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Global perspectives: A $226trn question

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- **A global slowdown appears to be underway.** Survey data show a steady deterioration in business optimism and consumer confidence in developed markets. In our view it is too early for anyone to answer precise questions of how deep or how long the slowdown will be and portfolios should be managed accordingly.
- **The main uncertainty is the duration of the surge in inflation and the resulting timing of the inflection point in monetary policy tightening.** Energy prices and headline inflation are strongly correlated. If oil prices remain above $100 per barrel, headline consumer price index (CPI) inflation is likely to remain well above 2% in the US and Europe over the next 12 months. Consequently, central banks may have little choice but to maintain pressure on the brake pedal, even as the global economy slows.
- **With an estimated $226trn of debt outstanding globally, rates are unlikely to rise as far as the 1980s.** We believe a relatively modest tightening of financial conditions will deliver the reduction in end demand that policymakers require to ease inflationary pressure. We are therefore neutral on US 10-year government bonds at yields above 3%.
- **In terms of asset prices, bond markets have moved ahead of central bank policymakers in 2022.** Equities are adjusting more slowly to the new reality of slower growth, higher interest rates and a new-found emphasis on the most basic immediate needs – food and energy. Nevertheless, meaningful progress has been made on eliminating the most glaring valuation excesses of the post-COVID era.
- **We maintain our neutral outlook on global equities but believe investors should remain highly selective and seek exposure to sectors that benefit from higher interest rates and stocks that represent defensive earnings streams.** In an environment of normalising equity valuations we maintain the same strategy, which is to focus on traditional sectors such as energy, pharma, banks, insurance and defence, which have historically offered a degree of inflation protection while avoiding more overvalued segments of the global equity market, either by region or sector.

A US$226trn question

Global markets remain under pressure from a maelstrom of challenging factors. In a sentence, these are inflation uncertainty, slowing growth, fears of deglobalisation and a broad-based yield expansion across global markets and asset classes as central banks step back from ultra-loose monetary policy.

At the start of 2022 we believed the primary near-term challenge to markets would be the central bank response to the surge in inflation. This is now 'old news' as interest rate markets discount a period of rapidly rising interest rates ahead and central bank heads compete to burnish their inflation fighting credentials.

Despite often claiming sensitivity to incoming data, we believe the extent of the inflation overshoot ties the hands of monetary policymakers to proceeding with at least 1–1.5% of interest rate increases in the US, UK and eurozone. European Central Bank President Lagarde's most recent public comments are merely repetition of what independent analysts have been saying for some time. Namely, that growth is under pressure due to supply side constraints rather than an absence of demand. With inflation above target, it is high time for the return of monetary policy to no less than neutral settings.

We suspect investors would prefer perfect foresight on the coming interest rate cycle over any other factor for predicting bond and equity returns over the next 12–18 months. Unfortunately, there is no such perfect foresight on hand. This interest rate cycle is critically dependent on the evolution of inflation, which has recently caught policymakers dramatically offside. Not only is inflation much higher than targeted levels but inflation uncertainty is also elevated.

Furthermore, the complex interaction of food and energy inflation on the consumer, the lagged effect of tighter financial conditions and the evolution of economic growth imply significant uncertainty in the envelope of future monetary policy. Not only are there economic factors at play but also important political dimensions.

For example, a ceasefire in Ukraine would be a purely political development but the likely consequent declines in energy and food prices would have broad ramifications for economic growth, interest rates and bond and equity markets.

