N° 172

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Perspectives

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- The global economy appears to be heading towards recession.
- Inflationary pressures show little sign of easing.
- The US Federal Reserve is tightening its monetary policy at a record pace.

Financial markets
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- After a first half of the year characterised by fears of inflation and rising interest rates, the possibility of a sharp economic slowdown could become the major theme of the second half of the year.
- An environment characterised by an economic slowdown and a continuation of monetary tightening by central banks cannot be positive for the stock markets.
- The outlook for Asian markets appears to be generally better than for Western markets.

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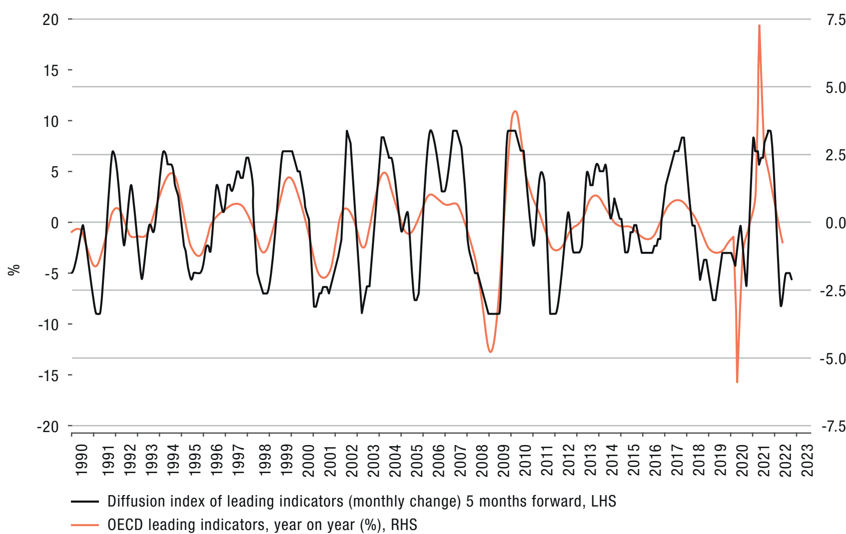
Macroeconomic environment

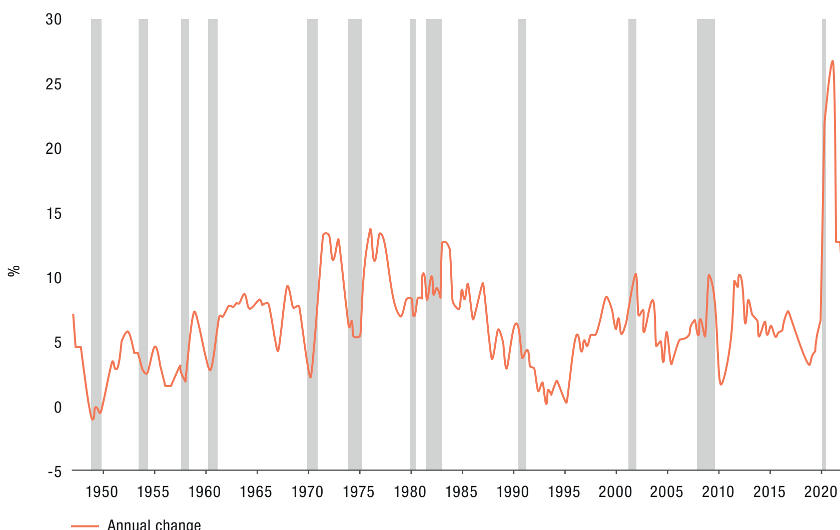
OECD LEADING INDICATORS



Source: OECD, Macrobond

The global economic slowdown is intensifying. Rising interest rates, the post-pandemic normalisation of government spending, high energy costs and general price increases are starting to weigh on growth. The weakness in activity is not confined to the manufacturing sector – which is still affected by the shortage of various materials and components – but is also extending to services activities despite final lockdown measures being lifted. Net energy importing regions such as the eurozone and Japan appear particularly vulnerable, and Europe could even be forced to ration energy this winter if Russia stops supplying natural gas. In the United States, the end of unprecedented government support measures is exacerbating the loss of household purchasing power, which is already being eroded by the general rise in the cost of living. In China, the continuation of the zero-tolerance strategy for new Covid-19 infections could mean the regular return of strict lockdown measures preventing economic activity from normalising. Given the scale and number of headwinds, the current global economic downturn could lead to a recession.

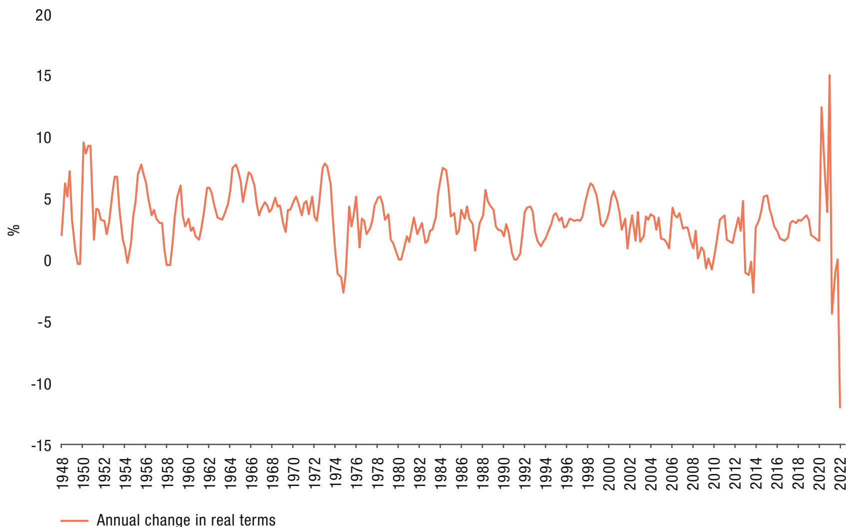
US M2 MONEY SUPPLY



Source: Federal Reserve, Evercore ISI

In the US, the government seems to have set economic activity on a 'boom and bust' trajectory. When the pandemic first emerged, the monetary and fiscal authorities joined forces to launch the biggest government stimulus package in US history. This resulted in a record increase in the money supply, generating the strongest economic growth of the post-war era and raising inflation to levels similar to those recorded in the early 1980s. The subsequent abandonment of the extraordinary fiscal support measures and tightening of monetary conditions have led to a cyclical slowdown, following which a recession seems increasingly likely. If the Federal Reserve reduces its balance sheet as planned, the money supply could decrease at the end of the year, something that has not happened since the early 1950s. Debate is now revolving more around the scale of the deceleration, as a technical recession (defined as two consecutive quarters of a fall in GDP) could be recorded as soon as the end of July when the second-quarter growth figures are published.

