May 2022

A final flourish from America before recession hits?

Overview

The US consumer price index rose 8.6% in the year to March, or 6.5% excluding food and energy. We have to go back to the oil shocks of 1973 and 1979 for anything comparable. Even in 2008, during the subprime crisis and when some commentators were talking of a third oil shock – crude prices were close to $150/bbl at the time, compared with around $105/bbl for WTI at the moment – US inflation got to only 5.5% in mid-year before falling back sharply. Moreover, the core inflation rate never exceeded 3% at the time, i.e. half the level it is now. Inflationary pressure is far greater today and implies a complete change of direction for a Federal Reserve that is already threatening higher interest rates.

The Covid pandemic raised both commodity prices and unit wage costs, the former because of China's rapid economic recovery (down to the initial success of its zero-Covid strategy) and the latter because of the adaptation of production methods to measures such as home working and social distancing. We would normally have expected inflation to pick up and then firmly establish itself, but initially at least this is not what happened. The reason was an improvement in US labour productivity: in 2020, GDP per hour worked rose by 2.6% year-on-year despite the pandemic. Apart from remaining relatively tame until the spring of 2021, inflation therefore looked pretty transitory, deceiving both commentators and the experts…

The recent inversion of the US yield curve leaves little room for doubt. The markets no longer believe in a temporary blip in inflation but a rapidly worsening situation. Quite rightly, they expect the Fed to tighten its monetary policy significantly, which will probably nudge the economy towards recession. Fed Chair Jerome Powell is clearly on that wavelength, as he announced a 50bp rate hike in May from the 0.5% set in mid-March. Another hike of the same magnitude was also under consideration.

Although the Fed has long sought to guide economic agents through commentary and half-measures, there can be no mistaking its mood. It has almost certainly switched track in response to a poorly calibrated fiscal policy.

The Q1 2022 results season is under way, with 55% of the S&P 500 companies already published. As expected, the numbers contrast with the stratospheric profits gains announced in 2021. S&P 500 earnings are now expected up 7.1% for the quarter, which would be the smallest increase since Q4 2020. Even so, there is still momentum behind positive revisions : the FactSet consensus at end-March was just 4.7%, and at 80% the proportion of positive surprises remains very high. It is simply that the magnitude of surprises is much smaller.

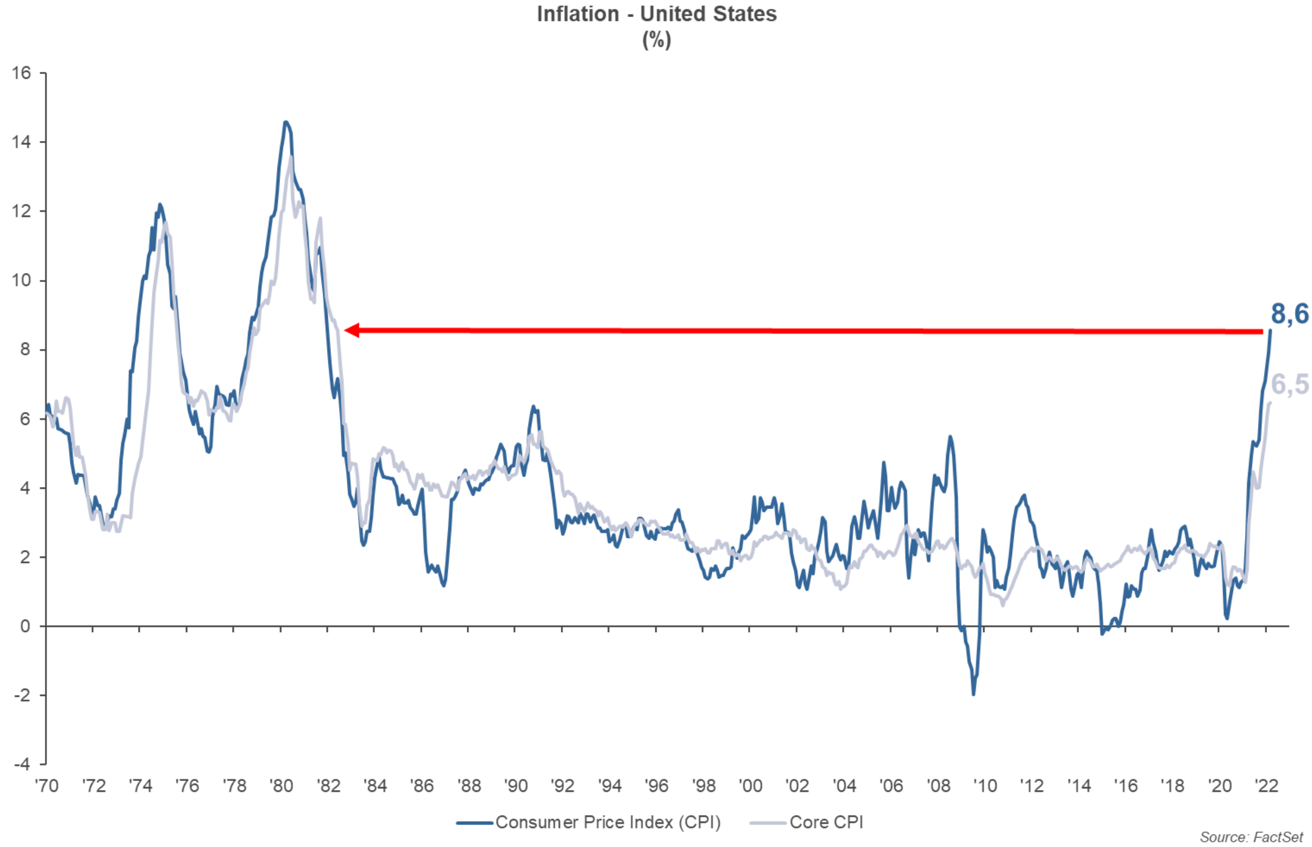
Taken as a whole, 2021 saw a 47.7% increase in S&P 500 profits! As the index itself appreciated 'only' 26.9%, this severely dented the exorbitant multiples that we saw the year before. The decline in equity prices this year has only amplified this phenomenon. The S&P 500 has corrected 13.3% since the start of the year, reflecting investors' fears over the risks to US economic activity, surging prices and on top of it all the war in Ukraine and its impact on raw materials. Highly sensitive to interest rates, tech shares have lost even more ground: the Nasdaq is down 21.2% since the start of the year. Multiples have effectively normalised and are back to their pre-crisis levels irrespective of the calculation method (i.e. based on results published over the past 12 months or using consensus forecasts for the future).

Michaël Sellam

American inflation: getting the measure of the problem

The US consumer price index rose 8.6% in the year to March, or 6.5% excluding food and energy. We have to go back to the oil shocks of 1973 and 1979 for anything comparable. Even in 2008, during the subprime crisis and when some commentators were talking of a third oil shock – crude prices were close to $150/bbl at the time, compared with around $105/bbl for WTI at the moment – US inflation got to only 5.5% in mid-year before falling back sharply. Moreover, the core inflation rate never exceeded 3% at the time, i.e. half the level it is now. Inflationary pressure is far greater today and implies a complete change of direction for a Federal Reserve that is already threatening higher interest rates.