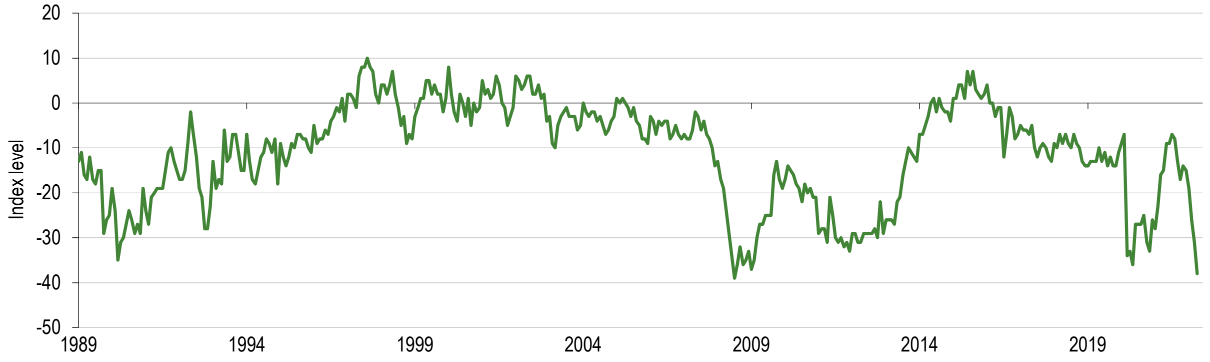
It may seem unlikely now, but we cannot rule out Russia aggressively making the case for a ceasefire and negotiated settlement once it has secured sufficient Ukrainian territory to claim victory in its war. The fissures in the international consensus against the invasion are already on display and will have been part of Russia's calculus from the start of the conflict. For example, Russia's recent initiative to request an easing of sanctions in return for a 'humanitarian corridor' for Ukrainian food supplies over the now aptly named Black Sea shows how the feared bargaining, or blackmail, of global food supplies for Russia's geopolitical advantage has become a reality.

Similarly, an easing of trade tensions between the US and China would have a step-change impact on global financial markets. In our view, portfolios should be prepared for a wider than normal range of economic outcomes. Although central banks may be cornered by high inflation, investors will need to be nimble as political events unfold.

Global slowdown underway

A global economic slowdown is now underway with purchasing managers' indices (PMIs) declining from the peak levels of 2021 and consumer confidence under pressure in both the US and Europe as food and energy prices rise. Furthermore, the most recent flash services PMI survey reading of 51.8 for the UK shows something of a collapse in activity compared to April's reading of 58.9, consistent with the rapid decline in consumer confidence observed since the start of the year, Exhibit 1.

Exhibit 1: UK consumer confidence plunges during Q222



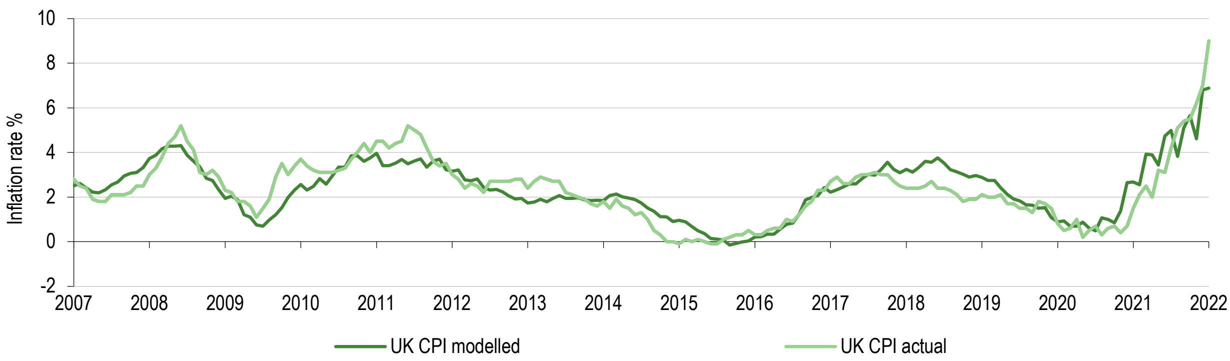
Source: Refinitiv

Western consumers are suffering the impact of higher food and energy prices in addition to a reduction in COVID-19 fiscal support and the initial interest rate increases in the US and UK. The recent surge in food and energy prices due to the war in Ukraine is therefore unfortunately timed, if arguably by Russia's design. Unless there is a halt to the fighting in Ukraine, consumer confidence is likely to remain under pressure from higher prices for basic commodities.

In these circumstances we believe that consumers are likely to continue to focus on necessities rather than discretionary spending. As a result, the profits rebound from COVID-19 consumer recovery may prove to be rather short-lived in the leisure, hospitality and travel sectors. Consumer demand is likely to be crimped by inflationary pressure on budgets. At the same time, costs are being inflated by food and energy bills and rising wages for staff. This implies both revenue shortfalls and margin pressure. We note that on a global basis the cyclical consumer services sector has suffered the largest downgrade to profits forecasts for 2022 over the past month.

