INDEX
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Chief Investment Office

March 2023

Index House View

Continued uncertainty

We believe the next three quarters of 2023 will be decisive.

We will either see the resumption of a strong expansion cycle in earnings, with the following large financial gains, or appreciate the true extent of damage to fundamentals. There seems to be a dichotomy between the bad macro situation and the numbers on the ground. It is difficult to say which one will put down roots in 2023.

Far from being an exhaustive list of this year's important variables, we chose some major ones and judged them as favourable (✓) or unfavourable (✗) for global markets.

	✓	✗
US dollar strength	Since May 2022 the US dollar stopped appreciating and began depreciating. This is great news for the US economy, as a weaker dollar will help exports and GDP. Also, markets tend to react very well to the inversion in US dollar strength.	Inversions in US dollar strength are usually accompanied by earnings expansion. Unfortunately the current situation is nowhere near a solid footing to begin another earnings expansion cycle. Expectations are of decreasing earnings, which markets will follow.
Earnings cycle		We have seen some of the longest and strongest earnings cycle since 2011. This cycle is about to end this year, or at least it has much more room to decrease than increase from current levels.
Energy prices		Higher energy prices for longer only benefit traders, producers and exporting countries. All other industries and consumers suffer from higher prices across the board.
Inflation		Forecasts are of higher inflation for longer. There is little hope the war in Ukraine will resolve, which gives all energy-related activities the perfect floor to keep prices high.
Interest rates		They will track inflation, with the permanent risk of hurting consumption any time, and trigger a recession.
Tech industry	The bubble burst in 2022. Unsustainable and unnecessary businesses of the free-money era have been flushed out of the system. Those who endured, have a chance to be the champions of the future. The runway for cash contribution remains very long.	
Job markets	The US job market is at its healthiest ever recorded.	
Saving ratios	Europe and China seem to be in good shape, historically and recently.	Japan and the US exhibit very thin cushions, at 3.2% and 3.9% ratios respectively. This is tantamount to having zero savings at household level.
Loan loss provisions	A good measure of cash has been set aside by major banks in the eventuality of defaults rising. This is a necessary cushion, and fast approaching the one set aside during the GFC.	
Loan default rates	Local banks might be experiencing a slight uptick in credit card and consumer loan defaults, but on an aggregate level things seems quite normal.	

Let’s see them in order.

US dollar cycles

The US dollar index tracks the value of the US dollar versus a basket of other currencies (57% against EUR). We normalized it and tracked it against both the price level of the Russell 3000 Index (the total US listed equity market) and its 2-year forward EPS (the earnings expected for the next 2 years by Wall Street analysts). Two distinct seasons appear, one pre-global financial crisis (GFC) where there wasn’t much correlation among the three variables, one post-GFC where correlation suddenly spiked to statistically significant levels.

US dollar cycles

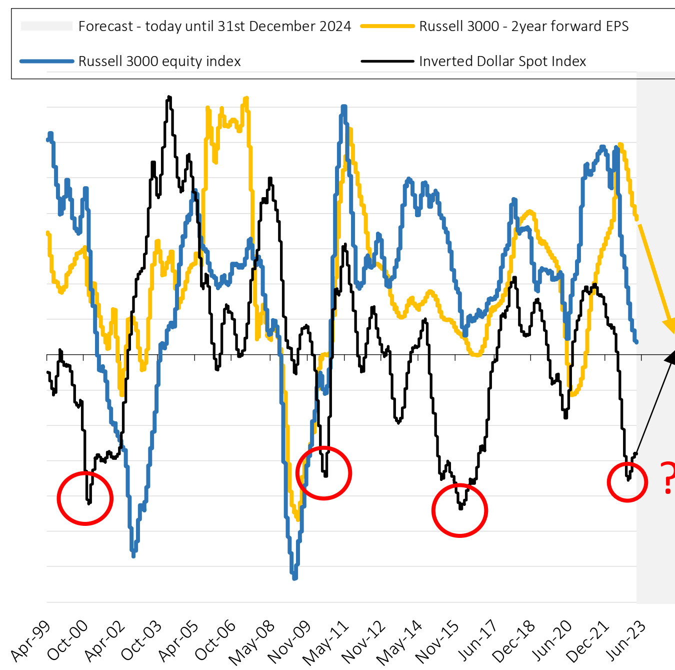
Phases of the inverted Dollar Spot Index, calculated as 2-year rolling average of quarterly returns

