June 2022

The economic situation is dividing emerging countries

Overview

Whether in terms of sanctions, the downturn in international trade or supply shortages, the war in Ukraine is proving costly for the world economy. International economic organisations are starting to get a handle on its precise impact. According to the OECD, the war will trim 1.1 points from the world's real GDP growth rate this year, to 3.4%. The IMF is on much the same page, having cut its own projection for 2022 by 80bp since January (i.e. since just before the invasion), leaving it at 3.6%. The FactSet consensus splits the difference at 3.5%.

The instability of energy and commodity prices stemming from the triple conjunction of Covid, war in Ukraine and climate change has hardly bypassed emerging countries. Albeit to different degrees, their inflation rates have risen: apart from Russia, which is of course a special case, Brazil and India have been the emerging bloc's biggest casualties in this respect. Brazilian consumer prices increased by 12.1% in the year to April, compared with a 2022 inflation target of 3.75%. In India, inflation amounted to 7.8% over the same period and is also above its target (4%, with tolerance of 2% either side).

In contrast, Chinese inflation is far tamer. At 2.1% in the year to April, it is still below its target of around 3%. For the reasons we explained in an earlier edition of this strategy letter, China is largely immune from inflationary pressure. Given the authorities' 'Zero Covid' strategy, the unplanned slowdown in economic activity will have serious implications, however. China's main business sectors are suffering (and could well continue to suffer in the months ahead, thanks to their inertia) a significant downturn: in May, the manufacturing PMI dropped to 46, and the sector contributed 39.4% of Chinese GDP in 2021. More alarmingly still, the PMI for the services sector (53.2% of GDP in 2021) slumped to 36.2.

Against this backdrop, we should not be surprised to have seen emerging market equities underperforming badly since the beginning of March (down 8.4%, compared with a 4% correction for US equities and a 0.6% gain in local currency terms For the European market). Although the partial removal of Covid-related restrictions could bolster Asian equities, the international situation continues to fuel our preference for developed country equities, especially in Europe.

On the corporate front, with 97% of S&P 500 firms now having published their Q1 results, we can now be more bullish on the numbers we reported last month and can confirm the positive trends we saw at the beginning of this results season. Momentum behind positive revisions persists, with a high proportion of positive surprises (77%, compared with 80% in our previous letter), and S&P 500 earnings growth is still an impressive 9.2%. But then the magnitude of surprises is fading: reporting firms have published earnings 4.7% higher than analysts were expecting at the end of March (they were looking for a 4.6% increase in aggregate S&P 500 earnings at the end of the first quarter).

Despite less upbeat projections for Q2, analysts are still largely positive and forecast earnings growth of no less than 10% for 2022 as a whole.

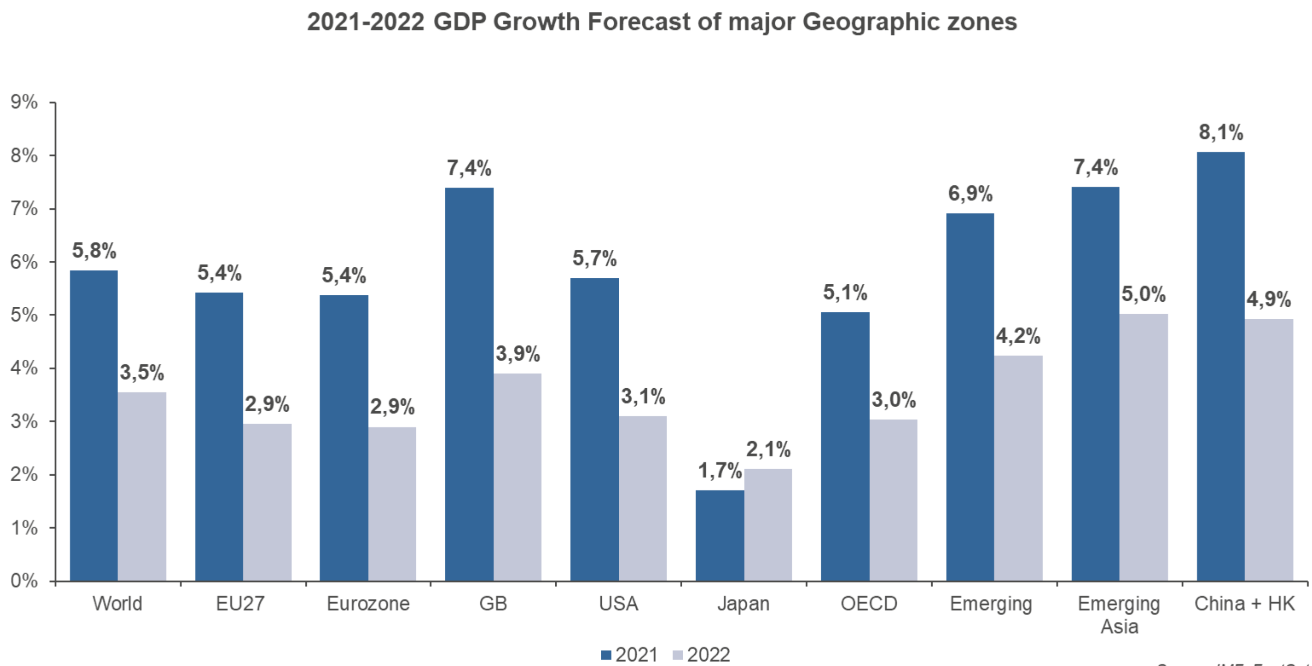
Michaël Sellam

Highly unequal growth prospects among emerging countries

Whether in terms of sanctions, the downturn in international trade or shortages, the war in Ukraine is proving costly for the world economy. International economic organisations are starting to get a handle on its precise impact. According to the OECD, the war will trim 1.1 points from the world's real GDP growth rate this year, to 3.4%[1]. The IMF is on much the same page, having cut its own projection for 2022 by 80bp since January (i.e. since just before the invasion), leaving it at 3.6%. The FactSet consensus splits the difference at 3.5%.

We would urge caution even on these numbers, however. The war in Ukraine is not over; in the meantime, pressure on private sector margins is growing and currency risks have returned. Despite this challenging backdrop, central banks are refusing to get involved and the slightest difficulty from here on could well derail current growth forecasts. And higher interest rates will slow growth in any case.

Emerging country growth rates to diverge in 2022



Source: IMF, FactSet

At first sight, emerging countries will not fare too badly with an expected growth rate a 4.2% this year (see chart). But this figure masks widely disparate outlooks. Unsurprisingly, given their proximity to the war, central and eastern European economies[2] will be badly affected and their combined real GDP is forecast to contract by around 2.4% this year. in contrast, Asian emerging countries are set to post GDP growth worth 5%. Yet even their outlook is uncertain, as China's changes of direction around its Covid strategy could prove costly and prevent it driving growth in the Far East and worldwide to the extent we have seen in recent years.

As far as the BRICS are concerned (Brazil, Russia, India, China and South Africa), growth trajectories even among these spearhead economies are very different. Activity in the two Asian giants is slowing but remains on track: the FactSet consensus is for 5% in China and 7.5% in India this year. On the other hand, the consensus view is extremely pessimistic on Brazil, where monetary policy has been tightened severely (growth of just 0.7% in 2022), and on Russia, which has been largely cut out of the international economic system (-10%).

