that future hikes could be bigger and that the Fed would intervene as often as necessary, as the origins of US inflation were endogenous enough to trigger higher interest rates. But would that be wise at the moment?

On one hand, and if the Fed is serious about reducing an inflation rate that hit 7.9% year-on-year in February with tighter monetary policy, rates would have to be hiked so much that recession would be all but guaranteed. On the other hand, economic agents (households, companies and the government) are starting to see expansionary policies as dangerous, as they raise a risk of establishing hyperinflation. That would eventually undermine purchasing power and drive the country into stagflation. After all, the Fed's balance sheet has increased by 115% in the past two years, to $8,955 billion. Between a rock and a hard place…

Is this the Fed's own fault? It has certainly reacted late to renewed inflation, but then wage inflation – the only type that has to be countered swiftly, by virtue of its structural nature – appeared only later on, i.e. from Q3 2021 onwards (see chart). The fact is that it remains difficult to pick out the underlying causes of current price pressures, tangled as they are between supply-side difficulties (Covid, China's over-rapid recovery and then the war in Ukraine) and super-abundant liquidity that may have overheated domestic demand.

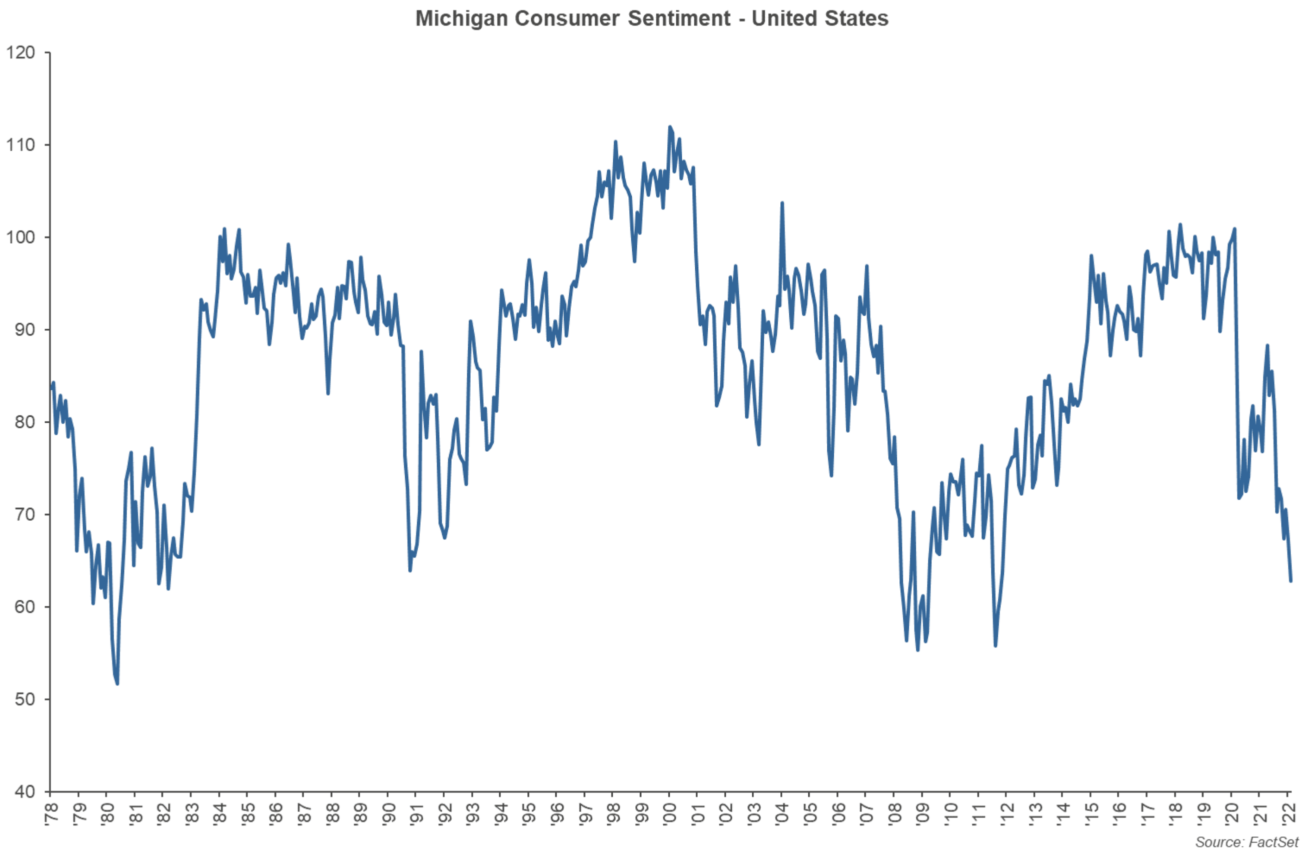
The recent pickup in wage inflation has left the monetary authorities with no choice



We think it highly unlikely that US interest rates will be driven up sharply in the medium term, especially as public and private debt levels remain very high (123.5% and 158.4% of GDP, respectively, in Q3 2021). Any significant increase in financing costs would swiftly weigh on American agents' finances and lead to a rapid deterioration in US economic activity.

Another factor pleading for Fed restraint is the state of the consumer confidence indices. Some are already at alarmingly low levels historically associated with recession. The Michigan Consumer Sentiment index has been as low as it is now only six times before in the post-war period: in 1974, 1980, 1982, 1991, 2008 and 2011 (see chart). In the world's largest economy, where household consumption accounts for over 70% of GDP, slower growth will soon be on forecasters' minds.