Big-ticket purchases may also be deferred as supply chain constraints deliver unusually high price increases, such as for cars where financing is also becoming more expensive as interest rates increase.

Exhibit 2: Headline inflation and oil price regression model - UK



Source: Refinitiv. Note: Chart shows actual year-on-year CPI inflation against regression model using energy prices.

Inflation in US and Europe closely geared to energy prices

Over the last 15 years the majority of the variation in headline CPI indices can be closely linked to energy prices in each of the US, UK and eurozone. From an economic perspective, the price impact of the war in Ukraine is particularly unwelcome as energy prices were already surging from the recovery in demand post the pandemic. While our models have closely tracked the evolution of headline inflation up to 2022, Exhibit 2, we also note that the most recent model predictions are well below current inflation. This suggests that additional factors are now in play. However, a wage price spiral of the form seen in the 1970s seems inconsistent with the current structure of developed labour markets, which now have comparatively limited unionisation.

According to our models, investors and central banks will have to become used to a stream of above-target inflation readings over the next 12 months if oil prices stay above US$100 per barrel. Only if oil prices quickly slip back to pre-war levels is inflation likely to return close to targets within a one-year time horizon. This means there is likely to be limited central bank policy room to ease the pace of monetary tightening even as the economy slows, suggesting that higher interest rates are here to stay over coming years.

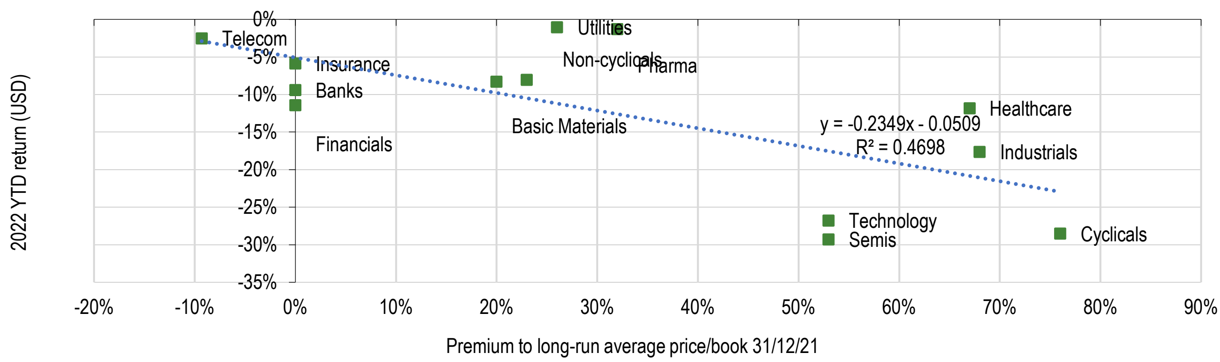
Nevertheless, we believe fears of a return to runaway inflation remain wider off the mark. A higher probability risk for investors in our view is an economic slowdown of a magnitude which meaningfully impinges on energy prices. In part incentivised by a long period of ultra-low interest rates, global debt has risen according to IMF estimates to US$226trn as of the end of 2020, or 2.6x world GDP.

Therefore, only relatively small changes in interest rates from current levels should be sufficient to lower the aggregate level of demand. Furthermore, as US dollar remains the world's reserve currency, higher US policy rates will impact economic growth worldwide. This suggests that a relatively modest set of rate increases will have the desired effect of balancing global demand in line with aggregate supply. For example, a sustained interest rate increase of just 3% would represent over time a substantial additional funding cost of as much as 7% of world GDP. Central banks seem well positioned to slow the economy should it prove necessary to ensure price stability.

Valuations: Improving, but US equities still expensive

Recent movements in global equity sector indices are consistent with investors reappraising portfolio allocations and shifting objectives towards capital preservation in real terms, given an inflationary yet decelerating growth environment. There continues to be a high correlation between global sector performance and the overvaluation of that sector at the start of 2022, Exhibit 3.