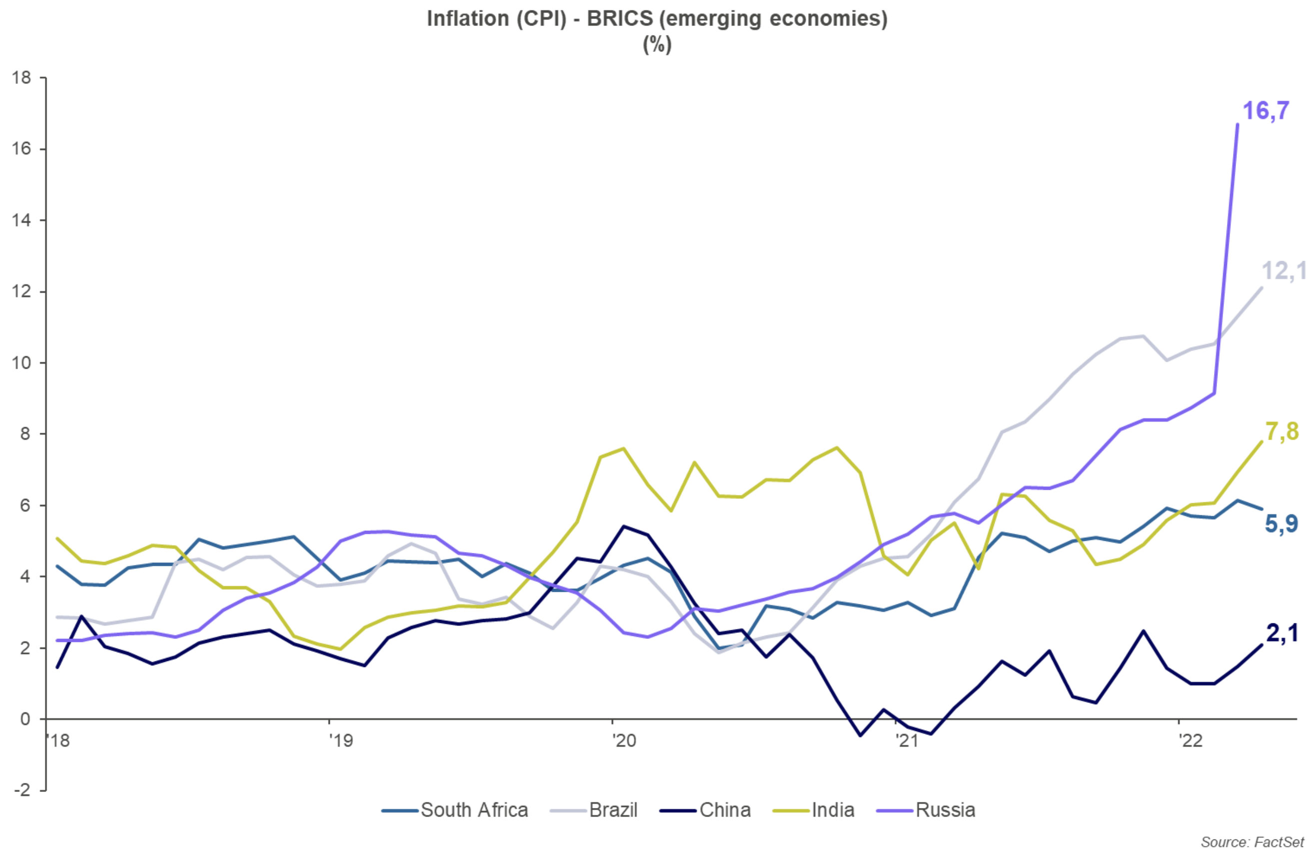
[1] 4.5% forecast in January.
[2] Indiscriminately, countries that the IMF considers "emerging" and "developing".

Inflation up sharply in most emerging countries

The instability of energy and commodity prices stemming from the triple conjunction of Covid, war in Ukraine and climate change has hardly bypassed emerging countries (see chart). Albeit to different degrees, their inflation rates have risen: apart from Russia, which is of course a special case[3], Brazil and India have been the emerging bloc's biggest casualties in this respect. Brazilian consumer prices increased by 12.1% in the year to April, compared with a 2022 inflation target of 3.75%. In India, inflation amounted to 7.8% over the same period and is also above its target (4%, with tolerance of 2% either side).

Brazil has opted to tackle inflation head-on with an extremely restrictive monetary policy involving sharp increases in interest rates. The Brazilian central bank has hiked its key rate ten times since March 2021, including a 100bp jump to 12.75% in May. The Reserve Bank of India has also raised its interest rates, but by far less, with a 40bp hike in May to 4.4%. Disconcertingly, this diversity of policy responses to inflationary pressure suggests that central banks are operating outside any consensus, in an ad hoc manner.

Apart from China, inflation is surging in the main emerging economies



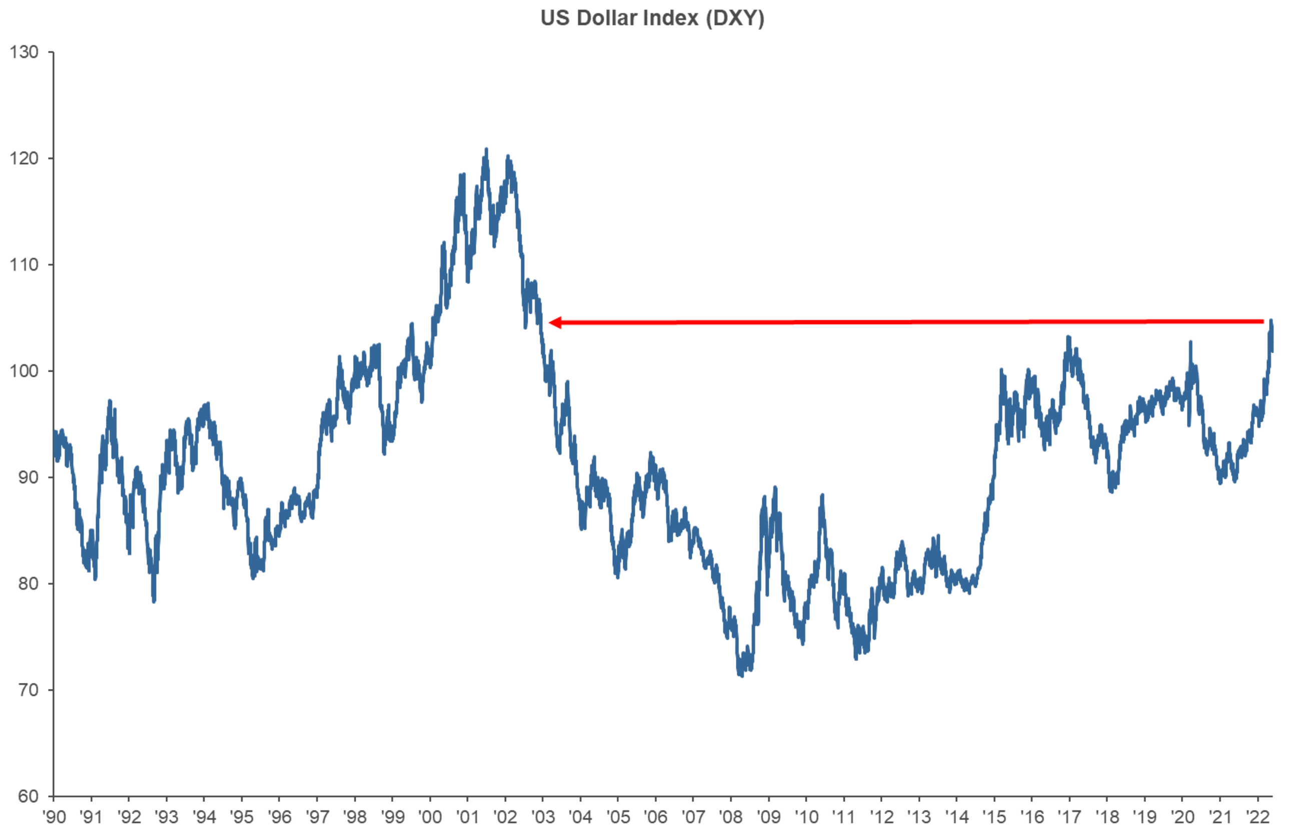
In China, inflation has remained far tamer. At 2.1% in the year to April, it is still below its target of around 3%. For the reasons we explained in the February edition of this strategy letter, China is largely immune from inflationary pressure. Unlike in most of the rest of the world, the government is still actively stimulating the economy and the central bank reduced the reserve requirement it imposes on the banking system by 25bp to 11.25% at end-April. Moreover, it cut one of its main interest rates (the 5-year loan prime rate) by 15bp in May, to 4.45% (the preceding cut was 5bp back in January). In the near term, this monetary policy might well buoy a Chinese hampered until now by excessively lengthy Covid restrictions, but it might not be enough to avoid a slowdown in growth and worsening international supply problems. And in the longer term, the Chinese monetary authorities are taking a non-negligible risk of stoking a real estate bubble. This is a theme that investors would be wise to bear in mind in the months ahead.