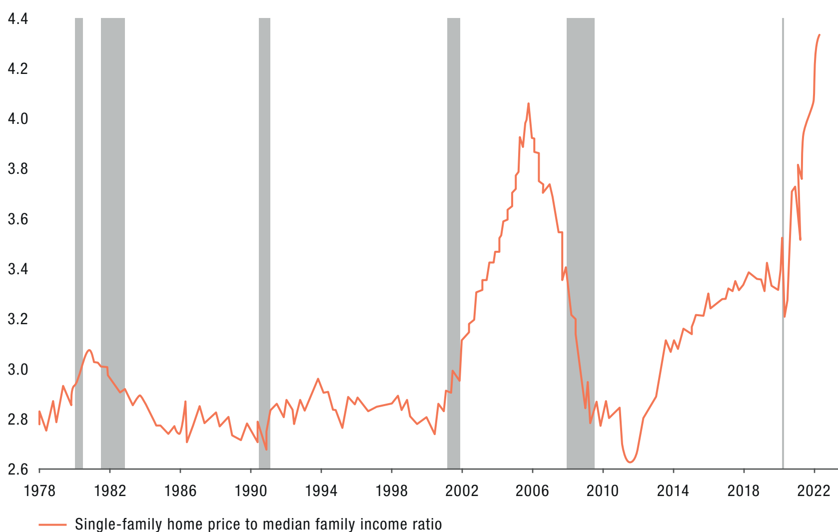
DISPOSABLE HOUSEHOLD INCOME IN THE US



Source: Bureau of Economic Analysis, Bloomberg

The growth outlook for US domestic consumption, by far the largest component of GDP, is gradually deteriorating. During lockdown, the unprecedented increase in disposable household income led to a temporary overconsumption of mainly durable goods. The knock-on effect is now a lean period to make up for the earlier excesses. In addition, a host of factors are starting to weigh simultaneously on household purchasing power: the end of public support measures, the increase in the price of many basic goods (such as food, petrol and electricity), a reduction in the value of financial assets, and the gradual depletion of the savings reserve accumulated during the pandemic. During the summer, the rebound in services activities, following two years of restrictions in popular sectors such as catering and tourism, will partially offset the slowdown in demand for consumer goods. Nevertheless, the significant decline in real disposable income is likely to lead to a gradual loss of spending power for US households.

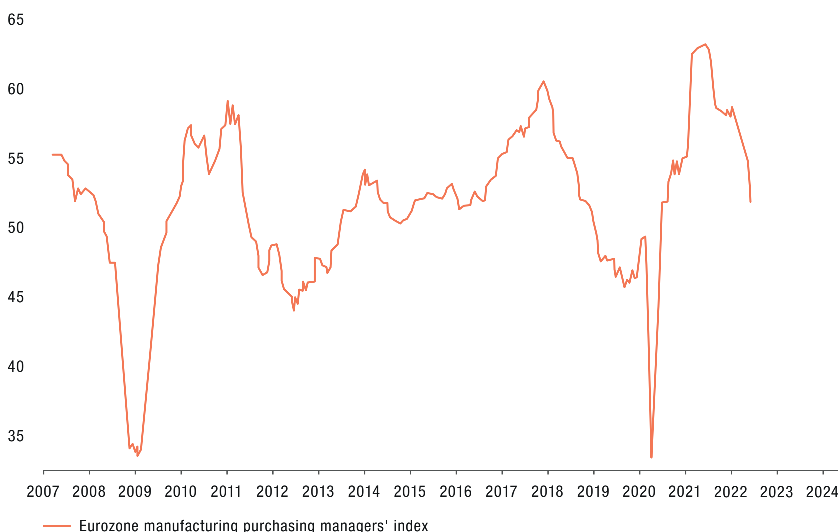
US HOUSE PRICES



Source: National Association of Realtors, Piper Sandler

Apart from the unfavourable outlook for domestic consumption, the current slowdown in the key sector of construction is of particular concern. The spike in mortgage rates to levels not seen since the collapse of the Lehman Brothers investment bank in 2008 could trigger a major weakening of the housing sector, especially as house prices (relative to household incomes) are higher than at the peak of the speculative bubble in 2006. Any such downturn would not only affect the labour market, but would also reduce the value of household wealth, in itself already affected by falling equity and bond prices. Meanwhile, the deterioration in the business confidence indices points to a fall-off in investments, these having been particularly robust during the recovery. Finally, the strength of the dollar and the even more pronounced signs of economic weakness outside the US are likely to prevent a significant improvement in the current account deficit.

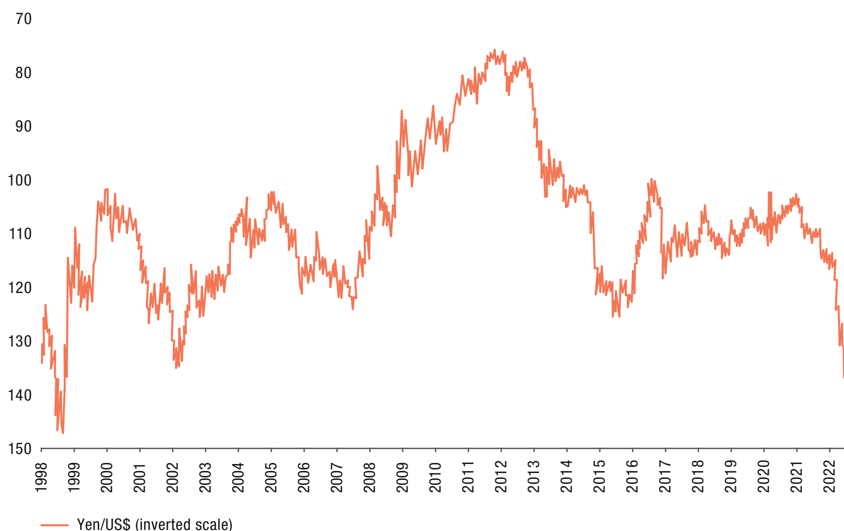
EUROZONE MANUFACTURING ACTIVITY



Source: S&P Global, Piper Sandler

In Europe, the energy crisis is hammering the economy. Germany, once the strongest link in the eurozone, is in a particularly difficult situation because of its excessive dependence on Russian gas imports. As it cannot entirely replace these with other sources of energy in the short term, Europe's largest economy is exposed to the risk of being totally cut off from Russian supplies, which would prevent it from filling its reserves before the start of the winter period. In the worst case scenario, it would have to implement a policy of rationing gas consumption. This would primarily affect the industrial sector because priority will be given to heating homes. This situation would have the potential to trigger a deep recession in the eurozone. Aside from the problems of energy supply comes the question of financing. Europeans governments are almost obliged to support loss-making energy companies. If, on the other hand, they cannot pass on the higher costs to their customers, they are compelled to support the end consumer. Whichever option is chosen, a further deterioration in the public finances of eurozone countries can hardly be avoided.