US inflation higher than at any time since the 1973 and 1979 oil shocks



Source: FactSet

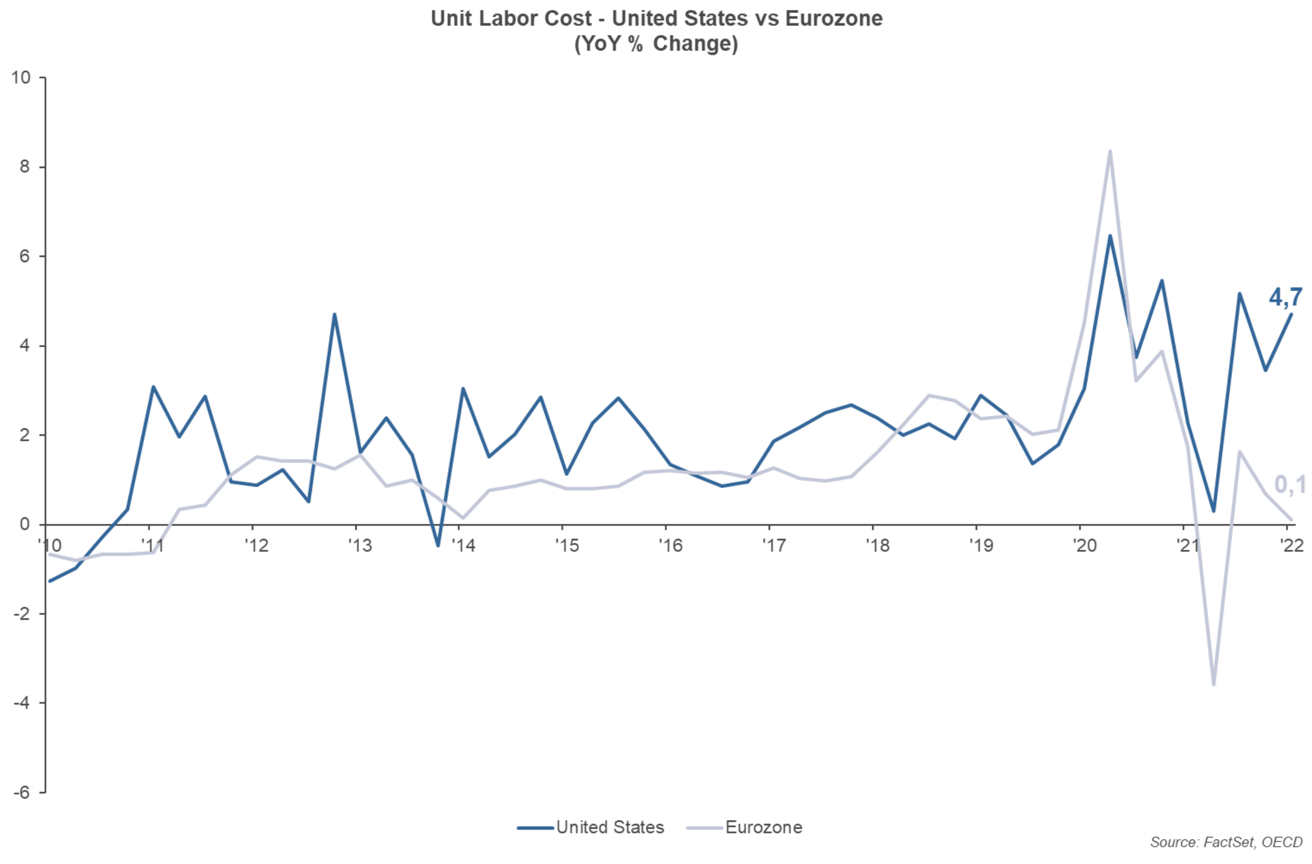
A detailed examination of the price data highlights the role of energy prices (up 32.2% in the year to March) and food prices (up 8.8% over the same period) in current inflation. This is unsurprising given the war in Ukraine, which is affecting – among much else – gas and cereal prices worldwide. In the USA itself, natural gas prices (Henry Hub) exceeded $7/MMBtu in mid-April, representing a 140% increase over a year. Similarly, durum wheat (used to make pasta) is up almost 85% over 12 months on the Kansas City market and soft wheat (bread flour) is up 60% in St Louis.

More disturbing still, non-food and energy prices continue to rise as well: transport goods up 21.6% year-on-year in March, furnishings up 10.8% and clothing up 6.8%. Used car prices were already surging in 2021 because of a world shortage of semiconductors and jumped 35.3% in the year to March. Unfortunately, it seems that economic difficulties are coming thick and fast without any time for any to be absorbed.

Rising wage costs validate the scenario of more durable US inflation

The Covid pandemic raised both commodity prices and unit wage costs[1] (see chart), the former because of China's rapid economic recovery (down to the initial success of its zero-Covid strategy) and the latter because of the adaptation of production methods to measures such as home working and social distancing. We would normally have expected inflation to pick up and then firmly establish itself, but initially at least this is not what happened. The reason was an improvement in US labour productivity: in 2020, GDP per hour worked rose by 2.6% year-on-year despite the pandemic. Apart from remaining relatively tame until the spring of 2021, inflation therefore looked pretty transitory, deceiving both commentators and experts alike.

A marked contrast between wage inflation in the USA and in Europe



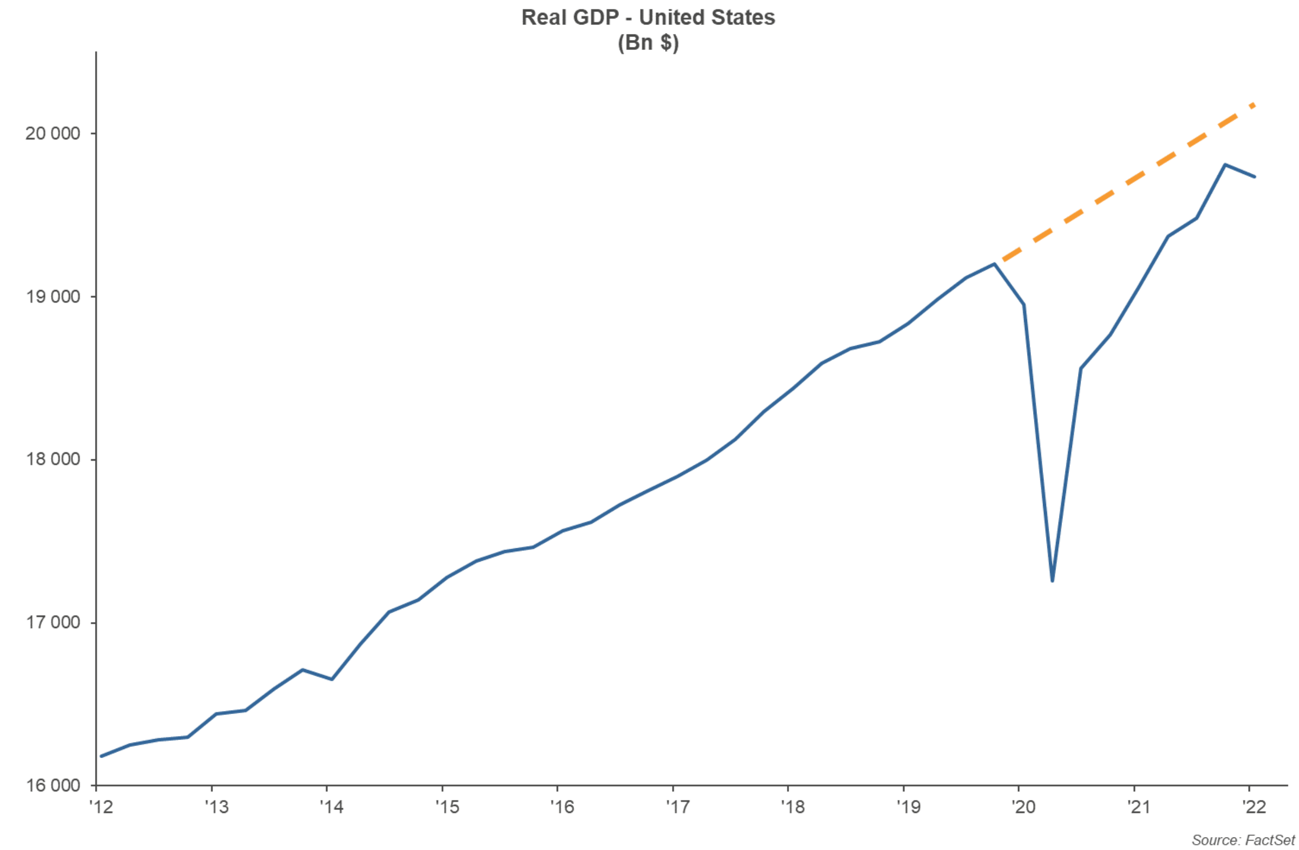
This phenomenon stems from the US stimulus packages inspired by President Biden, which have had a real impact since the spring of 2021. The 'Build Back Better' Plan has injected billions of dollars into the economy: $1,900 billion under the American Rescue Plan (countering Covid) and $1,200 billion under the Infrastructure Investment and Jobs Act. These measures have enabled workers approaching retirement age to take early retirement and employees dissatisfied with their terms and conditions to change jobs, leading to what has been dubbed 'the Big Quit'. This organised labour shortage has fuelled another jump in wage costs (see 2021 in the chart above) and continuing pressure since (up 4.7% in the yearn to March), suggesting that inflation will persist for as long as stimulus does.

[1] The ratio between the cost of labour and labour productivity.

Budgetary stimulus has had mixed results

President Biden's highly active fiscal policy has not been ineffective in countering the crisis. The fact is that as early as 2020, the US economy started to make up for the colossal drop in GDP prompted by the pandemic (see chart). Activity picked up very sharply in 2020 and 2021 and America's economic resilience was widely lauded. That said, activity was still not back to pre-Covid levels by the end of last year, and that raises questions because adjustments to the price level ensure that no budgetary stimulus works in the long term (as we see only too clearly today). It follows that the US administration's policy will become steadily less effective in the months ahead, apart from raising prices even more. We are looking at the snake eating its own tail: public spending is now starting to generate more negative than positive externalities.

