WILSONS

# Inflation Risk vs Growth Risk - the Shifting Market Narrative

Our weekly view on asset allocation.

11 July 2022

Issued by Wilsons Advisory and Stockbroking Limited (Wilsons) ABN 68 010 529 665 - Australian Financial Services Licence No 238375, a participant of ASX Group and should be read in conjunction with the disclosures and disclaimer in this report.

# Inflation and Growth: Both Slowing?

Bonds and equities have both been under intense pressure this year as higher-than-expected inflation has led to increasingly hawkish central bank interest rate guidance.

This has pressured both bond and equity valuations. More recently, the market narrative has shifted to focus more on economic slowdown (recession) risks. The inflation story is still very much bubbling away in the background, and central banks are still full of hawkish rhetoric, but recent market price action is telling a somewhat different story to what central banks are (belatedly) emphasising.

After the sharpest sell-off on record, bonds have rallied, with the US 10-year yield easing back from a mid-June peak of 3.4% to a current level of 2.9% (July 7). Australian yields have seen an even larger retracement, easing back from a peak of 4.2% to 3.4%. While this is perhaps based on a market view that inflation is peaking, it also reflects a view that growth is set to slow significantly. This view is also seen in the cash futures market, where expectations of peak policy rates for the Reserve Bank of Australia (RBA) and the Fed have been wound back in recent weeks.

So, while the inflation outlook is still very much in investor (and particularly central bank) thinking, the growth outlook is now arguably seen as the most significant source of risk.

This has been emphasised in the past week or so by the significant acceleration in downward momentum for the majority of commodity prices, most notably the oil price.

This is something of a double-edged sword in that a rapid weakening in commodity markets is signalling that a significant economic slowdown is likely unfolding. Still, it also relieves some of the inflationary/cost of living pressures that have been plaguing the global economy this year.

## Growth Slide, Inflation Slide, or a Bit of Both?

So, we are at an interesting juncture. The more bearish interpretation is that the global economy is set to slide into recession with a stubbornly high inflation backdrop (stagflation). The optimistic interpretation is that growth is slowing but not collapsing, while the stubborn inflation pressures of the past 12 months are finally showing signs of a meaningful deceleration.

Our own view is closer to the more optimistic of these scenarios than to the stagflation bear case. We still see the probability of the US and Australian economies avoiding a genuine recession as better than 50%. At the same time, the seeds of a sizeable deceleration in inflation over the second half of this year seem to be finally falling into place.

Of course, navigating current markets remains a tricky task. If the US is indeed set to fall into recession (not our central case), history suggests that equities have probably not bottomed.

We cannot find any evidence of equities bottoming ahead of a genuine recession (as defined by the National Bureau of Economic Research). Equities tend to bottom during recessions, not before (see figure 1). The better news, firstly, is that equities bottom well before recessions are over. Secondly, while we believe a recession is a risk that needs to be considered, it still does not seem inevitable in our view (see figure 2). If the US can avoid a genuine recession and inflation eases as we expect, then the market could now be forming a bottom and the rebound could be considerable given such a dramatic pullback in the first half of the year.

**Figure 1: US Equities tend to peak "during" not before but generally not after US recessions**

| Recession Period* | US market peak versus recession start Months (before)/ after start | Market low versus recession start Months (before)/ after start | Peak to trough US equity fall | Fed rate peak versus recession start Months (before)/ after start | Bond yield peak versus recession start Months (before)/ after start |
|---|---|---|---|---|---|
| Nov 73 - Mar 75 | -10 | 13 | -48 | 5 | -3 |
| Jan 80 - July 80 | 0 | 3 | -10 | 2 | 3 |
| July 81 - Nov 82 | -8 | 12 | -22 | -1 | 2 |
| July 90 - Nov 91 | -2 | 3 | -19 | -1 | -2 |
| Mar 01 - Nov 01 | -7 | 18 | -48 | -10 | -10 |
| Dec 07 - Jun 09 | -2 | 15 | -55 | -18 | -18 |
| Mar 20 - Jun 20 | 0 | 1 | -34 | -17 | -17 |

*Recessions defined by the National Bureau of Economic Research (NBER).
Source: Refinitiv, NBER.