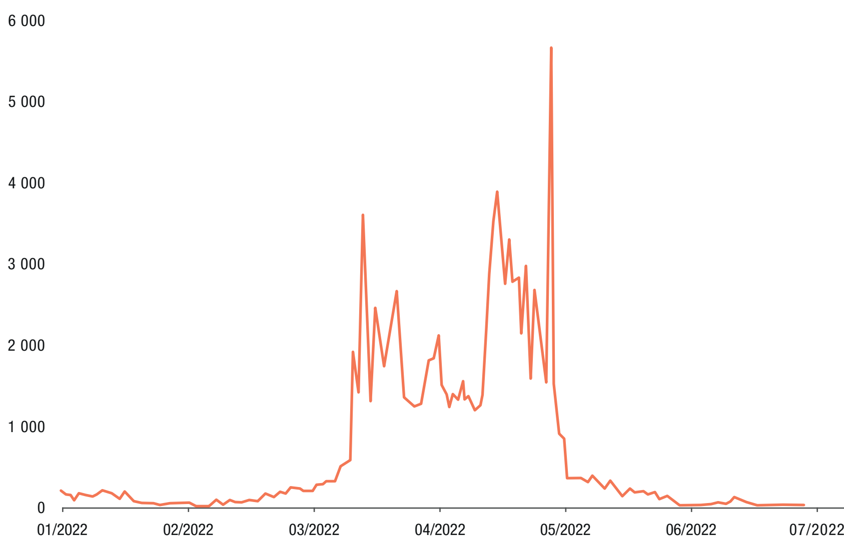
JAPANESE CURRENCY



Source: Bloomberg, Jefferies

In the event of a global slowdown, Japan can hardly escape a downturn in activity as its growth is mainly dependent on exports. Although the weakness of the yen (at its lowest level against the dollar since the 1998 financial crisis) boosts the competitiveness of Japanese industry, eventually the gradual weakening of the global economy is bound to weigh on foreign demand for machinery and capital goods. In addition, the Bank of Japan's still very accommodative monetary policy will do little to improve household consumption as long as the rise in inflation, driven by higher imported energy prices, remains higher than nominal wage growth. A further medium-term increase in government spending is the most likely option, especially as the Bank of Japan does not seem inclined to abandon active management of the yield curve as a way of keeping public financing costs at a minimal level.

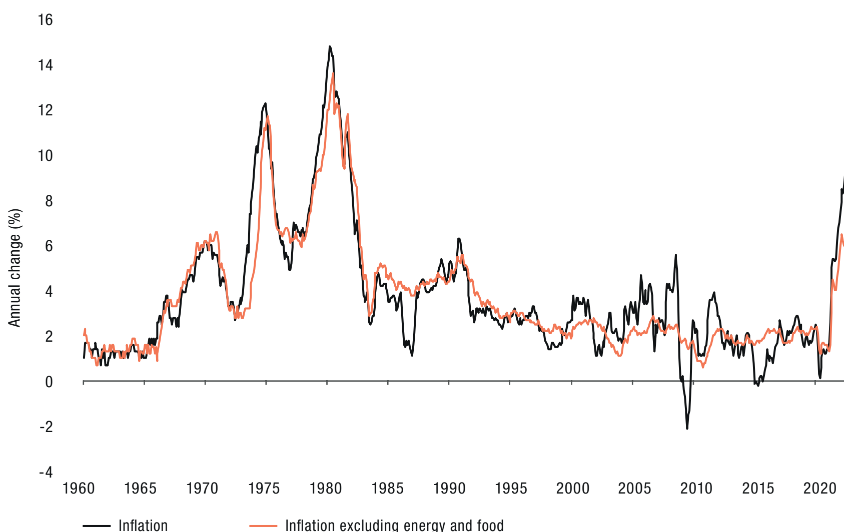
NUMBER OF COVID-19 INFECTIONS IN CHINA



Source: Piper Sandler

Although May's activity indices point to an improvement in the economy in the second quarter, the economic situation in China remains relatively fragile. The main uncertainties stem from the continued zero-tolerance policy towards new coronavirus infections and the ongoing weakness in real estate activity since the collapse of the construction giant China Evergrande. Although the spread of new Covid-19 infections was quickly halted by the implementation of strict lockdown measures, the reopening of major production centres like Shanghai could be short-lived in the event of a fresh outbreak. In the real estate sector, the public authorities have initiated support measures such as reducing mortgage rates and encouraging regional banks to support builders facing financial difficulties. Despite these measures, real estate transactions show no signs of improvement, suggesting the difficulty of reviving activity without a deeper purge of the excesses of previous years.

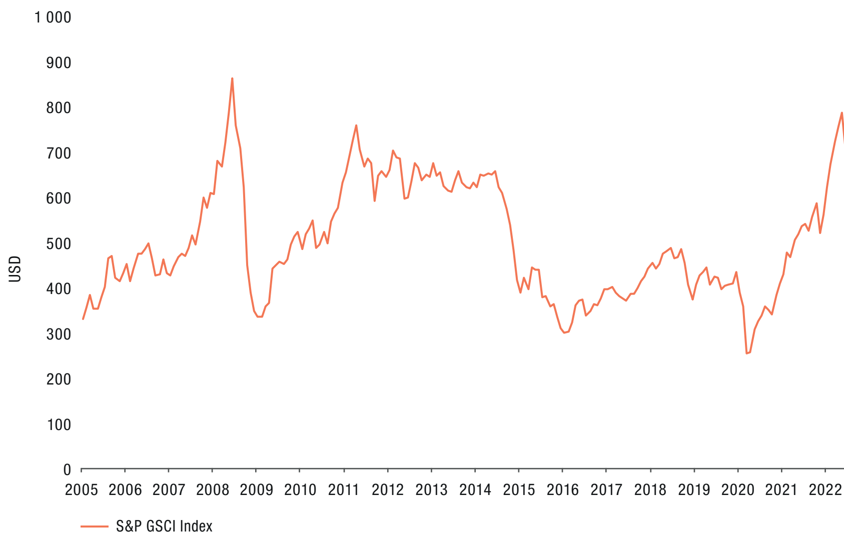
US INFLATION



Source: Bureau of Labor Statistics, Bloomberg

Economic data show no sign of inflationary pressures easing yet. In the US, the surge in the money supply that followed the pandemic continues to take its toll: households continue to consume, the job market remains tight, businesses are maintaining their pricing power, fuel prices are at record highs, and supply chain disruptions persist as a result of China's lockdown and the war in Ukraine. As a result, the inflation rate rose further in June, to 9.1%, a new high since November 1981. A slight glimmer of hope that inflationary pressures might soon ease comes from the decline in inflation excluding energy and food, which, notwithstanding its recent spurt to 40-year highs, has fallen marginally since its peak in March.

