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# DOLL'S DELIBERATIONS

QUARTERLY EDITION

## Attention Shifts from Multiple Compression to Earnings Concerns

U.S. equities finished lower for a third straight quarter. The S&P 500, which at one point experienced a seven-week losing streak, fell the most since the height of the pandemic fears in Q1 of 2020 (-16.5%). This has been the worst first half of the year for U.S. stocks since 1970. Inflation remained the big drag on risk sentiment in Q2. May headline CPI came in higher than expected, increasing 1.0% m/m and 8.6% y/y, the biggest annual increase in over 40 years. Surging food and energy prices were key upside drivers. The Fed's outsized focus on inflation led to a more aggressive pace of rate hikes. Tightening financial conditions drove concerns about a growth slowdown or recession with the Atlanta Fed GDPNow model estimating -1.0% growth for Q2 following the -1.6% print in Q1. Growth concerns were exacerbated by the widespread lockdowns in China due to a zero COVID policy. While the first half drawdown was entirely driven by multiple compression, a combination of slowing growth, tightening financial conditions, lingering input price and supply chain pressures, waning corporate sentiment, and FX headwinds drove a meaningful pickup in concerns about the downside risk to consensus earnings estimates. Treasuries came under pressure again, with ten-year yields up nearly 70bp to 3.01% (after getting as high as 3.49%). There were also bouts of curve inversion. The dollar index jumped over 7%, gold was down 7.5%, and Bitcoin lost nearly 60%. WTI crude added 5.5% to post its ninth straight quarterly gain.

The investment landscape will remain difficult in the near term until the outlook for inflation and growth become clearer. Expectations of a recession in the U.S. and Europe have escalated in recent weeks, reflecting the drags of elevated inflation (including for energy), and expected central bank policy tightening. Ultimately, the issue for investors is whether central banks can reduce inflation materially without triggering an economic recession. The Fed is expected to keep raising rates aggressively through year-end, with the funds rate peaking in mid-2023.

In the short term, markets will be on recession watch, with any weaker-than-expected economic data or declines in copper/oil prices, or a flattening of the yield curve, interpreted as evidence that a recession is brewing. The implication is that weak economic data will be beneficial for longer-maturity bonds, but, at least initially, bearish for corporate earnings expectations and equities. Fed members have already indicated that they need to see a string of lower month-to-month inflation readings to justify moderating the pace of tightening. Our forecast is that U.S. headline and core inflation will trend lower in the months ahead. This backdrop argues for a cautious investment strategy in the near term.

The more problematic outcome for investors would be stubborn headline and core inflation readings keeping pressure on the Fed to tighten more aggressively. The result would be a continuation of the horrific first half of the year, with rising bond yields forcing a further de-rating of equities and both bonds and equities suffering further losses in the coming months. While the Fed must get softer inflation data before it can temper its hawkish rhetoric and signal a more moderate rate path ahead, it will not blindly sacrifice the economy to achieve any specific inflation objective. It will likely be on data dependency mode by September.

The decline in asset prices this year has significantly unwound prior valuation excesses, improving the risk-reward outlook on a 6-12 month and longer-term horizon. However, to unlock that improved value in the near-term will require a definitive peak in inflation such that the Fed can hike rates at a slower pace, thereby allowing U.S. and euro area economic resilience to re-gain credibility. A sustained easing of COVID restrictions by Chinese authorities would provide an additional global growth impetus. Our base-case scenario is that there is a more profitable path ahead for equities, but it will take time to develop. Beyond the short term, the fundamentals warrant maintaining an underweight stance on fixed-income within a multi-asset portfolio, a neutral stance on equities, with overweight exposure to cash. While worries about global growth have increased in recent months, the magnitude of the declines in equity and bond prices is as much a reflection of their prior overvaluation enabled by easy money as deteriorating economic conditions. Current fears of a recession are primarily based on potential future policy outcomes rather than on currently measurable risks in the real economy. Future policy will be data-dependent, so the current recession fears are primarily sentiment-driven.

### FIXED INCOME

Key long-term government bond yields have retreated from mid-June highs. The earlier surge in bond yields may have eased, but bond market volatility remains elevated. Over the past month, bonds have been driven by rising real yields and moderating inflation expectations. Longer-term inflation expectations could drift lower in the near term, given economic growth concerns, but ultimately our view is that they will climb from current levels if the economic expansion is sustained. Spreads on credit products continue to widen and likely have more upside until investors re-gain confidence in the economic outlook.

## EQUITIES

The sharp decline in stock prices this year is a result of a pronounced de-rating as global interest rates have risen. Global equities remain under pressure as growth worries escalate and prices have dipped into bear market territory. The equity drawdown relative to their one-year peak is similar to those during the growth scares in the last economic expansion but significantly less than during the 2001-2003 and 2008-2010 bear markets. Stocks are somewhat oversold, reflecting both the magnitude and speed of the decline. Barring a deep recession, which we do not envisage, the current oversold reading bodes positively for equities on a 6-12 month horizon.

Forward earnings expectations remained in an uptrend through Q2, although cracks appeared across select markets and sectors. We expect downgrades in the coming months, consistent with slowing global growth. Downside earnings risk for the U.S. equity market would be meaningful only in the event of a recession, which we do not expect. Nevertheless, avoiding earnings disappointments will be key to equity performance.

## COMMODITIES AND CURRENCIES

Commodity prices have declined recently in response to global growth worries, with further downside likely in the near-term. The drop has been broad-based across major commodity groups, but the aggregate index still remains high by historical standards and is up significantly year-to-date, in contrast to other risk asset prices. Crude prices have retreated to reflect softer demand growth, but the oil market remains tight given low inventory levels. The U.S. dollar remains in an uptrend, registering gains against other currencies. Relative interest rates have been the key driver of currency performance in recent months and remain in favor of the dollar. That said, the U.S.' relative interest rate advantage is already elevated and has limited sustainable upside from current levels. If our macro scenario pans out, the ECB will be playing catch-up to the Fed, thereby gradually narrowing the dollar's interest-rate advantage. A turning point in the euro/U.S. dollar rate will likely correspond with a broader decline in the dollar, given the depressed levels of the yen and pound in particular.

## CONCLUSION

1. We expect global growth to slow further, but the resilience of the global economy is being underestimated.
2. Peak policy rate expectations for the Fed, ECB and other key developed economy central banks are not so high as to cause a recession in the absence of other shocks.
3. Headline and core inflation in the U.S. and euro area should gradually ease in the coming months, albeit less than central banks or the consensus anticipate. Nonetheless, the easing will provide temporary relief for capital markets.
4. If a global recession were to develop, it would be short and shallow given the absence of major imbalances in the household, business, and financial sectors.
5. Government bonds have rallied as inflation expectations have eased, which should allow yields to stabilize or modestly decline in the near-term if inflation moderates as we expect. We remain structurally bearish on bonds, but a more constructive tactical view is warranted.
6. Having already de-rated markedly and discounted at least some downgrading of corporate earnings expectations, stocks will likely remain choppy in the near term. Any meaningful upward move in stocks is dependent on containing earnings disappointments.
7. Elevated uncertainty and numerous possible problems warrant maintaining an overweight stance on cash, but near-term returns could lag long-term government bonds.
8. Portfolio returns should improve on a 6-12 month horizon, initially reflecting more stable bond returns and ultimately better equity returns.
9. The correlation between returns on equities and bonds will remain positive in the near term but should revert to negative if the global economic expansion is sustained as we expect.
10. Because of elevated levels of uncertainty, volatility in both directions is likely.

Source: BCA Research, MRB Partners, FactSet



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