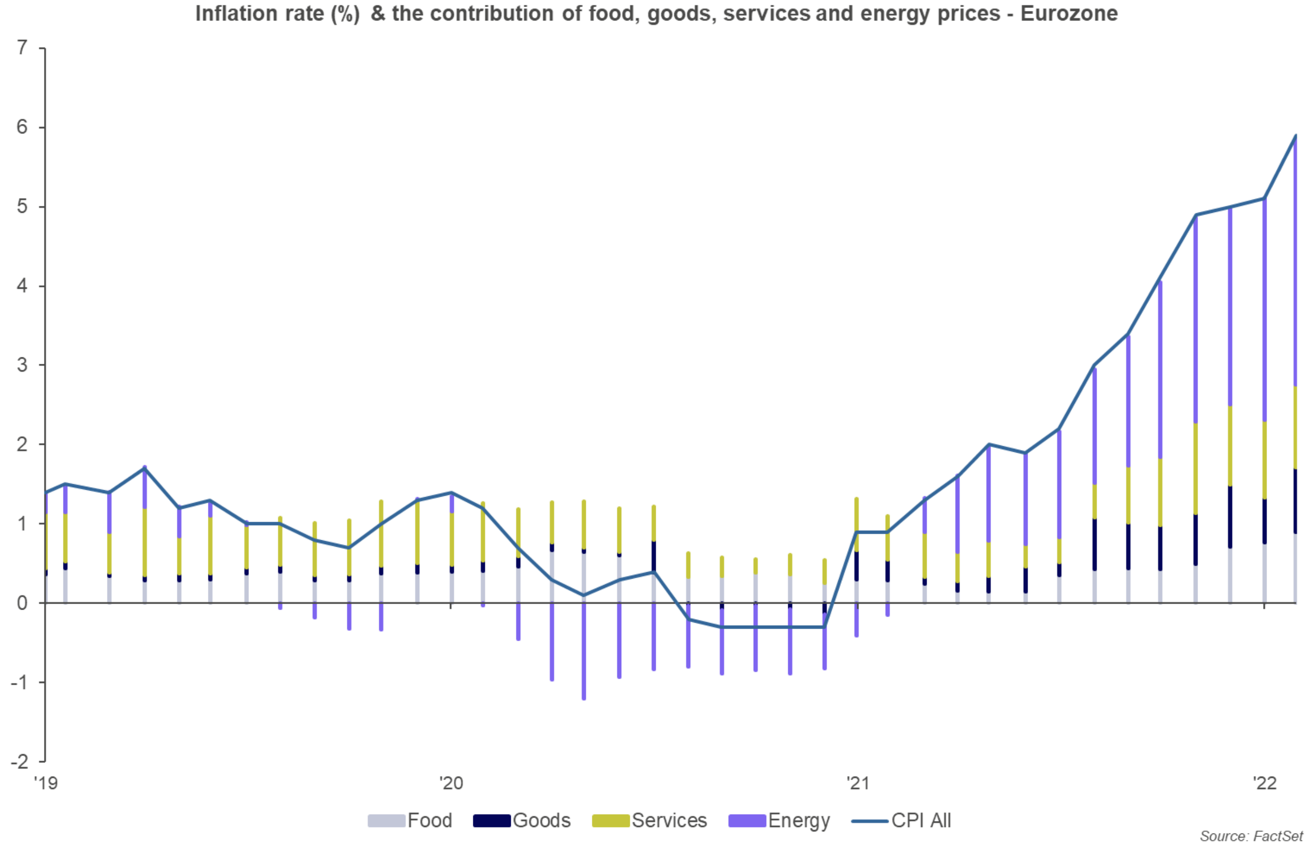
American confidence indices are not looking good



Can the ECB really follow the same trajectory as the Fed?

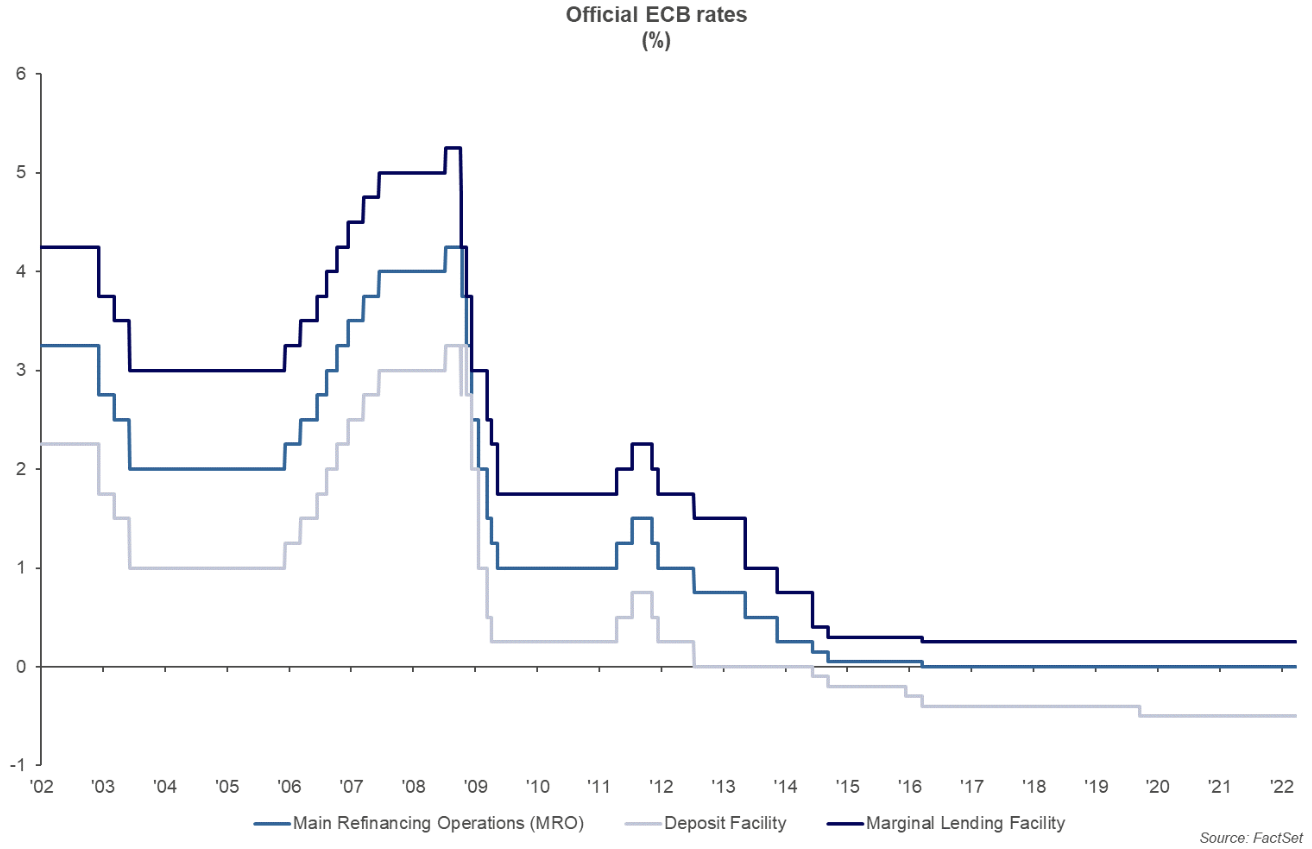
The war in Ukraine has fundamentally altered the nature of inflation in continental Europe. We have shifted abruptly from expensive energy (cyclical inflation) to energy scarcity (structural inflation), reflecting the fact that we will lose Russian supply in the short and medium term at least. We recall that Russian oil and gas accounts for 16% and 19%, respectively, of EU consumption. The European Central Bank's 2% inflation target has already been overshot for the past nine months, precisely because of higher energy prices see chart). Year-on-year consumer price inflation hit 5.9% in February and the problem is bound to worsen. The ECB's own scenarios give us inflation rates of between 5.1% and 7.1% for 2022 as a whole and it has reduced its eurozone growth forecast for this year from 4.2% to 3.7%. Given that the war appears to be nowhere near ending, growth forecasts will inevitably be reduced further in the months ahead.