Inversions	Phase		Length (months)	Russell 3000 2year forward EPS	Russell 3000 equity index
27-Apr-99	BEAR	BULL			
28-Aug-02	ends →	begins ↓	40.63	18.55	-19.41
23-Dec-05	↓ begins	← ends	40.43	49.78	30.00
17-May-06			4.83	9.03	5.94
04-May-07			11.73	7.68	5.87
25-Dec-08			20.03	-21.20	-35.52
28-Jul-09			7.17	-15.98	2.79
13-Nov-10			15.77	21.63	6.72
10-Nov-11			12.07	14.27	5.54
12-Apr-12			5.13	2.36	12.97
30-Sep-12			5.70	2.44	2.34
05-Jun-14			20.43	12.37	28.56
22-Sep-14			3.63	0.36	4.42
14-Aug-17			35.23	9.96	19.67
16-Jul-19			23.37	22.51	16.50
10-Sep-20	ends →	begins ↓	14.07	-11.71	13.22
07-May-22	↓ begins	← ends	20.13	40.99	27.81
05-Mar-23	*USD depreciating phase*		10.07	-5.91	-7.94

Average performances		Length (months)	Russell 3000 2year forward EPS	Russell 3000 equity index
	USD depreciates (BEAR)	19.52	5.12	4.02
	USD appreciates (BULL)	15.53	15.26	11.91

Historical correlations	Inverted Dollar Spot Index with (1) and (2)	(1) Russell 3000 - 2year forward EPS	(2) Russell 3000 equity index	years
	April 97 - Dec 2009	7%	4%	12.69
	Jan 2010 - today	38%	58%	13.14

Historical correlation with US equity markets



Source: Bloomberg, Index & Cie

In particular, we observe that markets anticipate an improvement in earnings whenever the US dollar depreciates. The relationship is key to understand: as the US dollar depreciates against other currencies, the value of US company sales and exports increases, which eventually has a positive impact on the country’s GDP. During the past four major inversion in US dollar strength, we note that markets substantially improved in the next two to three years (see red circles). Earnings took longer to improve, but markets always anticipate fundamentals. The most recent and fourth major inversion in US dollar strength since 1997 happened in May 2022, a sign that many would consider positive for risky assets by way of strengthening fundamentals.

Inferring positive times ahead out of the current situation is not wrong, but we remain cautious. The reason is that both expectations of the future 2 years of earnings and the actual 12-month trailing EPS have not corrected enough compared to their historical behaviour. The former began descending from its peak 7.5 months ago, the latter is peaking now. In other words, a market improvement might be just premature at these earnings levels, leaving space for further valuation downside throughout 2023.

Earnings cycles

When displaying the 12-month trailing EPS of the S&P 500 index since 1954, on a logarithmic scale, it appears the long-term growth trend is contained within clear upper and lower boundaries. Each new max coincides with touching the upper band. When that happens, an earnings contraction gets underway. The earnings cycles are visually clear. The table on the left shows more detail. It appears that earnings contraction cycles are not always met with a strong correction in capital markets. **On average, markets gained 4.63% annually during phases of earnings contraction cycles, which lasted on average 2.59 years. Conversely, they gained 9.24% annually during earnings expansion cycles, which lasted on average 5.85 years.**

Earnings cycles

Phases of expansion and contraction of the S&P500 aggregate earnings per share

Inversions	Phases of EPS growth		Length (months)	EPS performance	Price performance
01-Jun-56	Contraction	Expansion			
24-Apr-59	ends →	begins ↓	35.23	-24%	28%
03-Feb-67	↓ begins	← ends	94.73	76%	46%
29-Oct-71			57.63	-4%	11%
28-Feb-75			40.60	63%	-8%
26-Mar-76			13.07	-19%	24%
12-Sep-80			54.37	74%	24%
26-Aug-83			35.93	-19%	30%
27-Oct-89			75.13	83%	81%
30-Apr-93			42.70	-50%	30%
26-Jan-01			94.27	167%	122%
09-Aug-02			18.67	-30%	-36%
19-Oct-07			63.23	88%	54%
12-Feb-10			28.23	-39%	-24%
22-Nov-19			119.00	98%	116%
30-Apr-21	ends →	begins ↓	17.50	-15%	35%
16-Dec-22	↓ begins	← ends	19.83	49%	-5%
03-Mar-23	*EPS contraction about to begin*		2.57	-0.30%	5%