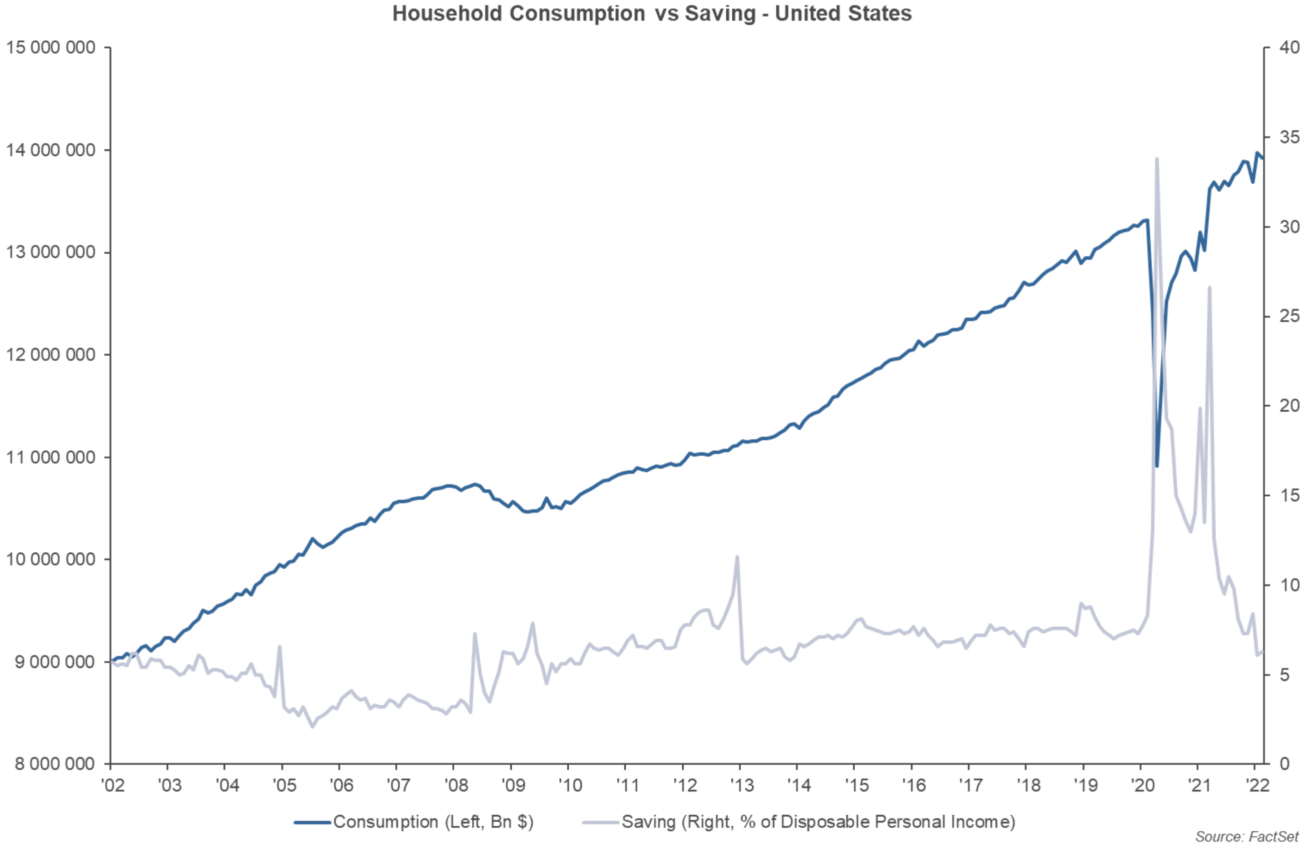
Budgetary stimulus has enabled the US economy to make up most of its Covid losses, but it is not back on its pre-crisis track



American households have reacted to the pandemic by drastically altering their savings behaviour. Traditionally, they save relatively little: around 7.2% of their disposable income during the 2010s, compared with around 12.5% in the euro zone. Given the US economy's capacity to finance itself, this is readily explicable. The two 'excess savings' peaks associated with Covid are therefore extremely striking: up to 33.8% of disposable income in April 2020 and 26.6% in March 2021 (see chart below). Those numbers are completely unprecedented in modern American economic history. The previous highs came at the end of the oil shocks, and even then were hardly close: 17.3% of disposable income in May 1975 then 12.9% in April 1982.

The underlying motivation for this new propensity to save is still being hotly debated. Are we talking about forced savings as a result of Covid-related postponement of consumption and then shortages, or is it a matter of precaution given the uncertainty stemming from the pandemic? Or then again, could it be in anticipation of higher taxes to finance highly expansionary fiscal policies? All of these factors have probably played a part, and either way the additional savings have certainly hampered stimulus efforts, at least in terms of the time they take (which is primordial).

Having hampered stimulus efforts, household savings behaviour is now promoting inflation

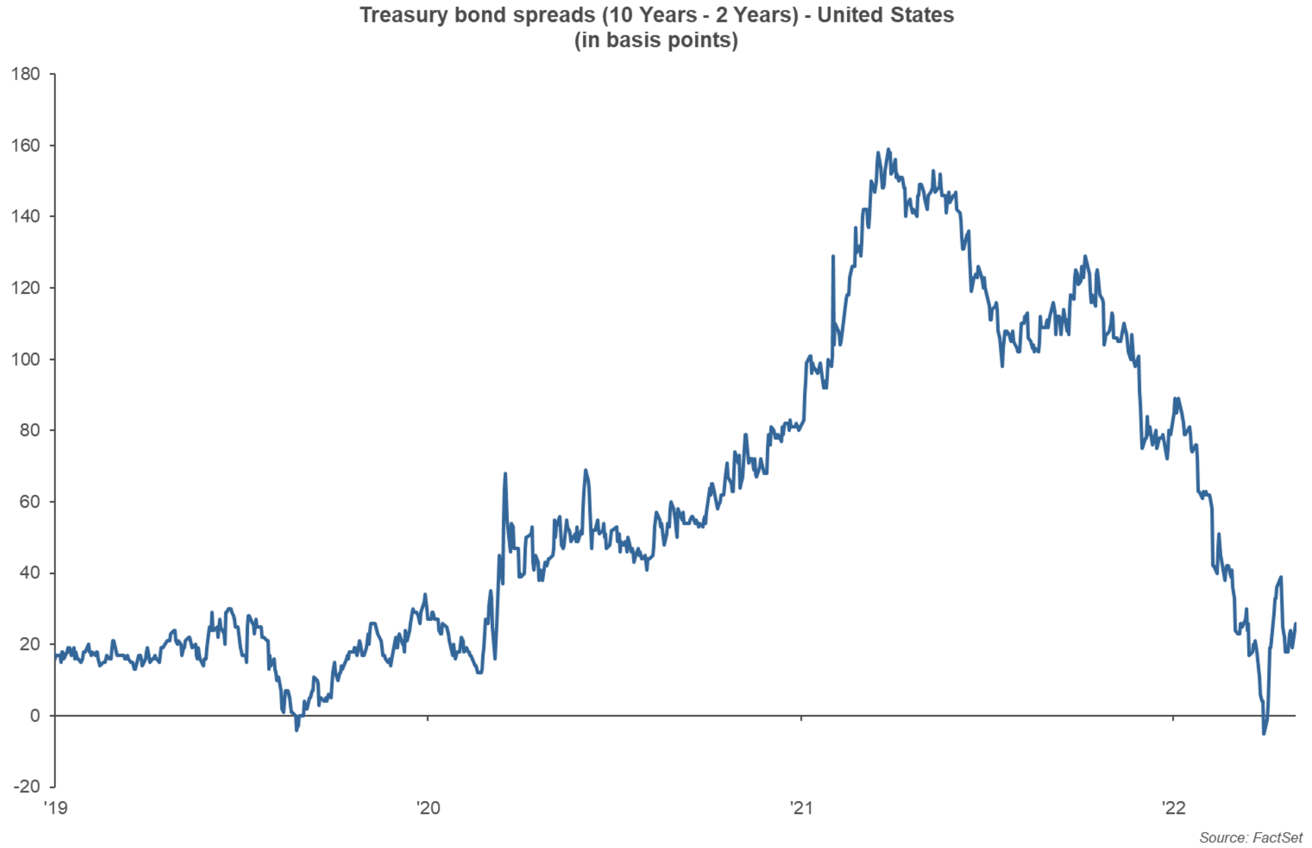


In contrast with the preceding two years, and whether by choice or necessity, US households saved only 6.3% of their disposable income in March 2022. This is well down on the pre-pandemic 7.8%, signalling that they are not seeking to maintain their efforts in this direction. The normalisation of consumption behaviour has arrived too late to back up the stimulus measures, however. Worse, it has come at a particularly bad moment as it will now fuel inflation…

Closer to recession? And so what?