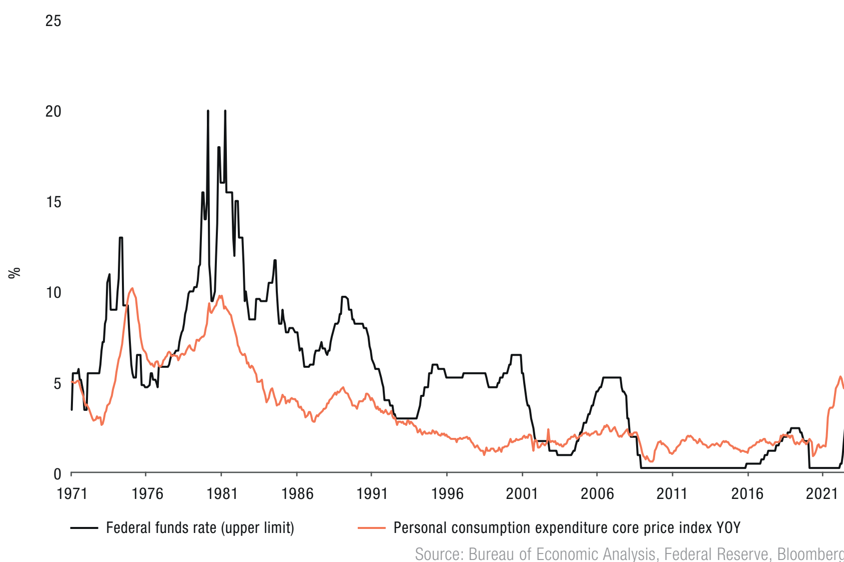
COMMODITY PRICES



Source: Bloomberg

Although all forecasts of a decline in inflation have been wrong so far, June may finally prove to be the turning point. With signs of an economic slowdown, the prices of several commodities, including oil, have started to fall. In addition, some goods, such as vehicles, which had seen excessive price increases during the pandemic, have now reached very high bases of comparison, such that future year-on-year changes will be significantly lower. Nevertheless, although inflation may have peaked, there is no indication that a major downturn is imminent. Most services activities are seeing price accelerations, such as medical care or the weighty component of housing costs, with rents tending to follow sharply rising house prices with a certain lag. Given the tenacity and pervasiveness of the current tensions, a major economic slowdown may be required before any significant improvement in inflation figures.

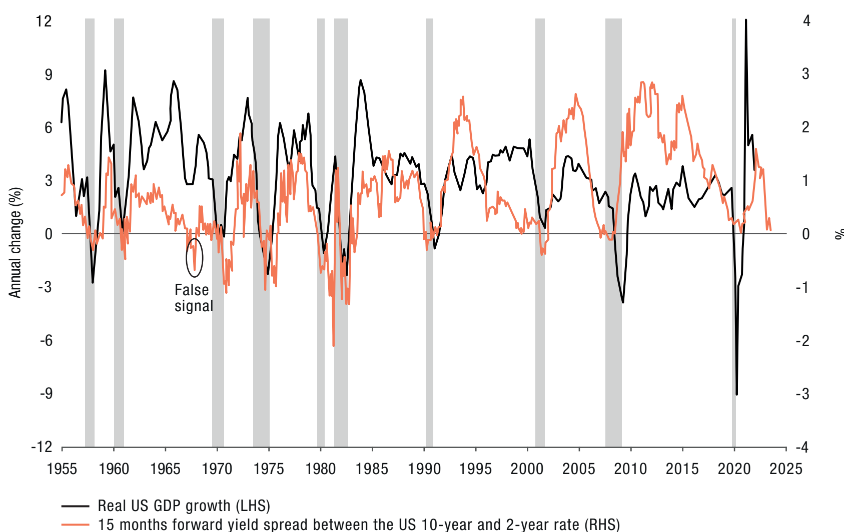
US MONETARY POLICY



Source: Bureau of Economic Analysis, Federal Reserve, Bloomberg

Fighting inflation is now the absolute priority for the US monetary authorities. With inflation figures for May showing no sign of easing, the Federal Reserve's monetary policy committee (the FOMC) accelerated the tightening process with a 75 basis point hike in interest rates, the biggest jump since November 1994. Although the top US monetary official, Jerome Powell, intends to steer the economy towards a soft landing rather than a recession, the fight against inflation is, in his words, 'unconditional', even if this will negatively impact economic growth. The focus on controlling inflation had already been emphasised by Vice Chair Lael Brainard when she quoted Paul Volcker, the illustrious Chairman of the Federal Reserve from 1979 to 1987, who managed to beat inflation 40 years ago through monetary tightening leading to a recession. According to Brainard, Volcker noted that the dual mandate of controlling inflation and maintaining full employment was not an either-or proposition, but that runaway inflation would be the greatest threat to the continuing growth of the economy and, ultimately, to employment.

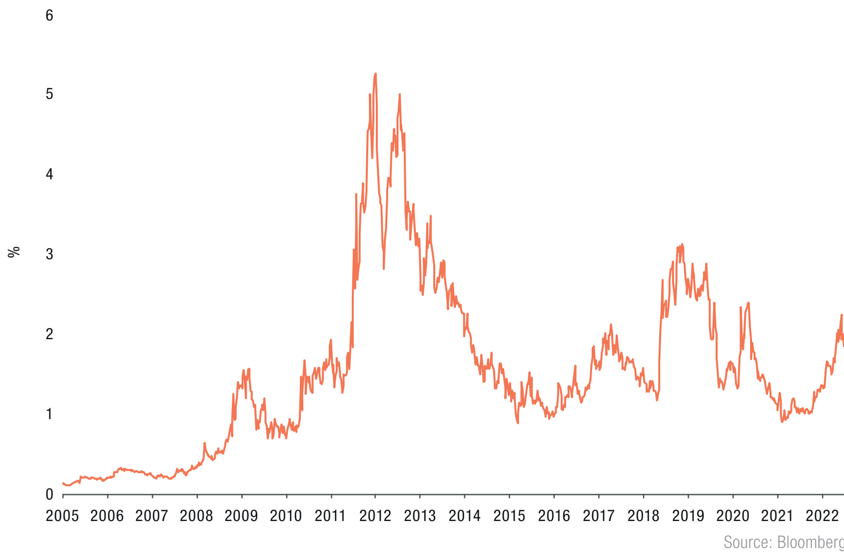
US GROWTH AND THE YIELD CURVE



Source: BEA, Bloomberg, GFD, NBER, Minack Advisors

Historically, the flattening of the yield curve is the best leading indicator of a contraction in US GDP. Whenever the yield spread between the 10-year and 2-year yields has become zero or negative, a recession has followed within a period of about one year. The only exception in the post-war era was in 1968 when the flattening of the yield curve gave a false signal. In the first half of this year, the US yield curve on the 2 to 10 year part flattened again. The Federal Reserve's planned increase in its main policy rate by 0.75% in July and 0.50% in September would extend the flattening of the yield curve to shorter maturities. If history is any guide to the future, such a development would presage a recession in 2023. Given the robustness of the current labour market and the persistence of inflationary pressures, monetary tightening could be more drastic than expected. Depending also on what happens to long-term interest rates, the scenario of a further inversion of the yield curve, increasing the probability of a deep recession, cannot be ruled out.

