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Global Equity Strategy

Asset allocation: Downside risks grow

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Equity Research | Global

Link to the report

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Asset Allocation: Downside risks grow

We have been cautious of equities since 10th Feb (see our note). We now along with our house view go underweight equities. Why we are increasingly cautious:

1. **A recession looks inevitable** in Europe and the US, but sticky inflation (i.e. wages) prevents the policy response. Unemployment has to rise above full employment before bear markets trough.

2. **Real money supply will contract.** Given QT, real M1 is now consistent with a recession and further declines in equities.

3. **Fair value implies downside**. The actual ERP is 4.9%, and the warranted has risen to 5.5%. The fair value P/E (driven by TIPS and credit spreads) should be c15.1x on our targets (c11% downside).

4. **Earnings are key.** Downgrade cycles usually last 19 months, and markets trough 6 months before downgrades trough. Our models continue to indicate S&P EPS for end '23 is 15-20% too high - EPS is likely to be closer to $210. Corporates can maintain margins only if PPI inflation is 7%+ in '23, but the Fed is unlikely to allow that.

5. **Credit not pricing in a recession.** High-yield spreads typically get to 8-9%+ versus 5.2-5.3% now.

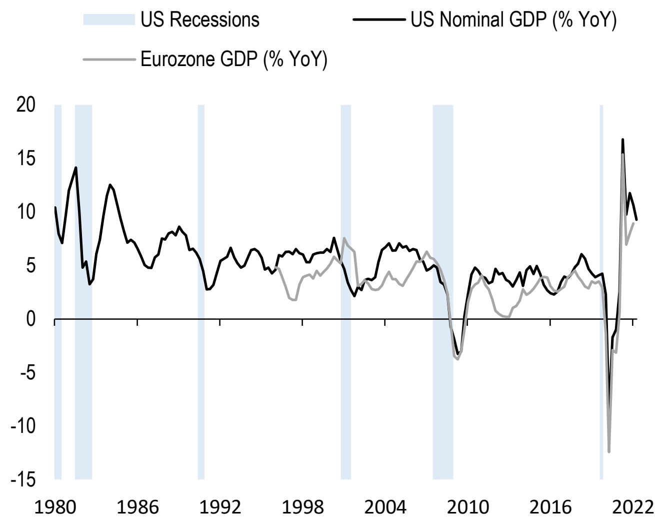
6. **Longer and larger bear market.** Typically down 35% over 14 months; worse if there is a recession.

7. **Tacticals are a bit misleading.** Tactical indicators are depressed but potentially misleading with risk appetite and bull/bear ratios not depressed.

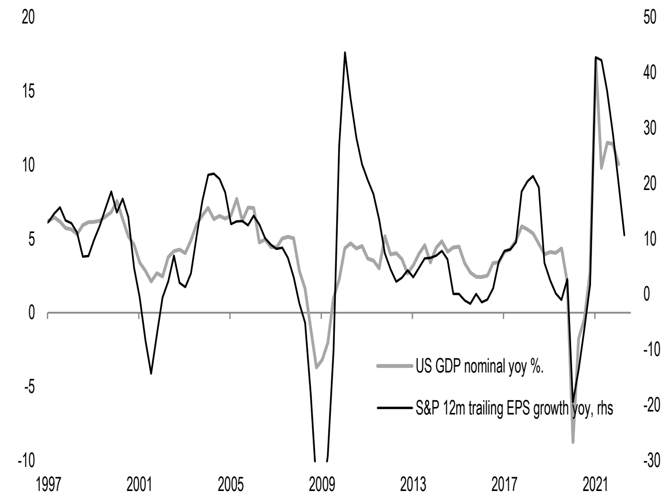
Many indicators suggest markets hit new lows. The risk is that the Fed accepts much higher long-term inflation, causing a big switch into real assets. We think this does not happen until unemployment rises to much higher levels.

Nominal growth is very high: Nominal GDP is very far removed from a recession and this has been a key driver of earnings.

Nominal GDP is 3x that associated with recessions



US EPS tends to move with nominal GDP



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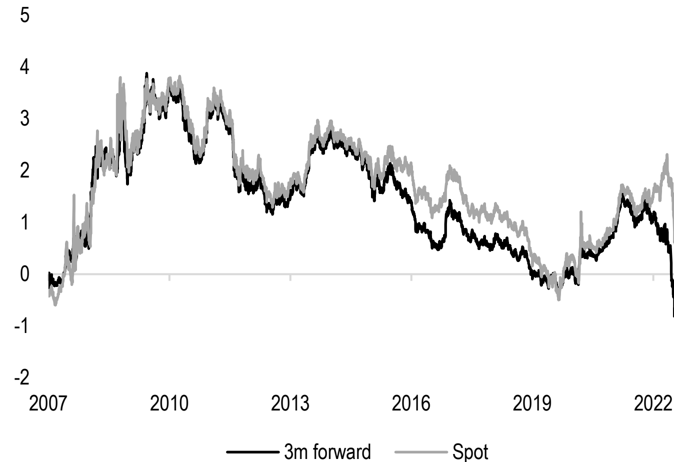
Source: Refinitiv, Credit Suisse research

Concern 1) A recession looks inevitable. Every time the 3m vs. 10yr US yield curve has inverted in the last 55 years we had a recession c10 months later. Q4 yield curve inversion = recession in Q3'23. Lead indicators of US growth are also consistent with a recession (-1.5% GDP growth).

3m forward 3m10y spread inverted in the middle of June



Inversions lead recessions by 10 months on average

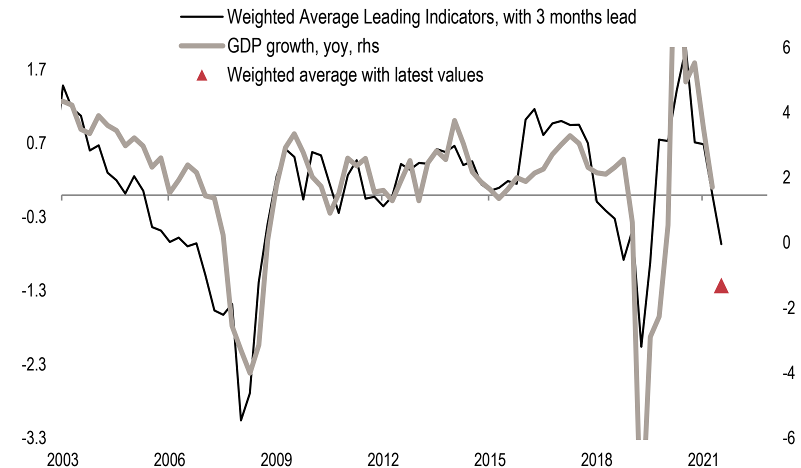
3m10y inversion date	Peak of business cycle	Lead (months)
Sep-66	na	na
Dec-68	Dec-69	11
Jun-73	Nov-73	5
Nov-78	Jan-80	14
Oct-80	Jul-81	8
Jun-89	Jul-90	13
Jun-00	Mar-01	7
Aug-06	Dec-07	16
Jul-19	Feb-20	7
Average		**10.1**
Median		**9.5**

