

Midyear Outlook Focus

A photograph of a person sitting on a rocky outcrop, looking out over a vast, misty mountain range at sunrise. The sun is low on the horizon, creating a bright glow and long shadows. The person is wearing a green and black jacket and dark pants. The landscape is filled with rolling hills and valleys covered in dense forests, with a thick layer of mist or fog filling the lower parts of the scene.

Prospects for the equity market in the shadow of inflation

As policymakers look to tame inflation without triggering a recession, we look for catalysts that could signal the market's path ahead.

Jim Allworth

For important and required non-U.S. analyst disclosures, see page 7.
All values in U.S. dollars and priced as of market close, June 28, 2022 unless otherwise stated.
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MIDYEAR OUTLOOK Focus



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Prospects for the equity market in the shadow of inflation

The trajectory of inflation in the coming months will have major implications for equities, in our view, but exactly what that trajectory will be remains unclear. We look for catalysts that could spark a new move higher for markets, or signal the approach of a recession.

Key points

- **Rapid rate hiking plans adopted by the U.S. Federal Reserve and other central banks have raised investor concerns that monetary tightening could eventually lead to a U.S. recession, at a time when Europe is contending with the heavy economic costs of the war in Ukraine and higher bond yields are pressuring price-to-earnings ratios.**
- **While monetary tightening doesn't necessarily preclude the stock market from trading back up to or near its old highs, we believe getting more than that over the next year would require the Fed to engineer a "soft landing" for the economy by ending its rate hiking cycle earlier than either policymakers or the market currently anticipate.**
- **In our view, it could take six months or more to determine whether the economy is landing softly or heading into a recession. Until greater clarity emerges, we prefer to hold a Market Weight exposure to equities, down modestly from our longstanding moderate Overweight positioning.**

Several important shifts occurred on the global economic and financial landscape over the first half of the year:

- First, the U.S. Federal Reserve shifted from being tolerant of higher inflation to being decidedly intolerant, and it was joined by other major central banks. Interest rate hikes have not only begun, they've become more aggressive in the past two months—as has the rhetoric about future rate increases.
- Central banks, for the most part, are no longer suppressing bond yields. Quantitative easing has turned into quantitative tightening. The result has been a pronounced upward shift in long bond yields.
- While most forecasters (ourselves included) expected last year's gradual inflation increase to turn into a price surge in the first half of this year, they underestimated the magnitude of that spike. In particular, the war in Ukraine has intensified the upward pressure on prices for oil, natural gas, and most agricultural commodities including fertilizer.
- Supply chain disruptions and port congestion have taken much longer than expected to resolve. The renewed shutdown of some Chinese cities has exacerbated this problem.
- As economies around the world reopen, consumer spending is shifting away from goods and toward services. Inventories of unsold goods are building as new orders weaken, which suggests manufacturing may be headed for a slowdown in the second half of the year.
- Meanwhile, ongoing labor shortages are hampering the reopening of the services side of the economy while simultaneously fueling inflation in those sectors.

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Market impact

The surge in inflation and bond yields has pushed equity valuations downward by lowering the discounted present value of future earnings. (For example, an increase in bond yields to three percent from two percent reduces the present value of a dollar of earnings 10 years down the road by about nine percent.)

This trend has had the largest impact on the mega-cap growth stocks with high price-to-earnings ratios, of which the six largest comprised more than 25 percent of the value of the S&P 500 at the peak of the market in early January. Their performance over the first half of the year was not helped by the fact that three of the biggest—Amazon, Meta (Facebook), and Alphabet (Google)—reported Q1 earnings declines.

This outsized market influence of a handful of companies with very large market capitalisations can be seen by comparing the performance of the cap-weighted S&P 500 Index, which has fallen some 22 percent from peak to trough, with the less dramatic 17 percent decline of its unweighted counterpart. This effect also helps explain why stock markets in some other developed economies—notably Canada's TSX (down 14 percent) and the UK's FTSE All Share (down just 9.5 percent)—have seen far smaller declines: neither include any of these six stocks.

The combination of continuing supply chain issues, bloated inventories, and labour shortages has driven corporate confidence down to much-reduced levels, taking investor confidence down at the same time. It remains to be seen whether this will affect corporate forward guidance when the Q2 earnings season gets underway in mid-July. So far, earnings estimates for 2022 and 2023 have not come down appreciably; however, if guidance proves more cautious, we believe some downward revisions of earnings estimates are likely in the second half of the year.

Is there a plausible path to new highs?

Measures of investor sentiment have been remarkably negative of late. Such unanimous pessimism does not generally occur at market tops, but frequently appears at or near tradable lows. However, even if the market were to turn higher from here, views about how far it could rally and for how long are decidedly downbeat. “Bear market rally” is the consensus interpretation.

Perhaps—but not necessarily, in our view. It is useful to look at potential market outcomes through the lenses of the two prevailing schools of thought on the likely trajectory of inflation over the coming year or two.

Scenario 1: Inflation remains stubbornly elevated, forcing the Fed to tighten harder for longer.

This view holds that inflation is becoming a bigger and more intransigent problem than central banks or the market have yet recognised, as evidenced by the fact that U.S. consumers' medium-term inflation expectations have climbed above the range of two percent to 4.5 percent that had prevailed for more than two decades, recently touching 5.5 percent. According to this view, reining in those expectations will require the Fed to raise interest rates higher than currently envisioned and keep them there for longer—likely well into 2024.