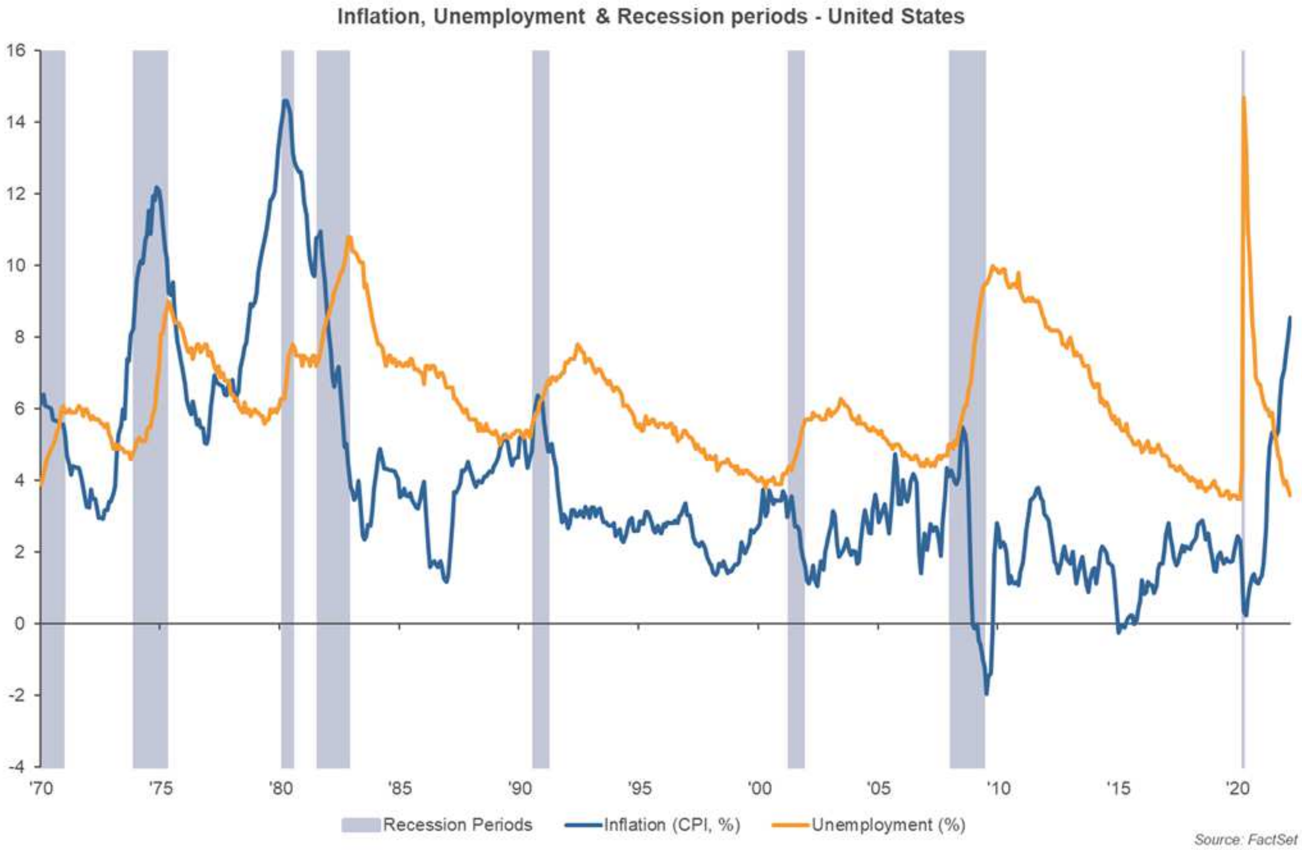
The recent inversion of the US yield curve leaves little room for doubt. The markets no longer believe in a temporary blip in inflation but a rapidly worsening situation. Quite rightly, they expect the Fed to tighten its monetary policy significantly, which will probably nudge the economy towards recession. Fed Chair Jerome Powell is clearly on that wavelength, as he announced a 50bp rate hike in May from the 0.5% set in mid-March. Another hike of the same magnitude was also under consideration. Although the Fed has long sought to guide economic agents through commentary and half-measures, there can be no mistaking its mood. It has almost certainly switched track in response to a poorly calibrated fiscal policy.

The 2-10 year Treasury spread has tightened dramatically since the start of the year



For once, financial indicators are pointing the same way as the macroeconomic signals, and towards recession. This is because vigorous inflation will undermine the labour market again, starting from an unemployment rate of 3.6% (9.3% if we count part-time workers and unemployed people who have given up looking for work). The situation could even swing rapidly towards under-employment (see chart below). In the present configuration of inflation stemming from raw materials and costs together, it would be naïve to assume that the political and monetary authorities would let inflation rip. The risk of economic and social (even systemic) instability would be too great for that.

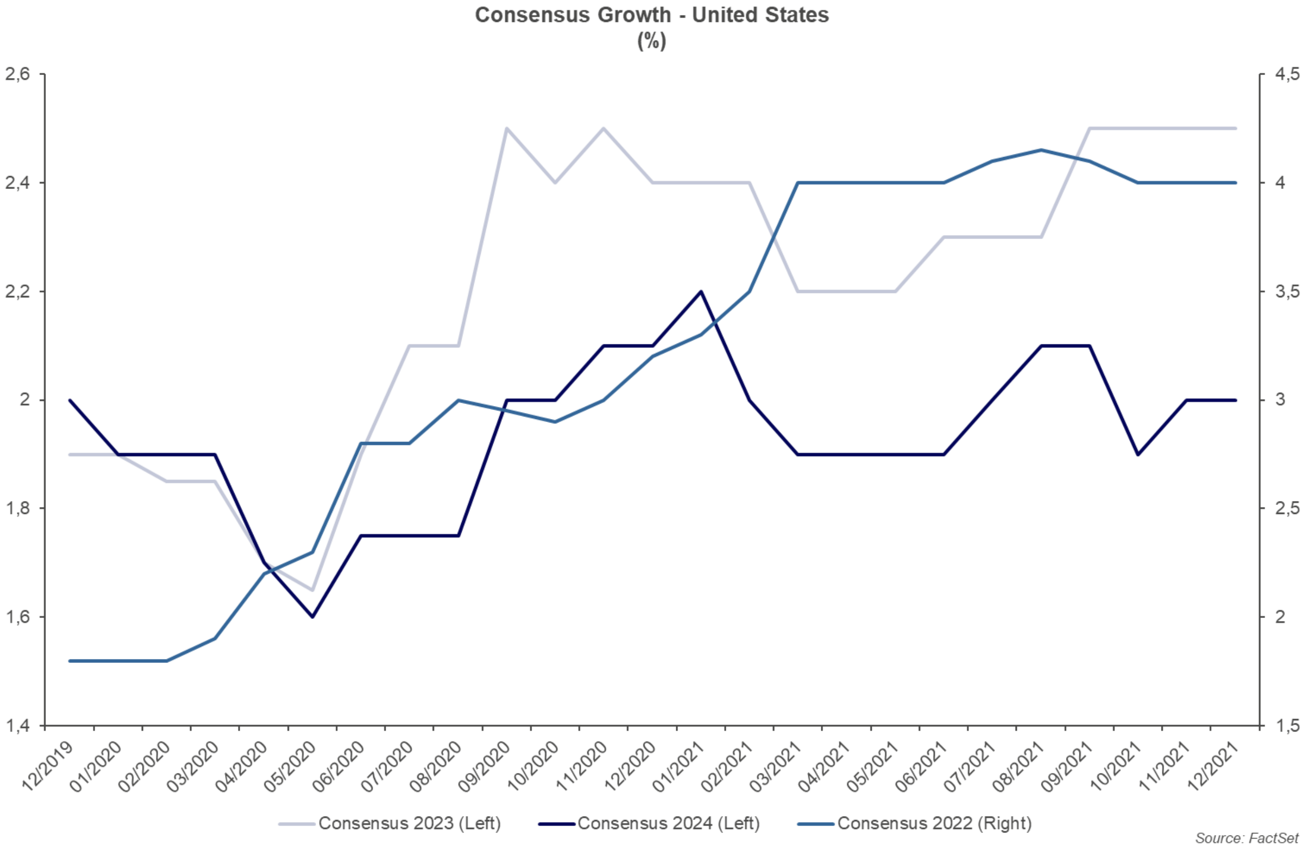
In the modern US economy, the combination of inflation and low unemployment generally foreshadows recession



Although it may seem paradoxical, we should consider that the US authorities will not necessarily seek to avoid recession. Given the federal government's desire to press on with massive budgetary stimulus, the Fed could opt to 'engineer' a recession via rate hikes in order to take the heat out of wage claims and to encourage firms to lower their margins. It would certainly be a severe response but it would also represent a standard means of dealing with cost-push inflation. If the Americans can contemplate this sort of policy despite government debt of $30,420 billion in March 2022, it is because of the dollar's predominance on the international money markets. This enables them to draw on international savings to finance the economy's deficits in general, and as is often the case, America's difficulties could be exported swiftly to the rest of the world, which already has (unrelated) problems of its own.