Average performances		Length (months)	EPS performance	Price performance
	EPS contracts	31.12	-25%	12%
	EPS grows	70.15	87%	54%

Weekly returns of the S&P 500 – logarithmic scale

Source: Bloomberg, Index & Cie

If we delve deeper into the significance of these numbers, a few points pop up:

1. Capital markets tend to be flat or positive even during cycles of earnings contraction;
2. This is found in the past 18 earnings cycles since 1954, accounting for major shifts in the US economy that is listed – tech and services are more prevalent today than they were in the past manufacturing and energy American economy;
3. The currently ending earnings expansion cycle is the smallest in magnitude (+49%) and shortest in time (1.65 years) among all recorded expansion cycles.

These observations generate the question of whether we are witnessing an inversion of cycle or a temporary setup to an otherwise strong earnings expansion cycle.

Inflation and interest rates

These two variables are closely intertwined and we have little expectation that either one will subdue during 2023, if not 2024.

The reasons are simple: energy prices will not moderate from current levels, since renewables are not an option, nor are all actors involved in this industry going to let go of easy gains.

The real issue with energy seems to be human greed more than anything else. We commented already on how 2022 prices spiked to totally unreasonable levels, and were ultimately driven by malicious expectations of a supply squeeze – no natural resources are expected to leave planet Earth, so it is either asinine or malicious to assume a permanent loss of Russian gas.

Considering that 100% of inflation is driven by fossil fuels, rates are not expected to come down in 2023.

This is both a positive and negative news. Positive for long-term investors, so that they can allocate capital at a healthy 5-7% annual return for the next 5-7 year. It is also negative because other financial metrics are already having a cooling effect on demand. Large banks are already discounting their own margins over benchmark rates, in order to not hurt existing mortgage owners while not killing new mortgage demand. The game is tight, and it will eventually push further the wealth gap in Western societies.

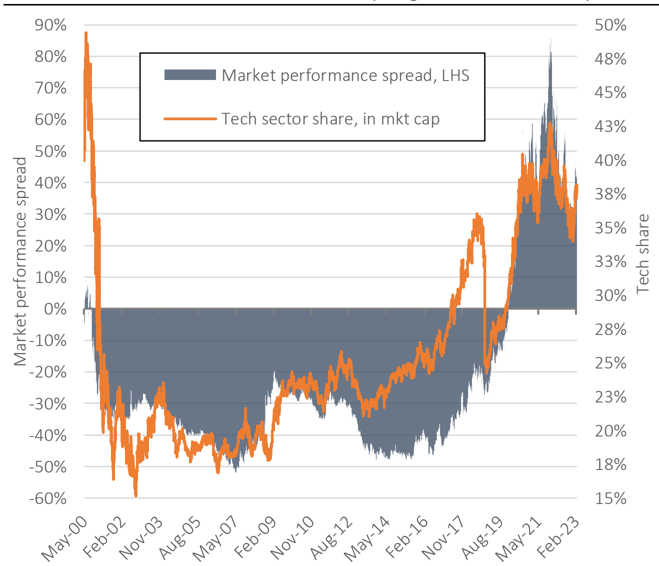
Tech industry

One of the few certainties we have is the future of the wider tech industry.

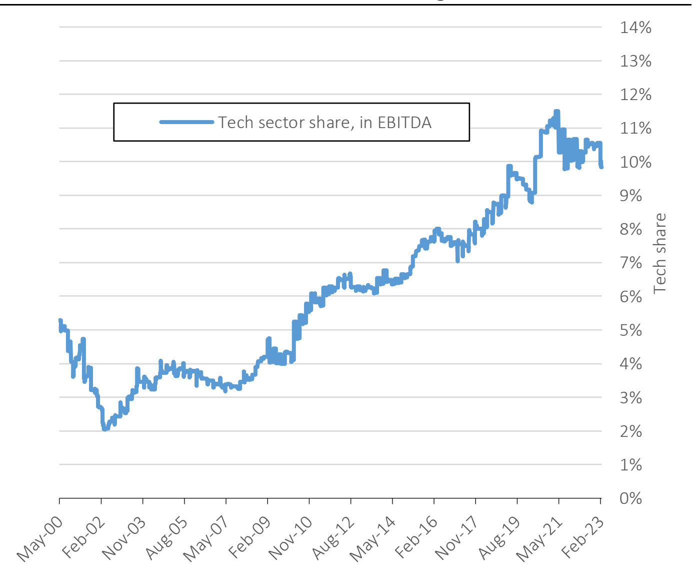
In an era where artificial intelligence on human language is fast spreading, we observe that the global cash contribution to existing listed companies is still very small, ~10%.

