Index House View

So where are we?

Not out of the woods yet, more likely halfway through. Since an economic contraction has not yet materialized, we examine at what stage of the market correction we might be.

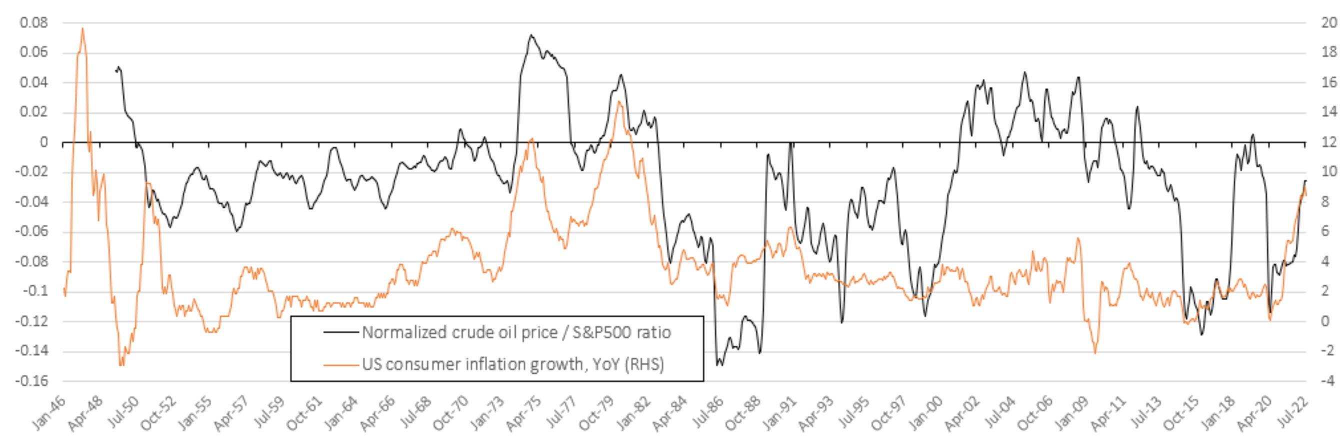
Considering that we are living through an hyperinflationary shock and a probable financial contraction, we need to analyze the relationship between US capital markets and the largest driver of inflation, i.e. oil.

The metric chosen is the normalized ratio between the S&P500 index and crude oil price, and its inverse (crude oil price over S&P500).

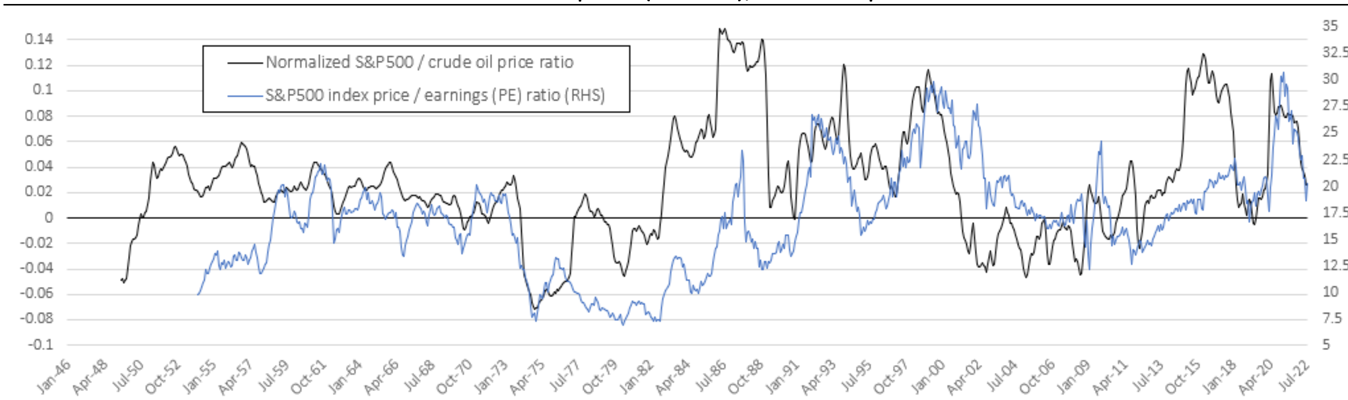
Normalization is needed to smooth out trends, so that we can bound whatever metric within an upper and lower band. This is done to identify extremes. We then represent the S&P/oil ratio versus US consumer inflation, and its inverse (oil/S&P) ratio versus the S&P index's price/earnings ratio (a metric of market valuation).