Against this backdrop, we expect further downward revisions to GDP growth forecasts in the months ahead, both for the USA (down from 4.2% in mid-2021 to 3.3% now) and across the world (see chart below).

Growth forecasts set to be revised down



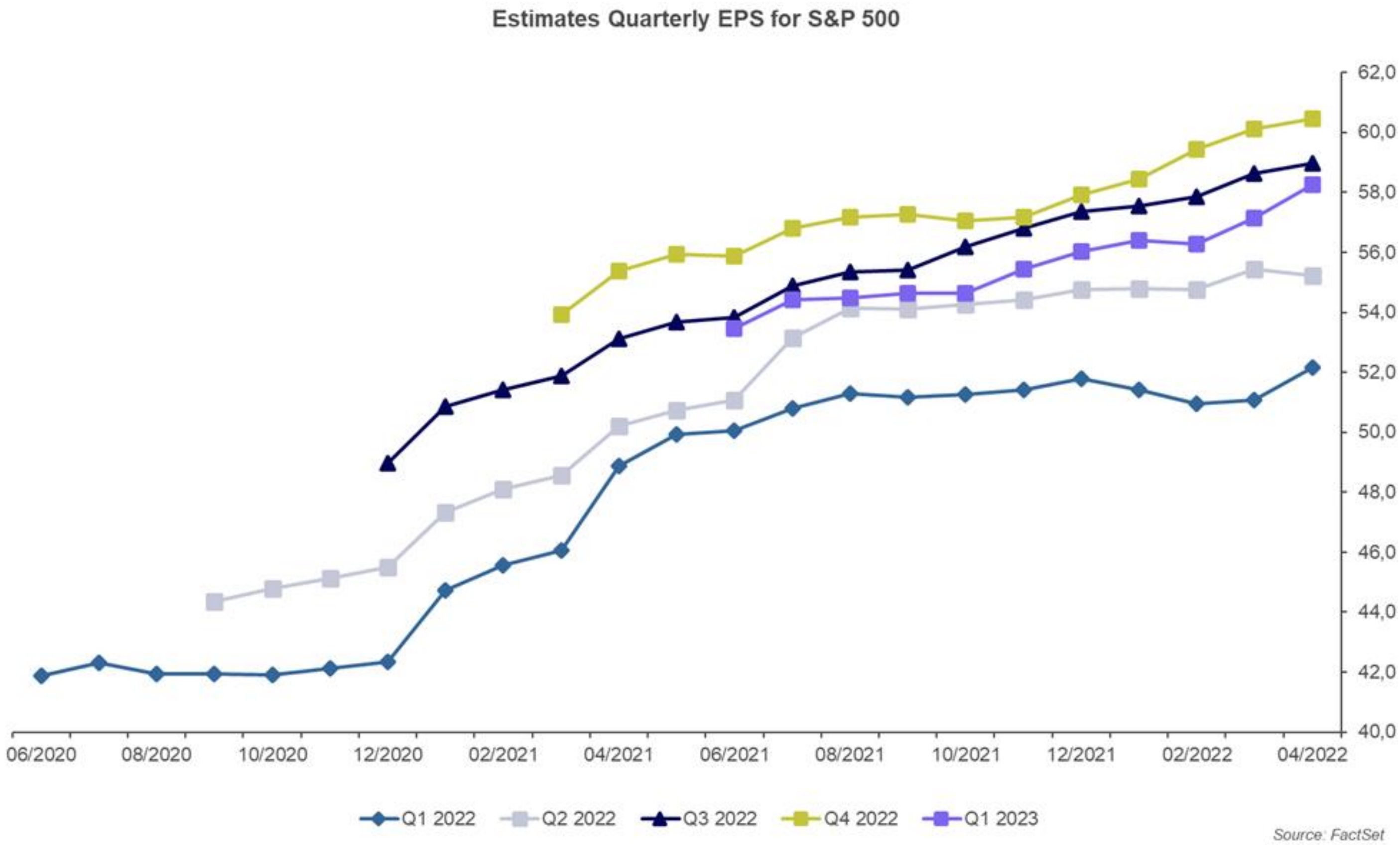
Source: FactSet

Q1 2022 results have not disappointed, despite an expected normalisation in corporate profits

The Q1 2022 results season is under way, with 55% of the S&P 500 companies already published. As expected, the numbers contrast with the stratospheric profits gains announced in 2021. S&P 500 earnings are now expected up 7.1% for the quarter, which would be the smallest increase since Q4 2020.

Even so, there is still momentum behind positive revisions : the FactSet consensus at end-March was just 4.7%, and at 80% the proportion of positive surprises remains very high. It is simply that the magnitude of surprises is much smaller.

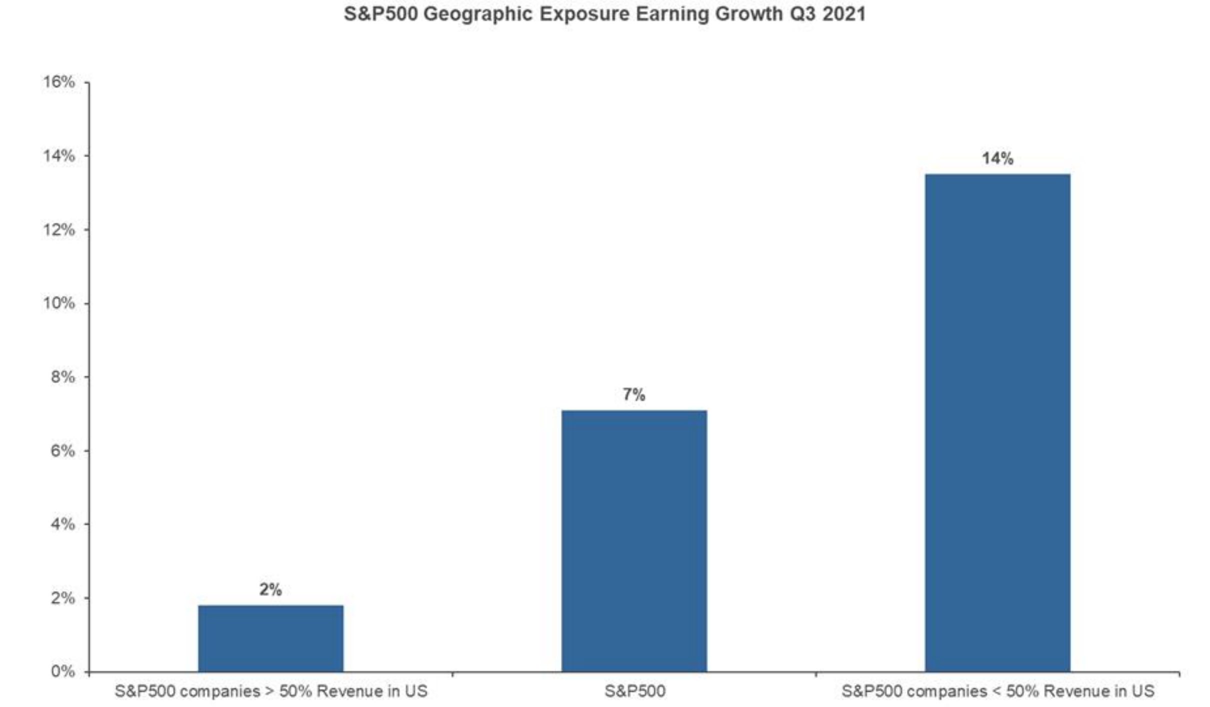
Earnings growth rates normalise but revisions momentum is still very positive



The buoyancy of earnings in Q1 2022 reflects the nature of S&P 500 companies, which are the most international in the USA. If we separate these firms into two groups, one with over 50% of their sales generated outside the USA and the other with most of their sales on American soil, we note that the group with the most international exposure is posting an earnings growth rate of 13.5%, compared with 1.8% for the ‘domestic’ group, highlighting the weakening of domestic demand already observed in macroeconomic data.