[3] Soaring Russian inflation is largely the result of its international isolation after its unilateral decision to invade Ukraine.

Significant swings in exchange rates

In mid-May, the US dollar hit a 20-year high against other major currencies[4] (see chart). This was a direct consequence of policy normalisation at the Federal Reserve. The Fed raised its key interest rate by 50bp at the beginning of May, to 1%, and together with commentary around additional hikes in the future this has sucked world savings into the dollar. Interestingly, developments have been more mixed around emerging currencies, some of which have held up well against the dollar (especially those of raw materials exporters) while others have had a far rougher ride.

The dollar's appreciation against other major currencies

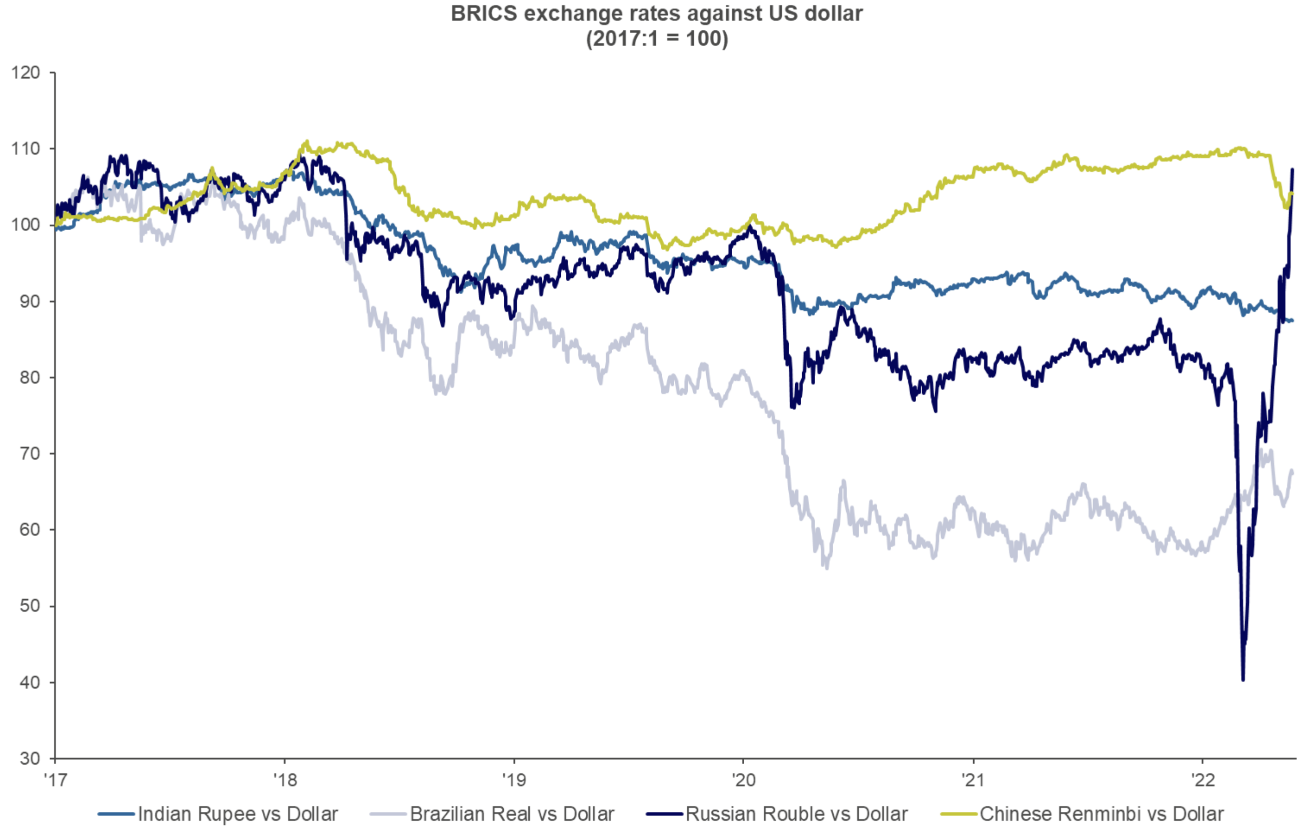


Source: FactSet

The Brazilian real is one of the exceptions, stabilising against the dollar over the past month but up 10.5% over the past year (see chart). There are two main reasons for this performance: sharply increased prices for some of Brazil's principal exports (soybeans, iron ore, oil); and the country's strenuous efforts to limit inflation. In these circumstances, Brazil is well capable of protecting its currency. This example highlights the main factors at work on currency markets, with the countries able to maintain their exports (especially when they are of the farm and energy commodities that have appreciated in value) reasonably capable of maintaining their exchange rates. By the same token, countries not in that fortunate position will see their currencies struggle. The Indian rupee is a good example, having tumbled to new lows amid government restrictions on cereal exports and a trade deficit widening to $23.7 billion in April alone.

[4] The US dollar index (DXY) compares this currency with a basket of the world's other major currencies (euro, yen, pound sterling, Canadian dollar, Swedish krona and Swiss franc).

