The battle of the titans
Part 2

In Part 2 of The battle of the Titans, we focus on the equity markets and how they are priced given the backdrop of low interest rates, excess liquidity and high public debt at a time when inflation is again spiralling out of control and as the war in Ukraine, which was something we did not foresee in our previous newsletter, continues.

When real life takes over

At the time of our February 2022 Newsletter, the world was quite different.

Now, after almost one month of war between Ukraine and Russia, the financial markets are still trying to determine what it means and where it will lead.

US, EU and other European policies in the crucial areas of defence and energy have changed over the last month in a way nobody expected - and at an unprecedented pace.

Excluding Russia from almost all international transactions and seizing the assets of Russian oligarchs so quickly was something unimaginable only a month ago.

War in Europe on a scale not seen since WW2 has added to the challenges facing central banks. How will inflation develop over the coming 12-24 months and will there be a drastic change in monetary policy in response?

Life has just become a lot more difficult for central bankers.

Should the stock markets be repriced?

If inflation is not as transitory as many central bankers had hoped, what then?

With the war between Ukraine and Russia, it is unlikely that energy prices will retreat to previous levels soon. Gas prices in Europe will most probably remain high for an extended period of time. Furthermore, food prices will also be affected by the war, since Ukraine is one of the world's big breadbaskets.

With inflation rampant in energy and food prices, it is difficult to envisage a scenario in which consumer prices will return to the annual rises of less than 2% that we have experienced over the last 20 years.

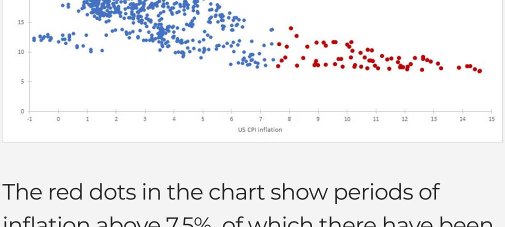
Already now, we know that the Federal Reserve will end quantitative easing as well as raise interest rates. The market is pricing in additional three to five hikes in Fed Funds rates this year. Furthermore, the ECB has also signalled an end to some of its purchase programs as a precursor to raising interest rates in the EU.

Given the combination of high inflation, the end of excess liquidity and looming interest rate hikes, could we see a significant correction in equity markets?

A look at the historical relationship between inflation and the S&P 500 in terms of 12 month trailing P/E might help assess the current pricing in stock markets.

Figure 1, below, illustrates this long-term relationship in the US since 1954. In the chart, inflation is plotted against P/E.

Figure 1 - US CPI inflation vs S&P500 P/E 12 month trailing since 1954



The red dots in the chart show periods of inflation above 7.5%, of which there have been three major ones since 1954:

- The first oil crisis in 1973
- The second oil crisis in 1979
- The current Ukraine-Russia war, with its accompanying oil and gas crisis

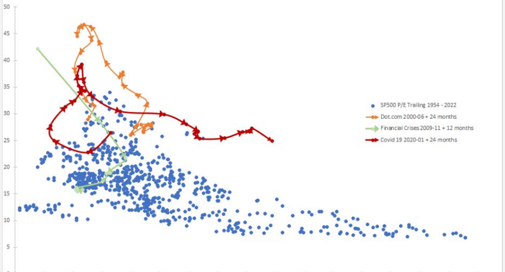
The charts clearly show it is difficult, at least historically, to have high inflation and a high P/E in the S&P 500 simultaneously.

In general terms, the lower inflation is, the more justifiable it is to pay a high P/E when investing in stocks. This is hardly a surprise, since interest rates are typically low when inflation is low.

So, where does this leave the central banks with their current monetary policy?

Figure 2, below, illustrates how the relationship between inflation and the S&P 500's trailing 12-month P/E developed after: the dot.com crisis in 2000; the financial crisis in 2008 (first 12 months omitted); the COVID-19 crisis in 2020.

Figure 2 - US CPI Inflation vs. S&P 500 P/E 12 month trailing – the path of development



During the dot.com crisis (orange line), inflation fell, which allowed the Federal Reserve to lower Fed Funds rates from above 5% to restart the economy; the P/E increased due to falling earnings. However, as soon as the US economy emerged from recession, P/E numbers fell, as earnings recovered and entered into the "normal" area of the relationship between inflation and P/E (as illustrated by the blue dots areas in Figures 1 and 2).

