Daily Note

YOUR QUESTIONS ANSWERED

Global Team

- **Are we in a new inflation regime? Is a recession needed to cure inflation?**
- **Where is the Fed put? Will the ECB act to contain peripheral spreads?**
- **How low will China growth be? Have equity valuations cheapened enough?**

In today's note we answer the questions that our clients are asking most frequently. We cover inflation, global growth, the Fed, the ECB and China and conclude by looking at whether the selloff in global equity markets this year has gone far enough for a rebound.

1. Are we in a new inflation regime? (Dario)

Yes. Inflation is set to be higher – and more volatile – in the 2020s. Still, there is no doubt current data are hugely overstating the magnitude of this shift, thanks to the lingering impact of COVID-19 and the Russia-Ukraine war. We expect a new regime in which DM inflation rates threaten to break above 3% per annum rather than return to their pre-COVID tendency to drift below 2% – i.e., around 100-150bp higher on average.

Naturally, this will create a different sort of environment for central banks and global financial markets. Instead of fighting secular stagnation with endless QE and perma-zero interest rates, the authorities will be raising rates into gentle secular reflation. Several forces will drive equilibrium interest rates higher over time: deglobalization, massive investment in green technologies and a growth-friendlier policy mix (more fiscal, less monetary).

Ultimately, the long-term (30- to 40-year) "supercycle" depends on the balance of power between labour and capital, and we see this balance beginning to shift towards workers. At the same time, climate change will make inflation a lot more volatile, owing to both the physical supply disruption associated with more extreme weather and the transition to less reliable/intermittent energy sources.

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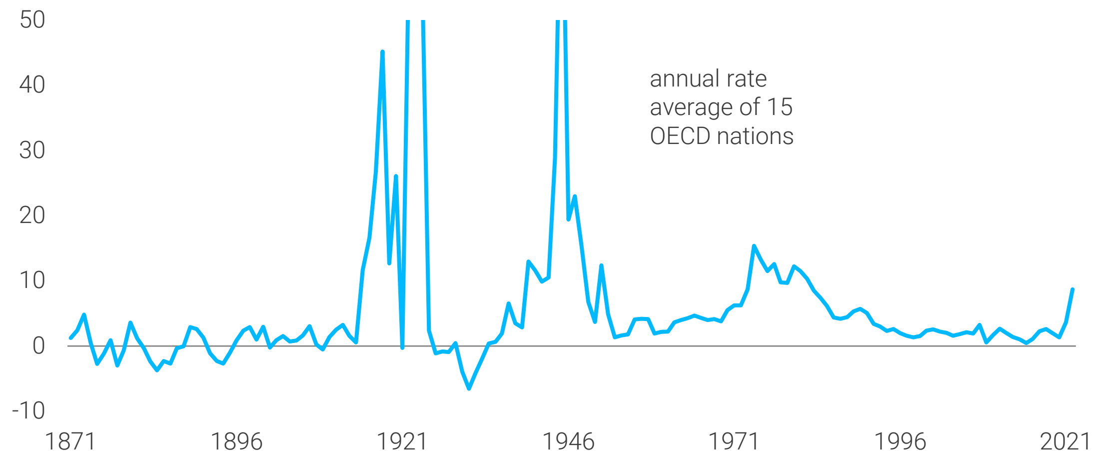
Chart 1: Inflation enters a new regime



Sources: OECD, TS Lombard.

2. Is a recession needed to cure inflation? (Dario)

No. Inflation is likely to decline to levels central banks find tolerable even if there is no recession (i.e., there is still a large "transitory" element to inflation). Nevertheless, we continue to see a period of significant weakness for the global economy over the next few months, thanks to: (i) the ongoing property slump in China; (ii) the stinging squeeze on real incomes in Europe; and (iii) the impact of a rapid tightening in financial conditions in the US. While manufacturing activity could deteriorate sharply, which would compound the current "growth scare" in financial markets, continued resilience in service-sector expenditure and DM labour markets should prevent an outright recession.

Ultimately, the recession question is about whether central banks will eventually need to raise interest rates to overtly contractionary levels in order to prevent overheating in their domestic labour markets. The Fed, in particular, is worried about excess demand for workers, which is pushing up wages and could generate a more sustained inflation overshoot. And, of course, all policymakers are haunted by the ghosts of the 1970s and the danger of a wage-price spiral. But a policy-induced recession is really a question for 2023; and there is a good chance that a soft patch in the global economy could damp central banks' hawkishness, especially when combined with a recovery in labour-force participation.