The main emerging currencies: different dynamics, contrasting performance



Source: FactSet

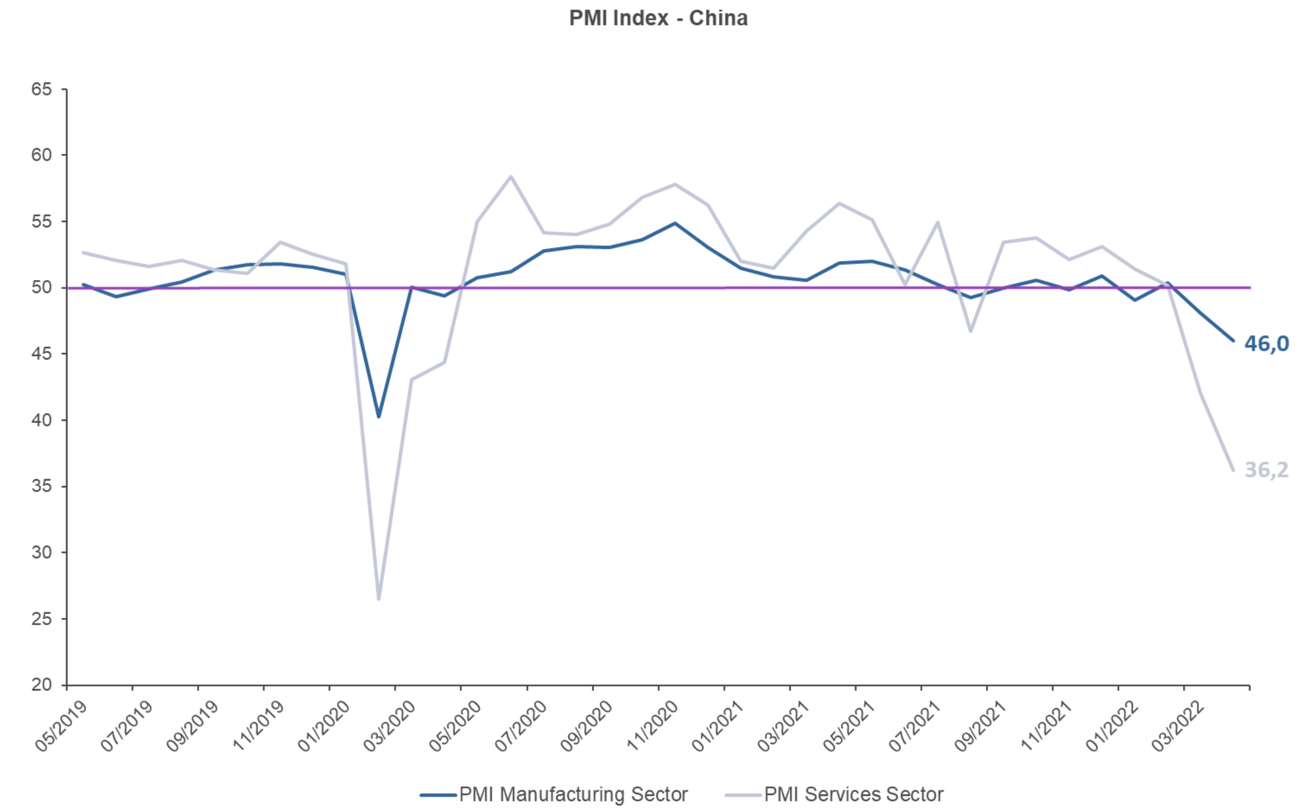
Finally, we need to mention the Russian rouble, which despite all the threats from western governments, did not weaken for long. Indeed, the rouble stronger now than it was before the war in Ukraine and even before Covid. The Kremlin has been systematically applying Soviet-era weapons such as an obligation for economic agents to place most of their assets in roubles, massive gold purchases (leading to rumours of the possible indexation of the rouble on gold) and the requirement for some 'unfriendly' international buyers of Russian gas to pay for it in roubles. Although this strategy is unlikely to work for very long[5], it has clearly worked pretty well so far.

[5] On the other hand, recent academic work on sanctions and their impact on exchange rates suggests that an international sanctions package that penalises imports of the target country without slowing its exports (as is the case with Russia) have every chance of favouring the appreciation of its exchange rate (*London School of Economics, Discussion Paper, May 2022*).

China's Zero Covid strategy backfires

Although most of the Asian and Pacific countries that had adopted 'Zero Covid' strategies abandoned it in the first quarter, including Vietnam, Singapore and hard liners Australia and New Zealand, China is only just starting to ease its own lockdown measures. This reflects poor vaccination rates, especially among the most vulnerable segments of the population, as well as the limited efficacity of the vaccines used (Sinovac, Sinopharm) at a time when the Omicron variant remains endemic. But popular discontent and the exorbitant costs of maintaining restrictions have ended up prompting the authorities to fall into line with the rest of the world and to accept that China will also have to learn how to live with the virus.

By maintaining its Zero Covid policy at any cost, China has created problems for its main business sectors



Source: FactSet

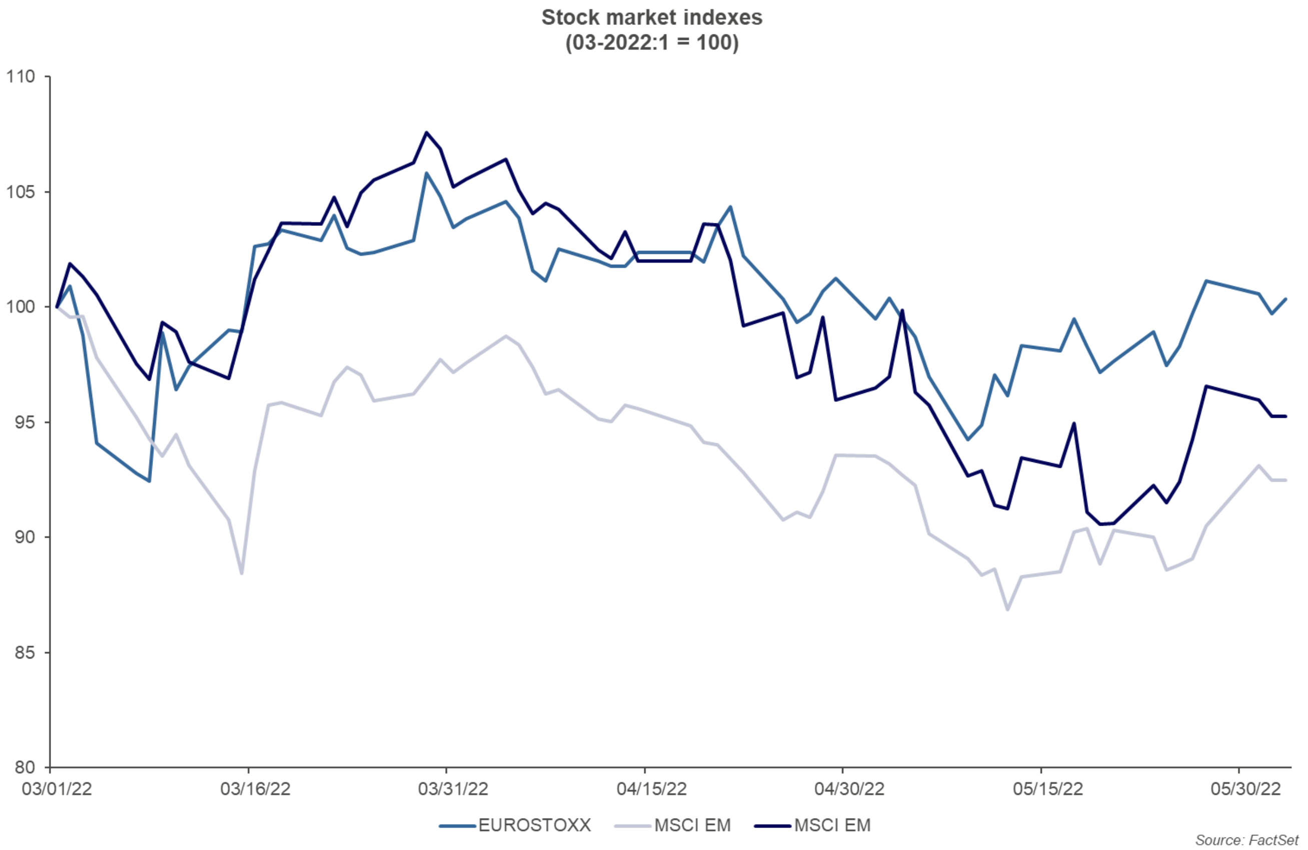
The unplanned shutdown has serious implications. China's main business sectors are suffering (and could well continue to suffer in the months ahead, thanks to their inertia) a significant downturn: in May, the manufacturing PMI dropped to 46, and the sector contributed 39.4% of Chinese GDP in 2021. More alarmingly still, the PMI for the services sector (53.2% of GDP in 2021) slumped to 36.2 (see chart).