The message that emerges is that the US equity market becomes clearly undervalued whenever the oil price spikes up suddenly. This is intuitive, as the cost of energy has both a direct and indirect effect on any and all human activities.

Normalized ratio of crude oil price over S&P500 index, versus inflation



Normalized ratio of S&P500 index over crude oil price (inverse), versus capital market valuation

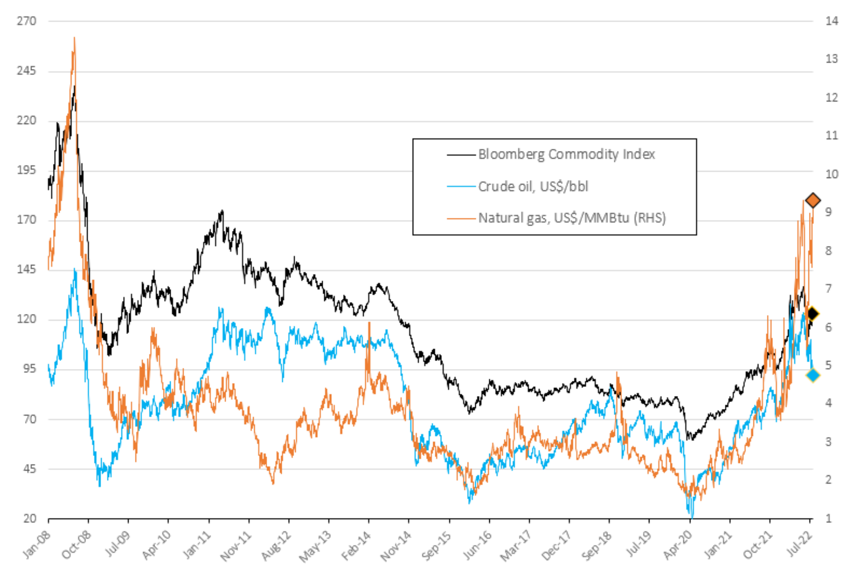


Source: Energy Information Administration (US), Bureau of Labor Statistics (US), Bloomberg, Index & Cie own calculations

During 2022 the S&P500 index has corrected quite markedly from a rarely expensive valuation (~30x PE, only saw twice since 2000). At the current 20 times earnings, the index is valued around its historical average, calculated since January 1946. This level might be a bottom, or, in our view, a halfway value towards perhaps cheaper valuations in the surroundings of 15 times. Through the goggles of history this correction is perfectly fitting the narrative of mean reversion and allows for imminent bargains in many industries. We stress that this is also a deserved correction after a long time of overvaluation, surely due to rates going to zero in the past ten years.

Energy cost has affected prices across the board for commodities. From this perspective, the Bloomberg Commodity Index below shows a general downtrend across the board, with the only exception of natural gas – indeed affected negatively by the Russian invasion and the consequent rearrangement of supply contracts in Europe. Oil directly commands about 22% of this index, so the correction seen in crude oil has been driving the whole index downwards only recently. Should this oil price correction continue – as we expect after Aramco's announcement of capacity expansion projects to meet growing demand for the next 10 years – other commodities will follow, such as industrial metals and soft commodities, both of which depend heavily on fossil fuels for manufacturing and shipping – that is the indirect influence of oil into all other commodities.

Commodity prices



Bloomberg Commodity Index

Futures & sectors	Weight in %
NATURAL GAS FUTR Nov22	17.61
WTI CRUDE FUTURE Nov22	7.59
BRENT CRUDE FUTR Nov22	6.76
Low Su Gasoil G Nov22	3.21
GASOLINE RBOB FUT Nov22	2.09
NY Harb ULSD Fut Nov22	2.47
Energy	39.73
GOLD 100 OZ FUTR Dec22	13.01
SILVER FUTURE Dec22	3.75
Precious metals	16.76
LME NICKEL FUTURE Nov22	2.56
LME PRI ALUM FUTR Nov22	3.01
LME ZINC FUTURE Nov22	2.79
Industrial metals	8.36
SOYBEAN FUTURE Nov22	5.00
CORN FUTURE Dec22	4.90
COPPER FUTURE Dec22	3.90
SOYBEAN OIL FUTR Dec22	3.08
SOYBEAN MEAL FUTR Dec22	2.94
WHEAT FUTURE(CBT) Dec22	2.66
SUGAR #11 (WORLD) Oct22	2.43
COFFEE 'C' FUTURE Dec22	2.21
KC HRW WHEAT FUT Dec22	1.64
COTTON NO.2 FUTR Dec22	1.33
Soft	30.09
LIVE CATTLE FUTR Oct22	3.29
LEAN HOGS FUTURE Oct22	1.77
Livestock	5.06