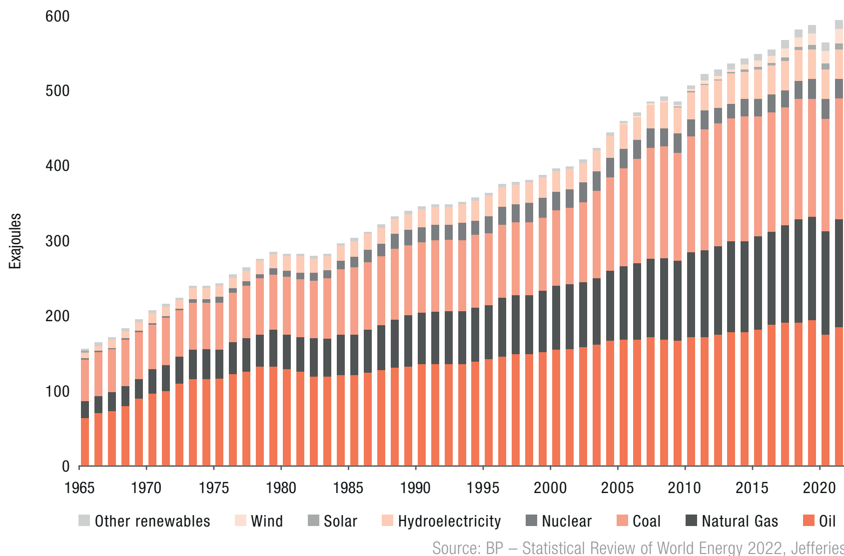
YIELD SPREAD BETWEEN THE ITALIAN AND GERMAN 10-YEAR YIELD



Source: Bloomberg

In Europe, the European Central Bank is facing an increasingly difficult dilemma. On the one hand, with an inflation rate rising at levels similar to those of the United States, the ECB is almost obliged to start its monetary tightening cycle, without which the euro will weaken even further, accentuating the rise in imported prices. On the other hand, an increase in interest rates could prompt credit spreads within the eurozone to widen and trigger a new crisis for the single currency. The ECB's announcement in June that it would start raising interest rates the following month has already been sufficient to start increasing the gap. To remedy this, the monetary policymakers have announced the development of an anti-fragmentation tool, which they are expected to present at the next Governing Council meeting on 21 July. The reinvestment of maturing debt securities in the ECB's asset portfolio into the bonds of Southern countries, or even the unlimited purchase of Southern countries' bonds seem to be the most likely ways forward.

WORLD PRIMARY ENERGY CONSUMPTION



Source: BP – Statistical Review of World Energy 2022, Jefferies

Although inflation has not been a key focus for the financial markets since China joined the World Trade Organisation in 2001, it once again became a major theme during the pandemic and may remain so throughout the next decade. The energy transition, aimed at replacing fossil fuels with renewables, is an additional source of inflationary pressure. It will create unprecedented demand for most minerals and metals, with fossil fuels currently still accounting for 82% of global primary energy consumption. Some studies estimate that copper consumption could almost double by 2035 as economic activity is increasingly electrified. On top of this, geopolitical tensions risk dividing the world into two blocs, pitting the Northern Alliance countries against China and Russia. In such an environment, the fight for access to raw materials is likely to intensify, leading to temporary shortages of scarce or in-demand resources. The result will be more volatile and permanently higher inflation.

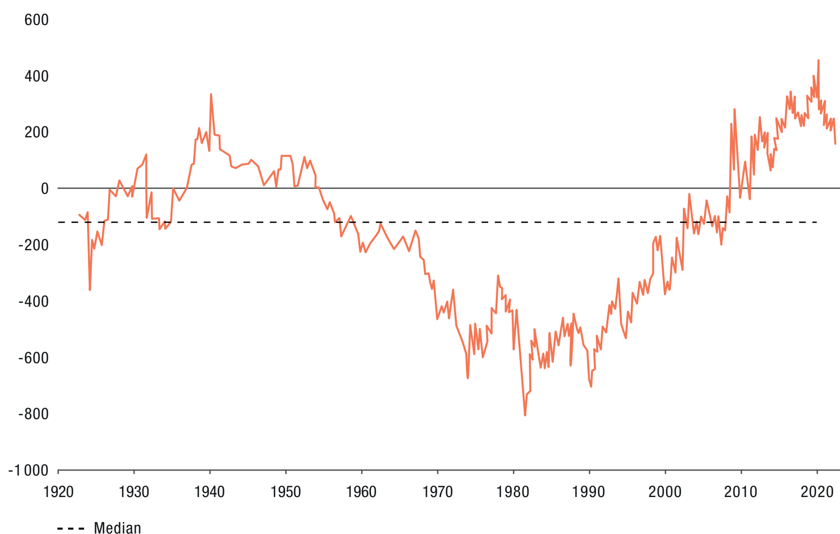
Financial markets

MSCI WORLD INDEX IN USD

Source: Bloomberg

Financial markets recorded one of their worst performances in the first half of 2022. Rising and persistently high inflation has forced central banks to tighten monetary policy, starting with the Federal Reserve in the US. After a 25 basis point increase in the first quarter, the Fed accelerated its tightening in the second quarter, raising its policy rate by 50 basis points in May and 75 basis points in June. The monetary tightening by the central banks led to a correction in the bond markets and a decline in equity valuation multiples.

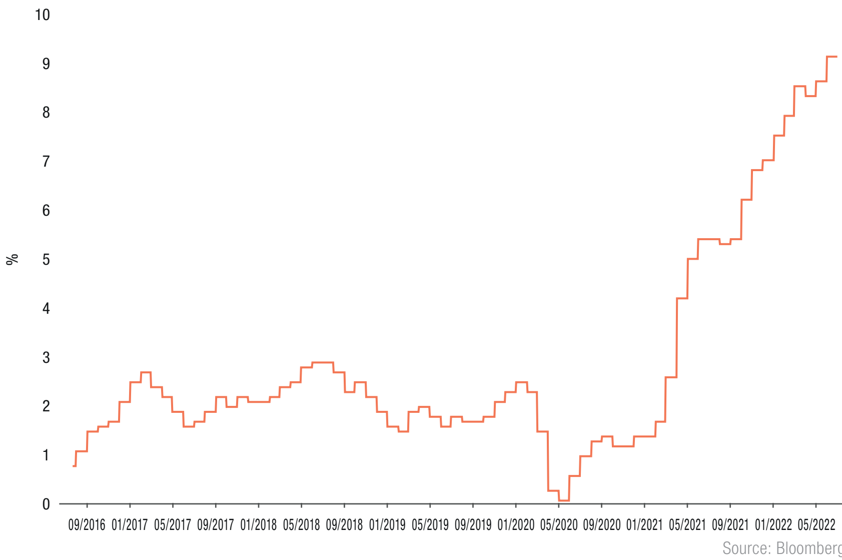
EUROPE: DIVIDEND YIELD - BOND YIELD



Source: Morgan Stanley

So far, the fall in stock prices has mainly reflected the rise in interest rates, and therefore in the discount rate applied to future cashflows. Corporate earnings have not yet fallen and the rise in earnings has even somewhat offset the fall in multiples. While equities have therefore become cheaper in absolute terms, their relative valuation, i.e. compared to bonds, has not become more attractive. Since 1930, 2022 is likely to become only the fifth year in which stocks and bonds have recorded a negative performance in the same year.