Energy has been the main factor in destabilising European prices over the past year



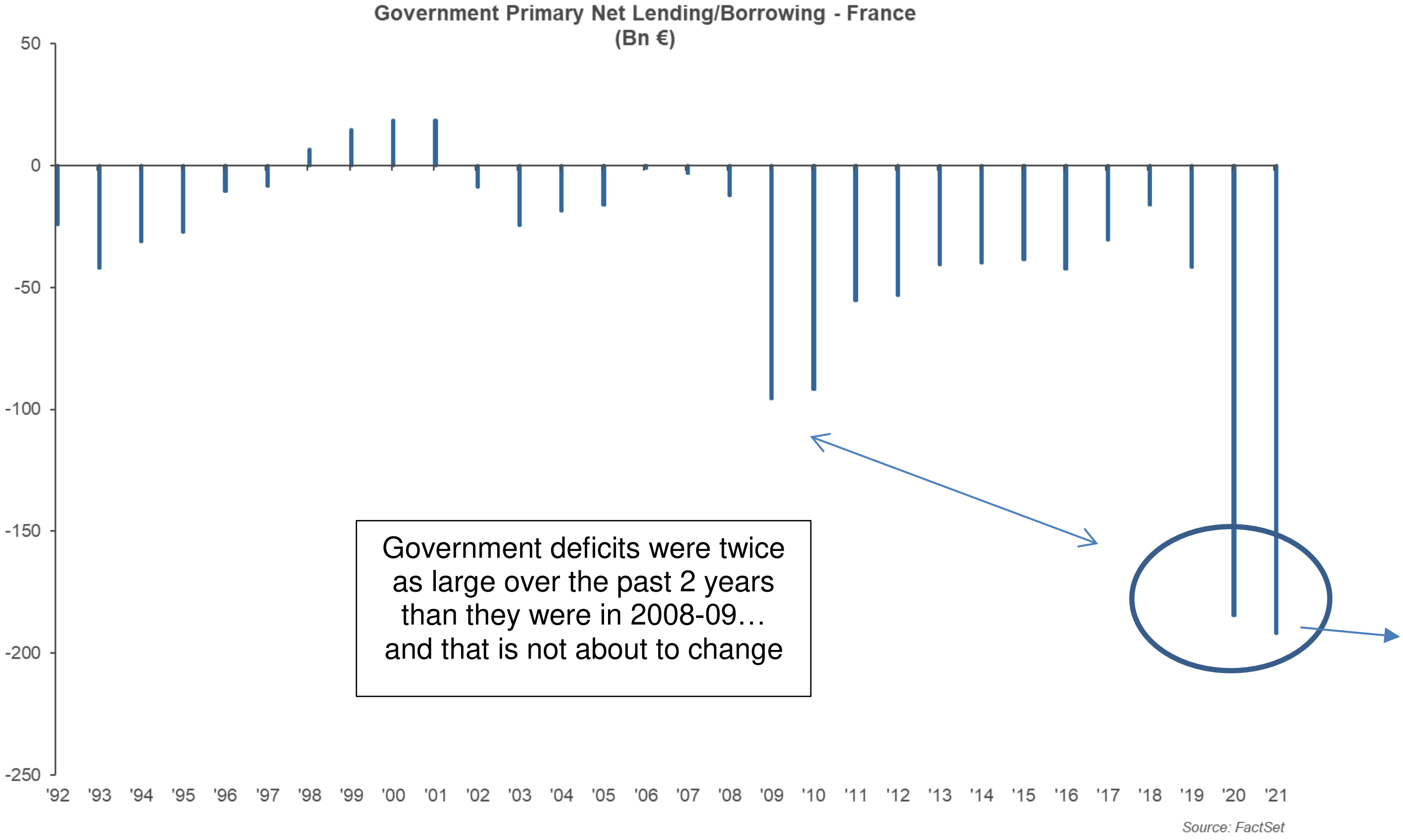
Despite the complexity of the situation and persistent uncertainty, the ECB has maintained its objective of imminent departure from its expansionary monetary policy. Its €1,850 billion Pandemic Emergency Purchase Programme will wind up on schedule between now and month-end, and the Asset Purchase Programme will take over only until the end of Q3 2022. At that point it will revert to its normal rhythm of €20 billion in purchases per month. As far as interest rates are concerned, the ECB will leave them unchanged for now even though Joachim Nagel, the new president of Germany's Bundesbank, has already called for a hike before the year is out.

Unfortunately, a hike in European interest rates would have no impact on energy prices