Exhibit 3: Starting valuations strongly linked to relative sector performance in 2022, to date



Source: Refinitiv, Edison calculations

The reason for this reappraisal by markets is twofold in our view. First, investors are slowly realising the US Federal Reserve (the Fed) is serious about bringing inflation under control. Recent comments from policymakers at the Fed suggest it remains highly confident it has the mandate to act aggressively on interest rates with the US economy still strong and inflation approximately three times the 2% Fed target.

As a result, interest rate markets are discounting one of the most rapid rates of US monetary tightening seen over the past 30 years. Higher US interest rate expectations are also now affecting emerging markets, as the dollar has strengthened significantly during 2022, Exhibit 4.

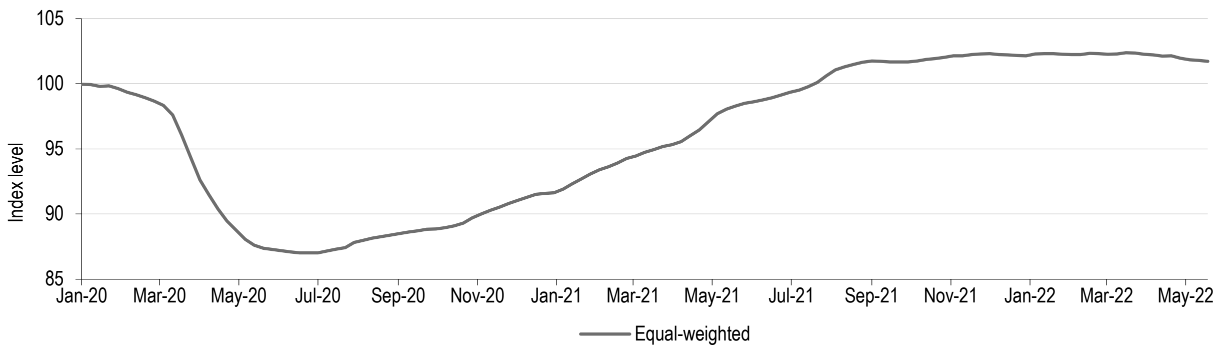
As the global economy loses momentum investors are becoming more cautious of earnings forecast risk. Earnings upgrades have become increasingly concentrated in the energy sector during 2022 and the anecdotal drumbeat of inflationary cost increases and softening consumer demand is yet to filter into consensus forecasts. We note the unweighted earnings revisions index for 2022 has started to decline on a global basis, Exhibit 5, and expect this trend to continue until economic activity has bottomed.

Exhibit 4: US dollar strengthens as the Fed tightens, delivering a global tightening of financial conditions

Source: Refinitiv, Edison calculations

Conceptually, for investors looking to take advantage of lower share prices, we would prefer to be investing in a 2023/24 recovery trade rather than writing insurance on 2022's earnings forecasts. It is in our view too early to be moving away from a defensive equity strategy in an environment where earnings risk remains elevated.

Exhibit 5: Global consensus earnings revisions on a downward trend for the first time post COVID-19



Source: Refinitiv, Edison calculations, equal-weighted

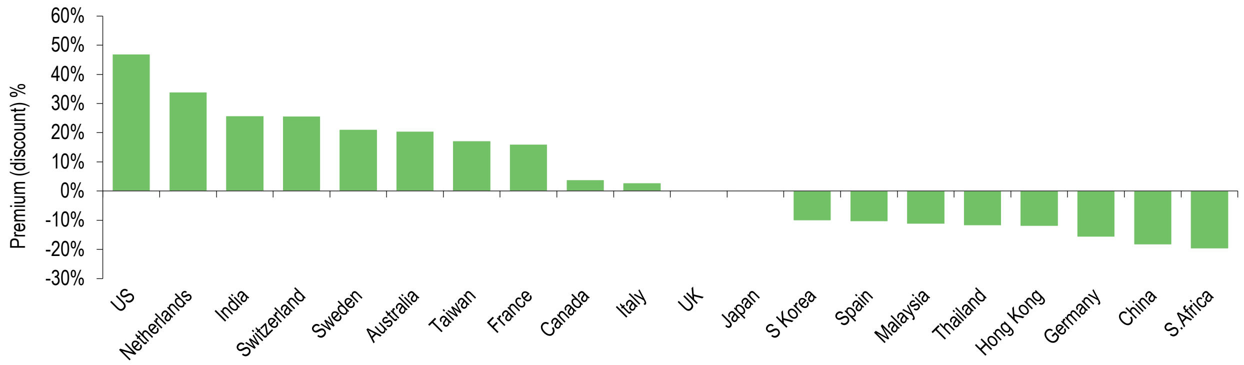
Any one of a large inflation shock, energy shock, fiscal shock or monetary shock would individually have the capacity to induce a major slowdown. In 2022, investors are having to contend with all four factors, and at once.