## Negotiating the Earnings Cycle

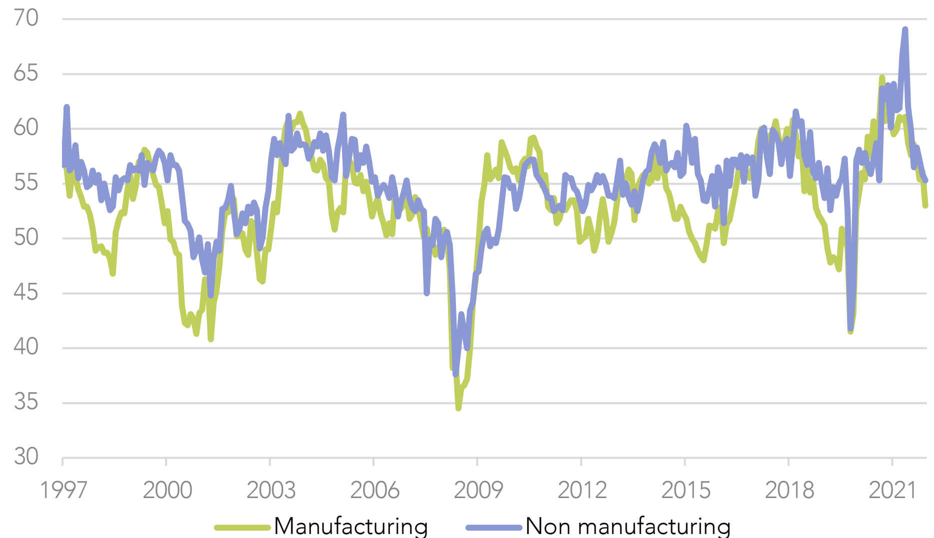
One issue the market will need to digest is the issue of earnings downgrades. Earnings estimates have remained resolutely high in the face of mounting evidence of slower economic activity. US earnings per share (EPS) growth for 2022 stands at 9% and at 10% in 2023. This has changed little in the past 3 months.

Once again, the bearish scenario is that a recession is coming, and US earnings have typically fallen 15% to 35% in recessions (see figure 4). This is why it would be unlikely the US market would be bottoming now if the US is headed for a genuine recession. Even if the US is going through a slowdown rather than a significant contraction, consensus estimates are likely to have a fair bit of downside, possibly to around zero growth in CY23.

Figure 4 shows that earnings contractions/recessions are more common than economic recessions. Markets can fall into mild earnings contractions accompanied by downward earnings revisions (figure 5) more readily than into economic recessions when earnings typically come under significant pressure. The ability to rally despite flat or mild falls in earnings is generally the case because the deterioration is priced in at the overall market level ahead of the earnings slowdown. At the same time, equities ultimately get support from lower bond yields and, often, from a shift in central bank policy. In this inflation-plagued cycle, a major central bank pivot is unlikely any time soon, but an end to the tightening cycle combined with stable to moderately lower bond yields may be enough for the equity market to regain its stride, even if we shift into a persistent earnings downgrade cycle over the next 6-12 months.

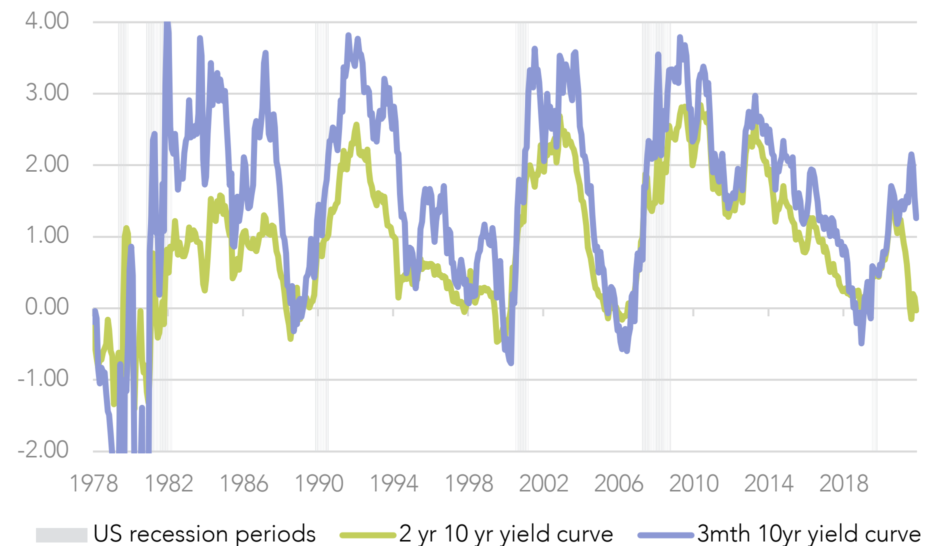
Of course, at this stock level, those companies whose earnings hold up relatively well are likely to perform above average. We have allowed for this scenario by overweighting quality defensive and quality growth stocks (and quality focused managers), which should be able to rise through a period of slower economic growth.

**Figure 2: Business surveys such as the ISM Purchasing Managers Index (PMI) suggest the US economy is slowing but exited June still in expansion mode**