US INFLATION RATE



Source: Bloomberg

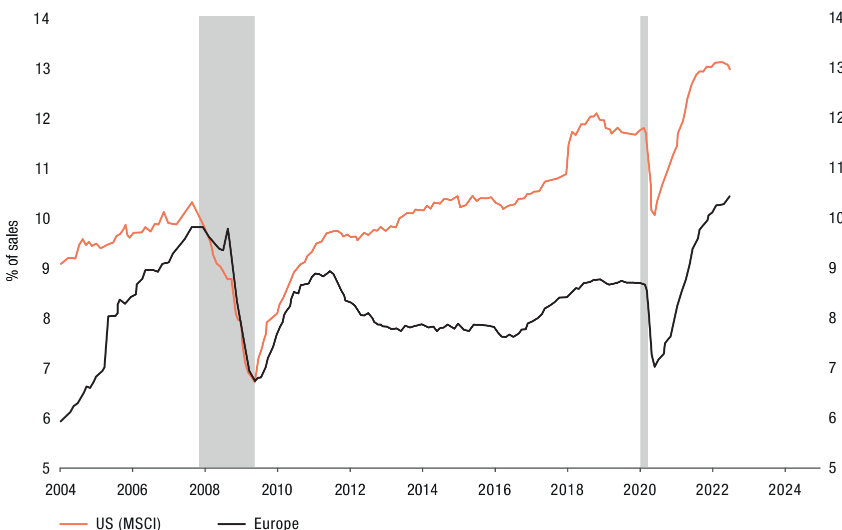
The main short-term risk for financial markets remains the monetary tightening cycle started by central banks. With inflation above 8%, a change in trend does not appear to be on the cards. Comparisons with 2018, when the Federal Reserve quickly abandoned its monetary tightening when the stock market started to fall, do not hold water, since at that time inflation in the US was below 2%. To effectively combat inflationary pressures in the current environment, the U.S. central bank will have to be prepared this time to reduce growth and accept the collateral damages in an economy and financial markets that are used to very low interest rates.

CITIBANK U.S. ECONOMIC SURPRISE INDEX

Source: Bloomberg

After a first half of the year dominated by fears of inflation and rising interest rates, the possibility of a sharp slowdown in the global economy, or even a recession, could now become the major theme of the second half. Recession fears already emerged in June, as evidenced by the fall in commodity prices and the decline in long-term rates. While some segments of the U.S. economy are showing clear signs of weakness, notably the housing market, others are showing resilience, which should encourage the Federal Reserve to continue tightening. An environment marked by an economic slowdown and continued monetary tightening by the major central bank cannot be positive for equities.

CORPORATE PROFIT MARGINS



Source: Minack Advisors, IBES/Datastream, MSCI, NBER

In the context of this environment, it is surprising that the consensus continues to expect corporate earnings to rise. It is important to note that corporate earnings have risen sharply through the end of 2020 and in 2021, helped by the reopening of economies and the significant stimulus programs that have been put in place. However, it is difficult to see how corporate profit margins, which continue to be at historically high levels, could not come under pressure and weigh on earnings, especially given rising wages and energy costs and the trend toward relocation of production lines. The era of massive debt-financed share buybacks also appears to be coming to an end, further limiting earnings per share growth.

MSCI VALUE INDEX VERSUS MSCI GROWTH INDEX OVER 1 YEAR

Source: Bloomberg

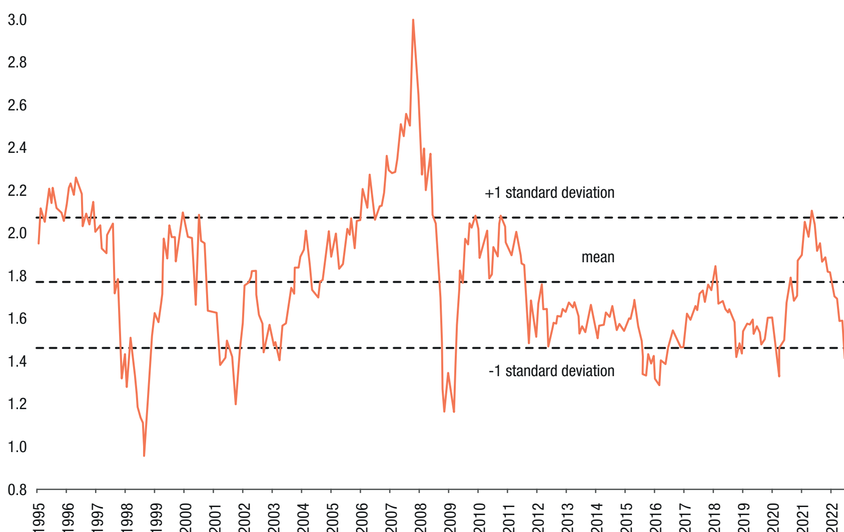
Although the value indices have strongly outperformed the growth indices since the beginning of the year, a trend reversal was observed in June. This trend reversal is explained by the appearance of fears about the global economy, which led investors to abandon cyclical stocks, which are more present in value indices, and to return to quality and growth stocks, which, as high-duration assets, had particularly suffered from the rise in interest rates. This is despite the fact that these companies have just the right attributes to continue to thrive in a more inflationary environment.

EVOLUTION OF THE JAPANESE MARKET

Source: Bloomberg

The main argument in favor of the Japanese market is its attractive valuation and the gradual improvement of capital allocation and profitability of Japanese companies. The main problem of this market still is its dependence on foreign investors, given the lack of support from local institutional investors. However, the companies themselves at least are aware of the attractiveness of their own shares, as evidenced by the amount of share buybacks that could reach a new record in the current fiscal year. Unlike in the US, where buybacks are pro-cyclical and financed by debt, Japanese companies are buying back their shares because they are cheap and because they can afford to, given the abundant liquidities they hold on their balance sheets.