This would greatly increase the likelihood that the federal funds rate eventually overshoots, producing the kind of tight credit conditions that would make an economic downturn inevitable. A recession resulting from restrictive credit conditions would almost certainly depress both corporate earnings and share prices, and such downturns have typically been associated with bear markets for equities.

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But this scenario is predicated on the Fed being forced to chase an overheated economy higher for much longer than expected—at least a year, perhaps two. That prolonged stretch might well see inflation-boosted sales and earnings grow faster than expected. It would be unusual, in our view, for new highs in sales and earnings not to be accompanied by new highs in share prices.

But how high could those new highs be? A bit of history might be instructive. From the beginning of 1977 until the end of 1979, the Fed followed the course described above, chasing an overheated economy higher and raising the federal funds rate from five percent all the way to 15 percent in the process. The dollar value of the economy was growing at better than 10 percent per year (as it is now), and S&P 500 earnings per share advanced by a very satisfactory 40 percent over the three-year period. But the index itself was flat, starting and finishing at about 100. Bond yields rose from seven percent to almost 11 percent over the same period, compressing price-to-earnings multiples and limiting investors to no better than dividend returns.

In our view, the same dynamic would probably yield similar results if the harder-for-longer tightening scenario were to play out over the next couple of years. Therefore, although it would be possible for averages to get back to old highs and perhaps even surpass them, we think it likely that appreciation potential would be heavily dampened by rising bond yields.

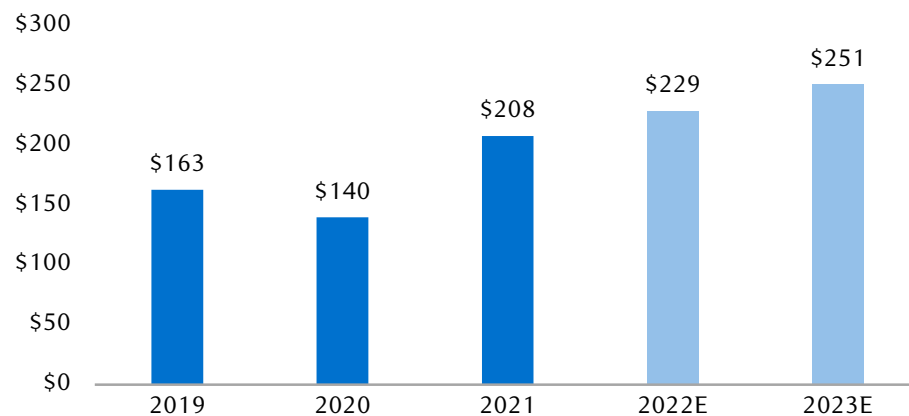
Scenario 2: Inflation ebbs, the economy slows, and tightening becomes less urgent, with the Fed perhaps even putting rate hikes on hold.

The other prevailing view—and one to which we subscribe—has inflation subsiding somewhat over the second half of 2022 and retreating further next year. Today, with the two-year boom in stay-at-home spending on goods waning just as household budgets are being squeezed by rising food and fuel prices, the goods side of the economy finds itself needing to pare back bloated inventories of unsold merchandise. This should produce some price weakness for nonessential goods, in turn allowing the core rate of inflation to recede somewhat and the headline rate to peak. While the 12-month rate of change for both may still be uncomfortably high at year's end, inflation's momentum may have turned lower by then, according to this view.

Together with a further slowdown in the goods-producing side of the economy and some associated labour market weakness, we think this turn of events could induce the Fed to rethink how far and how fast interest rates need to rise. Any sign of the Fed backing away from further tightening would bring the

Consensus estimates for this year and next have held steady despite market turmoil

S&P 500 earnings per share



Source - Refinitiv I/B/E/S; data as of 6/24/22

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possibility of a “soft landing” for the economy back into play, which would support an outlook for stronger earnings growth and higher share prices.

Catalyst needed

However, turning the equity market decisively higher, to the degree that new highs become plausible, usually requires the arrival of some catalyst that reignites investor optimism. Potential catalysts include a Fed rate cut, a marked downturn in energy prices, a couple of inflation readings that are significantly softer than expected, or a stronger-than-anticipated Q2 earnings season (especially on the guidance front, as improving forward guidance would greatly lessen fears of downward earnings revisions in the second half of the year). In our view, none of these appears likely at the moment. Until some catalyst emerges, we believe a convincing reversal in the equity market trend is unlikely to be forthcoming.

On the other hand, current readings of unusually deep investor pessimism suggest limited downside from here. We think the most likely path for equity prices through the remainder of this year will be generally sideways until evolving circumstances reinvigorate the case for sustained economic and corporate earnings growth—or, conversely, reveal that a recession is rapidly approaching.

At this juncture, we believe both outcomes are plausible, but we see lingering inflation and central banks’ pivot toward more aggressive rate hikes prolonging risks for equities. Accordingly, we would prefer to wait out the six months of aggressive monetary tightening that almost certainly lie before us with a modestly lower Market Weight exposure to equities, down from our longstanding moderate Overweight position.

Research resources

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			Count	Percent
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