It seems only logical that a long runway for growth awaits this industry, both in terms of substitution of existing industries and business models, and of creation of new industries or verticals.

Market metrics – tech market cap / global market cap



Fundamental metrics – tech EBITDA / global EBITDA



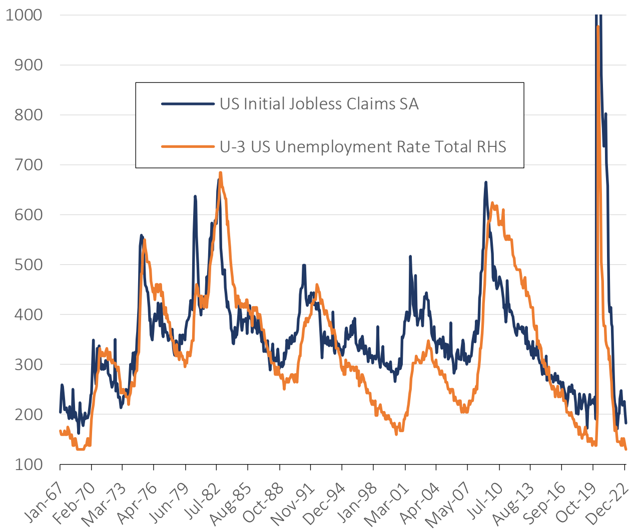
Source: Bloomberg, Index & Cie

US labour market

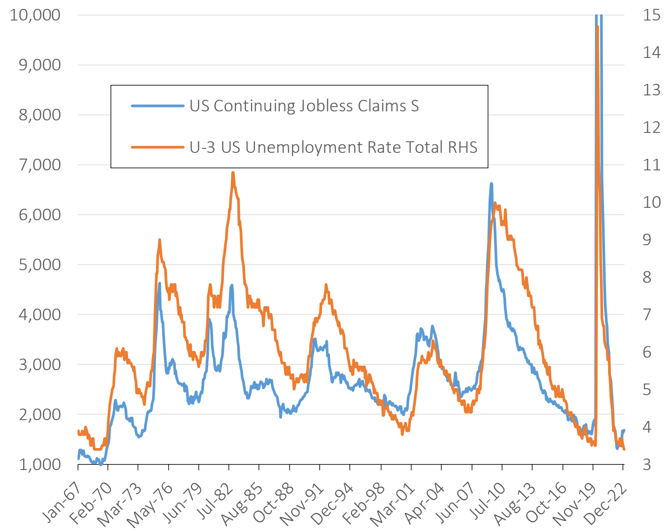
The answer to the previous question is not immediately clear.

The most conflicting signals are coming from the US labour market, which is at its healthiest ever.