China might have been spared inflationary pressure, but has been caught out by its own intransigence on Covid. Its industrial production slumped 2.9% in the year to April and his exports are on a downtrend (up just 3.9% year-on-year in April). These sorts of figures could start casting doubt on China's trading model. Rejoicing at China's difficulties would be a mistake, however, as slower growth will undermine world activity. We can only hope that its accommodating monetary policy will work, as nobody has anything to gain from another deceleration in international economic conditions.

Continuing uncertainty hits emerging markets

Against this backdrop, we should not be surprised to see emerging market equities underperforming badly since the beginning of March (down 8.4%, compared with a 4% correction for US equities and a 0.6% gain in local currency terms For the European market). Although the partial removal of Covid-related restrictions could bolster Asian equities, the international situation continues to fuel our preference for developed country equities, especially in Europe.

Emerging country equities have underperformed Europe by almost 800bp and US equities by 300bp since the beginning of March



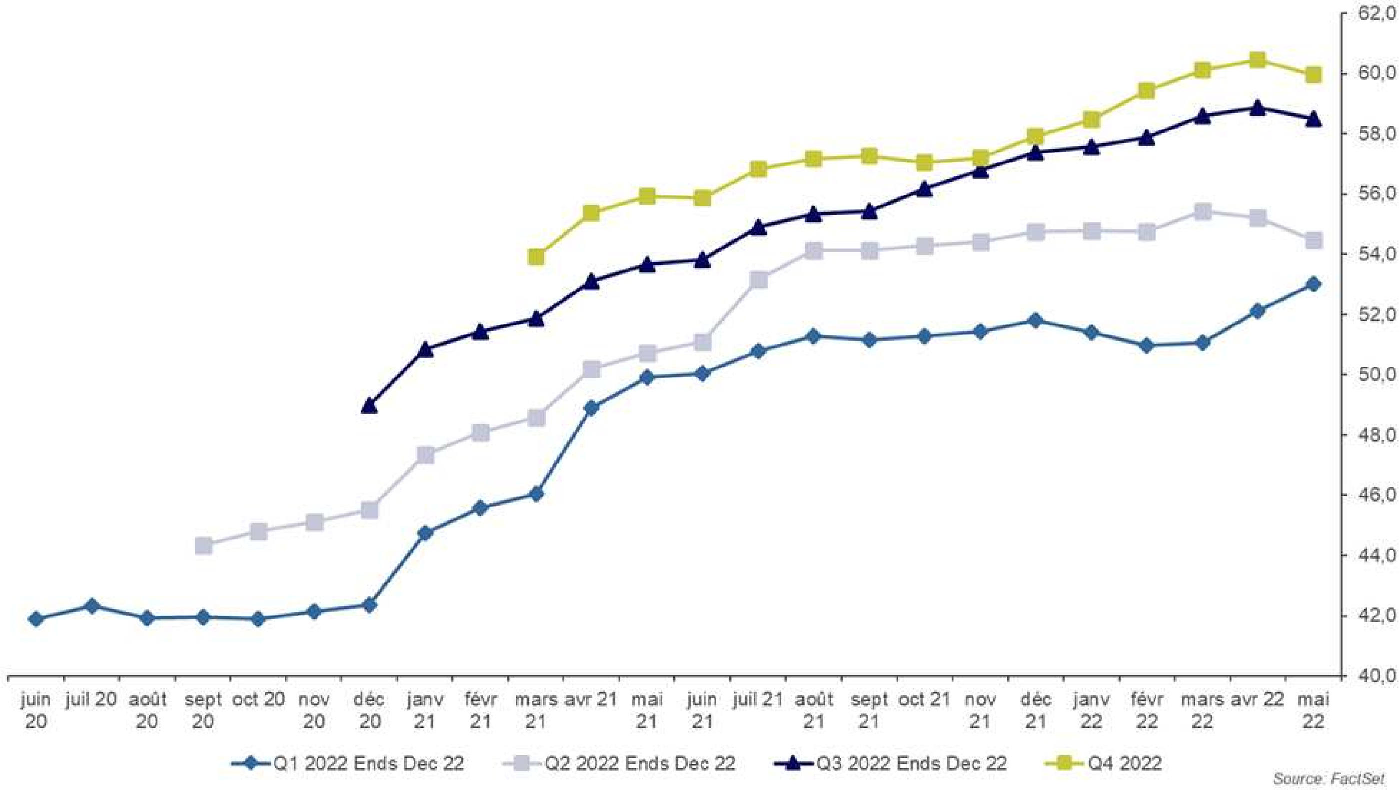
Source: FactSet

America's Q1 2022 results season draws to a close, confirming the positive trends noted last month

With 97% of S&P 500 firms now having published their Q1 results, we can now be more bullish on the numbers we reported last month and can confirm the positive trends we saw at the beginning of this results season.

Momentum behind positive revisions persists, with a high proportion of positive surprises (77%, compared with 80% in our previous letter), and S&P 500 earnings growth is still an impressive 9.2%. It is simply that the magnitude of surprises is fading: reporting firms have published earnings 4.7% higher than analysts were expecting at the end of March (they were looking for a 4.6% increase in aggregate S&P 500 earnings at the end of the first quarter).

