FORSYTH BARR

Macro Weekly

Unintended Consequences

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The price of copper (often referred to as Dr Copper), as measured on the COMEX exchange, suggests the current business cycle peaked in late 2017. This is supported by the yield on German bunds peaking about the same time. While US 10-year Treasury yields continued to rise for a few more months, due to relatively stronger US growth, they subsequently followed global rates lower. Bond markets tend to be the best predictors of global growth. Yields have increased about 25 basis points from the recent cyclical lows, but the rising level of negative interest-rate bearing bonds in the world is telling us that increasing levels of monetary and fiscal support will not generate either inflation or growth.

Draghi rolls back the years

ECB President Draghi, in one of his final acts before his term ends, has set the stage for full implementation of Modern Monetary Theory (MMT), which will delight Socialists all over the world. MMT is designed to induce governments to borrow as much money as they want, due to very low interest rates, and spend it on stimulating their economies. In a comprehensive stimulus package, Draghi lowered the official cash rate a further -10bp to -0.50%, reintroduced the asset purchase programme which will add to the EUR 4.7 trillion already on the ECB balance sheet, and banks were provided support to sustain the transmission mechanism of monetary policy to the real economy. Draghi quoted persistent risks from trade and geopolitics, lower inflation projections, and a wider slowdown in the Euro area economy, as indicated by the manufacturing recession. The renewed asset purchase programme, at EUR 20 billion per month, will continue “as long as necessary”. In other words, Europe is heading down the same path as Japan.

Race to the bottom

The ECB’s actions in restarting quantitative easing (QE) puts a lot more pressure on the Fed to cut rates much more aggressively than currently anticipated (later this week). Ongoing QE in Europe and Japan explains the renewed strength in the USD, and relative weakness in commodity prices. With China responding to the trade war by depreciating its currency but remaining heavily dependent on imported oil, the price of which is now spiking higher, China is becoming even more vulnerable to the current unravelling of globalisation. Inflation has always increased during times of global or regional conflict. Usually, conflict has been accompanied by a spike in commodity prices, raising the cost and decreasing the availability of many consumer items. Saudi Arabia’s war with Yemen and its potential escalation to include Iran, could be a geopolitical flashpoint that has more economic significance than is currently priced in.

Sobering statistics

Governments have become more interventionist over the last few decades and borrowed increasingly large amounts of money, to force-feed growth, or redistribute within society. Yet trend economic growth rates have declined. This now looks to be structural and is reflected in some equity markets. Japanese equities are trading well below their peak in the late 1980’s and the European ESTX 50 PR index remains a long way below its peak seen in Q2 2000.

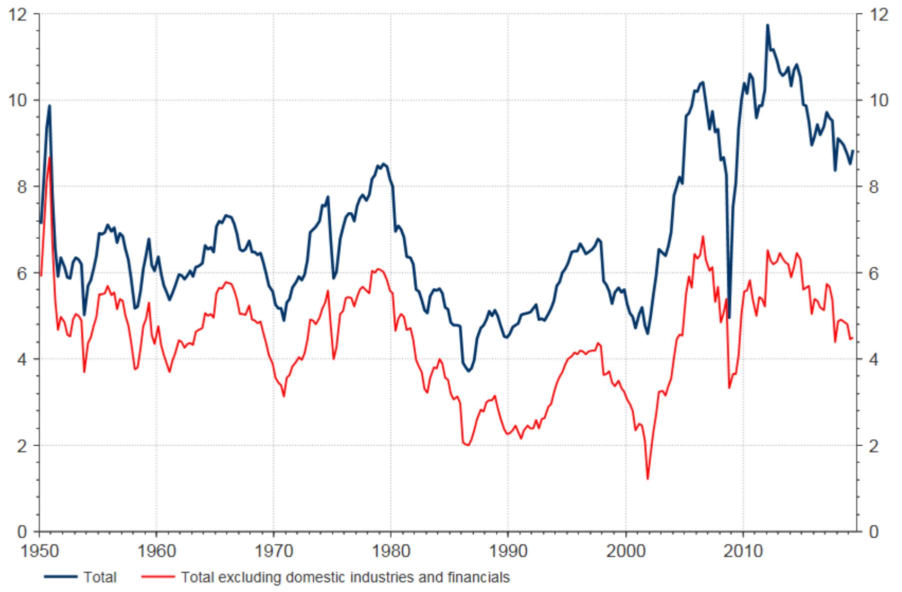
Negative interest rates cripple the savings and pensions industries, and distort capital allocations. Debt levels are rising while incomes are falling. This is the reverse of what a stable and growing economic environment usually indicates.

A reset is needed, which will likely make the next decade much more challenging than the last.

The Valuation Conundrum

Bonds role in equities pricing

Figure 1. US corporate profit margins (%)



Source: Forsyth Barr analysis, Thomson Reuters DataStream

The US equity risk premium (ERP) has widened over the last two decades as firms have paid out an increasing share of free cash flow in dividends and buybacks. Collapsing bond yields have also contributed to a widening of the ERP. Assuming interest rates remain at, or below, current levels, the forward trend in ERPs will be most likely influenced by the growth rate in firms' free cash flows. Over the very long-term these cash flows should converge to the nominal growth rate of the economy.

Profit margins under pressure

Equity markets have outperformed most other asset classes as interest rates have fallen. In a low growth environment, any reversal to low interest rates would therefore be toxic to equity markets. S&P 500 revenue growth has declined over the last year, with analysts expecting a continuation of this trend into the end of 2019. Year-on-year revenue growth by quarter has declined from +9.2% (Q3 2018), +5.4% (Q4 2018), +5.3% (Q1 2019), and +4.0% (Q2 2019). Analysts expect a further reduction to +2.8% in Q3 2019.

US profit margins troughed in the early 1990's and then benefited as globalisation (outsourcing), technology (widespread use of computers) and falling inflation reined in prices and lowered interest rates (debt servicing costs). In the US, periods of quantitative easing following the early 2000's tech bubble crisis and the 2008 GFC resulted in the debasement and devaluation of the USD. This boosted revenues and earnings, particularly for large US multinational companies. The same companies are now decrying the strength of the USD as a headwind to earnings, and a reason why profit margins are under pressure.

Non-US revenues make up ~38% of total S&P 500 sales and are currently the drag on overall market earnings. Without a policy shift to lower the value of the USD, this is likely to be an ongoing headwind for market earnings. The risk to profits is exacerbated if interest rates rise from current low levels.

The bottom line is that the last three downturns in US profit margins preceded corrections in equity markets. The strong USD is a drag on non-US earnings, offset by historically low funding costs. Stronger economic growth will lift earnings. But at the moment, the bond market is refuting the likelihood of a growth or inflation uplift into 2020. This makes the equity market vulnerable to any exogenous shocks, such as a spike in oil prices.