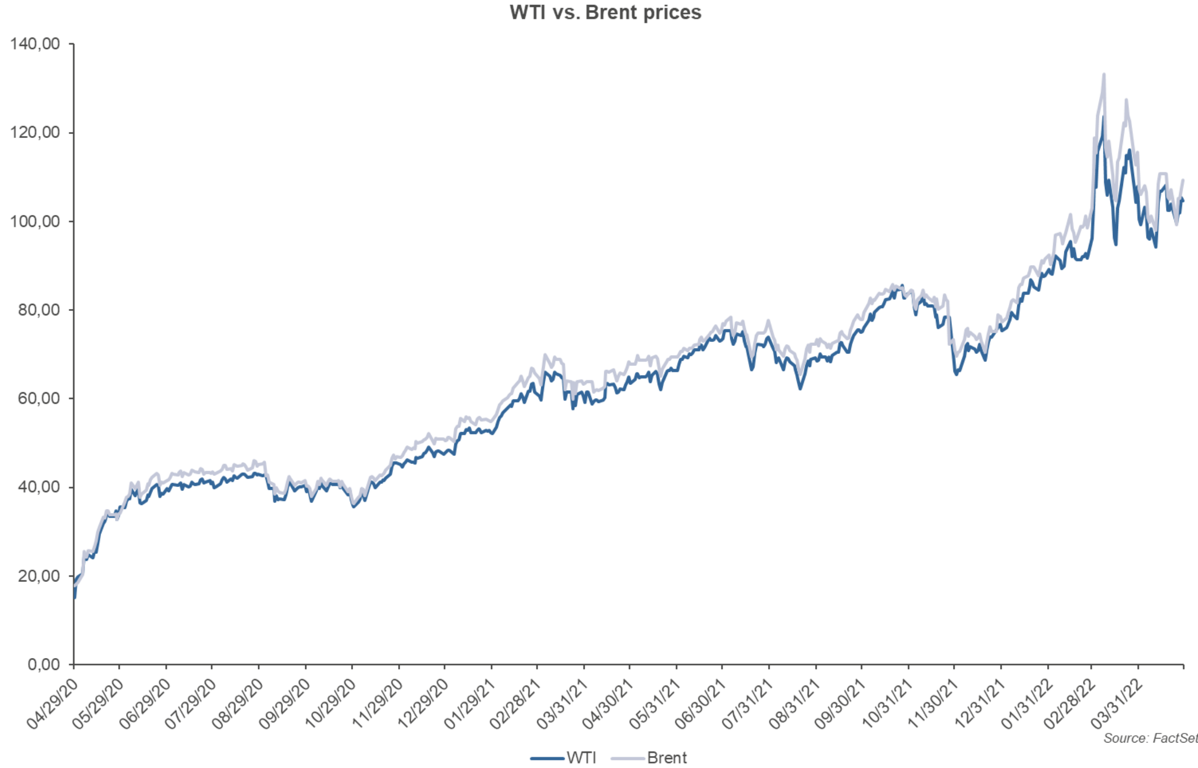
This differential should be put in context, however. If we remove the three biggest contributors to the group generating more than 50% of their sales outside the USA – Exxon Mobil and Chevron, which have benefited enormously from soaring oil prices in the wake of the war in Ukraine, and Pfizer, from a healthcare sector still taking advantage of Covid-related spending – the 13.5% wanes to a somewhat less impressive 5.1%, which is not so far from the rest of the index.

The firms with the biggest international exposure have boosted index earnings figures…



Source: FactSet

… but largely because of soaring oil prices, which have generated vast profits for the US majors



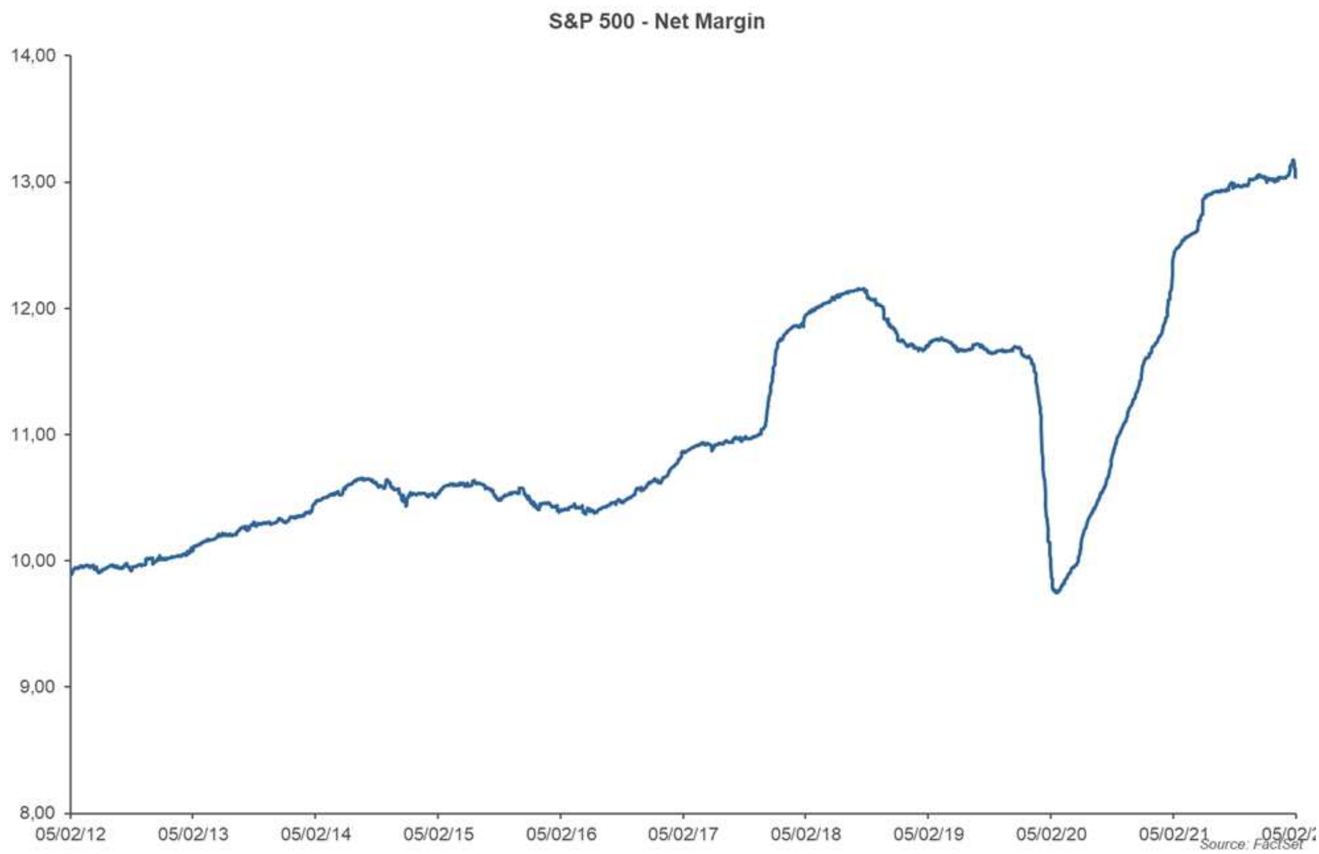
Source: FactSet

Note that WTI averaged $57.90/bbl in Q1 2021 and $94.90/bbl in Q1 2022, meaning that crude prices rose 64% between the two periods. This readily explains why the two US oil giants have performed so well and have gained so much from the invasion of Ukraine.

In contrast, some of the S&P 500 heavyweights disappointed in Q1 2022, penalised by supply chain issues and the effect of surging inflation on consumption. Amazon is a case in point. The negative profits figures it published for the quarter made around 2.75 points of difference to the overall index result! If we remove Amazon from the S&P 500, index earnings growth would jump from 7.1% to 10.1%, which is quite a difference.

As far as profitability is concerned, net profit margin for the S&P 500 is a robust 12.2% for Q1 2022. This would be the fifth highest margin recorded for the index since FactSet started tracking this series in 2008 and is above the average for the past five years (11.2%). That said, net margin has been heading lower on trend for the past few quarters, and the Q1 score would be the third quarterly decline in a row for this benchmark index.