US growth - lead indicators

	Economic indicator	Lead (+) / lag (-) with the cycle	Correlation between indicator and cycle	Z-score (dev from 10-year average)
Leading indicators	US Heavy truck sales	+6 months	0.06	0.14
	ISM manufacturing new orders	+4 months	0.34	-1.29
	Consumer confidence	+3 months	0.52	-1.39
	Core cap goods orders	+3 months	0.29	0.80
	CEO business confidence	+3 months	0.59	-1.76
	Copper price, $/mt, yoy % chg	+3 months	0.18	-0.96
Coincident indicators	US housing starts	+1 months	0.43	-0.48
	Kansas City Fed Labor Market Conditions Indicators	+1 months	0.50	-0.20
Lagging indicators	Employment growth, 3mma	-3 months	0.58	1.03
	NFIB survey (% of firms planning to increase employment)	-6 months	0.42	0.71
	C&I lending intentions survey, inv	-6 months	0.31	1.49
	Weighted average of leading and coincident indicators			-1.23
	Weighted average of lagging indicators			1.03

**latest available data points are shown for all indicators*

Weighted average leading recession indicators imply -1.5% GDP growth



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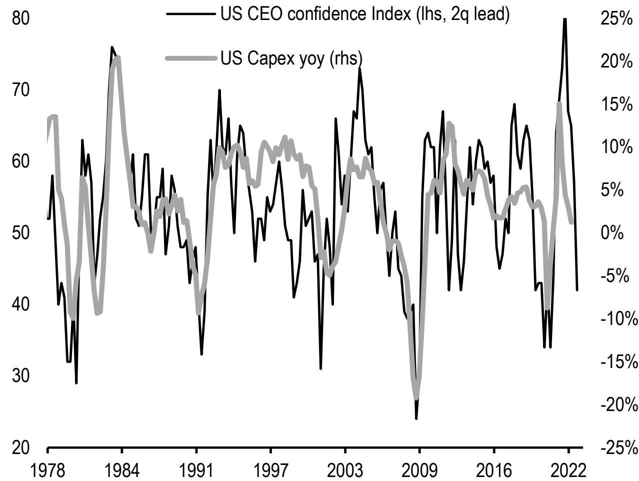
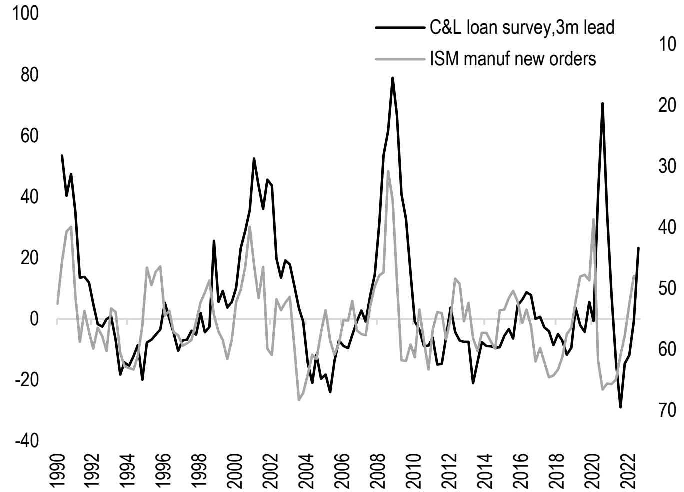
Source: Refinitiv, Credit Suisse research

Other recession signs include: the weakness in CEO business confidence, the tightness of bank lending conditions, the collapse in housing and the rise in excess inventory.

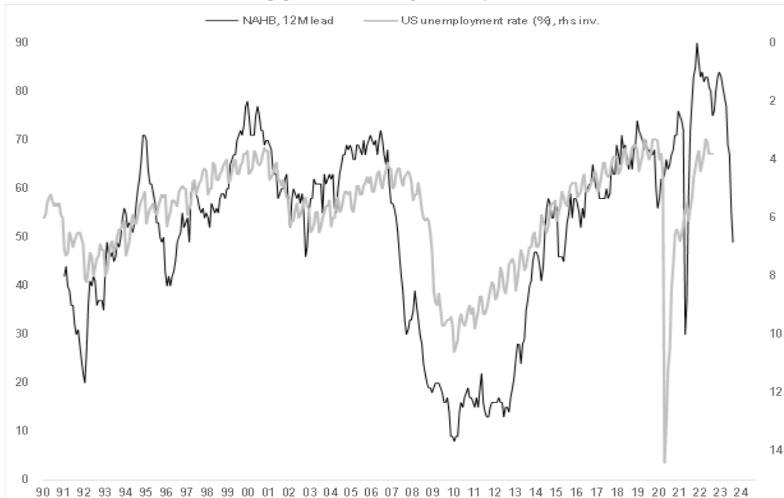
CEO confidence implies a sharp slowdown in capex



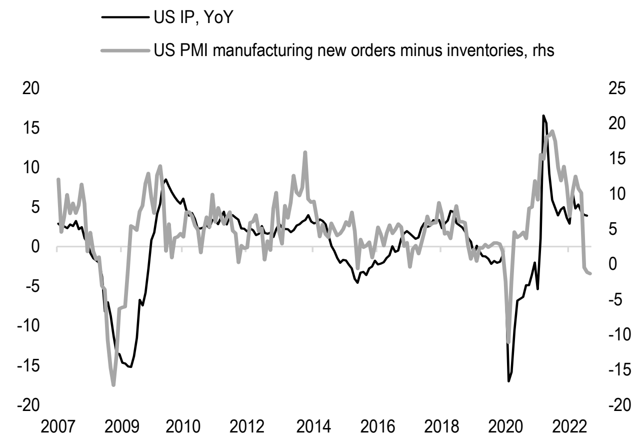
Fed Loan Survey leads ISM by 3 months and implies new orders fall to c42



