Global Equity Markets Commentary

"Are we there yet? From rates to growth..."

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Looking forward to the rest of 2023, it is important to assess whether we have reached a turning point in the markets as the focus shifts from rates to economic growth. For this, investors are faced with three key questions. First, what type of recession is the market preparing for in terms of timing and depth? Second, what trajectory will inflation follow over the coming months and are we at risk of stagflation? And third, how will corporate earnings hold up under these conditions?

While investors appear to have largely made their peace with the banking sector's temporary crisis of confidence the speed of monetary policy post-Covid has highlighted specific pressure points. The mismatch between liabilities and assets at certain specialist US banks has not spiralled into a systemic risk, the quick conclusion to First Republic's issues made it possible to avoid renewed fears regarding US bank deposits, while Credit Suisse has been all but underwritten by the Swiss government via UBS. And while confidence has been damaged, European banks have liquidity coverage ratios of 160% and net stable funding ratios of 130%[1] and are still, for now, benefiting from the lagged impact, compared to the US, of the interest rate cycle. However, the episode neatly highlights how protracted the process of adjusting to rapidly rising interest rates can be across the global economy.

Recessionary clouds

In a period of monetary policy adjustment, the financial sector becomes the primary mechanism of transmission. In the US, M2 money supply has contracted for eight straight months and the impact of such contraction generally has a lag of between four to six quarters. In a context where "money has a cost again" industries and consumers will ultimately be impacted, although in an initial phase of inflation deceleration, real income will improve and support consumption.

Some economic indicators are also deteriorating, albeit slowly. The latest manufacturing PMIs (Purchasing Managers' Indices) in the US, Eurozone, UK, and China all declined by 1 point in their latest readings, with the US firmly in contraction at 47.1. US jobs numbers similarly show that while unemployment remains at a multi-decade low, the pace of hiring is decelerating. However, while all lead indicators are pointing down, the "time to impact" – in terms of potential recession – is being delayed by excess liquidity injected during the pandemic. At the same time, with China reopening, and India continuing to grow healthily, we see, as so often in the past, a divergence in growth paths between the two Asian behemoths, and the G7 economies, which are stagnating. Indeed, looking at growth recorded by China and India in Q1 2023, we expect that they will contribute 50% of world's economic growth in 2023.[2]

So, while there are some contradictory signals, with equity markets remaining relatively buoyant in the face of an inverted yield curve that is often an omen of recession, the outlook remains cloudy. While the major economies have managed to shrug off the danger of recession in 2023, the prospects for 2024 are much less clear.

Inflationary environment

Softer economic data has combined with easing inflation numbers. In the US, the consumer price index (CPI) for March rose 5% year on year, easing to its lowest level in nearly two

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years. Recent financial stress has further reduced banks' willingness to lend, with European bank lending falling 22% in Q1. As a result, market participants now expect the US Federal Reserve to start cutting interest rates as early as September, with a peak of 5% in June.

Yet with core CPI (which strips out volatile energy and food costs) rising 5.6%, there is reason to believe that price pressures for services will remain resilient, even as economies potentially begin to slow, especially with wage demands and labour costs, a lagging indicator, rising in many sectors. The risk of stagflation cannot be ignored, and central banks thus continue face the difficult task of determining a policy stance that is sufficiently restrictive to lower inflation, yet not so high as to risk financial stability. And, of course, given so many unknowns, there is the risk of a policy mistake. The market currently views erring on the dovish side as most likely, pricing in a rate cut by July of this year with further easing to come.

The rhetoric from central banks so far suggests that policy makers will still want to see clearer signs of inflation decelerating before pivoting. Indeed, in the Eurozone, prices rose 7% in the year to April, compared with a rise of 6.9% the previous month – the first rise in six months – while core inflation fell marginally to 5.6%. Weighing the risk of a policy mistake, central banks may still take the view that recession and significant damage to labor markets is the necessary price to pay to mitigate cyclical inflation.

Corporate earnings

At a corporate level, aggregate earnings revisions remain negative – Q1 earning have been cut sharply, with consensus estimates of -10% in Europe and -8% in the USA. While the pace of negative revisions has slowed from the depths of Q4 22, market participants have been quick to punish companies with lacklustre guidance. In the USA, close to 70% of companies have so far beaten Q1 EPS forecasts and income surprise has been at about 6% – higher than expected – while sales have beaten by 2%, pointing to a smaller than feared margin contraction in Q1. There, the technology sector has been the greatest contributor to the strength of this season.

The European earnings season is not as advanced with less than a quarter of the companies having reported. However, early indications are that results are following the pattern of the US with some room for a positive beat for net Income. Looking into the rest of the year, one topic recurrent with companies we meet is the prospect of the impact of higher labour costs even as raw material prices soften. For some companies, the game of margin preservation via price increases (or what some have dubbed *greedflation*) is a key component – the extent to which organisations can or choose to pass these pressures on without impacting volumes will be vital for margins going into H2. Given the asymmetrical impact of inflation on costs and revenues, companies that find themselves victims of such greedflation – where rising prices inordinately affect volumes – may struggle as a consequence. Clearly, the context of slower global economic growth will also weigh on results for the rest of the year although there is still room for possible positive surprises which will support stock pickers. For example, China's continued reopening and positive early growth figures from India may offer some mitigation.

Outlook

Persisting uncertainty on these fronts continues to create volatile equity markets. Recession seems to be looming, but leading indicators may be giving us lagged predictions due to extreme monetary policy at the height of the pandemic. As investors shift their focus from inflation and rates to recessionary pressures, key for their portfolios will be keeping strong companies across the style spectrum, with an emphasis on quality, dividend, sustainability, anchored around reasonable valuations and long-term structural trends. Understanding margin resilience for the rest of 2023 is critical as volatility around the US debt ceiling and US elections will also arise. Particular themes which we believe remain attractive include profitable technology and selective industrials – such as those companies benefiting from reshoring, automation, or climate solutions. Consumers real income should also appreciate in an environment of slowing inflation albeit dependent on economic growth or lack thereof. China's historically counter-cyclical economy also continues to present selective opportunities.

1. https://www.bankingsupervision.europa.eu/press/pr/date/2023/html/ssm.pr230412~43e29866e8.en.html.
2. https://asia.nikkei.com/Economy/China-and-India-to-drive-half-of-2023-s-global-economic-growth-IMF#:~:text=The%20IMF%20forecast%20in%20April,%25%2C%20according%20to%20the%20IMF.

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