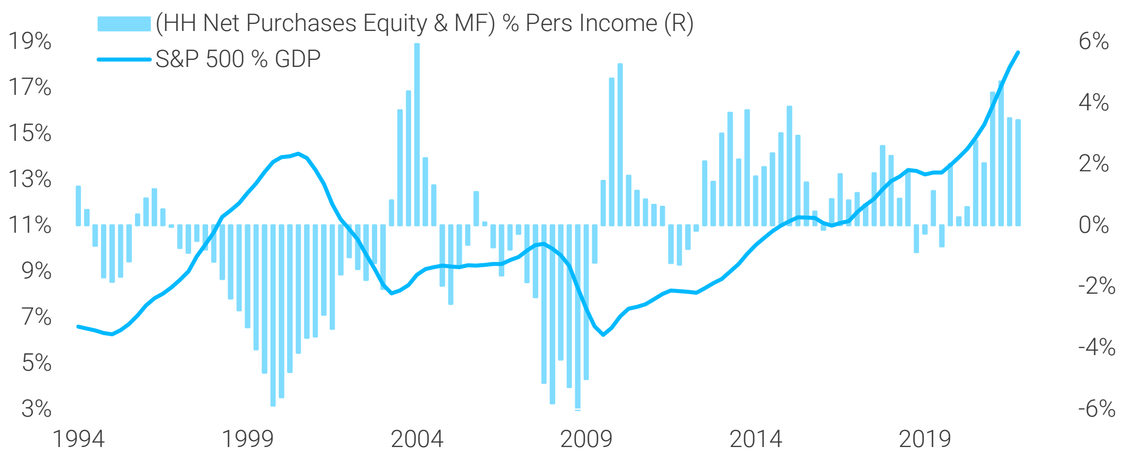
3. Is there still a Fed put and, if so, when will it be triggered? (Steve)

Market participants counted on the Fed put; they did not count on the Fed turning oblivious to their losses. What happened? They got sucker-punched. When the Fed needed net inflows of household cash to buoy equities and create the only inflation available during an extended period of broad deleveraging, the Fed adopted large-scale QE and abetted inflows with an implied put rising along with the market. They turned households, historically net sellers of equities, into net buyers even as the market continued to climb (Chart 2).

Now that the Fed's full-employment-and-low-inflation-forever combo has proved undeniably wrong, the Fed reverses course and undercuts households – deflating markets and allowing prices to drop through the implied strikes. It turns out there was an alternative, after all. The Fed recently offered a "soft put" by telling markets that what is priced in for policy is probably all that is needed, and the pace to get there will soon slow. Do not be fooled. This "soft put" only means they do not want a crash seizing markets (central banks favour devaluations when it suits, but they always want them orderly).

To be clear, it will be economic circumstances (cooler demand, lower inflation), not market levels, that brings the put back into play – and the economy is a long way from where the Fed wants it to be. By late this year or early next year, after assessing the cumulative impact of what they have done, stubborn inflation will move the Fed to hike beyond what is currently priced in and the equity market will likely tumble anew. The economy determines when the put is triggered, but the S&P does help determine the economy. The S&P level that finally gets the Fed's attention is probably around 3,600 –essentially where the index was pre-Covid, relative to GDP.

Chart 2: Fed turned households from net sellers of equity to net buyers



Sources: Federal Reserve, S&P, TS Lombard.