Houses leads unemployment claims by a year and suggests a very sharp rise

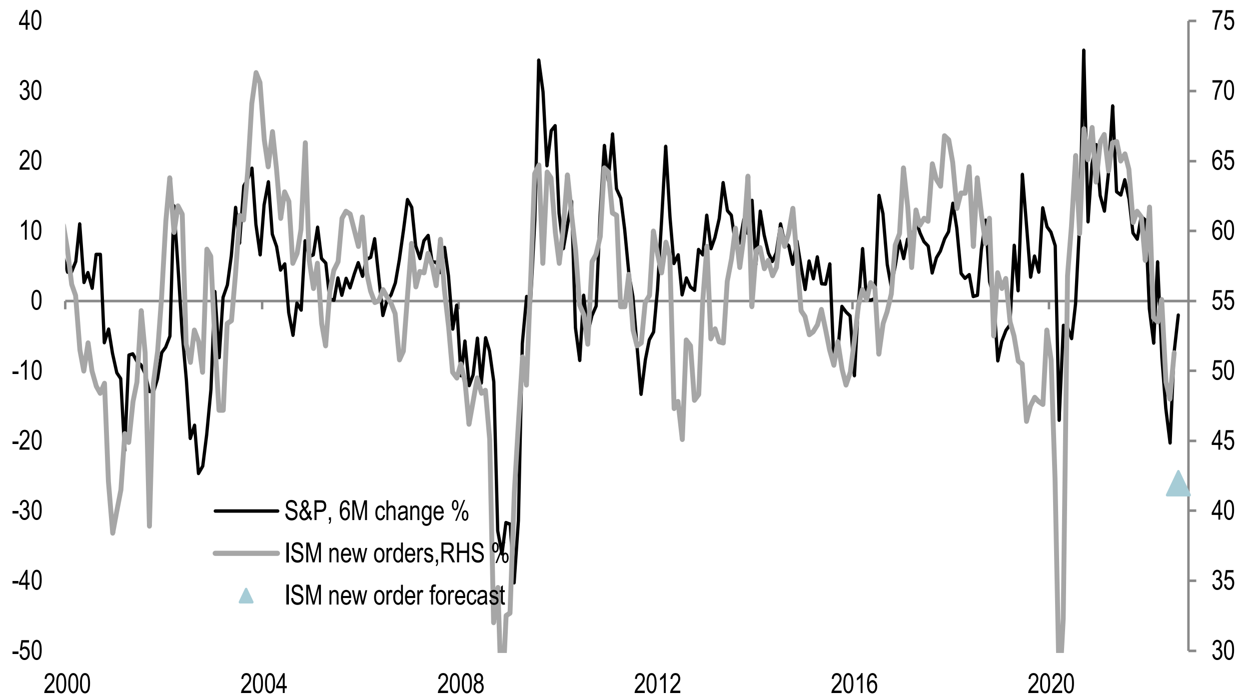


Excess inventories relative to new orders cause a fall in IP



Source: Refinitiv, Credit Suisse research

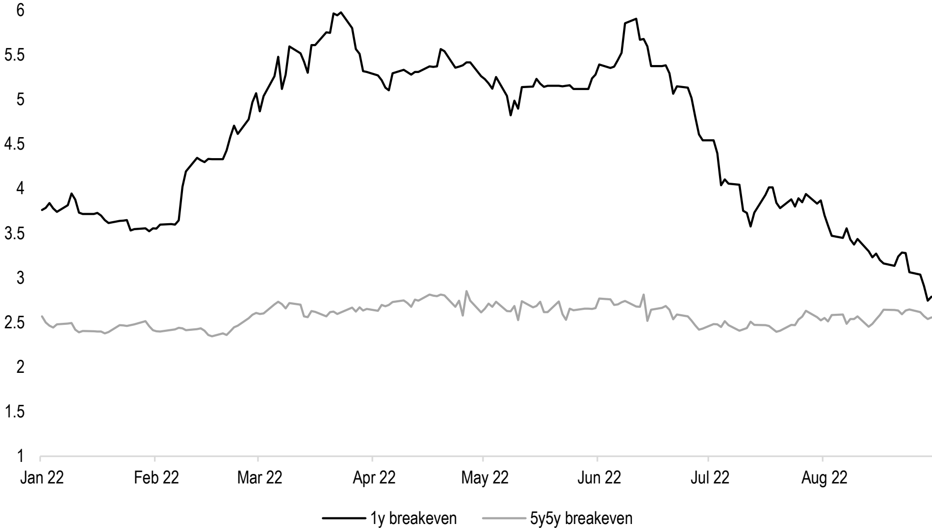
We can see a very close fit between changes in the S&P and changes in ISM. ISM has to be above 55 (2% GDP) for markets to go up. We think ISM new orders potentially falls to the low 40s.



Source: Refinitiv, Credit Suisse research

There is huge hope that inflation falls quickly, with 1 year US breakevens at c2.8% and consensus Q4 '23 inflation forecast at c2.7%. This is too optimistic, in our view.

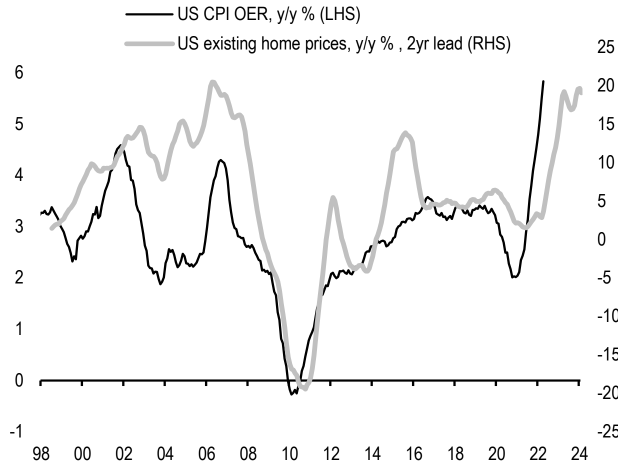
The market is giving the Fed full credibility, even in the short term

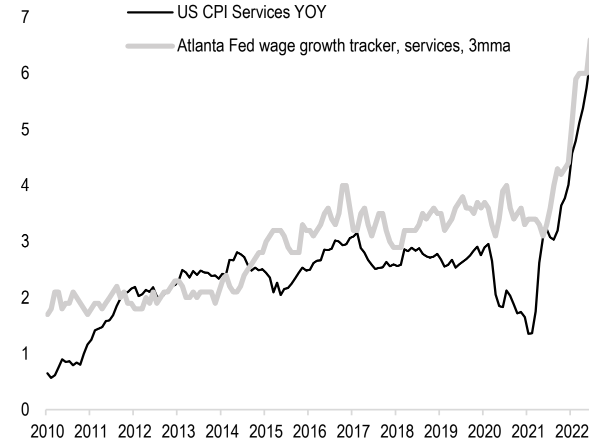


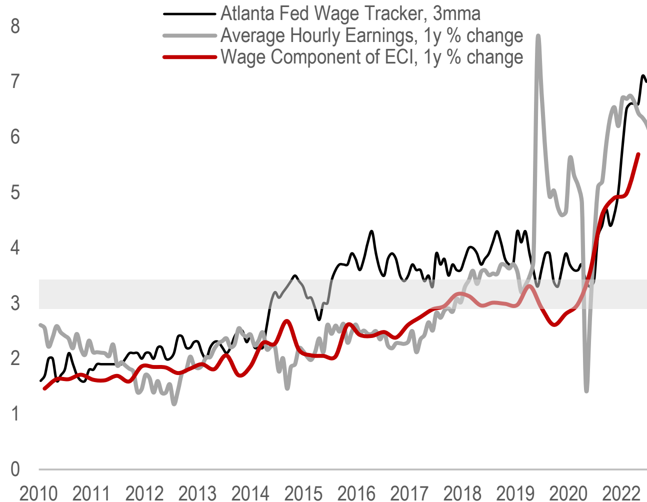
Inflation expectations are too sanguine

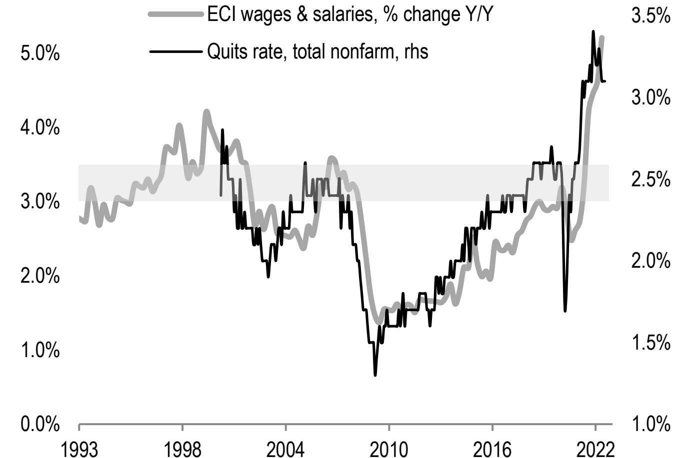
Region	CPI YoY lates t%	Q4 23 consensus forecast %	Difference %
US	8.5	2.7	5.8
Eurozone	9.1	2.2	6.9
UK	10.1	3.1	7.0

The problem is the policy response, as inflation is much stickier. The housing component of inflation (OER) lags houses prices by 2 years. But service inflation is driven by wage growth (wages are 60% of costs) – which has to slow to 3-3.5% and on all measures is now well above. The best lead indicator (quits rate) implies no meaningful decline in wage growth.