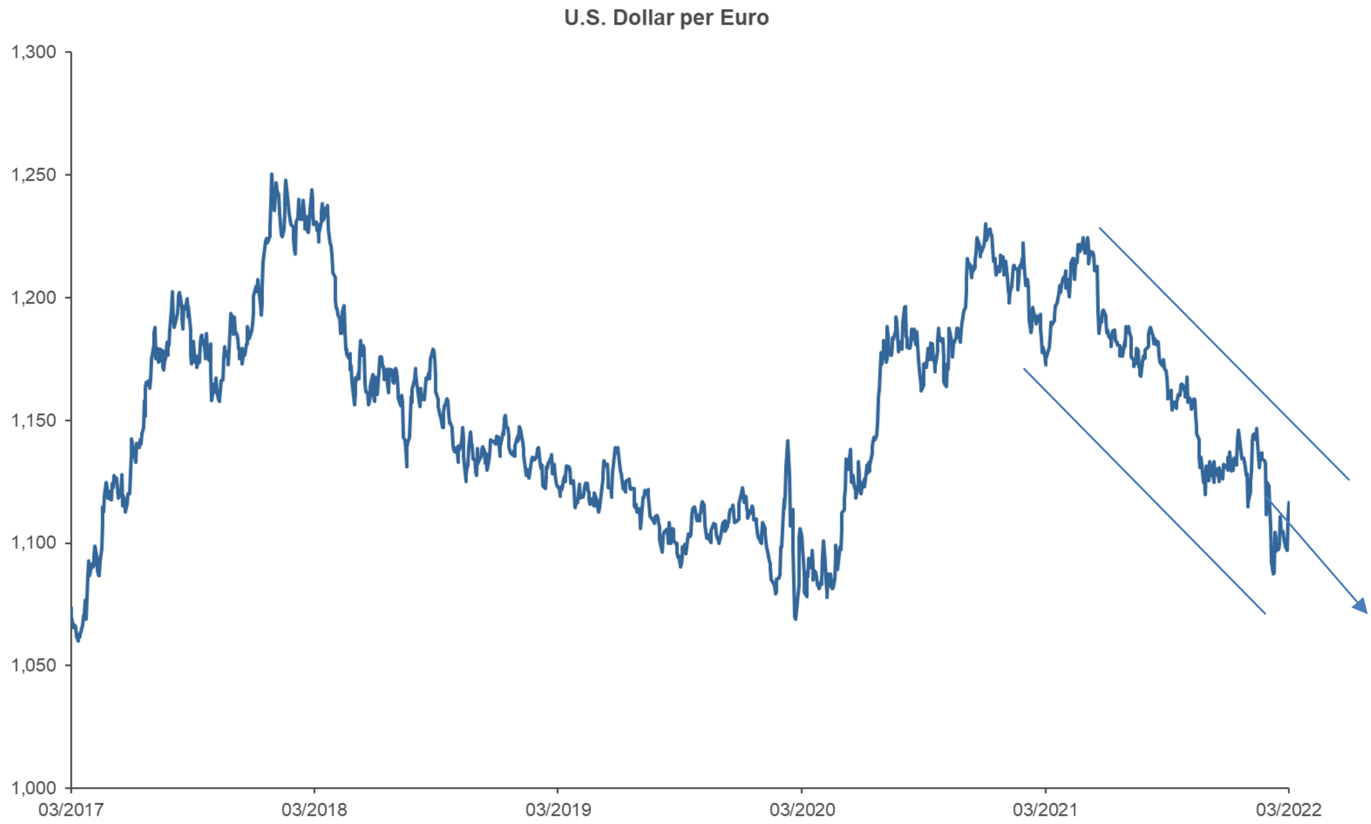
Fixed-income markets have not been slow to realise the consequences, and European government yields have risen almost 100bp in less than three months. This development has helped to stem a slide in the value of the euro against the dollar related to the war in Ukraine. But we urge investors to be wary of the ECB's resolve to stick with its present strategy. The reason is simple: the situation in Europe has little in common with the situation in America. In Europe, inflation is essentially an imported phenomenon, stemming from higher raw materials prices rather than higher wages. This makes it unlikely that a more restrictive monetary policy will have any effect on European final inflation. Moreover, and considering that the state of public finances has worsened, with several major eurozone countries now running high debt levels (116% of GDP in France, 122% in Spain, 155% in Italy in Q3 2021), greater government financing requirements could weigh on the prices of other European assets as most private savings are now pre-empted by sovereign bonds. The potential impact of an inert ECB – lower prices for assets such as equities or real estate – could aggravate the economic downturn and even trigger recession.

ECB hesitation over continued support when European governments have enormous financing requirements could put other assets under pressure



At the end of the day, only massive ECB intervention could forestall this negative wealth effect. This consideration ought to encourage it to switch strategy and fall back into line with other central banks that have chosen to persist with expansionary monetary policies, in contrast with the Fed and Bank of England. The implication is that the euro could depreciate further in the medium term, just like the yen over the past year and a half.

The dollar has strengthened dramatically against the euro

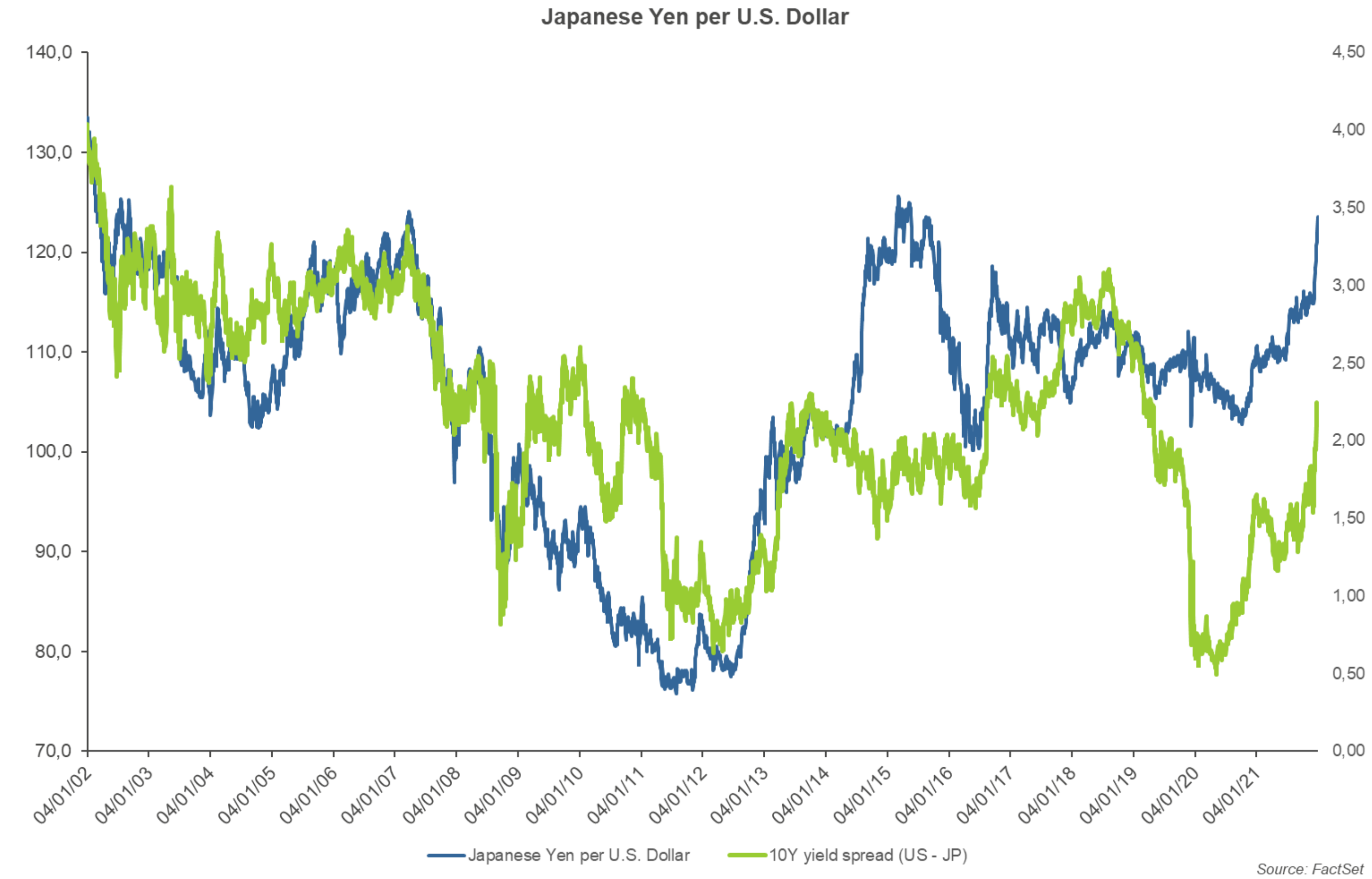


Source: FactSet

Japan shows Europe the way: a weaker currency

Divergent central bank policies will have a major impact on currency markets in the coming months, ensuring more volatility in international asset prices. The best example is that of Japan, where the yen has depreciated 6% since the start of the year and 17% since the beginning of 2021, leaving it at its lows of 2015 and 2007. The reason is evident: the Bank of Japan's clear desire to persist with unconditional support for the economy in general and government in particular via market intervention and extremely low interest rates. The resulting interest-rate differential with respect to other currencies has pushed international investors out of yen and into the UK, for example, and especially the USA. As we have seen, both have made tackling inflation a priority and have unambiguously initiated tightening cycles.

