



What falling inflation will mean for markets

Equity markets experienced a mean reversion in July, with H1 2022 losers rallying sharply but H1 2022 winners flatlining. What drove this mean reversion and how long will it last?

In terms of the macro environment, bonds got pretty oversold and yields overbought in early June. This happened just at the point that the economic data started to point to a marked slowdown. For example, the Citi US Economic Surprise Index fell sharply from mid-April to late June as economic data consistently missed forecasts. Oversold bonds and a run of negative surprises on economic data fueled a sharp drop in bond yields. US 10-year yields fell from 3.5% in mid-June to 2.6% in early August.

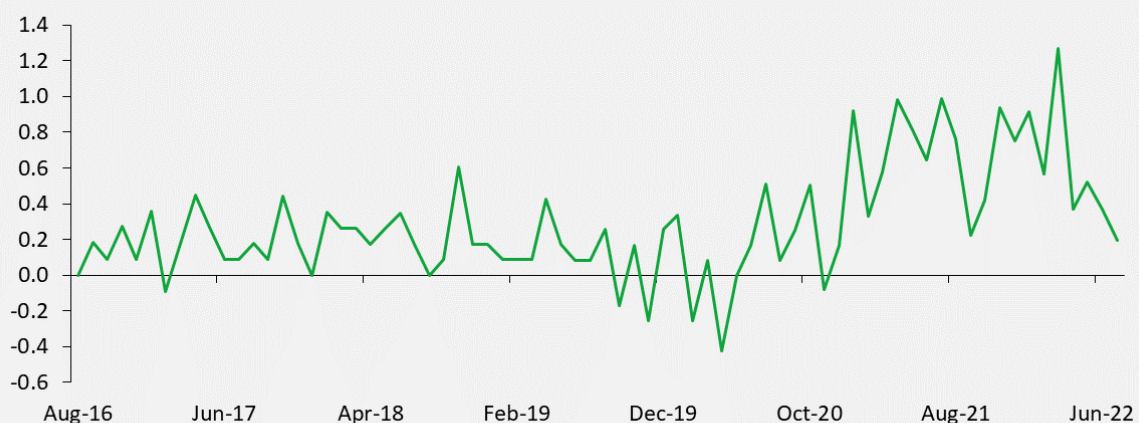
In H1 this year the top 10 winners in the Stoxx 50 rallied 4.1% while the bottom 10 losers dropped 37%. In July 2022, however, the H1 winners only rallied 2.1% while the H1 losers rallied 11.5%, a 9.4% spread. This was mirrored in value versus growth, with value underperforming growth by -6.3% in July.

Our view is that this mean reversion will probably not last very long. The drop in bond yields was the main driver and this was rooted in increased economic pessimism. However, pessimism regarding the economic outlook is now a widely held consensus view. It is also reflected in cross asset performance. There has been a major flight to the dollar, which is at its highest level since 2003, up 19% since June 2021.

Our view is that as inflation starts to fall in the coming months, this will trigger a major turnaround in market performance with a more risk-on flavour. This is because falling inflation will reduce the fear that central banks will have to slam the economy into recession and will lead to a steepening of the yield curve. Our central case is that inflation will come back towards target, enough to get central banks to slow their interest rate increases but not enough for them to cut aggressively.