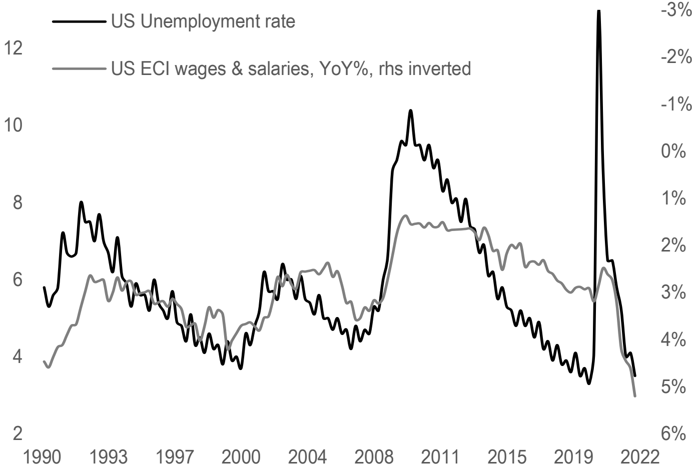




Source: Refinitiv, Credit Suisse research

The usual way to control wage growth is to raise unemployment and normally wage growth responds very quickly to the rise in unemployment.

Falling unemployment should lead to rising wage growth



Normally it takes 3 months of rising unemployment for wage growth to slow

	Unemployment rate	Wage growth at UR trough	Gap to wage growth peak, months	Change in UR 6 months later	Change in wage growth 6 months later
Jun-90	5.20%	4.40%	0	1.00%	-0.80%
Apr-00	3.80%	4.23%	7	0.10%	0.00%
May-07	4.40%	4.20%	1	0.30%	-0.19%
Average	4.47%	4.28%	3	0.47%	-0.33%

Source: Refinitiv, Credit Suisse research

This time around, we think unemployment has to rise to 5% to drive down wage growth to 3-3.5% - because labour has much more pricing power than normal. This means US GDP growth needs to be close to zero for a year.

The reasons wage growth is so sticky:

i. **Immigration in the US** and for that matter globally has fallen sharply (by around two thirds).

i. **Offshoring has been replaced by onshoring** (owing to the threat of tariffs, the wish to localise/diversify to minimise supply chain disruption, reduce the carbon footprint, diminish the threat of cybercrimes as well as China being not as inexpensive as it used to be).

ii. **Minimum wages nearly everywhere rising well above the rate of overall wage growth.** This is because of ESG reasons as well as political.

iii. **The reluctance of corporates to shed workers as quickly as normal** owing to the post pandemic experience of labour shortages.

iv. **Labour has pricing power while the profit share of GDP is very high.** Normally, when labour has pricing power, the profit share of GDP is very low. This in turn means the corporates are liable to acquiesce to higher wage demands.

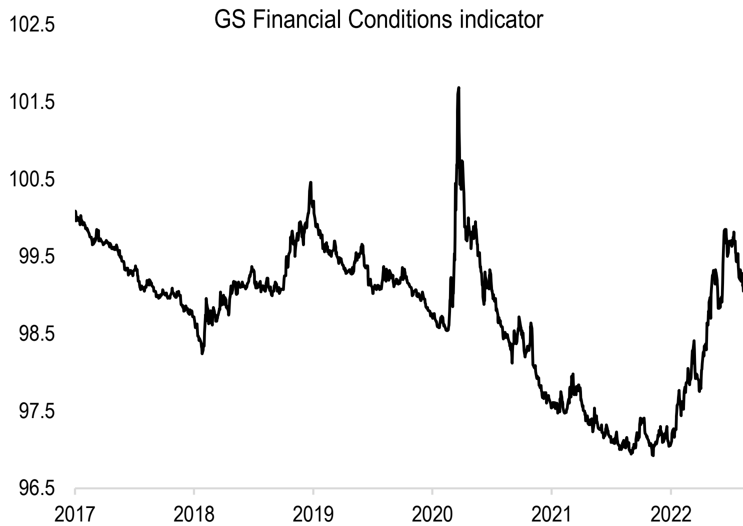
v. **We might also be seeing a return of unionisation** (which is now just 10.3% of the US workforce). There is the highest support for unionization since 1965 according to the BoL (FT June 27th) with the Labor Relations Board receiving a 57% yoy increase in requests for union membership.

vi. **Public sector wage growth has been suppressed relative to private sector wage growth** and there are signs of a catch-up (caused in some instances by increasing strike action by the public sector).

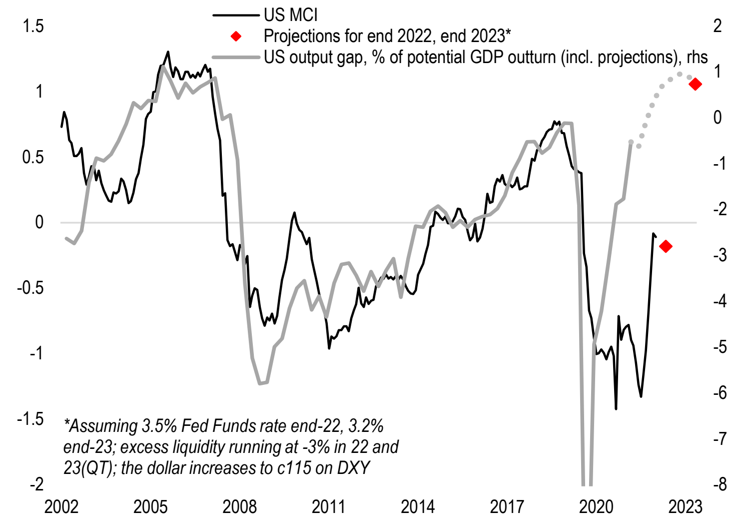
Source: Refinitiv, Credit Suisse research

The Fed cannot afford to pivot when monetary conditions are neutral and financial conditions are neutral. Jackson Hole was clear –'Keeping at it'.