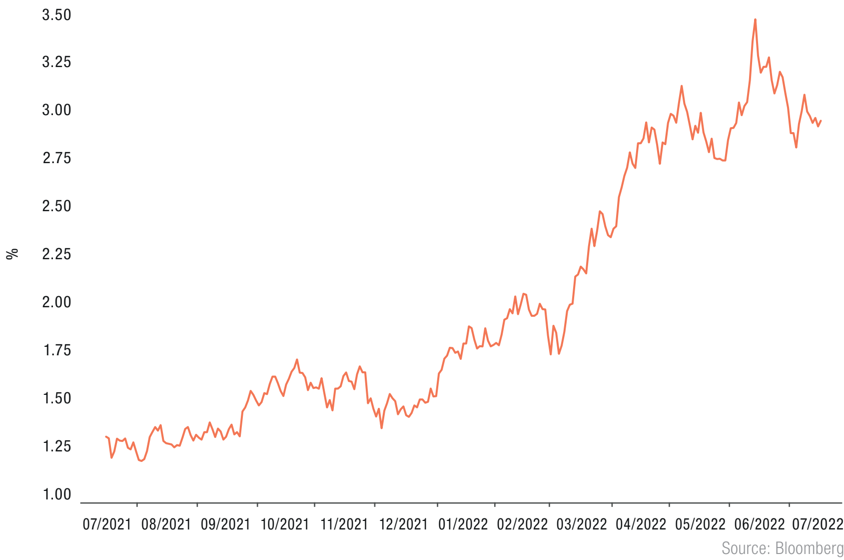
PRICE/BOOK VALUE RATIO OF THE MSCI ASIA PACIFIC EX. JAPAN INDEX



Source: Bloomberg, Jefferies

The outlook for Asian markets generally appears to be better than for Western markets. For the latter, all of the components that drive stock returns - sales growth, profit margins, valuation multiples, stock buybacks and dividends - may be suffering from reversion to the mean in the coming years. This is not the case for Asian markets. Moreover, unlike in the West, Asian countries have continued to maintain orthodoxy in their monetary and fiscal policies, so that inflationary pressures are now much lower.

10-YEAR US GOVERNMENT BOND YIELD



Source: Bloomberg

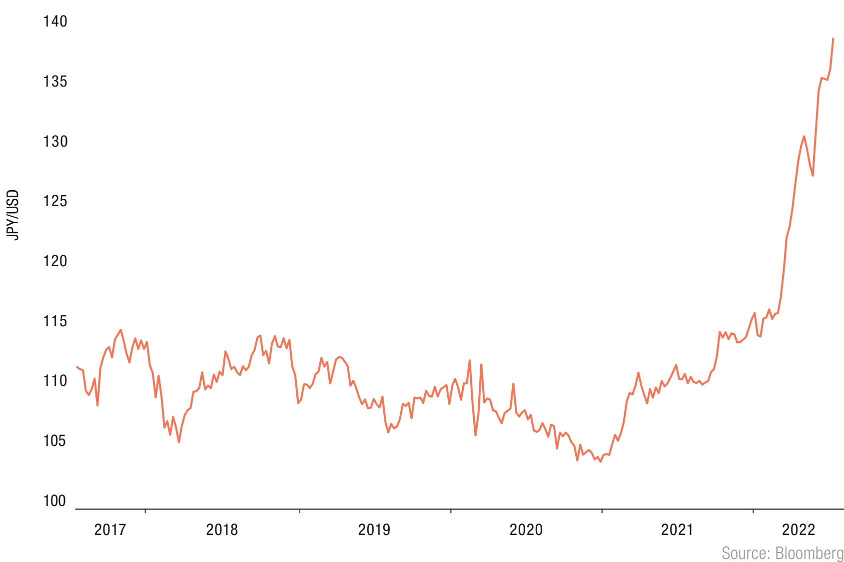
It will be interesting to see how the bond markets will be able to compensate for the cessation of central bank bond purchases, and the willingness of central banks to reduce the size of their balance sheets. The bond markets will thus lose an important buyer who, moreover, was completely price-insensitive. At the same time, the confidence of emerging countries in Western currencies is being lost, so that these countries will also be more reluctant to invest their savings in U.S. or European bonds. All this at a time when, between financing the energy transition and rearmament and social transfers to compensate for the effects of inflation, the financing needs of governments will remain high, especially in Europe. All of this would argue for a continued rise in bond yields, especially as these yields remain very low compared to current inflation levels. A marked slowdown in the global economy could, however, temporarily slow this rise, or even reverse it.

EURO EXCHANGE RATE AGAINST THE RUBLE

Source: Bloomberg

The euro is one of the weakest currencies in 2022. Between price stability and avoiding an increase in the interest rate differential between the countries of the South and those of the North, the objectives of the European Central Bank are no longer aligned and the flaws in the construction of the single currency are once again becoming visible. The result is an incongruous situation where the ECB deposit rate is negative, despite an inflation rate of 8.1% in May. The market assumes that, in the end, European monetary authorities will do everything to defend the survival of the euro, even if it means not credibly fighting inflation. This makes the single currency a weak currency, especially since the weakness of the euro further increases inflationary pressures by pushing up import and energy prices. The ECB's strategy to fight inflation seems to be to hope that it will come down by itself.

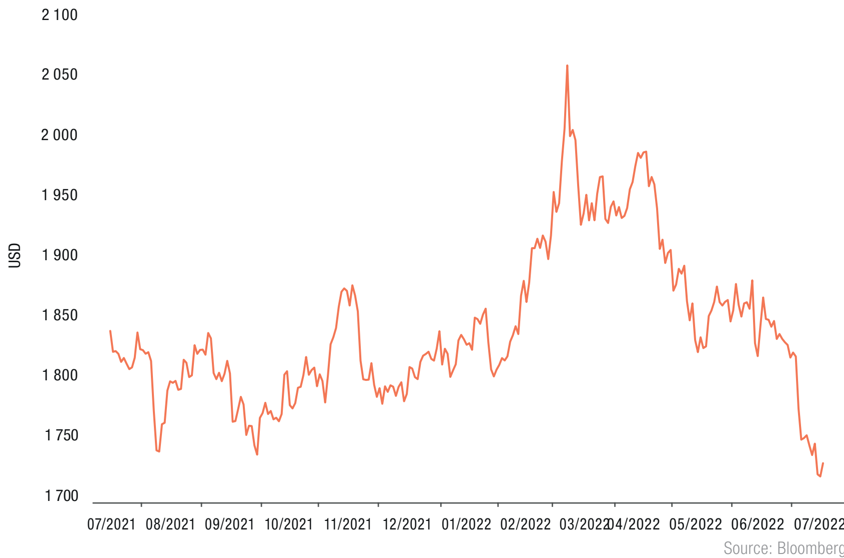
USD/JPY EXCHANGE RATE



Source: Bloomberg

The change in the Federal Reserve's attitude has given the dollar some color. The greenback's trade-weighted exchange rate index has risen by 11% since the beginning of the year. However, the dollar's strength must be put into perspective. The U.S. currency is especially strong against the euro (for the reasons given above), the pound sterling and the yen. While the British currency is suffering mainly from political uncertainty, the yen is a special case. Among the major central banks, the Bank of Japan is the only one that wants to continue its policy of recent years. It considers that the main danger for the Japanese economy is not high inflation, but a rise in interest rates. It therefore continues to oppose any tightening of its monetary policy and to maintain its control of the yield curve by fixing the 10-year rate at 0.25%. The yen has borne the brunt of this policy, losing nearly 20% against the dollar and some 7% against the euro. As in the case of the euro, the weakness of the yen is adding to inflationary pressures. The Bank of Japan's strategy therefore seems less and less tenable. An abandonment of the yield curve control policy in Japan would have significant ramifications across financial markets.