Estimates Quarterly EPS for S&P 500 (US) in USD as of 05/31/22

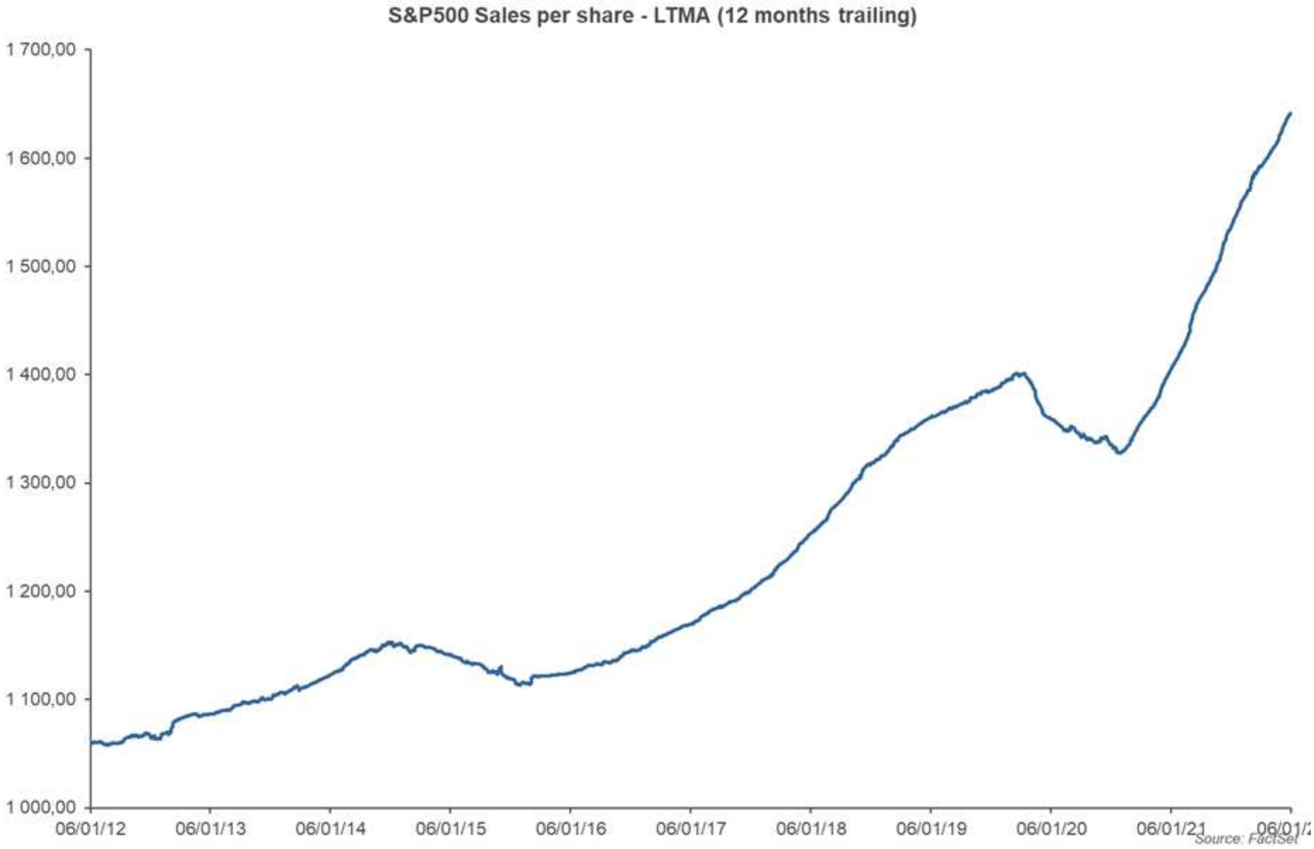


Source: FactSet

Note that one sector is posting results well down on analysts' expectations: discretionary consumers, whose aggregate earnings dropped 32.7%. That is down to just one company: Amazon, without which the sector's earnings would not have been down at all but up 3.8%. As we mentioned last month, some index heavyweights were hugely disappointing in Q1, damaged by persistent supply chain problems and surging inflation rates that are starting to weigh on consumption. The negative earnings growth reported by Amazon for the quarter made a massive -2.75% contribution to the overall S&P 500 result.

Momentum on US revenue growth is also very positive, with an aggregate 13.6% gain for the S&P 500 in Q1. This was the fifth quarter in a row of double-digit year-on-year growth. All sectors reported higher revenue in Q1, led of course by the energy sector (up 60.2%).

Excellent momentum on corporate revenues

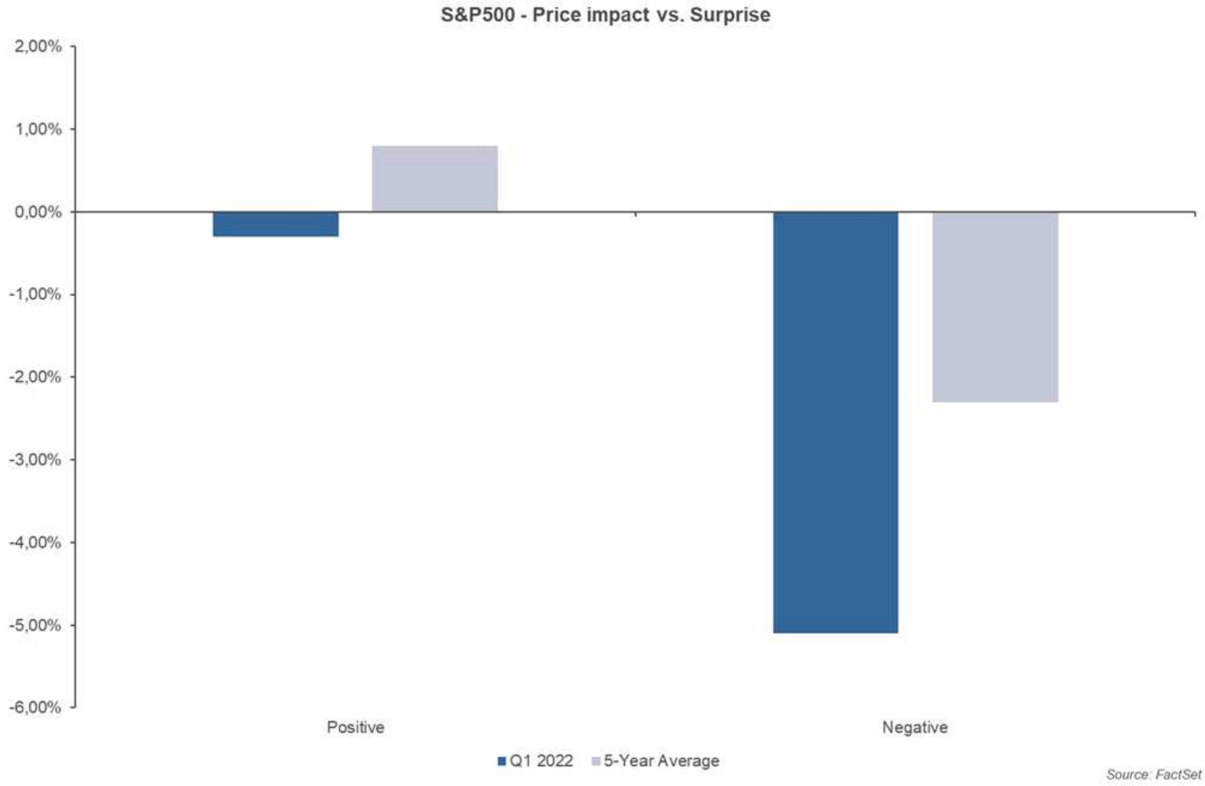


Despite good results overall, even the best performers are down by historical standards