GS Financial conditions index

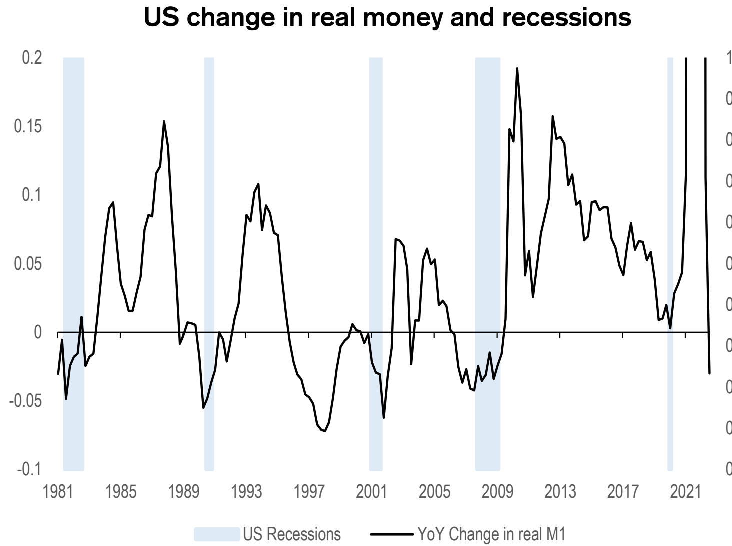


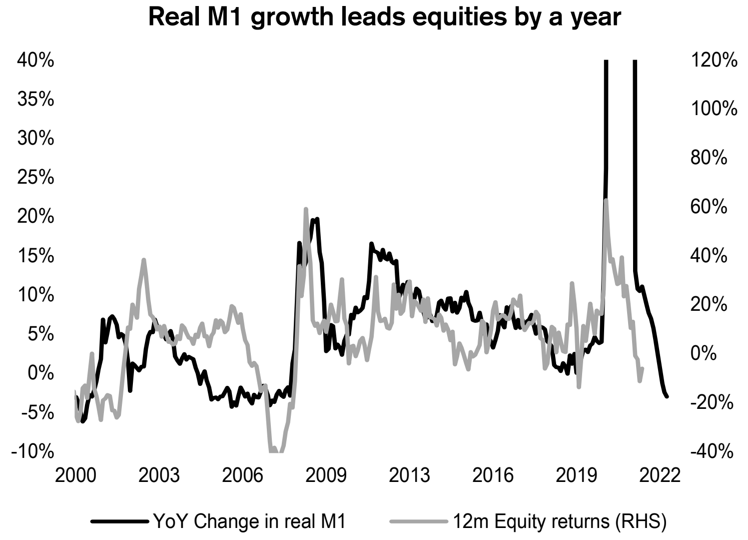
Monetary conditions versus output gap

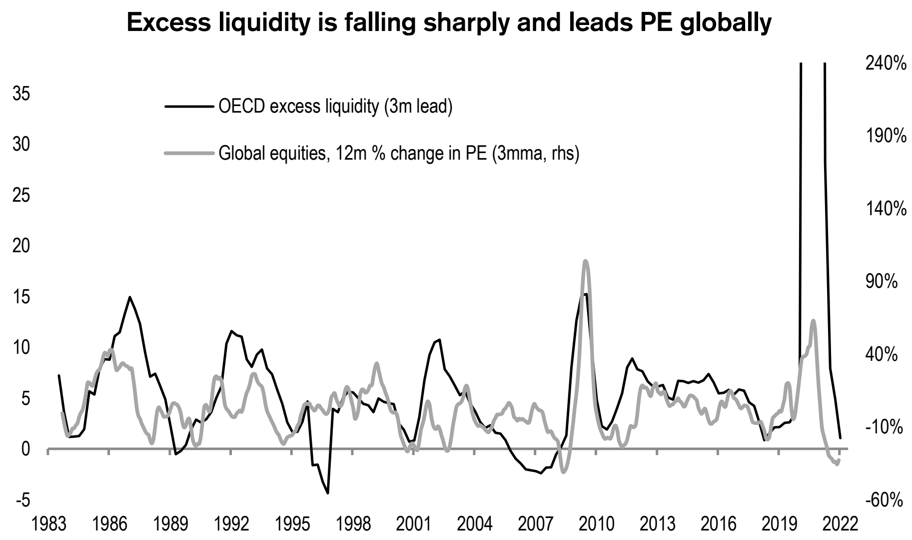


Source: Refinitiv, Credit Suisse research

Concern 2) Real M1 falling. QE is now QT. The Fed only start max QT in September ($95bn a month). The net result is contracting *real* M1 growth which implies a recession and lower markets. Excess liquidity is falling very sharply.

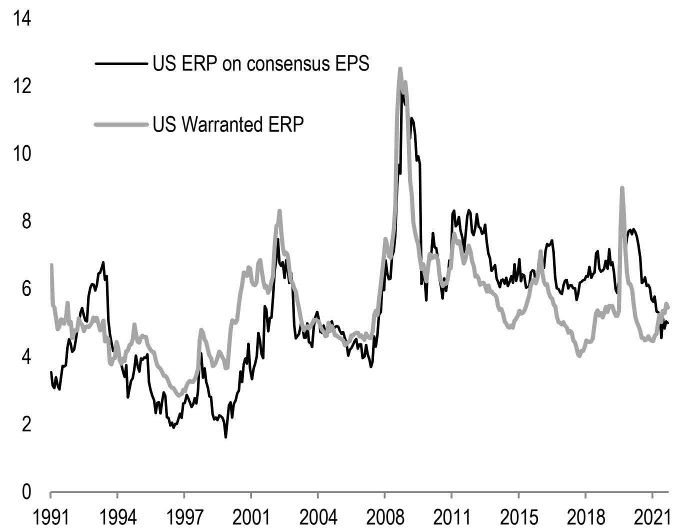






Source: Refinitiv, Credit Suisse research

Concern 3) The equity risk premium at 4.9% is below its average. The warranted ERP (which is based on ISM/PMI and credit spreads) is 5.5%. The ERP has since February given us downside.



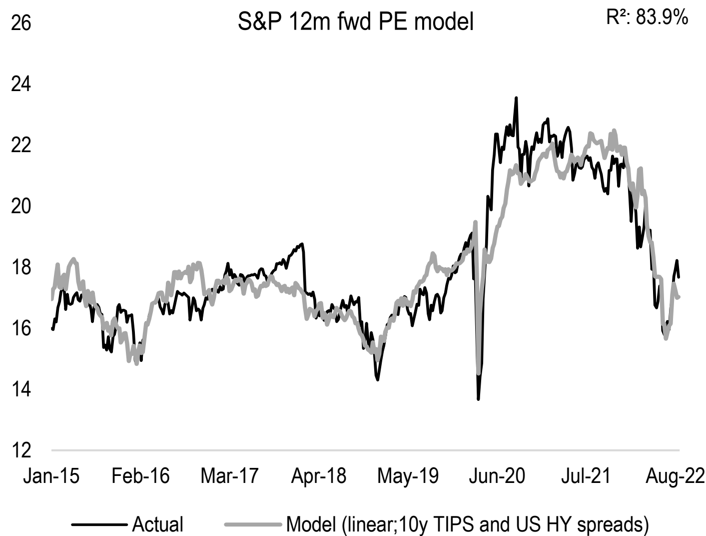
Model details

Model inputs	Coeff.	t-value	Current
US lead indicator - dev. from trend	-28.1	-7.4	0.10%
BAA corp. bond spread	1.3	12.4	2.41
Model output			
US warranted ERP (consensus, operating)			5.48
Current ERP on consensus EPS			4.90
Post-1991 average			5.44
RSQ	0.59		
Intercept	2.42		

Source: Refinitiv, Credit Suisse research

Our fair value P/E model is driven by TIPS and credit spreads. Right now it shows the market is c8% overvalued, but if we put in our targets, it implies fair value of 15.1x (i.e. markets c11% expensive).