Initial jobless claims



Continuing jobless claims



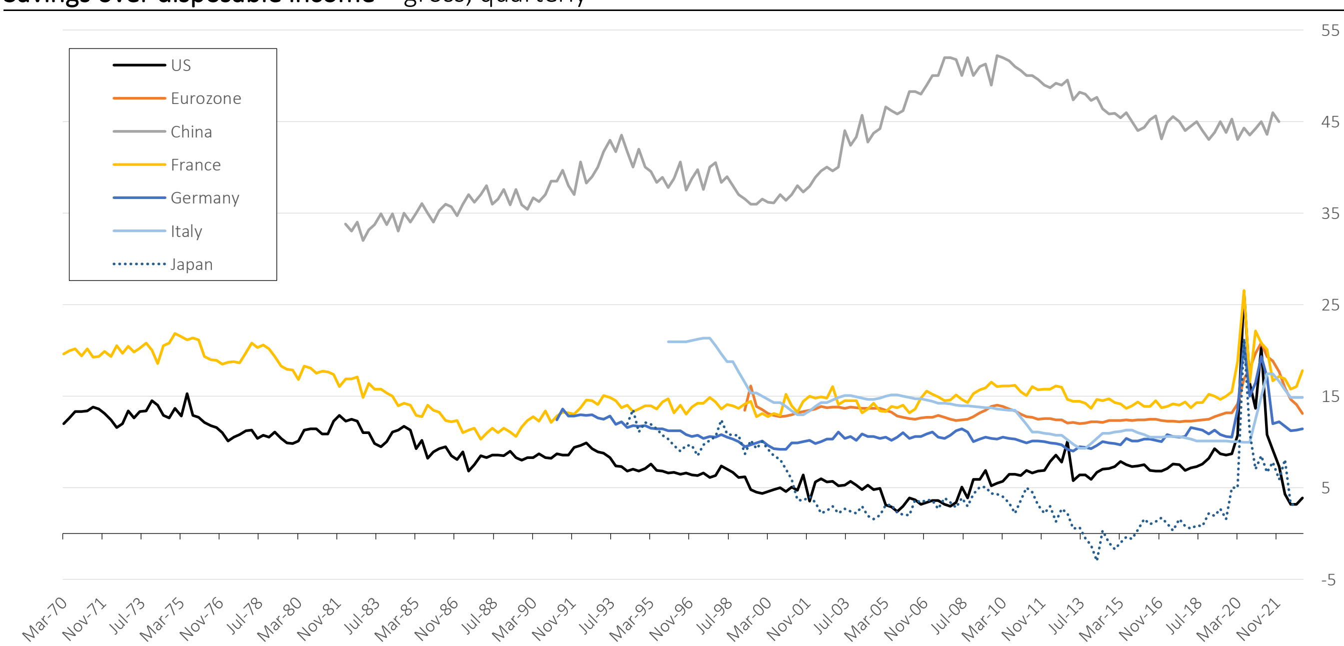
Source: Bloomberg, Index & Cie

A strong job market means a strong economy, where labor opportunities abound. In turn, there is little danger to consumption, and eventually to the usually non-existent savings at a household level. This job market status stands in contrast to the rising cost of living.

Saving ratios

The ratio between cash savings and disposable income sheds some light on the cash cushion that households have globally. The picture is reassuring if one looks at historical trends in some of the top economies. If we disregard the 45% of China, which is of dubious origin, Europe is doing well both at largest-country level, and on average at 13%. Japan and the US are not in a good shape, with 3.2% and 3.9% savings ratios respectively. This is tantamount to having an insignificant amount of cash in store for households.

Savings over disposable income – gross, quarterly

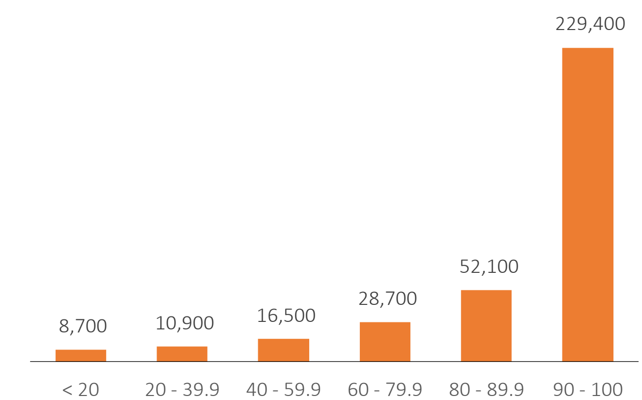


Source: Bloomberg, World Bank, OECD, Eurostat, Japan Center for Economic Research, Index & Cie

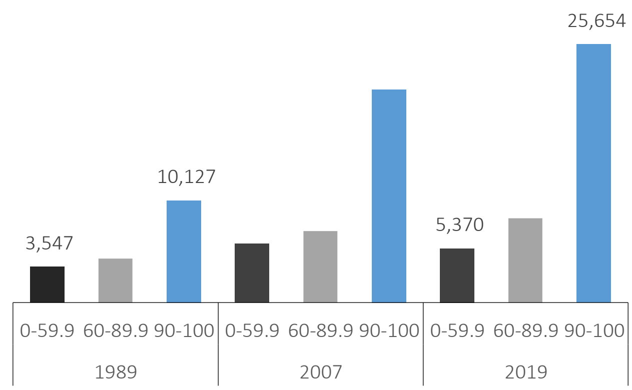
While it might be alarming, the American culture is founded on consumption. The cultural upbringing, the absence of social security and a public pension system, the cost of health insurance and the entrenchment of the capitalistic mentality are not conducive to a high savings ratio. As evidence, the FED conducts a Survey of Consumer Finances (SCF) every three year – the 2022 is undergoing – on the state of American household finances. See the following statistics:

Average bank account balance, 2019

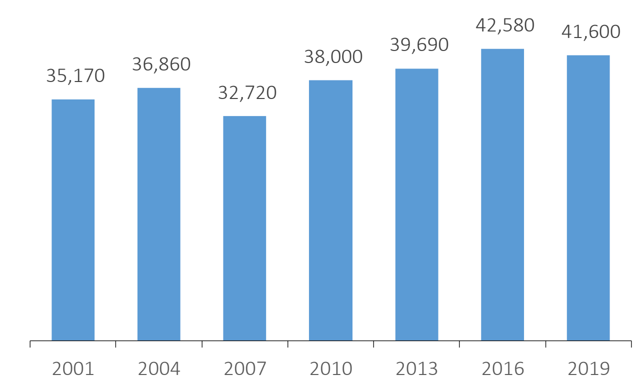
By income percentile



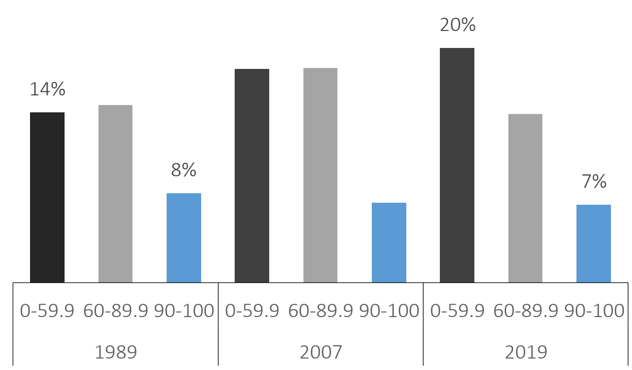
Household net assets



Historical average bank account balance



Debt to assets ratio



Note: US dollar amounts are in 2019 dollars.
Source: 2019 Survey of Consumer Finances (SCF), US Federal Reserve

These graphs summarize as follows:

Savings accumulation	Growth since 1989	Annualized
0-59.9	51%	1.70%
60-89.9	91%	3.00%
90-100 (top ten earners)	153%	5.10%

Debt to assets ratio	Growth since 1989	Annualized
0-59.9	38%	1.30%
60-89.9	-5%	-0.20%
90-100 (top ten earners)	-13%	-0.40%

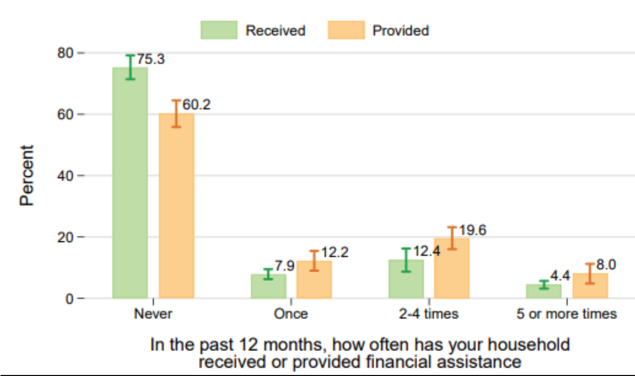
A picture of high wealth inequality emerges. More than 80% of the population has an average bank account balance lower than $28,700, while the national average in pre-Covid 19 times was $41,600. Things could have changed post-Covid 19, but any large departure from the average is likely to be temporary. The average dollar amount is very low, but at least constant over the past 22 years.

In addition, it appears that about 60% of households have accumulated savings substantially slower than the rest of the population, with the top ten percentiles growing at 5.1% annually over 30 years – the S&P 500 grew 6.4% in real dollar terms since the 1980s. At the same time, 60% of households likely grew these savings by accumulating debt, which nullifies the concept of savings. The rest of the population decreased their debt load to the tune of ~-0.3% per annum.

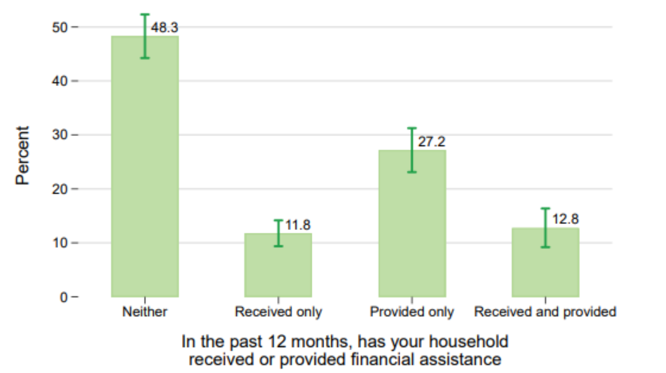
This is not the typical picture of a money-conscious country, and it renders any defense against recession practically null.