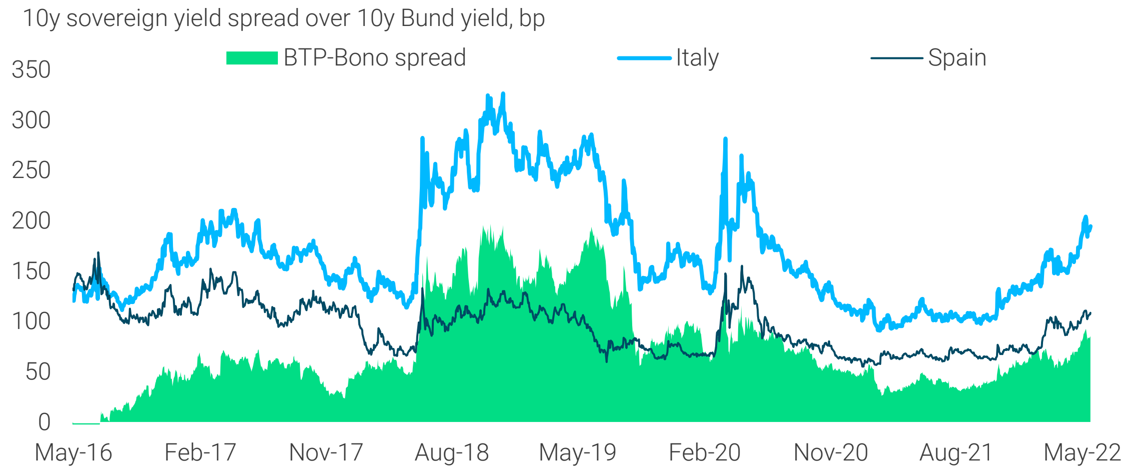
4. Will peripheral spreads blow out? And, if so, how would the ECB react? (Davide)

Wider peripheral spreads were always to be expected when the ECB exited emergency mode while identifying the end of net asset purchases as a precondition for raising rates ("sequencing"). Confronted with a stagflation trifecta and an aggressive Fed, the ECB's elasticity to growth has reduced, as policymakers prioritized supporting EURUSD and putting an end to the negative interest rate policy (NIRP) and QE as soon as possible. As we flagged (see, for example, here and here), the implication is greater tolerance for wider peripheral – i.e., Italian – spreads.

Amid a growth slowdown, still high budgetary needs, spillovers from US monetary tightening and increasing political risks going into the March 2023 general election in Italy, it is not surprising to see the 10y BTP-Bund spread breaking above 200bp. Historically, 200bp has been considered the lower bound of the BTP spread danger zone (200-250bp) triggering ECB intervention. But more bad news on the inflation front and the determination to end NIRP and QE mean the pain threshold for spreads is likely to be closer to 300bp this time, especially if the widening continues to be orderly (i.e., it follows a linear rather than a parabolic trend).

The ECB is said to be working on a "spread-fighting tool" (widely expected to consist of targeted bond purchases), but legal constraints and the hawks' fear of being accused of giving way to "fiscal dominance" imply that the ECB will need an emergency to act. ECB's Müller de facto confirmed this, saying that "the tool should be tailored to a specific situation". We envisage the ECB taking its foot off the brake because of rapidly slowing growth later this year, but momentum suggests clear risks of disorderly periphery markets.

Chart 3: The ECB needs an emergency to get its act together

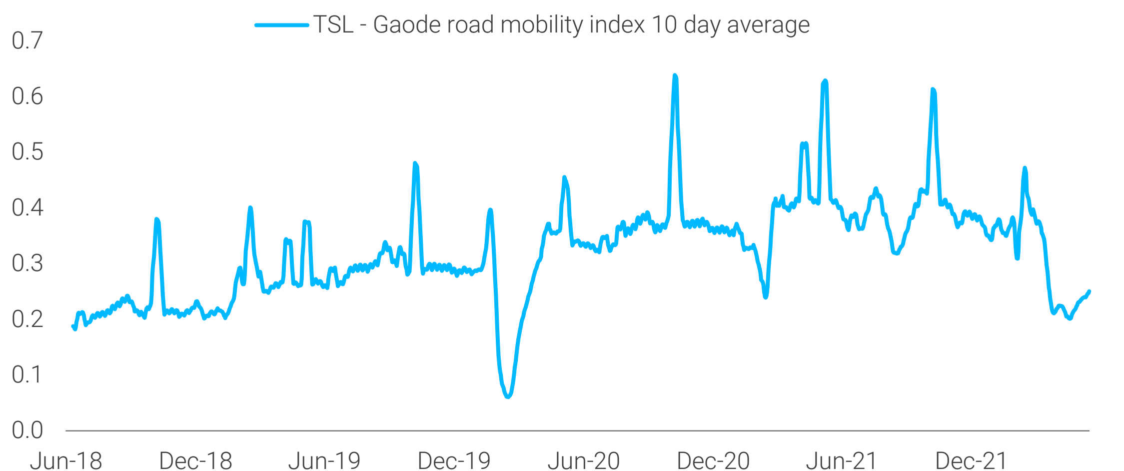


Sources: Datastream, TS Lombard.