On our P/E model, we are now close to fair value…



…showing P/E should not change

12m fwd PE model (2015 to present)

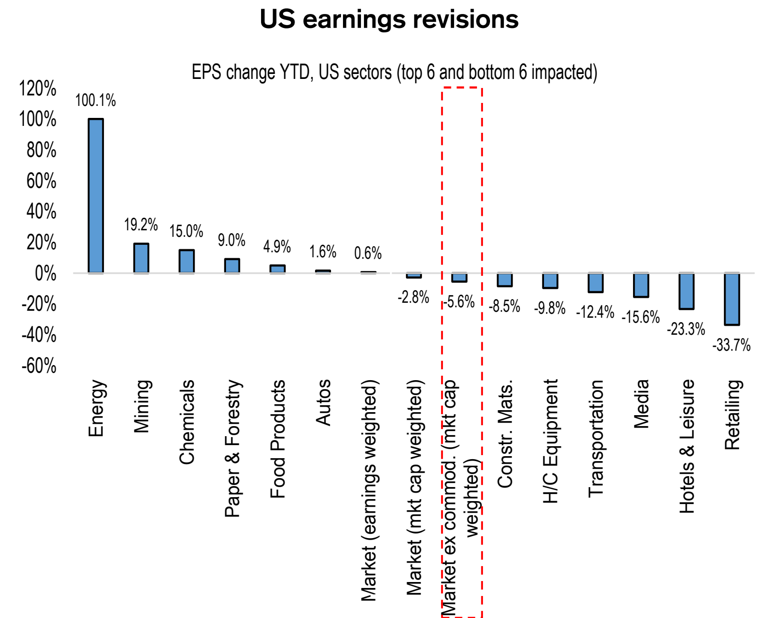
Variable	Coefficient	t-value	Current	Projection
TIPS yield	-2.98	-42.37	0.81	0.81
US HY spreads	-0.47	-12.44	5.4	6.4
		Model	15.6	15.1
Intercept	20.6	Actual	16.9	
R^2	83.9%	Upside	-8.0%	-10.9%

Source: Refinitiv, Credit Suisse research

Concern 4) An earnings downgrade cycle has only just started - they normally last 19 months and the typical time to buy is 6 months before the low.

Global earnings revisions

US earnings revisions



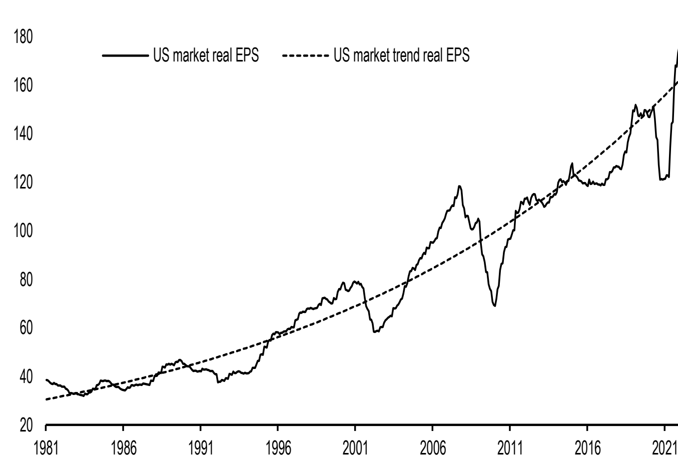
Previous earnings downgrade cycles

Peak to trough changes, S&P 500				
	PE	Price	Fwd EPS	Trough PE
1990 recession	-20.0%	-19.9%	-7.9%	13.8x
2000 recession	-23.1%	-29.7%	-17.8%	15.4x
2008 recession	-39.3%	-54.8%	-38.9%	14.0x
COVID recession	-21.2%	-32.8%	-21.3%	21.8x
Average	-25.9%	-34.3%	-21.5%	16.3x
Current	-28.8%	-23.4%	0.0%	15.8x

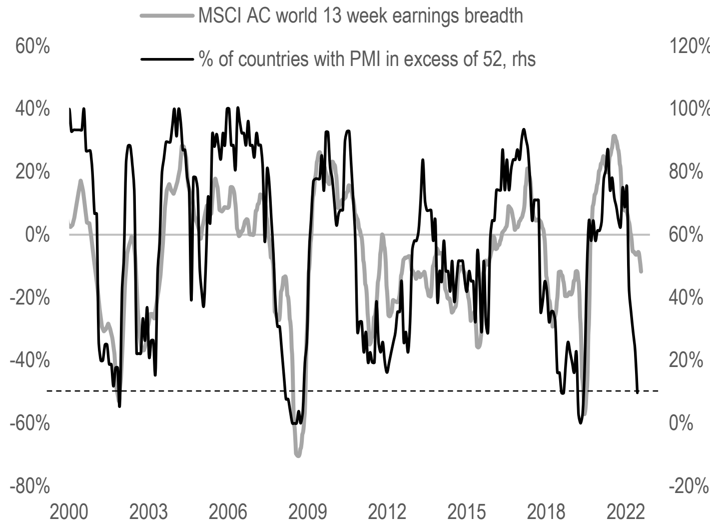
Source: Refinitiv, Credit Suisse research

On a lot of our models, US EPS end '23 needs to be revised down 15-20% (to c$210 EPS vs $239 consensus. PMI breadth is consistent with a sharp fall in earnings breadth which in turn would mean markets falling c15%.

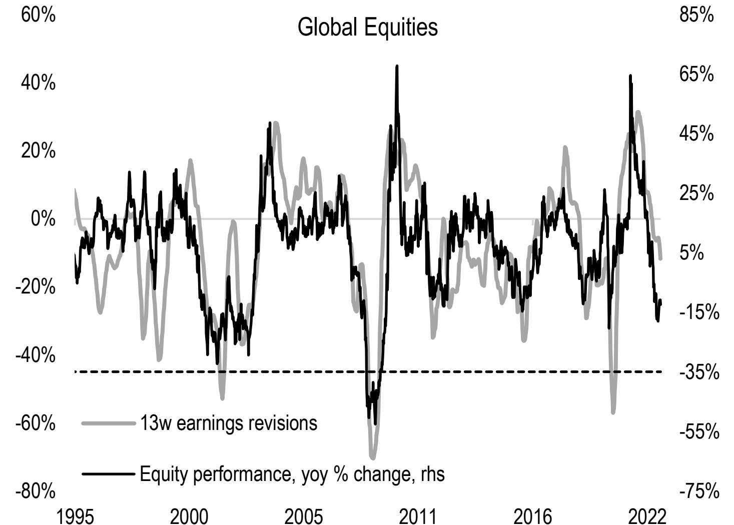
Real EPS would need to decline 10% to return it to trend