Japan's accommodating monetary policy has opened the door to yen depreciation

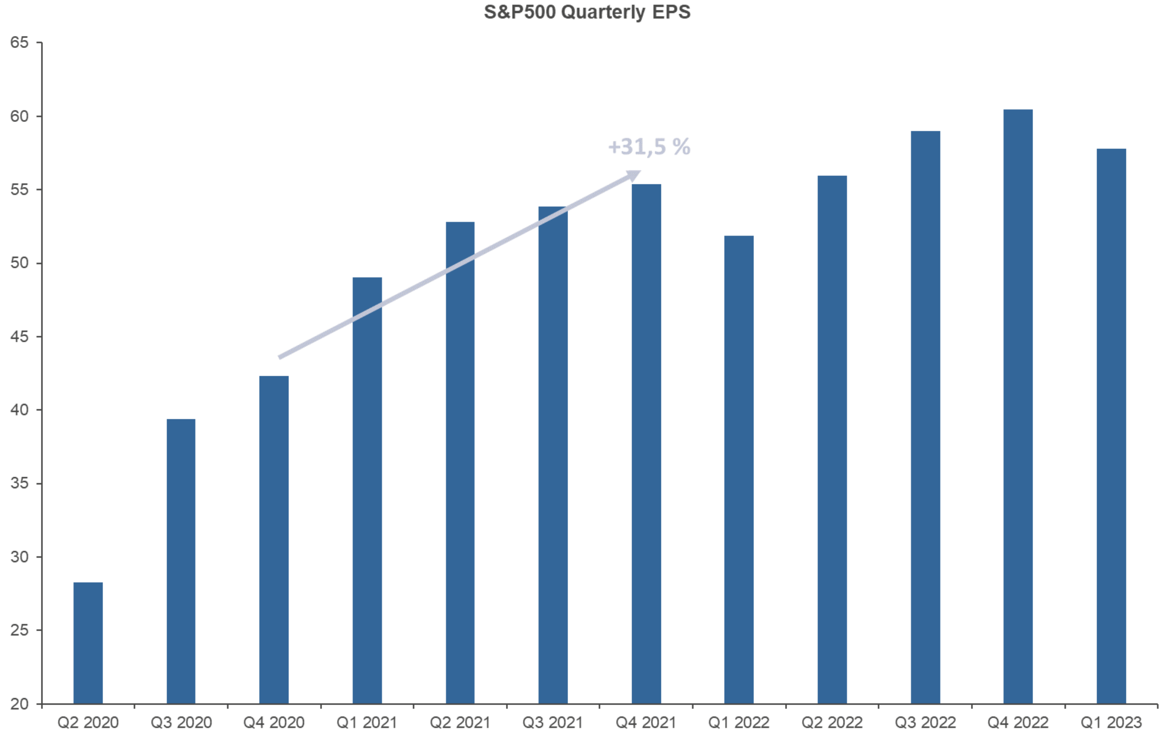


Source: FactSet

Following a very upbeat end to 2021, 2022 will see less buoyant US corporate performance, especially in H1

The American Q4 2021 results season ended on a strong note. S&P 500 earnings per share increased 31.5% over the year before, compared with a consensus forecast at end-December of 21.2% (source: FactSet). This made it the fourth consecutive quarter of 30%-plus earnings growth, a phenomenon that we have not seen since Q3 2010.

Q4 and 2021 as a whole were exceptional for American companies



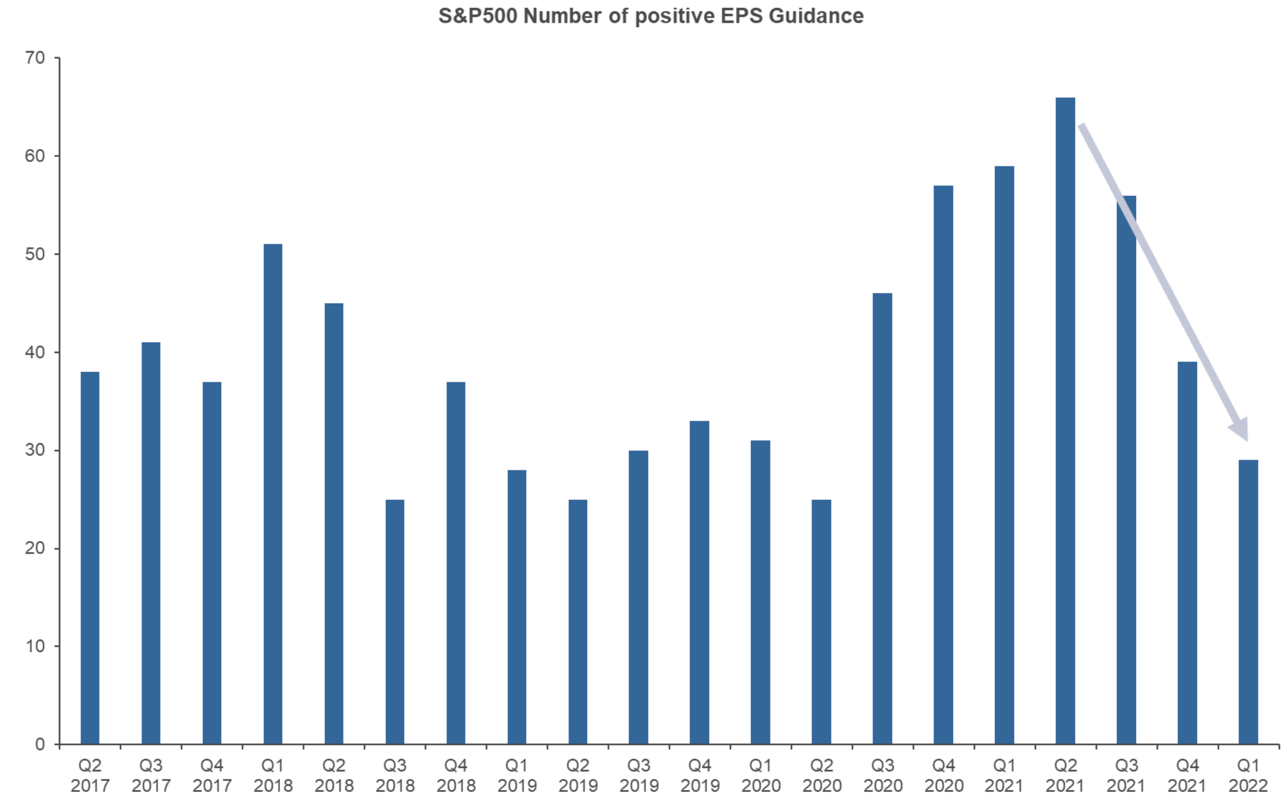
Source: FactSet

That said, Q4 2021 saw the consensus outstripped by 8.2% overall, compared with an average 8.6% over the past five years. We believe this signals the end of a trend of large flows of positive surprises over the past few quarters.