Another, darker aspect of the American culture, this time highlighted by surveys made by the Consumer Financial Protection Bureau in December 2022, a US government agency, can be found in the frequency of help provided and received during pandemic times by households. See graphs below.

How frequently households received or provided financial assistance to friends or family in the past 12 months



Households that received, provided or both received and provided financial assistance in the past 12 months



Source: Making Ends Meet in 2022, CFPB Office of Research Publication No. 2022-9, December 2022

Without delving into the tragedy of absent social safety nets within households, this reality amplifies the damage of recessions. If your family and friends cannot help you when you're in financial trouble, how are you going to survive? By finding another source of income fast. The strength of the job market becomes an even more important gauge to watch when judging the health of a society. Perhaps the two characteristics are inter-dependent.

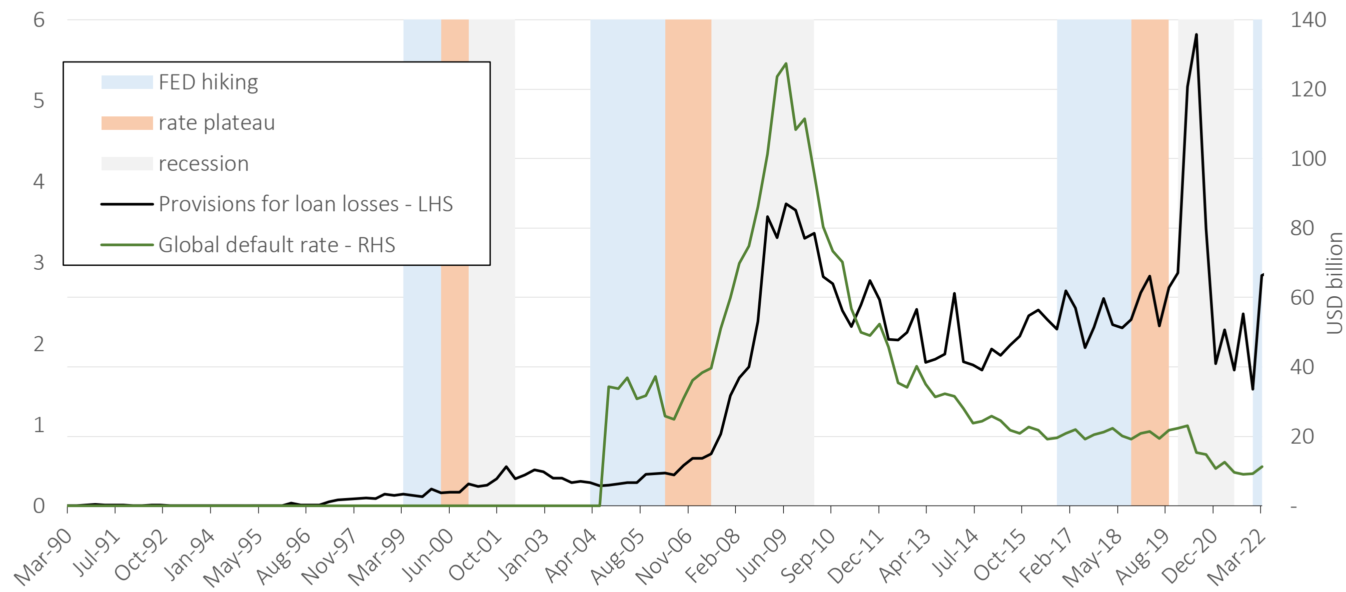
We could summarize the American culture as "*every man for himself, but at least jobs aplenty*".

Loan loss provisions

The global financial system is aware of a probable recession, so defenses have been built. These defenses are usually provisions for loan losses, typically earnings set aside to absorb the loan default damage to the balance sheet.

Our calculation takes the top 100 banks by market cap and shows that current provisions are fast approaching the level set aside during the GFC, which was in fact a real-estate generated financial crisis. We should expect further increases going into 2023.