Margins stabilise ahead of likely normalisation

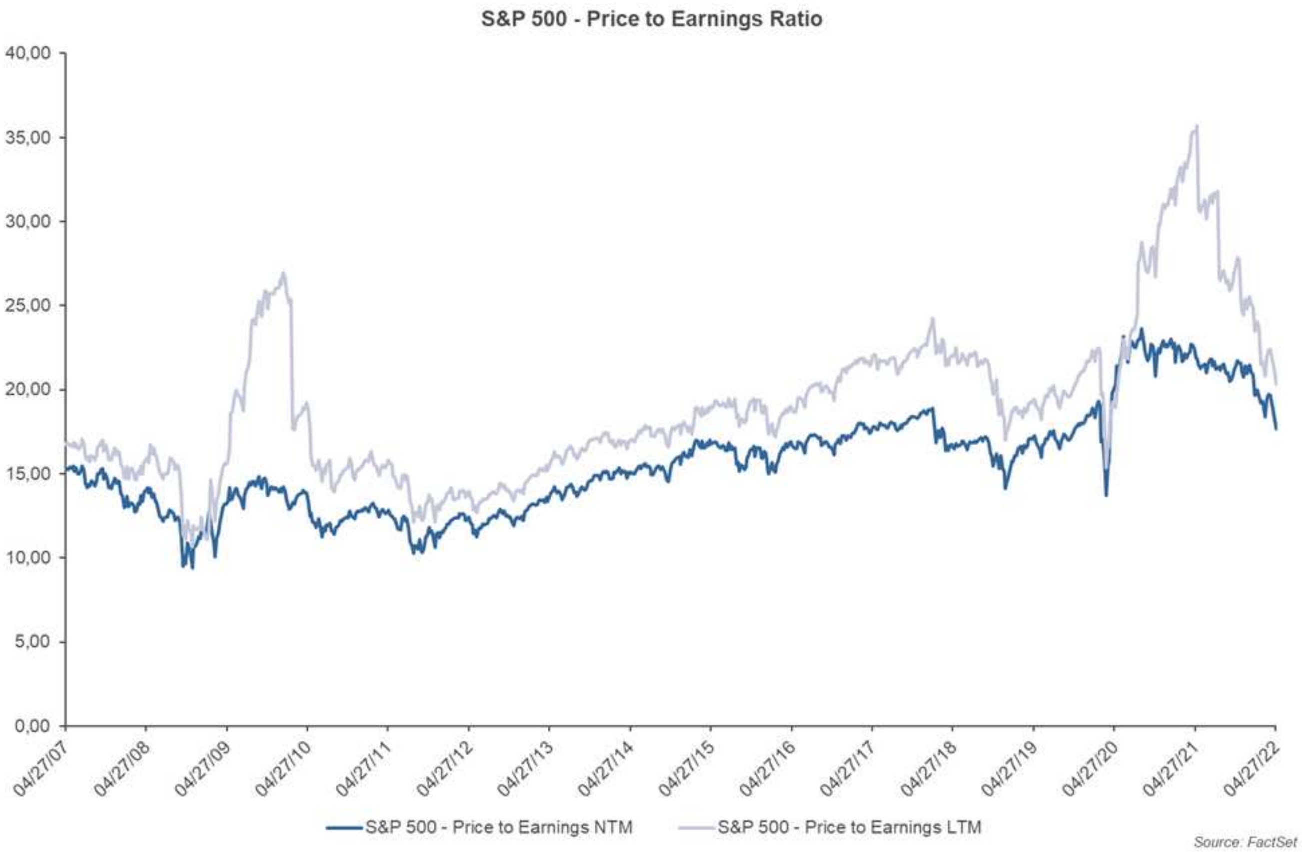


Needless to say, the sector posting the sharpest rise in profitability is energy, which reported a margin of 4.6% a year ago and is up to around 10.6% for Q1!

The recent correction has brought valuations back to more normal levels, at last

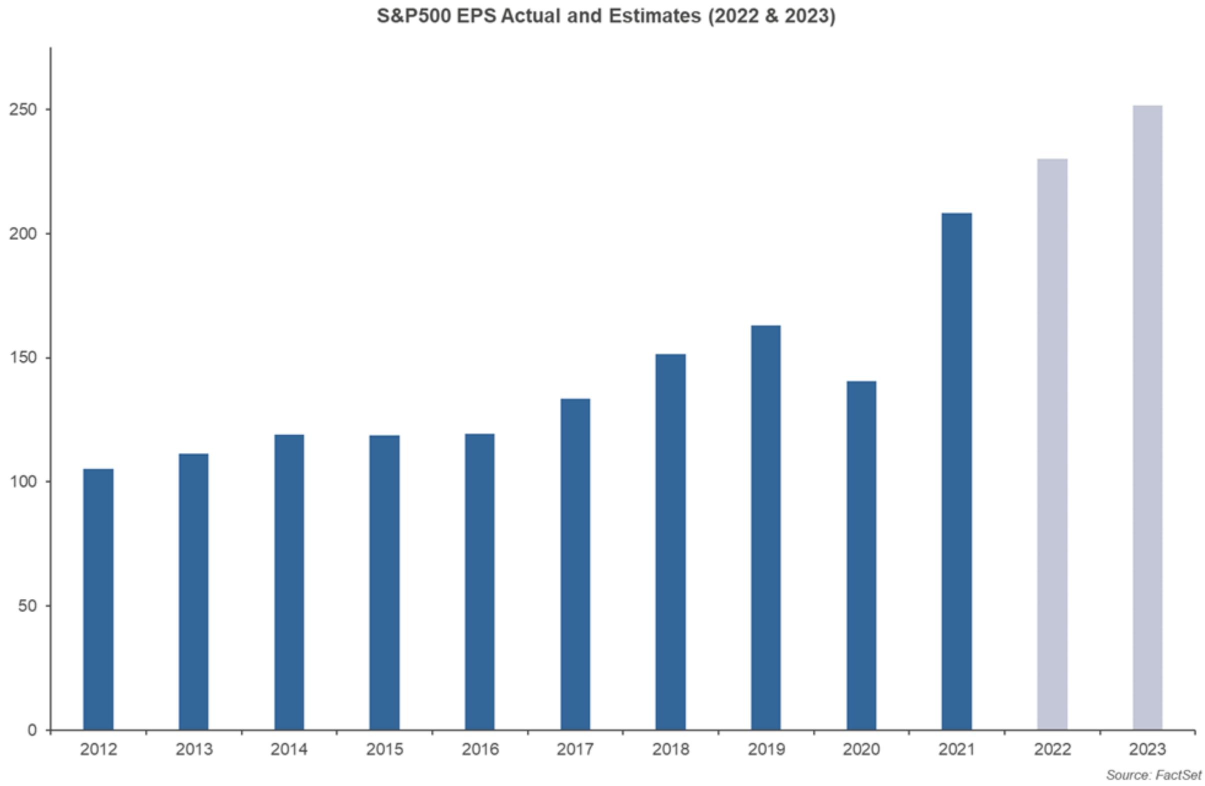
S&P 500 earnings per share jumped by a massive 47.7% in 2021. As the index itself appreciated 'only' 26.9%, this severely dented the exorbitant multiples that we saw the year before. The decline in equity prices this year has only amplified this phenomenon. The S&P 500 has corrected 13.3% since the start of the year, reflecting investors' fears over the risks to US economic activity, surging prices and on top of it all the war in Ukraine and its impact on raw materials. Highly sensitive to interest rates, tech shares have lost even more ground: the Nasdaq is down 21.2% since the start of the year. Multiples have effectively normalised and are back to their pre-crisis levels irrespective of the calculation method (i.e. based on results published over the past 12 months or using consensus forecasts for the future).