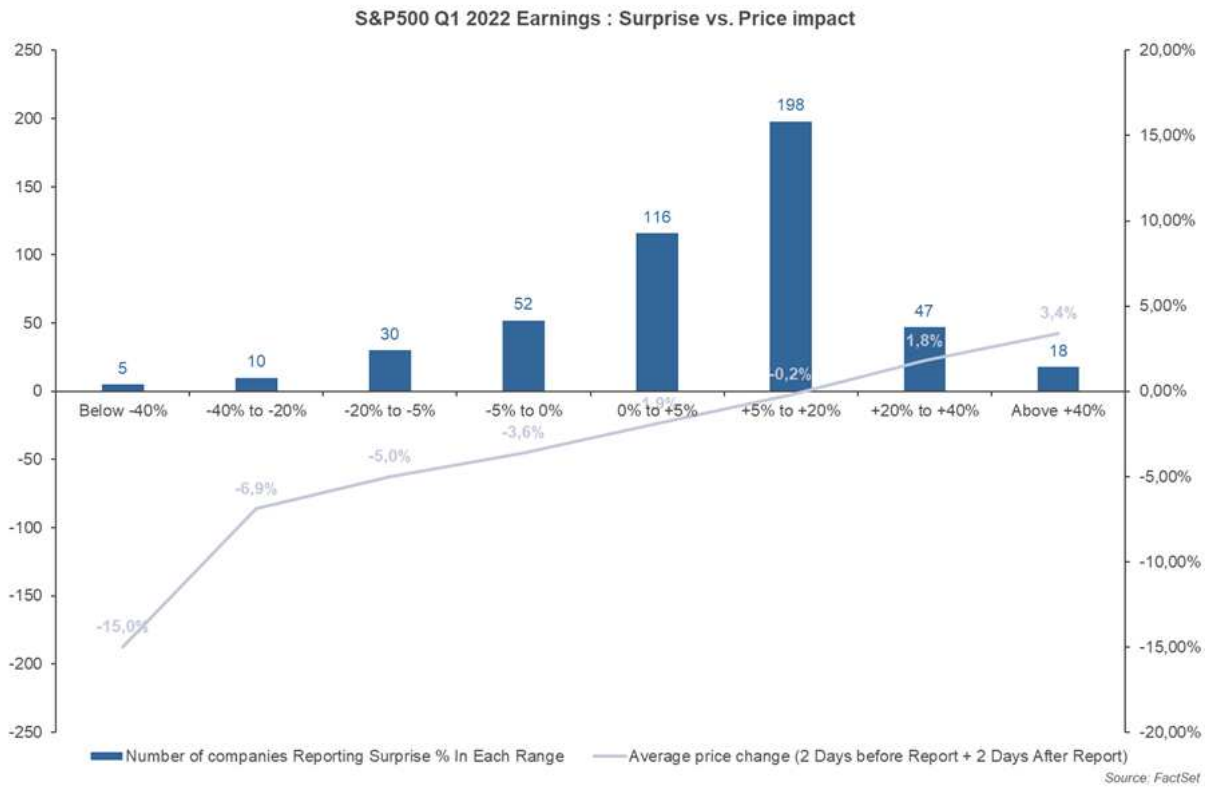
The investor reaction to these results has been unusually grudging. Over the past five years, companies reporting better than expected EPS have seen an average 0.8% gain in their share prices afterwards, but following the Q1 numbers this year such firms have seen an average 0.3% decline in their share prices instead. Similarly, companies publishing EPS below expectations have been sanctioned by an average 5.1% off their share prices rather than the five-year average of -2.3%. There are several reasons for this change:

- Renewed geopolitical tension, which has both undermined equity prices and increased market volatility since the start of the year;
- Worsening macroeconomic fundamentals, particularly in China where an apparently interminable Zero Covid policy led many analysts to lower growth forecasts for the country by an average 50bp;
- Smaller positive surprises than in the recent past;
- Downward revisions to Q2 earnings estimates.

Despite good results, investors have sanctioned both good and bad surprises…



… with the exception of firms reporting profits at least 20% greater than consensus estimates



On top of all that, we have factors that have regularly featured in the past few results seasons or will do so in the future, and which all have negative implications for earnings growth. The first is inflation, mentioned by 85% of S&P 500 companies in their results announcements. The second is supply chain issues, cited by 73% of firms (a proportion that has been unchanged for three quarters). Thirdly, we have the war in Ukraine, mentioned by 59% of reporting companies. As one would expect, the sectors raising the Ukraine factor the most are energy (76%), consumer staples (75%) and basic materials (75%). It is interesting to note that although more than half of S&P 500 companies mentioned the war in their Q1 announcements, FactSet estimates that the combined exposure of index firms to Ukraine and Russia combined is only around 1%, i.e. practically zero.

The outlook for Q2 and 2022 overall

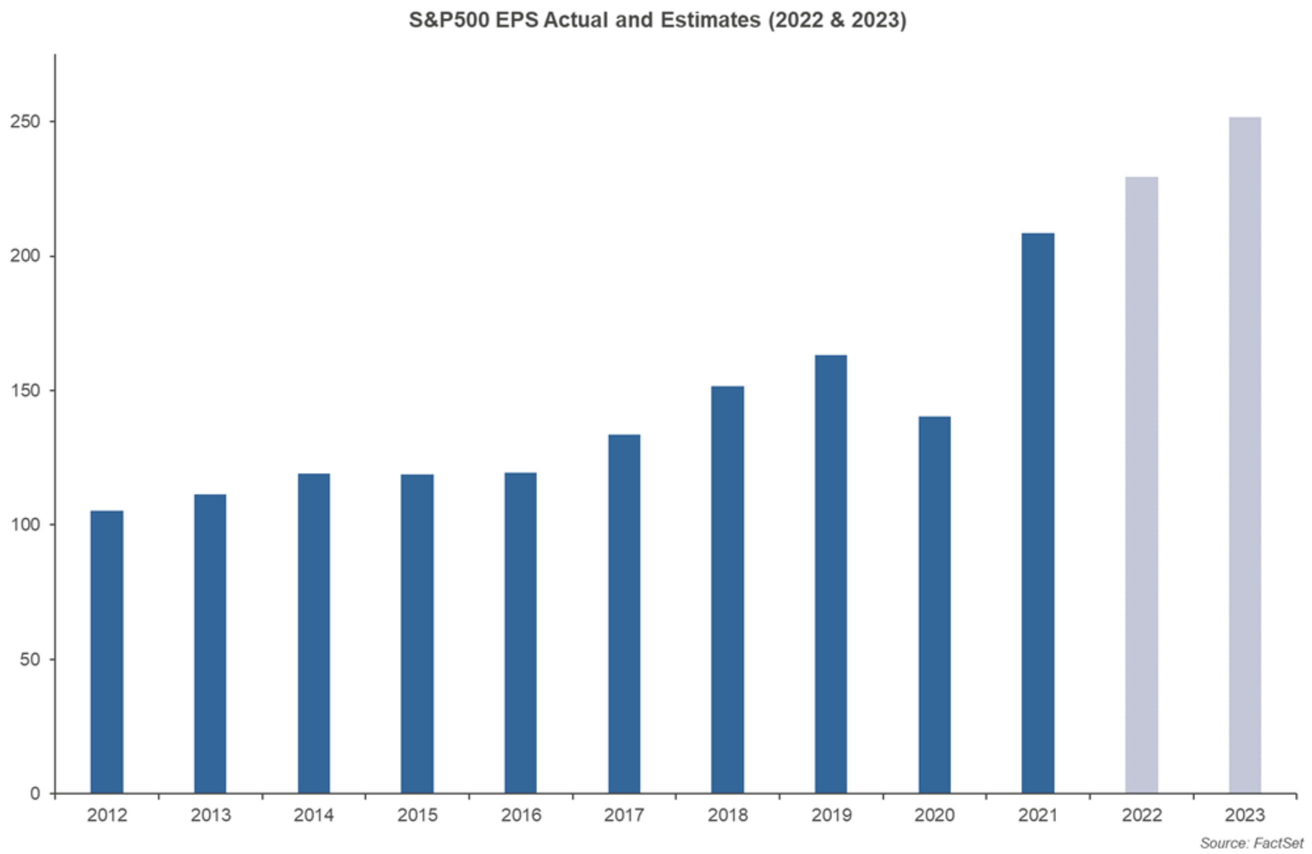
96 S&P 500 firms have already published guidance for Q2. So far, there has been no change in the trend we have seen for the past few quarters, with the number of firms publishing negative guidance[6] up for the fourth quarter in a row to 67. That amounts to 70% of all the firms issuing guidance for the current quarter, well up on the average for the past five years (60%).