Source: Bloomberg

In turn, a pause or a beginning of trend inversion in energy and commodities in general is supportive of a better environment for capital markets.

The FED has signaled that although the most recent inflation readings might suggest prices are coming under control, equilibrium will be reached with further rate hikes in 2022 and possibly in 2023.

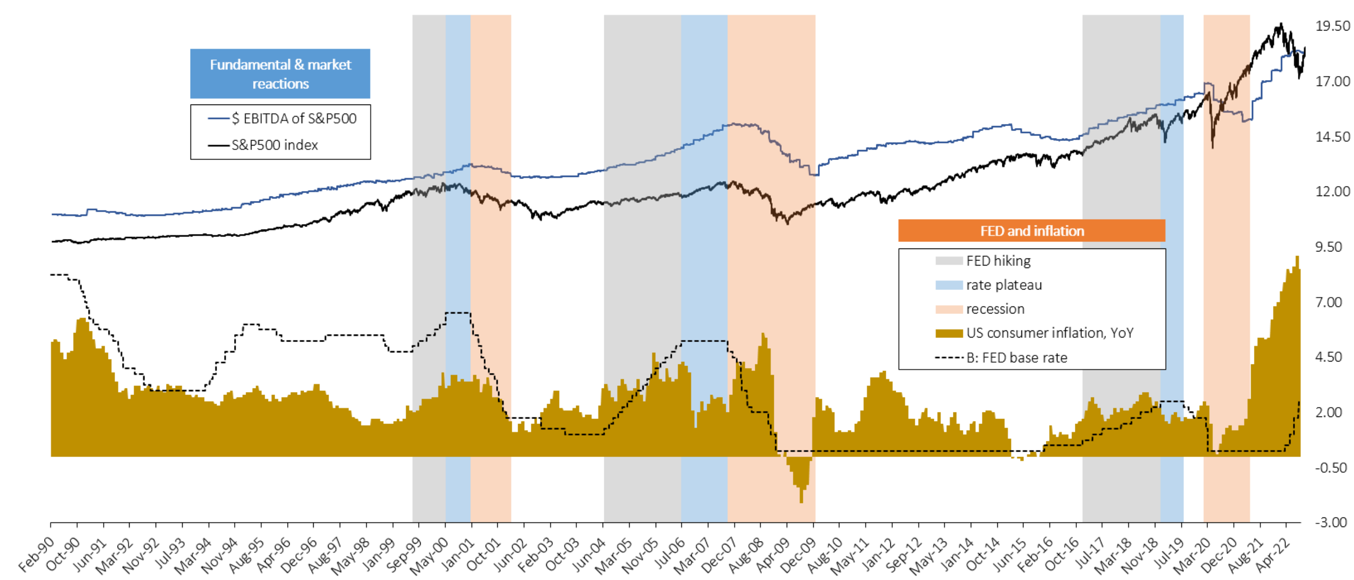
A short recap on our view

Early this year we shared our conviction that a state of non-zero interest rates in the US is unsustainable for its economy. Same goes for the rest of the developed economies. The reasoning is simple: no company playing in a developed economic environment is happy to lose earnings to an increased cost of leverage, which anyway made that earnings growth possible.

To compound the earnings-eroding effect of rising rates, we noted that monetary policy instruments are the wrong instrument to tackle supply-generated inflation shocks. The solution to inflationary problems lies is not in curbing healthy consumer demand, but in fixing supply chain restrictions – heritage of pandemic times and myopic capacity expansion expenditures – and releasing the blocks imposed by the Russian invasion of Ukraine. Both processes are underway, the effects of which are beginning only now to show in inflation readings.