We therefore believe it should be uncontroversial to suggest the risk of a recession is mounting as COVID-19 related fiscal stimulus is being withdrawn while food and energy costs erode consumer confidence and crimp discretionary spending. In Germany, the key 'ifo institute' survey is now at levels not seen outside the initial COVID-19 downturn or financial crisis of 2008.

Nevertheless, the poor performance of equities pushed many of Europe's national stock exchanges below their long-term average price/book multiple, even if US equities remain expensive on this measure, Exhibit 6. This progress on the normalisation of equity valuations, which corresponds to recent monetary developments, is an encouraging development for long-term investors. However, we do not expect a dramatic rebound in the short term, given the deteriorating macroeconomic outlook.

We therefore maintain a neutral outlook on global equities at this stage but in the context of a defensive sector and regional asset allocation, which avoids the most overvalued segments of the market. A quality but defensive equity portfolio valued inline with long-term valuation averages also offers a degree of inflation hedging within a portfolio. Investors should, in our view, start to look for opportunities thrown up by the market turmoil where valuations are below long-term averages, while remaining aware of rising downgrade risks to earnings forecasts.

Exhibit 6: Global equity valuation picture improving following market declines



Source: Refinitiv, Edison calculations. Note: Price/book premium versus 15-year average.

While the probability of an economic contraction is rising this should not deter investors where valuations are already discounting this outcome. We believe positive catalysts for the market include reduced Russian military activity in the south and east of Ukraine, in addition to any potential softening of China's zero-COVID strategy.

Conclusion

Investors should be clear about where the uncertainty lies in portfolios. The most highly valued segments of the global equity market continue to be at risk from the ongoing normalisation of global monetary policy, a trend that has only continued during May. Precisely how far this valuation correction will extend remains an open question. However, any floor in asset valuations is likely to be contingent on the perception of a ceiling for policy interest rates.

In this respect, we believe bond markets have moved swiftly to account for a significant proportion of all but the most extreme scenarios for US Fed policy over the coming three years. With US government 10-year bond yields now close to 3% and the US yield curve expecting a similar level of short-term rates over the coming 12 months, we believe market expectations fairly discount the monetary tightening required to slow the economy sufficiently to bring inflation down to target levels. Nevertheless, given current food and energy prices this process is likely to take 12–18 months, a period in which consumers will suffer rising unemployment and below-inflation wage increases, thus impacting profits for consumer-facing segments of the stock market.

The ultimate economic outcome from the war in Ukraine remains uncertain. Russia for now appears boxed in militarily and economically. International aid for Ukraine is supporting its war effort while sanctions on Russia continue to impede its economy. However, a sudden twist, such as Russian or Ukrainian breakthrough in the south to end the acute phase of the war or a further escalation, cannot be ruled out.

For investors, political events remain unusually important, if unpredictable. For example, any weakening of the sanctions against Russia in the event of a fracture of the international consensus is likely to weaken energy markets. This political development could bring down inflation more rapidly than currently anticipated and tear up the current outlook for sustained higher rates.

We maintain a neutral outlook on global equities while acknowledging the return to a more normal monetary policy setting could continue to challenge investors in the more highly valued segments and regions of the global equity market. We are also observing an ebbing of earnings momentum outside the obvious beneficiaries of the enormous gains in energy prices which, in combination with weakening purchasing managers' survey data, suggests our defensive portfolio positioning remains appropriate.

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