Earnings revisions vs PMIs



Global equities performance vs earnings revisions



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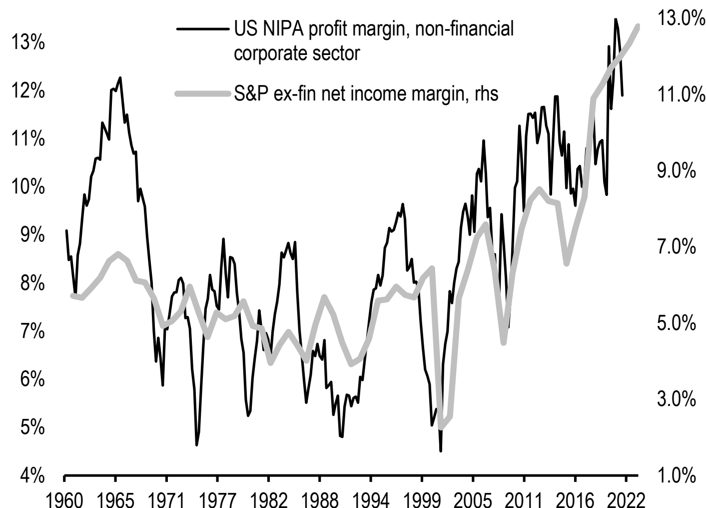
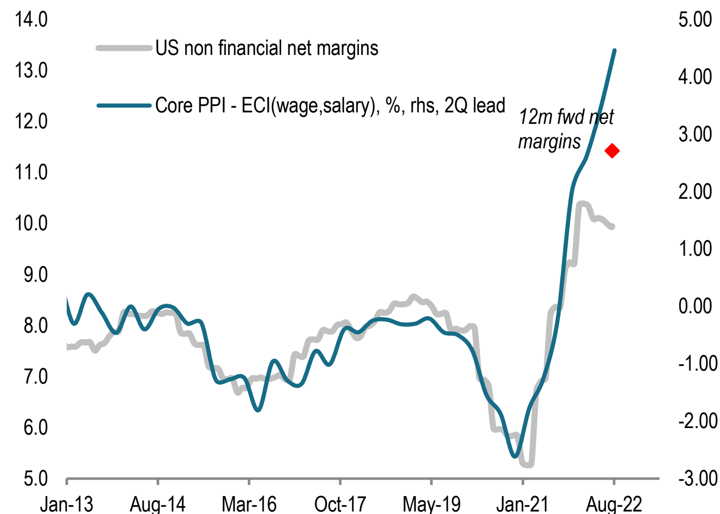
Source: Refinitiv, Credit Suisse research

The problem is that record profit margins can be maintained only if corporate selling prices are well above employment costs, and this requires PPI inflation of c7%+ (currently core PPI is 7.6%). The Fed will not allow this to be the case. Also, nearly 60% of margins improvement have come from tax and rates, which are reversing.

Both the profit share of GDP and profit margin are at all-time highs



Record margins in the last decade have been associated with a gap between PPI and ECI



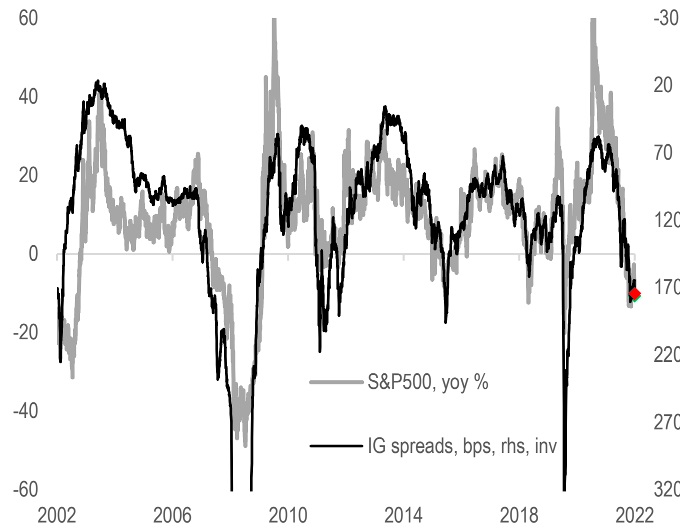
Tax and rates have been the big driver of US margin improvement

US sector margins (Ex Financials & Resources)				
Component	post-1990 avg	Latest Quarter	Ch (% pt)	Contribution to change in net income margin
EBITDA margin	17.3	19.0	1.68	60.3%
Interest	-2.6	-1.9	0.73	26.3%
Depreciation	-5.0	-5.6	-0.54	-19.5%
Tax	-2.9	-1.9	0.93	33.5%
Net profit	6.9	9.6	2.79	

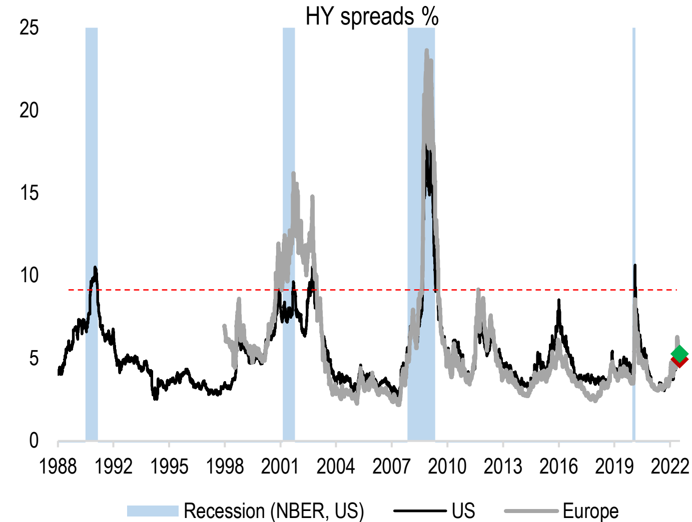
Source: Refinitiv, Credit Suisse research

Concern 5) Credit spreads in a recession have to get to 8-9% over the Treasury versus 5.2-5.3% currently. Credit and equity tend to be joined at the hip.

Credit spreads and equities are very closely correlated



HY spreads are far removed from recession levels



The average HY spread during recession in the US and Europe was at 9.4% and 11.9%, respectively, vs 5.2% and 5.3% now

HY Spread during peak recession			
Date US	**Peak US %**	**Date Euro**	**Peak euro %**
25/01/1991	10.5	02/10/2001	16.2
14/10/2022	10.4	18/12/2008	23.4
17/12/2008	19.8	23/03/2020	8.3
23/03/2020	10.6		
Average	12.8		15.97
Latest	5.2		5.34

Concern 6) Bear markets are usually larger and longer. The normal bear market is 35% over 14 months - worse and longer if there is a recession. Adjusting for inflation makes little difference: down 38% over 14 months.

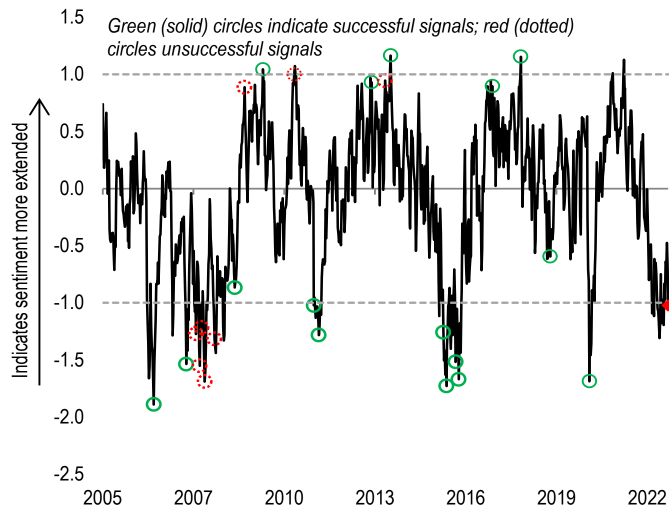
S&P 500 in bear markets and recessions (grey)