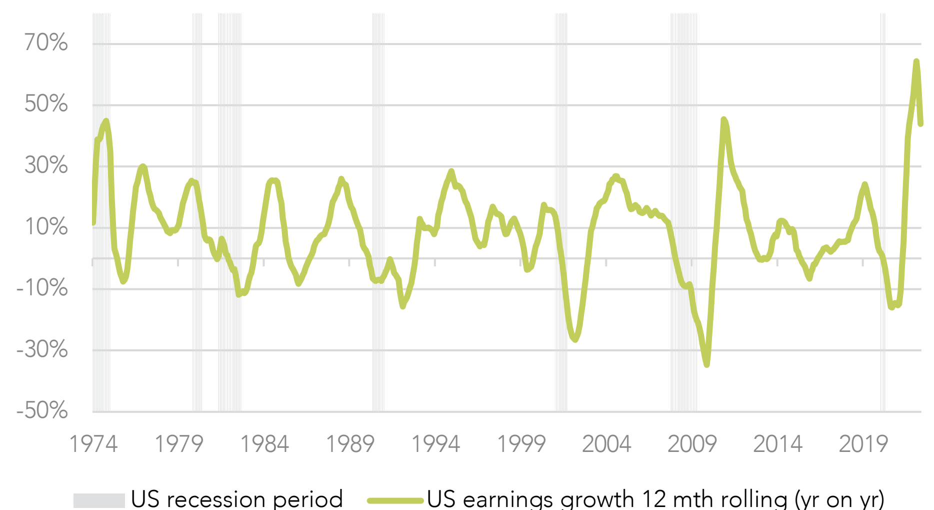

Source: Refinitiv, Wilsons.

**Figure 3: A US yield curve "inversion" has been quite a reliable predictor of US recessions but mixed signals currently**



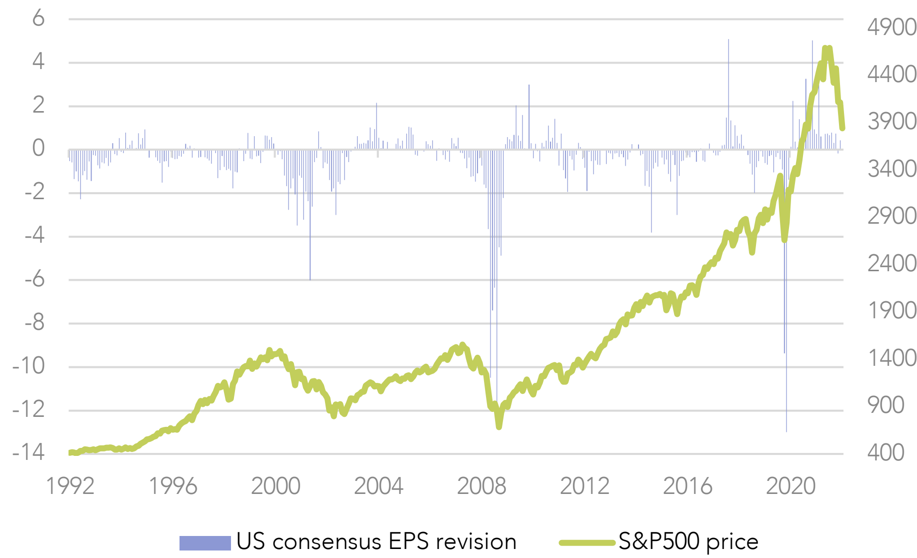

Source: Refinitiv, Wilsons.

**Figure 4: US earnings contractions are more frequent than economic recessions**




Source: Refinitiv, Wilsons.

**Figure 5: Downgrades are the norm. The market can rise into moderate downgrades but not dramatic (recessionary) downgrades**




Source: Refinitiv, Wilsons.

In summary, we continue to assess conditions in terms of the inflation, interest rates and economic/profit growth outlook. Conditions are continuing to shift quite rapidly, with growth concerns rising but rate pressures easing somewhat. We remain neutral on equities and are emphasising quality in equity portfolios. We have upweighted bonds close to neutral, given more attractive running yields and a slower economic outlook. We still hold an overweight to alternative assets (albeit somewhat reduced) as an attractive risk-adjusted position given unusually uncertain macro conditions.

# Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

**Disclaimer**

All figures and data presented in this research are accurate at the date of the report, unless otherwise stated.

This document has been prepared by Wilsons Advisory and Stockbroking Limited (AFSL 238375, ABN 68 010 529 665) ("Wilsons") and its authors without consultation with any third parties, nor is Wilsons authorised to provide any information or make any representation or warranty on behalf of such parties. Any opinions contained in this document are subject to change and do not necessarily reflect the views of Wilsons. This document has not been prepared or reviewed by Wilsons' Research Department and does not constitute investment research. Wilsons makes no representation or warranty, express or implied, as to the accuracy or completeness of the information and opinions contained therein, and no reliance should be placed on this document in making any investment decision Any projections contained in this communication are estimates only. Such projections are subject to market influences and contingent upon matters outside the control of Wilsons and therefore may not be realised in the future. Past performance is not an indication of future performance.

In preparing the information in this document Wilsons did not take into consideration the investment objectives, financial situation or particular needs of any particular investor. Any advice contained in this document is general advice only. Before making any investment decision, you should consider your own investment needs and objectives and should seek financial advice. You should consider the Product Disclosure Statement or prospectus in deciding whether to acquire a product. The Product Disclosure Statement or Prospectus is available through your financial adviser.

Wilsons Corporate Finance Limited ACN 057 547 323, AFSL 238 383 may have participated in some capacity with regard to capital raisings for some of the companies mentioned in this article. To manage any conflicts of interest with Wilsons Research, full disclosure on any relevant corporate transaction may be found on our website.

**Wilsons contact**

david.cassidy@wilsonsadvisory.com.au | +61 2 8247 3149

rob.crookston@wilsonsadvisory.com.au | +61 2 8247 3101

www.wilsonsadvisory.com.au