Analysts are also less enthusiastic than they were and are revising their Q2 estimates downwards. They are now looking for EPS growth of just 4.1%, revenue growth of 9.7% and net profit margin growth of 12.5% (currently 12.3% for Q1). Thanks to higher energy prices, the energy sector is expected to lead those gains.

Despite this less upbeat view, analysts are still bullish on 2022 as a whole and continue to forecast 10% EPS growth overall.

[6] We recall that positive guidance corresponds to expected earnings growth higher than the mean consensus estimate (on the day the results are announced), while negative guidance is lower than the mean consensus estimate.

Despite some clouds on horizon, analysts remain optimistic



Main ratios for markets and sectors as of 31/05/2022 (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%	
31/05/22	World	2022	2021	2023	2022	2023	2022	2021	2022	Fiscal 23	Fiscal 22
World - Developed	**100,0%**	**-13,82%**	**13,18%**	**14,3 x**	**15,7 x**	**9,86%**	**14,34%**	**67,03%**	**2,2%**	**0,4%**	**0,7%**
United States	56,4%	-15,45%	21,64%	16,7 x	18,7 x	11,91%	14,99%	62,79%	1,6%	0,1%	0,1%
Japan	7,1%	-14,13%	-2,20%	12,4 x	13,3 x	7,24%	15,54%	36,85%	2,6%	0,9%	0,4%
Eurozone	10,3%	-17,13%	11,04%	12,4 x	13,4 x	7,92%	9,91%	101,78%	3,2%	2,2%	3,6%
Europe	19,6%	-14,35%	12,88%	12,6 x	13,4 x	6,14%	12,37%	93,38%	3,3%	1,7%	2,5%
Austria	0,2%	-16,05%	25,54%	8,7 x	8,6 x	-1,35%	5,64%	123,44%	3,9%	6,1%	6,2%
Belgium	0,4%	-14,27%	5,03%	16,0 x	18,0 x	12,59%	3,40%	31,20%	2,6%	0,9%	2,2%
Denmark	0,7%	-14,58%	13,23%	18,9 x	16,6 x	-12,13%	21,33%	69,39%	2,6%	5,2%	7,5%
Finland	0,3%	-19,57%	5,66%	14,6 x	15,2 x	4,74%	3,69%	43,76%	3,6%	2,2%	1,6%
France	3,6%	-16,95%	19,06%	13,4 x	15,4 x	14,77%	10,51%	157,69%	2,8%	2,2%	2,5%
Germany	2,6%	-19,01%	4,34%	11,2 x	11,5 x	3,27%	6,92%	80,98%	3,7%	1,6%	3,6%
United Kingdom	4,1%	-8,27%	12,03%	10,9 x	11,1 x	2,00%	24,68%	103,76%	3,7%	1,3%	3,3%
Ireland	0,1%	-18,25%	12,86%	13,5 x	16,9 x	24,64%	35,33%	5223,40%	1,6%	-0,3%	-1,2%
Italy	0,9%	-15,46%	13,37%	9,4 x	9,7 x	3,20%	40,87%	82,72%	4,4%	3,5%	6,8%
Netherlands	1,2%	-24,08%	14,28%	15,0 x	15,5 x	3,80%	-5,15%	102,64%	2,1%	1,3%	3,9%
Norway	0,6%	0,76%	14,05%	10,9 x	10,1 x	-7,62%	70,41%	217,89%	4,4%	2,5%	3,5%
Spain	0,8%	-5,64%	-0,49%	12,4 x	13,6 x	9,38%	9,38%	83,97%	3,9%	2,3%	3,9%
Sweden	1,3%	-13,51%	21,33%	14,9 x	18,3 x	22,87%	-20,73%	135,27%	2,8%	-1,3%	-11,2%
Switzerland	2,6%	-15,02%	17,46%	16,3 x	18,2 x	11,51%	-0,01%	29,41%	2,9%	0,7%	-0,2%
Europe / Commercial Services	0,5%	-21,43%	9,58%	15,7 x	18,1 x	14,82%	19,24%	61,10%	2,4%	0,3%	0,6%
Europe / Communications	0,6%	-0,71%	0,96%	14,5 x	15,9 x	9,53%	57,32%	-26,81%	4,4%	2,6%	3,9%
Europe / Consumer Durables	0,8%	-21,86%	21,32%	7,0 x	7,4 x	6,60%	1,12%	314,96%	4,9%	1,5%	-0,5%
Europe / Consumer Non-Durable	3,0%	-18,55%	13,18%	18,5 x	20,5 x	10,92%	11,02%	32,83%	2,5%	1,4%	1,3%
Europe / Consumer Services	0,4%	-15,51%	4,84%	16,1 x	23,6 x	46,45%	41,91%	132,92%	2,2%	2,1%	-7,9%
Europe / Distribution Services	0,2%	-22,46%	20,56%	15,2 x	16,2 x	6,50%	22,70%	54,51%	2,3%	2,4%	5,0%
Europe / Electronic Technology	1,1%	-19,93%	15,23%	17,9 x	21,3 x	18,98%	20,21%	148,98%	1,5%	1,6%	1,0%
Europe / Energy Minerals	1,0%	26,15%	21,06%	7,0 x	5,9 x	-16,48%	90,80%	4592,02%	4,2%	4,4%	11,8%
Europe / Finance	3,5%	-15,18%	15,23%	9,4 x	10,6 x	13,41%	-11,46%	87,20%	4,7%	1,2%	-0,6%
Europe / Health Services	0,2%	-22,00%	20,45%	18,4 x	19,9 x	8,14%	0,18%	24,64%	1,8%	-0,1%	-0,4%
Europe / Health Technology	2,5%	-10,61%	15,32%	17,1 x	19,2 x	12,22%	8,90%	11,95%	2,3%	0,9%	1,5%
Europe / Industrial Services	0,3%	-8,79%	6,82%	12,6 x	15,2 x	21,01%	12,03%	105,61%	3,6%	1,3%	1,6%
Europe / Miscellaneous	0,0%	-29,15%	35,07%	8,6 x	7,6 x	-25,58%	-1,63%	149,21%	3,2%	1,5%	14,1%
Europe / Non-Energy Minerals	0,6%	0,21%	13,30%	8,1 x	6,3 x	-22,41%	2,56%	136,61%	5,9%	4,0%	6,2%
Europe / Process Industries	0,8%	-15,58%	9,77%	15,3 x	15,2 x	-0,70%	13,13%	54,69%	3,1%	1,9%	3,3%
Europe / Producer Manufacturin	1,2%	-12,90%	21,04%	15,1 x	18,7 x	23,83%	9,11%	89,84%	2,4%	-0,3%	-1,8%
Europe / Retail Trade	0,4%	-31,49%	-1,51%	15,0 x	18,1 x	20,50%	9,90%	91,23%	2,8%	-1,5%	-1,4%
Europe / Technology Services	1,0%	-29,80%	2,33%	18,8 x	22,9 x	21,90%	6,06%	28,80%	1,1%	-1,6%	-0,9%
Europe / Transportation	0,6%	-12,29%	26,29%	12,3 x	10,0 x	-18,48%	115,86%	178,10%	4,7%	2,6%	11,8%
Europe / Utilities	1,1%	-8,45%	-4,61%	13,1 x	15,5 x	18,44%	0,87%	21,59%	4,2%	4,1%	1,2%

FactSet Market Indices - Data as of 31/05/2022