5. How low will growth go in China? (Rory)

Beijing is pushing the stimulus accelerator but slamming on the "zero Covid" handbrake. We think growth is what gives and forecast China TSL GDP at 3.3% yoy in 2022 with risks to the downside. Although the current Covid wave has peaked and April is likely to prove the nadir in monthly data, more lockdowns appear inevitable over the next nine months. Healthcare and political constraints mean Beijing is unlikely to alter its "zero Covid" policy this year. A persistent Omicron risk hanging over the economy makes any post-lockdown rebound sluggish. Two years ago China bounced back from the initial outbreak thanks to very strong external demand, a property boom and a relatively less infectious Covid strain. In 2022, diametrically opposite conditions apply. Crucially, although we expect a large infrastructure stimulus and continued monetary easing, "zero Covid" and its impact on mobility, confidence, wage growth and credit demand lowers the multiplier of stimulus efforts (particularly property and credit). China is stuck between "zero Covid" and a desire to prop up economic activity. We think Omicron will take precedence and growth will remain weak.

Chart 4: Lockdown recovery slower than in 2020

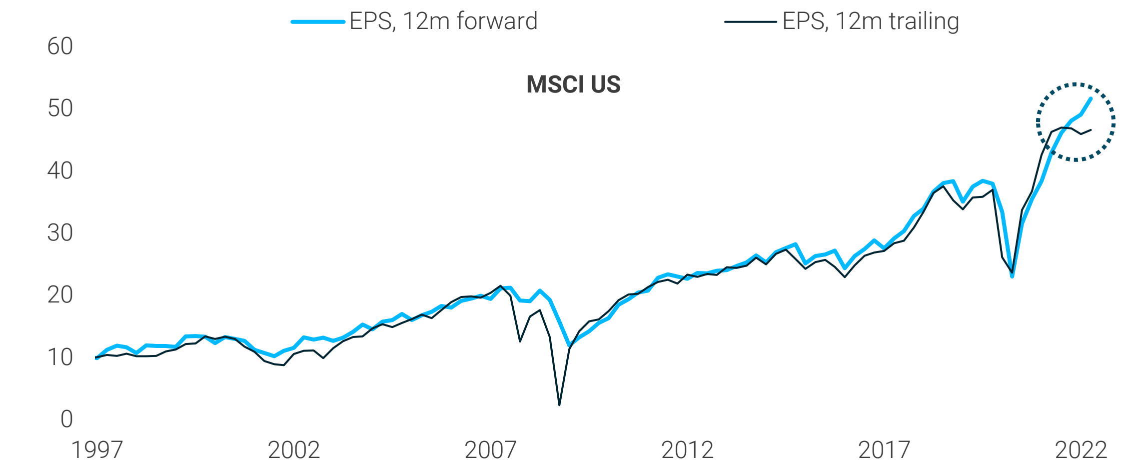


Sources: TSL calculations, GaoDe navigation app data.

6. Have equity valuations cheapened enough? (Andrea)

Our DCF model for the S&P 500 suggests that an increase of 250bp in the cost of debt (roughly the rise in corporate yields in the past 12 months) should be worth only around 13% of decline in the index level – while the market is down more than 18% so far in 2022. However, that is for the cost of debt alone. The cost of equity itself will have risen this year, as investors demand more compensation owing to higher risks. Another increase of 100bp to the required return on equity would cause the WACC to rise by 1¼% in total, which would be worth about 30% of decline for the index. This would suggest there is further downside for equities.

Chart 5: The earnings trajectory, not valuation, is what matters around turning points



Source: Bloomberg, TS Lombard

Ultimately, we believe that valuations are a red herring right now. At possible turning points, investors should pay attention to the earnings trajectory, not to multiples. Back in November 2020, when Covid vaccines were announced, we turned positive on stocks even though we thought equity valuations were still at bubbly levels: the expected earnings recovery was the key metric to watch back then. We would advise doing the same now: even if current valuations were cheap – and it is not obvious that they are – the likelihood of an earnings recession is going to keep equity prices under pressure.