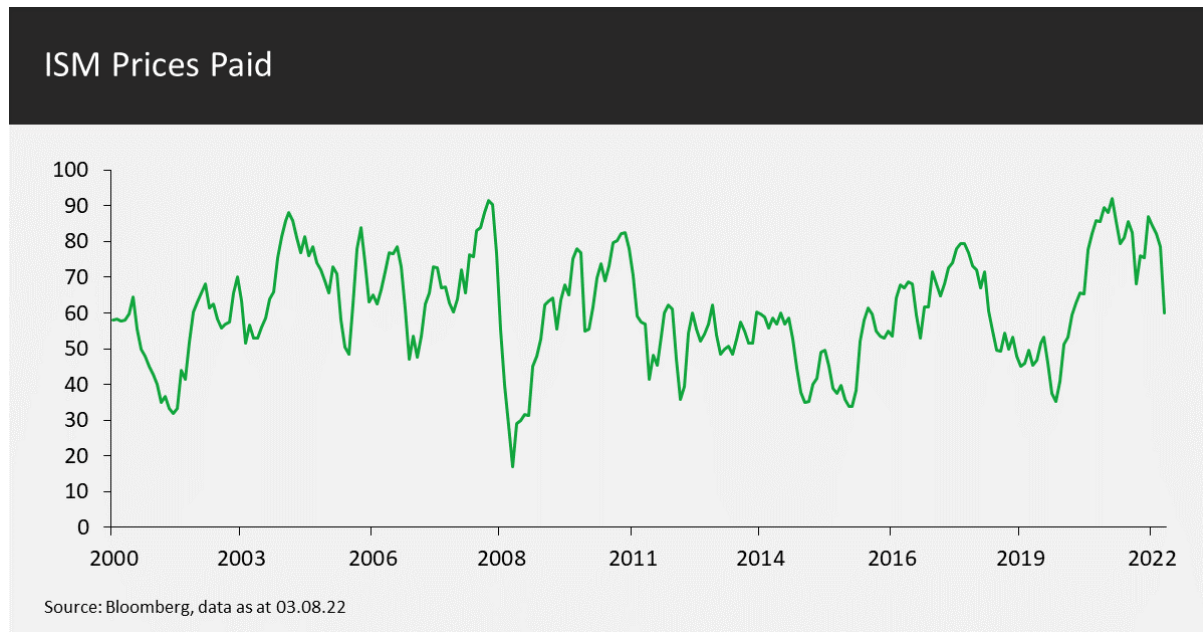
We are seeing particularly encouraging data on inflation. First, US PPI (producer price index) has clearly rolled over. US Core PPI only rose 0.4% month on month in June, which is an annualized rate of just under 5% and while still high is well below the 11-12% annualized rate it was regularly hitting in the last 18 months. The July reading slowed further, to just 0.2% MoM, or 2.4% annualised.

US Core PPI MoM %



Source: Bloomberg, data as at 03.08.22

In addition, the ISM (Institute for Supply Management) prices paid index, which hit a more than 20-year high in mid-2021, has recently fallen sharply.



Finally, wage inflation is being driven by extreme shortages of bodies in the labour market, with vacancies running at twice the number of the unemployed. The Fed has noted that the main route to a soft landing is for companies to cut vacancies but not employment. This is plausible and vacancies have finally started to roll over. There is a chance that vacancies will fall in the coming months, maybe as fast as they rose in 2021, as companies cut hiring in the face of weakening demand. A normalization of labour market demand would be a major positive for inflation.

We think the most likely outcome remains an environment of relatively high inflation and interest rates which should be positive for lower duration cheap stocks. This is not just a pipe dream, it is pretty much what the bond market is starting to price in. At the time of writing, Fed Funds futures contracts assume Fed Funds will hit a peak of 3.4% in Q1 2023 before being cut to 2.4% by the end of 2024 and then rising back to 2.9% in 2026. This is very different to the close to zero rates that prevailed for much of the last decade.

From a longer term technical perspective, three of the major 'value' equity indices - the Stoxx 600, FTSE 100 and Topix - all broke out of their 15 to 20 year trading ranges over the last year, and the recent sell-off looks like the standard retest of this break before a more decisive move higher. It is difficult to overestimate the deleterious effect that more than 20 years of sideways trading has had on investor sentiment towards these three value orientated indices and value stocks in particular.

In July, we trimmed some of the Liontrust GF Tortoise Fund's long defensive positions and added to existing cyclical long positions. This brought the overall beta of the long positions closer to 1.00. The long portfolio remains well balanced, but with a slight cyclical skew: at the end of the month cyclicals were 53% of long positions and defensives 47%.

In general, over the last year, we have been trying to boost the overall revenue growth profile of the long portfolio but at still low multiples, with the median P/E (price/earnings ratio) of the long positions being 11 times. We did not make major changes to the short book, which remains focused on S&P 500 futures.

As a last point, there was a good chart in the Financial Times recently which clearly illustrates just how crazy the start-up market got in 2021. There is a good chance that this signaled the peak in optimism for growth investing. Make deals in haste, repent at leisure.

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