Earnings growth forecasts for Q1 2022 are already far less upbeat than results for recent quarters: just 4.8%, the most sluggish growth since Q4 2020. More disturbingly, earnings forecasts have been revised down month after month. At the end of last year, the FactSet consensus view on Q1 was 5.7% EPS growth.

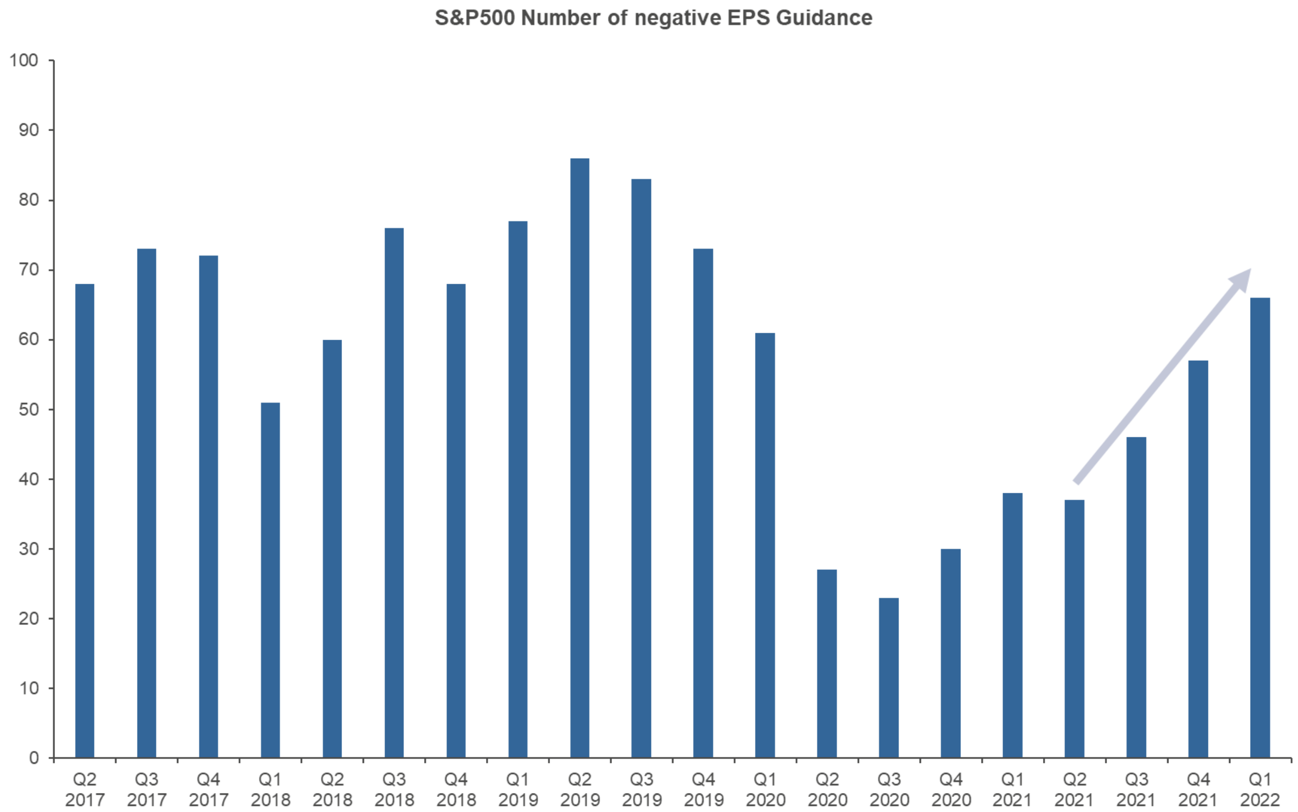
Another significant sign of change is the number of S&P 500 companies issuing negative guidance, which has risen for the third quarter in a row. 66 firms have now issued negative guidance for the current quarter. In parallel, the number of firms issuing positive guidance has declined continuously since Q2 2021 to settle at around pre-Covid levels.