Despite what seems to be encouraging news from energy and consumer inflation, we still expect economic fundamentals of global businesses to suffer through at least mid-2023. Caught between a cooler consumer demand and higher operating and financial costs, companies will likely feel the pinch in their earnings growth in the next 12 months. This temporal evolution does not mean that capital markets will need to adjust downward in the future, after what they have already lost. The graph below shows there is a lag between trends in aggregate EBITDA and in equity market valuations when rates plateau – the FED will stop raising rates when inflation decreases convincingly.

Fundamentals, markets and economics



Source: Bloomberg, Index & Cie own calculations

The time lag between aggregate EBITDA correcting and capital markets rising shown in the past three recessions since 1990 is not constant and therefore not useful for future projections. However, the lag might be a sign that what matters to markets is to have visibility on what to expect more than actually seeing the real recovery in EBTIDA.

After a solid correction in valuations during 2022 and encouraging macro signs, we feel that capital markets are cautiously optimistic. Market expectations are that we might have seen an inversion of trend, or at least a pause, in the negative escalation of economic conditions. This cautious optimism should not distract from the possibility that market sentiment could reverse quite fast in case the macro landscape suddenly deteriorates.

The rest of 2022

Our own expectations for 2022 are of a controlled landing of oil & gas prices, which will in turn bring down the general inflation readings in the US. This would result from the announcement of increased supply in oil capacity from OPEC, lower consumption due to higher prices across the consumer world, and a gradual resolution of the troubles generated by the Russian invasion of Ukraine – see grain shipments resuming from Odessa. When that happens, the FED will first stop raising rates, then decrease them to help the economy recover – in line with the past three recessions. The economy-helping card of lowering rates is an undeniable political angle that the Biden administration is almost certainly going to play to curb the electors' favor.

Europe might experience longer disruption to business due to the main economic engines still being dependent on Russian gas. Reorganizing supply chains does take time, also considering the ineptitude and unwillingness of various political classes in major European countries – to this point, there seems to be a sea of difference between Germany preparing for a heat-less winter and July's agreements signed by Mario Draghi's exiting government with Algeria on gas supply to Italy. In addition, consumption is indeed slumping, with retail sale volumes turning negative in June (this is usually a very steady metric historically).

In China, the PBoC cut its main lending rate by 10bps a couple of days ago. The cut is not significant to the currency or any asset value, but it does signal the Party is concerned about recent trends – July's fixed asset investments, retail sales and industrial production were all below expectations. The economy is not in a bad state, but authorities must balance out helping the economy (rates down) and controlling inflation (rates up). For instance, July's trade surplus stood at a record $864bn. This increase is mainly due to backlog in export orders after lockdown relaxation in major cities, leading to exports far outpacing imports. While very positive, this trend will not last, as global demand will either normalize or slowdown from certain regions. In addition, the Chinese property market is also facing some issues, with a few developers suffering and buyers not paying their mortgages on non-delivered units. This speculation-driven reckoning was a longtime coming, and the pandemic only brought forward the judgement day. As always in Chinese affairs, the largest unknown is government intervention. President Xi recently declared that the property market should be intended to bring harmony to the population by ways of accommodation, not by way of speculation. This line of thought is consistent with the previous interventions against Ant Financial, Jack Ma and other Chinese tech tycoons with dreams of total market domination. With the "collective harmony" principle now extending to the property market, we expect some developers to disappear and some financial operators – whether shadow or regulated – to suffer via NPLs with an average life of at least 10 years. However, in many ways we are less preoccupied of such internal affairs going bad than Western ones. In the Chinese century, the Communist Party has way more to lose than any elected Western administration of bureaucrats, which probably means their reign over the excesses of their own economy will be much swifter.

This global reality has encouraged us to get busy with purchases in equity and bond markets. Remuneration in both markets is becoming increasingly attractive and, with our view of US rates going back to zero in the next two to three years, this is an opportunity we shall not pass. After many years of insignificant returns from the bond market in developed economies, now we can find solid companies offering 4-6% yield in both short and medium maturities. Considering the bond price adjustments, we expect will happen when rates return to zero, the overall yield extracted can be higher than 6% annually for the two years.

Yes, inflation and higher rates will contract earnings in 2022 and 2023, but the real devil for long-term investing is only a permanent loss of business. We see little probability of such loss in the names we selected.

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