This pattern repeated itself during the financial crisis of 2008-2009 (green line), when inflation fell due to the economic recession and the P/E increased, followed by a recovery in earnings to bring inflation vs P/E into the "normal" blue dot area as the US economy began to grow once more.

The COVID-19 crisis has not followed the normal pattern (red line).

Zero or close-to-zero interest rates and plenty of central bank liquidity have created a new paradigm of high inflation and high P/E numbers (end of the red line in Figure 2).

Currently, we are in a situation where inflation is approaching the levels prevailing during the oil crises of the 1970s, and may perhaps be referred to later as the oil-gas crisis caused by the war in Ukraine. At the same time, the S&P 500 12-month trailing P/E is behaving as if we are in a period with less than 2% inflation.

Where is this leading?

Three scenarios

There is no historical evidence to suggest that the current combination of inflation and S&P 500 12-month trailing P/E will continue. Going forward then, there are several scenarios which investors ought to consider:

Scenario	Likely outcome
Goldilocks	Despite the war in Ukraine, inflation somehow retreats below 2% and the P/E remains at current levels.
Central banks are lucky	The Federal Reserve and the ECB manage to bring inflation down to around 4% by ending purchase programs and raising interest rates, which will bring the S&P 500 P/E down to somewhere between 15 and 20 – a "soft" landing for the equity market.
Oil-gas crisis	Inflation continues to rise due to the war in Ukraine and the central banks are way behind the curve. When inflation hits 10% in the US, the financial markets react by bringing the P/E down to around the 10 level, as was seen during the 1970s. A "hard" landing for equity markets.

Unfortunately, the "Goldilocks" scenario is quite unlikely, especially given the monetary policy adopted by central banks during the COVID-19 crisis. As we are on the "reverse path" of a normal crisis development, it is difficult to see this as a high probability outcome.

For any equity investor, the two latter scenarios are not very appealing, as a very volatile situation may develop depending on changes in monetary policy.

If the "Central banks are lucky", and manage to drain liquidity from the financial system in a smooth and orderly fashion while simultaneously signalling that interest rates will rise to bring down inflation to between 3% and 4%, this will create a path for a "softer" landing for the equity markets and take P/E numbers down to between 15-20, significantly lower than the current level of 25. This scenario would lead to a severe drop in equity prices.

The "Oil-gas crisis" scenario is even less appealing. In this scenario, oil and gas will remain at current levels or rise further if the war in Ukraine is prolonged, creating a significant knock-on effect for food and goods prices.

Wage increases to compensate for the loss of real income will soon follow. The central banks will increase short-term interest rates significantly and quickly send their economies into a recession for a period of time.

This will result in the P/E dropping down to "Oil Crisis 1 & 2" levels, with the trailing S&P 500 P/E at around 10, resulting in a significant fall in equity prices for most markets and sectors.

Not alone

In an article entitled "What goes up" in its edition of 12 February 2022 (p.63), The Economist examines what could happen if the financial market beings to correct and investors stop 'buying the dip' as before:

> *"Instead of retail traders and other investors buying the dip, as has been their habit, markets continue to slide. Moves are big and wild because market-making capacity is reduced. Margin calls go out to a slew of hedge funds, some of which fail to meet them because they are more leveraged than anyone anticipated. Bond and equity funds suffer overwhelming outflows. To meet redemptions, managers sell their most liquid assets, like Treasuries or blue-chip stocks, causing yields to jump and equities to fall further. Retail investors use their brokerage apps to bail out of their investments, too."*

Battle of the Titans

For more than 40 years, central banks have been battling inflation, and with much success.

Now they are battling an insidious cocktail of inflation, low interest rates, excess liquidity, high stock market valuations, mediocre economic growth, rising public debt and an energy crisis caused by the war in Ukraine.

The monetary regime which has been in place for more than 40 years may be coming to an end. Something new will have to replace it, but it will be a lengthy process, just as it was when Paul Volcker began to fight inflation in 1979.

The financial markets will most likely be in a volatile state for many years to come as they react to what has truly become a battle of titan forces.

Quantrom Limited,
59-60 O'Connell Street
Limerick, Ireland
+353 1 513 6215
client@quantrom.com