Positive guidance is normalising at pre-Covid levels…



Source: FactSet

… while the converse is also true: more and more negative guidance

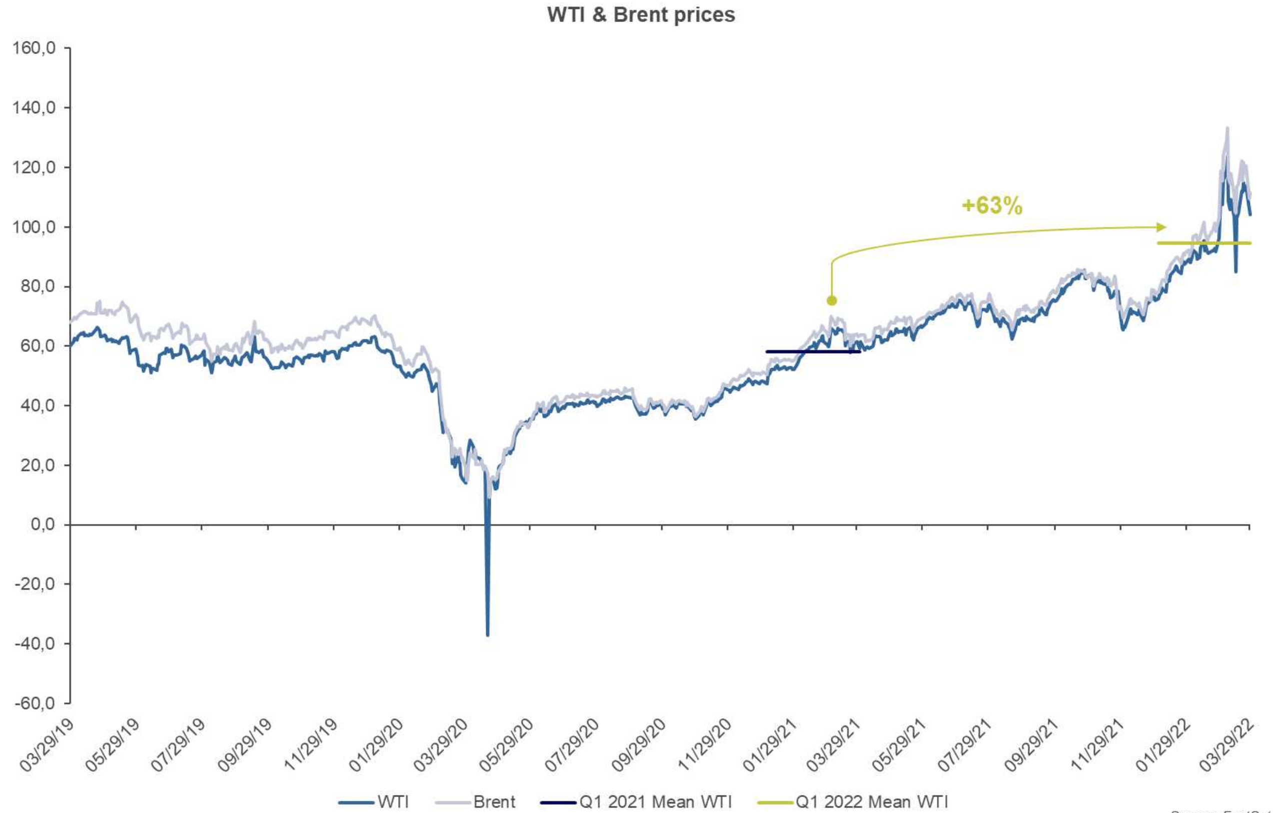


Source: FactSet

Thanks to soaring oil prices, energy stands alone with rapid earnings growth so far this year

In sector terms, the energy sector will post the fastest earnings growth in Q1 2022. We are now looking at 237.4%, compared with the 165.2% expected by the FactSet consensus at the end of last year. This is obviously related to soaring energy prices, with crude oil around 40% more expensive in Q1 than it was at the end of 2021. WTI averaged $58.09 per barrel in Q1 2021 and $94.63 in Q1 2022, a 63% difference.

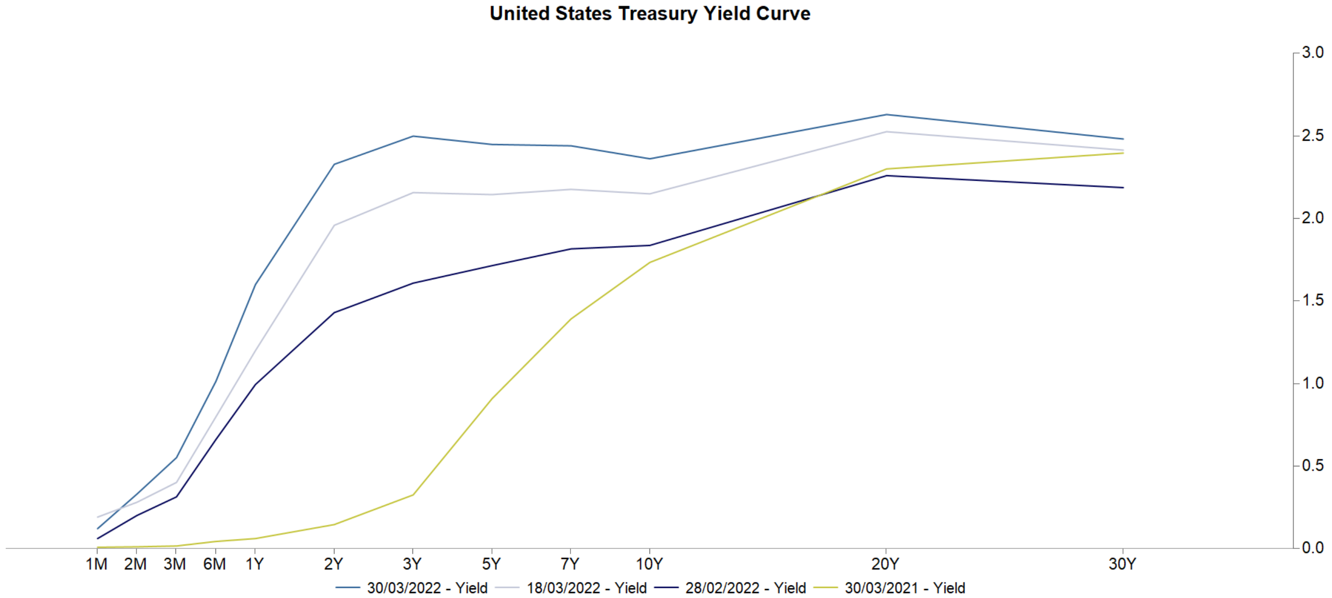
Higher oil prices have driven energy sector profits skywards this year



Source: FactSet

To nobody's surprise, the financial sector is generating the worst EPS growth numbers in 2022 (an expected -23.5%). The banks alone are looking at -32%. Two factors are at work here. Firstly, base effects stemming from bank provisioning, which affect profits but not revenues. Banks set aside enormous provisions in 2020, when the pandemic slashed economic activity. The resulting positive base effect in 2021 will disappear in 2022. 'artificially' penalising banks' results. Secondly, the yield curve will hamper banks' transformation efforts if it continues to invert in the coming months, and that will be particularly unwelcome at a time when trading income is likely to be less easy to come by than it was last year.

The yield curve flirts perilously with inversion



Source : FactSet

Although analysts are over-optimistic on 2022, the situation could favour US assets

As we have argued for several months now, companies face a number of challenges: higher inflation, sourcing problems, supply chain bottlenecks, labour shortages and wage hikes in some sectors. These factors will all shake up performance in 2022. The war in Ukraine is making matters worse, especially for European firms. On a like-for-like basis, earnings growth estimates look too aggressive for the coming years in both the USA and Europe, although we should emphasise that (as usual) the US economy should deal with the situation better, thanks to a more adroit monetary policy and of course its far smaller dependence on Russia than Europe has.

Against a backdrop of a widening GDP growth gap between the USA and Europe, with a healthier corporate sector in the former and a more helpful dollar exchange rate, we would argue that conditions have now been met for US equities to outperform their European equivalents once again in the short and medium term.