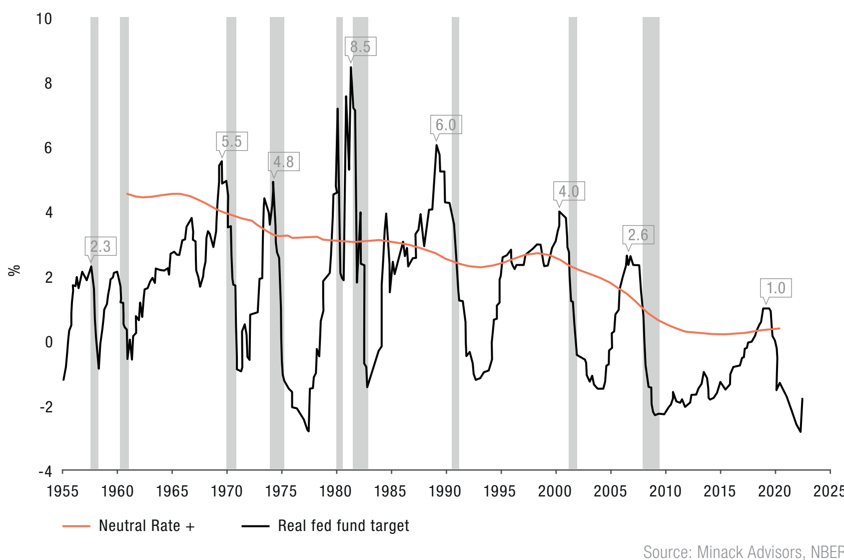
GOLD PRICE



Source: Bloomberg

Gold initially held up well against rising interest rates and a strong dollar. Since mid-March, however, the gold price has begun to decline, particularly affected by rising real interest rates (based on inflationary expectations, with real rates remaining very negative based on current inflation rates). As long as the Federal Reserve persists in its fight against inflation, it seems unrealistic to think that the price of gold can sustainably rise. The main argument in favor of gold, however, is precisely the inability of the U.S. central bank to normalize its monetary policy, given the economic and financial damage that such a normalization would cause.

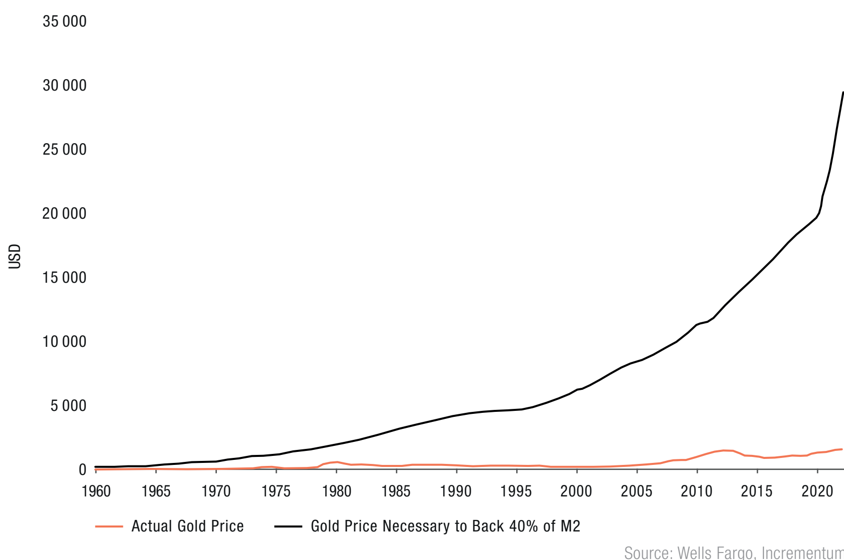
FEDERAL RESERVE FUNDS RATE IN REAL TERMS



Source: Minack Advisors, NBER

It is reasonable to assume that central banks will not have the courage to raise and maintain their key interest rates at levels necessary to eliminate inflation on a sustainable basis. It is much easier to adopt very expansive monetary policies than to stop them. The dependence of the US economy on financial markets is greater than ever. The central bank could therefore use a temporary decline in inflation to claim victory and return to a more expansive monetary policy. This would be the moment for gold to start a new bullish cycle.

GOLD PRICE NEEDED TO COVER 40% OF M2 MONEY SUPPLY



Source: Wells Fargo, Incrementum

Another structural element in favor of gold is the fragmentation of the world economy into two blocs, East and West, and the loss of confidence in the dollar. The freezing of the Russian Central Bank's foreign exchange reserves in euros and dollars by the G7 and the European Union at the end of February is a major event in monetary history and could reduce the willingness of some countries to hold their foreign exchange reserves in dollars as well as encourage China's willingness to pursue its efforts towards monetary sovereignty. Gold could play an important role in a new financial system, as it is not the currency of any country and has no counterparty risk.

Summary

In short, economic reality has caught up with central banks. With rising inflation, they are now facing a very different kind of problem. The solution to this problem requires another strategy than the one they have adopted since the financial crisis, which consisted essentially of reducing interest rates as soon as there was the slightest problem, flooding the markets with liquidity and thus supporting asset prices. After years of central banks' objectives (fighting the risk of deflation and stimulating growth) being very favorable to financial markets, the situation has fundamentally changed.

History teaches that when the main objectives of central banks, growth and inflation, are in conflict, it is better to exit the financial markets. Today, we are in such a situation and central banks, at least the most important one, have clearly decided that their priority is to fight inflation and that a reduction in growth, or even a further decline in the markets, can even help them achieve this objective. In this respect, it is also important to put the fall in stock markets in 2022 into perspective by comparing it with the rise of recent years. In euro terms, the global equity index remains almost 17% above its pre-pandemic level and more than 60% above its end-2018 level.

The positive scenario for the financial markets would be a rapid decline in inflation and a soft landing for the economy. However, it seems somewhat illusory to count on such a scenario. On the inflation side, a new surge in energy prices is a possibility, while rising food prices will lead to social demands. As far as growth is concerned, soft landings are the exception, rather than the rule.

The main positive longer-term argument for the stock markets and for gold is that the high level of debt in the global economy and the fragility of the financial system will prevent the monetary authorities from going very far in normalizing their monetary policies. They could therefore use a temporary decline in inflation as an opportunity to claim victory and stop monetary tightening, or even to return to expansionary policies. Such a reversal would clearly be favorable for gold. For equities, it will be a matter of being selective. To the extent that inflationary pressures are likely to reappear fairly quickly, it will be a matter of distinguishing between companies whose business model is being undermined by inflation and those that have the qualities necessary to continue to thrive in a more inflationary environment.

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