Market multiples back to pre-crisis levels

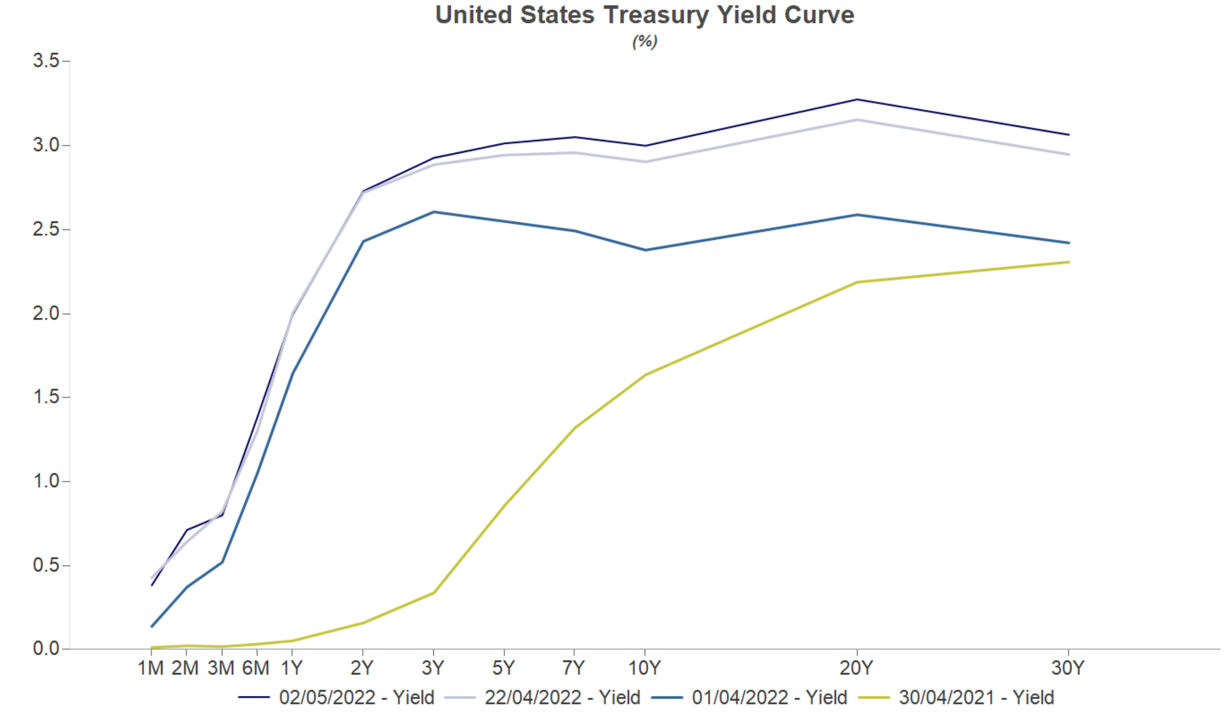


Our view has been unchanged for several months now, and a number of factors are liable to weigh on corporate performance. Higher inflation, shortages of raw materials, supply chain bottlenecks, a lack of labour and wage hikes in some sectors will all have an impact in 2022, and the war in Ukraine will not make anything easier. On a like for like basis, earnings growth expectations for the coming years appear too aggressive in both the USA and Europe. For the S&P 500, for example, analysts are looking for EPS growth of 10.3% in 2022 and 9.3% in 2023. We believe that these numbers are unrealistic, especially if financing conditions tighten significantly. Jerome Powell has already adopted a tougher line, pointing out ahead of time that the 50bp hike in May was "appropriate". There can be no doubt that the Fed will raise its interest rates more than we once thought, and several times over the rest of this year. But we are maintaining our prediction of a fed funds rate of 1.5% by year-end, as the current rise in long rates (now up to 2.8%) could be enough on its own to slow US final demand, weaken the fundamentals and thereby exercise downward pressure on prices. In that case, the Fed could adjust its policy swiftly at some point later this year.

We believe that analysts are over-optimistic on the years ahead…



… especially if interest rates rise further, inevitably hurting a high-tech sector that drives the US indices



Source: FactSet

Main ratios for markets and sectors as of 02/05/2022 (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%	
02/05/22	World	2022	2021	2022	2021	2022	2021	2020	2021	Fiscal 22	Fiscal 21
World - Developed	**100,0%**	**-13,99%**	**13,18%**	**14,4 x**	**15,9 x**	**9,96%**	**14,47%**	**67,13%**	**2,2%**	**-1,4%**	**-1,3%**
United States	57,0%	-14,35%	21,64%	17,0 x	19,0 x	11,80%	14,95%	62,76%	1,6%	0,6%	0,5%
Japan	7,0%	-16,13%	-2,20%	12,4 x	13,2 x	6,49%	13,14%	36,85%	2,5%	-5,7%	-5,5%
Eurozone	10,0%	-19,24%	11,04%	12,4 x	13,5 x	9,54%	8,91%	101,76%	3,2%	-4,2%	-3,9%
Europe	19,2%	-16,71%	12,88%	12,7 x	13,6 x	6,76%	13,00%	93,39%	3,3%	-3,1%	-2,8%
Austria	0,1%	-19,30%	25,54%	9,1 x	9,0 x	-1,23%	3,22%	123,44%	3,9%	-3,1%	-3,9%
Belgium	0,4%	-11,82%	5,03%	16,6 x	18,7 x	13,39%	3,39%	31,20%	2,6%	-4,1%	-4,1%
Denmark	0,7%	-13,89%	13,23%	20,1 x	17,7 x	-11,98%	15,53%	69,39%	2,4%	-2,8%	0,7%
Finland	0,3%	-21,31%	5,66%	14,6 x	15,6 x	6,64%	1,21%	43,76%	3,6%	-3,9%	-5,8%
France	3,5%	-18,52%	19,06%	13,5 x	15,4 x	14,72%	13,68%	169,88%	2,8%	-3,3%	-6,0%
Germany	2,5%	-21,42%	4,34%	11,1 x	11,7 x	5,91%	4,36%	80,98%	3,7%	-4,9%	-1,1%
United Kingdom	4,0%	-9,15%	12,03%	11,0 x	11,3 x	2,84%	22,81%	103,91%	3,8%	-0,6%	-0,9%
Ireland	0,2%	-15,69%	12,86%	14,1 x	17,8 x	26,01%	37,81%	5223,40%	1,6%	-3,7%	-3,9%
Italy	0,9%	-18,61%	13,37%	9,4 x	10,0 x	6,01%	35,33%	82,72%	4,5%	-5,2%	-3,9%
Netherlands	1,2%	-25,76%	14,28%	14,5 x	15,6 x	7,66%	-6,45%	102,63%	2,0%	-4,2%	-4,4%
Norway	0,5%	-5,41%	14,05%	10,6 x	9,9 x	-7,21%	65,16%	216,33%	4,5%	4,1%	2,7%
Spain	0,8%	-11,77%	-0,49%	12,2 x	13,3 x	9,69%	6,26%	84,07%	4,1%	-4,5%	-3,6%
Sweden	1,3%	-27,46%	21,33%	14,7 x	16,4 x	11,37%	8,99%	135,27%	2,8%	-6,0%	-4,8%
Switzerland	2,6%	-14,45%	17,46%	16,7 x	18,6 x	11,30%	-0,09%	29,41%	2,8%	-3,8%	-3,6%
Europe / Commercial Services	0,5%	-19,88%	9,58%	16,5 x	18,9 x	14,80%	19,44%	61,10%	2,3%	-4,1%	-4,1%
Europe / Communications	0,5%	-5,51%	0,96%	13,7 x	15,3 x	11,44%	55,89%	-26,80%	4,6%	-5,0%	-3,9%
Europe / Consumer Durables	0,8%	-24,09%	21,32%	6,9 x	7,5 x	9,36%	-1,42%	314,96%	4,8%	-4,9%	4,7%
Europe / Consumer Non-Durable	3,1%	-17,70%	13,18%	19,0 x	21,1 x	10,80%	10,68%	32,83%	2,4%	-3,5%	-4,0%
Europe / Consumer Services	0,3%	-16,61%	4,84%	16,2 x	23,0 x	42,30%	552,24%	132,92%	2,2%	-4,4%	-4,6%
Europe / Distribution Services	0,2%	-21,21%	20,56%	15,9 x	17,1 x	8,35%	20,33%	54,20%	2,3%	-2,6%	-1,2%
Europe / Electronic Technology	1,0%	-21,34%	15,23%	17,9 x	21,3 x	18,73%	20,30%	148,96%	1,5%	-4,4%	-5,0%
Europe / Energy Minerals	0,9%	12,08%	21,06%	6,7 x	5,8 x	-13,10%	71,98%	4592,05%	4,6%	7,5%	7,2%
Europe / Finance	3,5%	-17,02%	15,23%	9,4 x	10,4 x	11,47%	-5,94%	87,18%	4,6%	-4,6%	-6,0%
Europe / Health Services	0,2%	-27,11%	20,45%	17,1 x	18,9 x	10,14%	-1,47%	24,64%	1,9%	-4,7%	-4,9%
Europe / Health Technology	2,4%	-11,08%	15,32%	17,8 x	20,1 x	13,05%	8,14%	11,99%	2,2%	-3,3%	-2,9%
Europe / Industrial Services	0,3%	-10,18%	6,82%	12,7 x	15,3 x	20,40%	13,38%	105,61%	3,5%	-4,7%	-5,7%
Europe / Miscellaneous	0,0%	-29,91%	35,07%	13,5 x	15,1 x	5,60%	-10,48%	149,21%	2,6%	-3,4%	-3,7%
Europe / Non-Energy Minerals	0,6%	-3,46%	13,30%	7,9 x	6,0 x	-23,60%	8,81%	136,61%	6,4%	3,6%	2,0%
Europe / Process Industries	0,8%	-15,18%	9,77%	15,8 x	15,8 x	-0,22%	11,46%	54,70%	3,0%	-3,7%	-1,6%
Europe / Producer Manufacturin	1,2%	-28,04%	21,04%	14,3 x	17,2 x	20,24%	11,21%	89,72%	2,6%	-5,8%	-7,3%
Europe / Retail Trade	0,4%	-30,32%	-1,51%	15,1 x	18,3 x	20,86%	11,75%	91,23%	2,7%	-7,4%	-7,8%
Europe / Technology Services	0,9%	-29,80%	2,33%	18,0 x	22,6 x	25,23%	10,00%	28,78%	1,1%	-6,8%	-8,0%
Europe / Transportation	0,6%	-12,62%	26,29%	12,8 x	10,9 x	-14,74%	99,46%	164,15%	4,5%	-5,0%	-0,3%
Europe / Utilities	1,0%	-11,09%	-4,61%	14,7 x	19,5 x	33,15%	-12,54%	21,59%	3,9%	-5,0%	-15,0%

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