Main ratios for markets and sectors as of 30/03/2022 (in local currency)

CHAHINE CAPITAL
PERFORMANCE ENGINEERING

Data as of	Weight vs	Perf		Weighted P/E		% Wted EPS Chge			Div Yield	Revision vs M-2%	
03/30/22	World	2022	2021	2022	2021	2022	2021	2020	2021	Fiscal 22	Fiscal 21
World - Developed	**100,0%**	**-5,18%**	**13,18%**	**17,2 x**	**18,6 x**	**13,68%**	**67,11%**	**-19,14%**	**2,0%**	**0,4%**	**2,6%**
United States	57,5%	-4,74%	21,64%	21,2 x	22,6 x	14,08%	62,67%	-15,60%	1,4%	0,6%	3,3%
Japan	7,0%	-7,33%	-2,20%	13,7 x	15,3 x	13,83%	36,85%	-8,89%	2,3%	-3,5%	0,1%
Eurozone	10,1%	-10,01%	11,04%	14,2 x	15,7 x	11,92%	101,73%	-38,94%	2,9%	-0,3%	4,9%
Europe	19,3%	-8,18%	12,88%	14,4 x	15,8 x	13,01%	93,43%	-35,74%	3,0%	1,3%	3,9%
Austria	0,1%	-13,32%	25,54%	9,3 x	9,9 x	3,96%	123,48%	-41,34%	3,8%	-3,0%	4,6%
Belgium	0,4%	-3,78%	5,03%	19,2 x	19,4 x	3,91%	31,20%	-25,61%	3,2%	1,8%	3,0%
Denmark	0,7%	-7,68%	13,23%	19,1 x	20,3 x	11,24%	69,40%	-7,16%	2,1%	-1,0%	0,8%
Finland	0,3%	-14,34%	5,66%	16,3 x	16,2 x	-0,40%	43,76%	-13,69%	3,9%	-1,7%	2,1%
France	3,5%	-8,77%	19,06%	15,9 x	18,8 x	17,81%	169,60%	-55,00%	2,6%	-0,1%	6,0%
Germany	2,6%	-11,50%	4,34%	12,4 x	13,3 x	5,45%	81,04%	-20,04%	3,1%	0,3%	6,3%
United Kingdom	3,9%	-3,45%	12,03%	12,1 x	14,1 x	18,27%	103,90%	-40,25%	3,6%	4,3%	1,5%
Ireland	0,1%	-12,18%	12,86%	17,7 x	24,7 x	37,02%	5229,04%	-105,07%	1,2%	0,0%	14,3%
Italy	0,9%	-9,33%	13,37%	10,6 x	12,1 x	34,43%	82,51%	-41,54%	4,0%	-1,1%	1,5%
Netherlands	1,2%	-15,03%	14,28%	17,4 x	16,8 x	-1,80%	102,64%	-27,12%	1,8%	-1,4%	6,5%
Norway	0,6%	10,27%	14,05%	12,2 x	16,4 x	48,30%	215,39%	-55,06%	3,7%	14,9%	-1,0%
Spain	0,8%	-5,44%	-0,49%	13,7 x	14,0 x	4,61%	84,41%	-42,81%	3,7%	0,1%	-0,1%
Sweden	1,3%	-15,79%	21,33%	17,7 x	15,1 x	7,67%	134,26%	-38,43%	2,8%	0,9%	3,3%
Switzerland	2,6%	-7,03%	17,46%	19,3 x	19,2 x	0,98%	29,97%	-7,86%	2,6%	-1,1%	6,3%
Europe / Commercial Services	0,5%	-11,02%	9,58%	20,0 x	23,4 x	18,71%	61,01%	-29,26%	2,1%	-2,0%	-5,8%
Europe / Communications	0,5%	0,90%	0,96%	15,5 x	17,0 x	58,92%	-26,82%	4,86%	4,6%	-1,9%	0,0%
Europe / Consumer Durables	0,8%	-13,96%	21,32%	8,0 x	8,5 x	1,07%	314,88%	-58,41%	4,0%	0,4%	20,7%
Europe / Consumer Non-Durable	3,0%	-10,91%	13,18%	21,8 x	23,9 x	9,67%	32,82%	-21,01%	2,2%	-2,4%	6,2%
Europe / Consumer Services	0,3%	-9,21%	4,84%	23,8 x	197,1 x	649,04%	133,15%	-122,47%	1,6%	-4,8%	-1,4%
Europe / Distribution Services	0,2%	-14,81%	20,56%	17,8 x	20,7 x	18,93%	54,15%	-15,04%	2,2%	0,3%	1,5%
Europe / Electronic Technology	1,1%	-8,66%	15,23%	23,3 x	27,2 x	20,50%	149,11%	-51,15%	1,2%	-0,6%	1,8%
Europe / Energy Minerals	0,9%	17,48%	21,06%	6,8 x	9,4 x	49,13%	4591,11%	-92,11%	4,4%	17,5%	4,3%
Europe / Finance	3,6%	-6,01%	15,23%	11,0 x	10,3 x	-1,04%	87,44%	-34,83%	4,4%	-1,7%	3,6%
Europe / Health Services	0,2%	-16,07%	20,45%	20,5 x	20,1 x	-1,05%	24,64%	-0,81%	1,7%	-1,4%	-0,6%
Europe / Health Technology	2,3%	-4,44%	15,32%	20,9 x	21,3 x	8,01%	11,92%	-0,93%	2,3%	-0,6%	-0,9%
Europe / Industrial Services	0,3%	-2,49%	6,82%	15,5 x	16,9 x	15,24%	106,49%	-51,28%	3,3%	-1,5%	-7,4%
Europe / Miscellaneous	0,0%	-14,32%	35,07%	12,2 x	9,2 x	-27,00%	175,68%	-81,20%	3,2%	-3,6%	0,4%
Europe / Non-Energy Minerals	0,7%	7,36%	13,30%	7,1 x	7,2 x	0,46%	136,61%	26,97%	6,2%	13,5%	4,4%
Europe / Process Industries	0,8%	-10,68%	9,77%	16,8 x	17,8 x	6,01%	54,69%	-13,98%	2,9%	-0,6%	0,4%
Europe / Producer Manufacturin	1,3%	-17,19%	21,04%	18,3 x	21,3 x	14,76%	89,05%	-32,19%	2,2%	-2,4%	1,3%
Europe / Retail Trade	0,4%	-20,01%	-1,51%	19,2 x	22,5 x	16,18%	91,23%	-24,55%	2,6%	-4,2%	0,0%
Europe / Technology Services	0,9%	-19,15%	2,33%	24,5 x	26,9 x	10,51%	28,79%	-5,82%	0,9%	-2,1%	-0,2%
Europe / Transportation	0,6%	-7,75%	26,29%	11,4 x	21,4 x	93,27%	163,94%	-255,26%	3,2%	0,8%	7,6%
Europe / Utilities	0,9%	-6,34%	-4,61%	15,5 x	16,4 x	10,18%	21,59%	-17,21%	4,0%	0,0%	2,8%

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