S&P bear markets; (r) are bear markets during recessions					
Peak	Peak to Trough (m)	Trough	Peak to Trough Performance	Time to return to Previous Peak	Return to Previous Peak
May-46	11.8	May-47	-28.5%	52.3	Sep-50
Aug-56	14.9	Oct-57	-21.5%	26.1	Sep-58
(r) Dec-61	6.5	Jun-62	-28.0%	21.0	Sep-63
Feb-66	8.0	Oct-66	-22.2%	15.0	May-67
(r) Nov-68	18.1	May-70	-36.1%	39.8	Mar-72
(r) Jan-73	21.0	Oct-74	-48.2%	91.5	Jul-80
(r) Nov-80	20.7	Aug-82	-27.1%	23.5	Nov-82
Aug-87	3.4	Dec-87	-33.5%	23.4	Jul-89
(r) Mar-00	31.0	Oct-02	-49.1%	64.9	Jul-05
(r) Oct-07	17.2	Mar-09	-56.8%	66.1	Mar-13
(r) Feb-20	1.1	Mar-20	-33.9%	6.0	Aug-20
Average	14.0		-35.0%	42.3	
Median	14.9		-33.5%	32.9	
(r) Average	16.5		-39.9%	56.6	
(r) Median	18.1		-36.1%	64.9	
03-Jan-22		Local trough	-23.6%	Current perf.	-17.5%

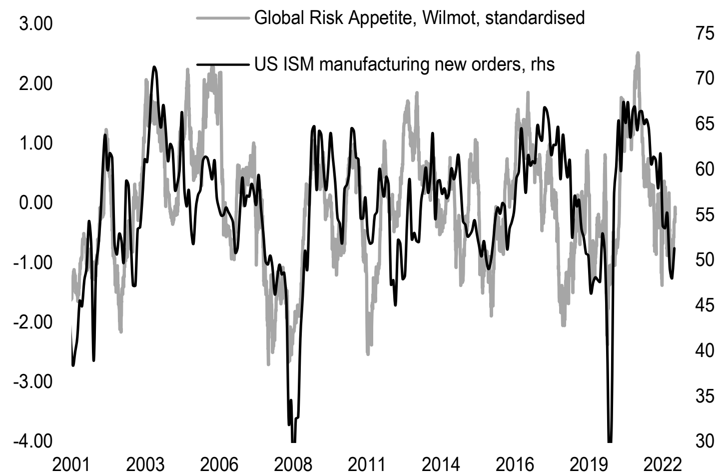
Source: Refinitiv, Credit Suisse research

Concern 7) The tactical indicators are depressed but potentially misleading. Risk appetite is only at neutral levels (consistent with ISM of 55 or 2% GDP growth). Bull/bear ratios are also less depressed.

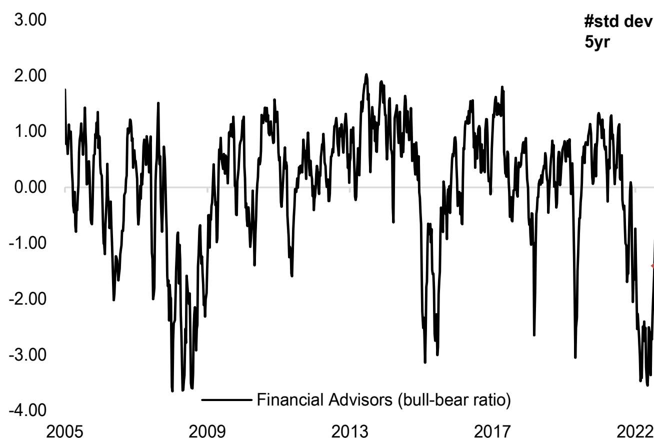
Aggregate tacticals are not at a buy level



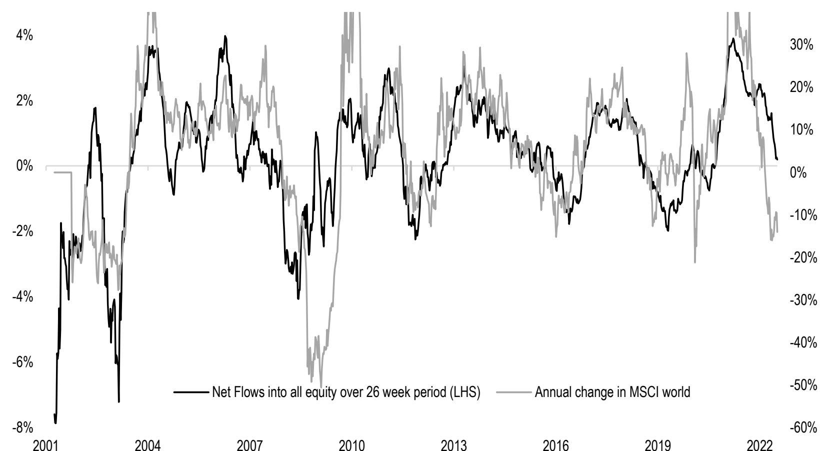
Global risk appetite has picked up and is now consistent with 55 ISM



Bull/bear ratios now look less depressed



Flows are holding up despite performance



Source: Refinitiv, Credit Suisse research

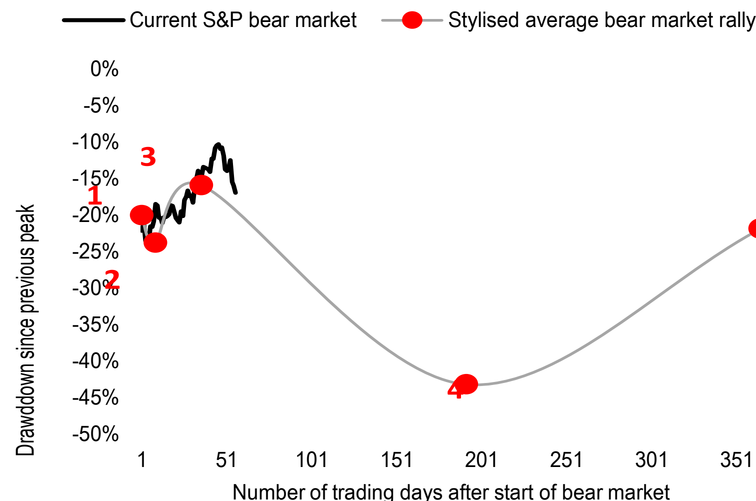
Bear-market rallies tend to stop at just below their 200-day MA (S&P 500 4,280). This happened again.

Performance of historical bear market rallies (from 200-day MA)

Start of Bear Market (only those with a bear market rally)	First Trough (marker 2)		Rally Peak (marker 3)		Second Trough (marker 4)	
	Distance from 200dma at trough	No. days	Distance from 200dma at peak	No. days	Distance from 200dma at trough	No. days
29/01/1970	-11%	2	-3% (8% from trough)	45	-23%	84
27/11/1973	-14%	7	-2% (12% from trough)	77	-28%	223
22/02/1982	-13%	11	0% (13% from trough)	57	-11%	124
12/03/2001	-19%	18	-1% (18% from trough)	51	-27%	357
09/07/2008	-13%	5	-4% (9% from trough)	37	-40%	97
Average:	**-14%**	**9**	**-2%**	**53**	**-26%**	**177**

S&P 500 current bear market vs historical average

Comparison against bear-market rallies only



Source: Refinitiv, Credit Suisse research

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