Savings over disposable income – gross, quarterly

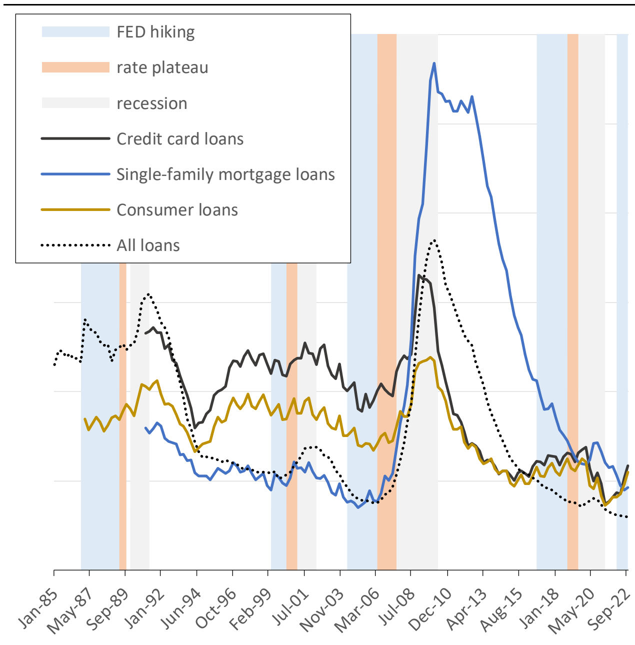


Note: top 100 banks by market cap, all higher than USD 20bn equivalent.
Source: S&P/Experian Consumer Credit Default Index Composite, Index & Cie

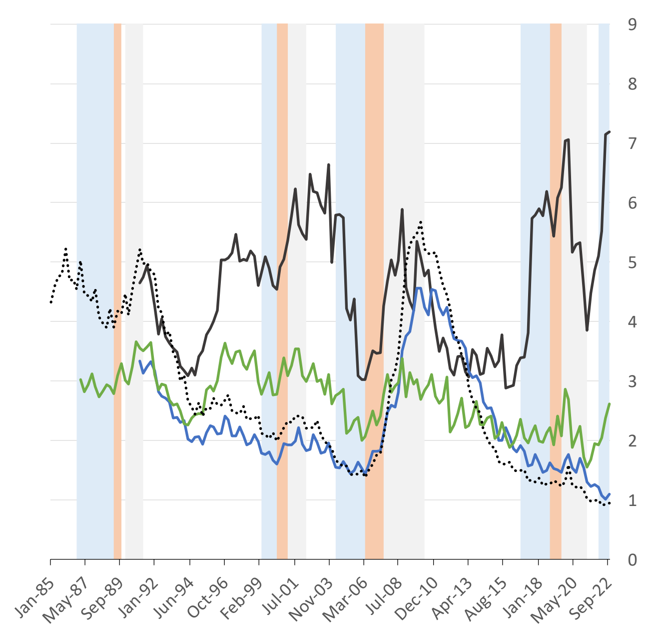
Loan default rates

We worked on two sets of banks: all banks and those outside the top 100 US banks by assets.

All US banks



Banks not among top 100 by assets



Source: Federal Reserve Bank of St. Louis, Economic Research Division, quarterly figures, end of period

When looking at defaults across products for all banks, the situation is nowhere near alarming.

Defaults have only been lower in 2004-2005, years of fat mortgages helped by bubbling real estate prices. While there has been an uptick since June 2021 among consumer, credit card and mortgage default rates, the situation seems quite under control.

Could it be the calm before the storm? While that is possible, the non-top 100 banks' graph gives interesting hints.

For instance, mortgage loans during the GFC did not default en masse among local lenders, as it seems the majority of mortgages were taken from top 100 banks.

In an opposite trend, credit card loan defaults are now higher than they were during GFC, surely a side effect of the consumption encouragement of consumer credit companies (Klarna, Affirm, Apple Pay). It could mean that defaults could rise more on the consumption sector than on the mortgage side. This is not at all surprising, since a mortgage ranks higher than shopping in the pyramid of needs.

Conclusion

This long macroeconomic excursus leaves us with uncertainty on what 2023 will produce.

The doubt is on the significance of cycle inversion. While the US dollar depreciating is great news, the earnings contraction cycle is not. While consumption and job markets are strong, inflation and rates staying higher for longer is not good news.

We believe the next three earnings seasons will show the true extent of the damage to fundamentals.

For the moment, bond and private markets are our favourite targets for yields and entry point.

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