INTUITION
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When Wall Street Sneezes…

One of the oldest adages in investment markets goes something like this: "When Wall Street sneezes, the rest of the world catches cold." It implies that not only is the US the centre of the investment universe, but also that trends there get amplified as they reverberate to other regions. This certainly feels like the case at the moment. US markets are incredibly volatile as they react to each and very data release and news item. This week, we will explain, through seven charts, some of the key issues facing the US and their implications for investors elsewhere.

Michael Porter

One of the key benefits of travel is its ability to broaden one's horizons and appreciate other cultures. Americans are generally exceptionally friendly and welcoming people, but one is often left with the impression that they believe the US to be the centre of the World. Unfortunately, when it comes to investment markets, they are actually right! This is encapsuled beautifully in the old adage above, but why is this so? Firstly, because US markets are just so big relative to others. Combined, the NYSE and Nasdaq account for 46% of global equity market capitalization, meaning that all other exchanges worldwide (those across Europe, Asia, Latin America and Africa) combined only account for the remaining 54%. The US is so dominant that trends there tend to be exported quickly. Secondly, US interest rates form the anchor point on which all other interest rates are calculated. Bond yields across the world are based on the US rate, plus an adjustment for extra currency and sovereign risk. So, whilst the US might seem a million miles away, what happens in their financial markets is important to us all. This article examines a few key issues through seven informative charts.

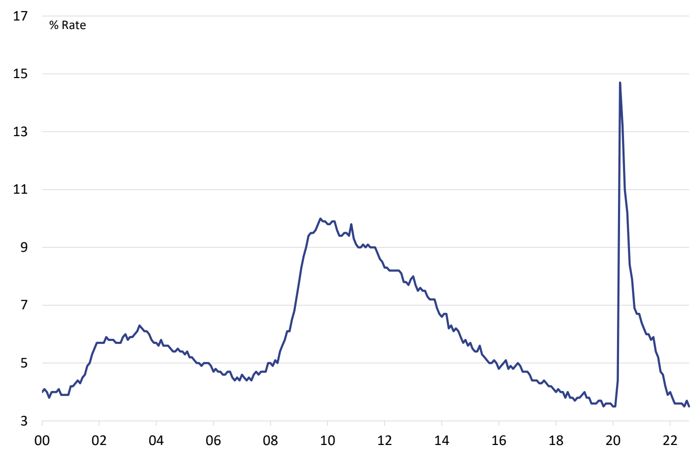
SPEED READ

- US employment remains extremely robust, with the unemployment rate at a record low.
- That in turn is fuelling higher inflation and consequently higher interest rates. Interest rates have not been raised this quickly in the last 40 years.
- Higher interest rates and risk aversion have sent investors scurrying for the safety of the US Dollar. It is at its strongest level in twenty years.
- Higher interest rates are also manifesting themselves in the real economy – for example in housing and savings.
- Markets fear that a recession is coming, so valuations (and by implication, markets) are under pressure.

Employment

The starting point for my analysis is the US Unemployment Rate. After the Covid-induced surge, unemployment has now reached its lowest level – at 3.5% - since 1968. Clients will be familiar with terms like the Great Resignation that has occurred over the past 18 months. This is evident from the Labour Participation Rate (the proportion of the working population available to work) which has dropped from 63.4% before Covid to 62.2% now. Essentially, the US has a shortage of workers, which is pushing up wage inflation. However, there are a few cracks – the number of new jobs created every month is still positive but declining, and retrenchments are on the rise. A weaker labour market would certainly ease the pressure facing the Federal Reserve.

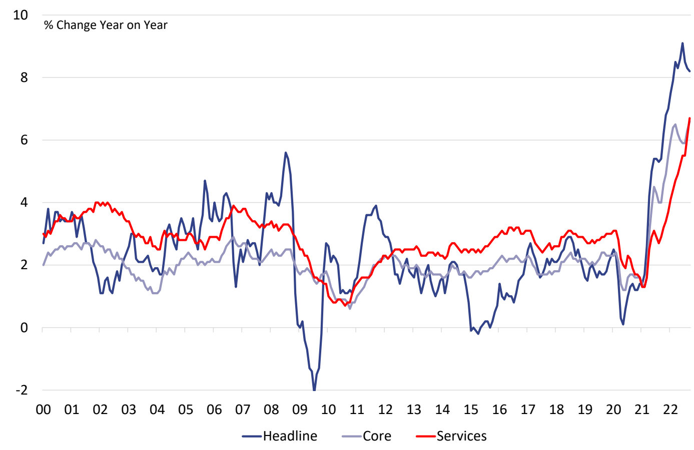
US UNEMPLOYMENT RATE



Inflation

Initially, the rise in inflation was sparked by excessive demand and limited supply – due to the supply chain disruptions caused by lockdowns around the world – and exacerbated by rising commodity prices. Fuel (excuse the pun) was added to the fire post the invasion of Ukraine, as oil prices shot through the roof. Despite China's "Zero Covid" policy and the implications that it is still having on selected supply chains, there is ample evidence that goods inflation is receding, as is inflation due to excessive energy prices. This is evident from the rollover of headline inflation. But core inflation (which excludes food and energy) and services inflation continue to trend higher, which is of concern. There must be moderation in these trends before interest rates will stabilize.

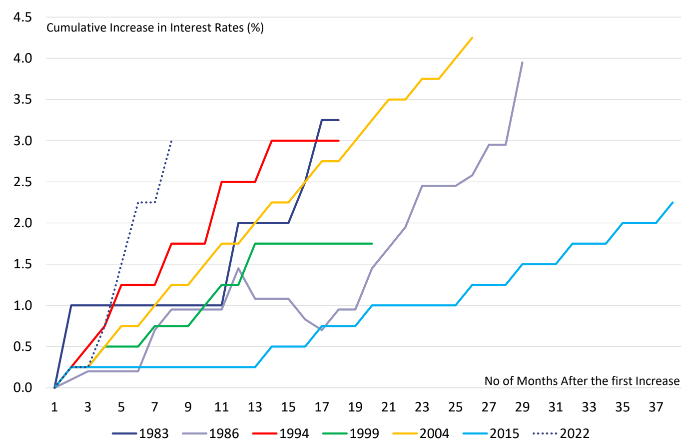
US CPI INFLATION



Interest Rates

The combination of a tight labour market and rising inflation has forced the Federal Reserve's hand. Initially slow to act, the Federal Reserve is now trying to ensure that is seen to be "ahead of the curve." The result has been an aggressive increase in interest rates – the most aggressive since the early 1980s. So far, US rates have risen by 3% in just 8 months. They are forecast to rise another 1.5% - 2% over the next four months. The last time rates rose by anything like this quantum was in 2004, when they rose from 1% to 5.25%, but it took 26 months. This upcycle will see a larger cumulative increase in less than half the time. Higher interest rates are feeding through to US bond yields – the 10-year bond is now at 4%, vs just 0.5% in July 2020.

PACE OF CUMULATIVE US RATE INCREASES



The Dollar

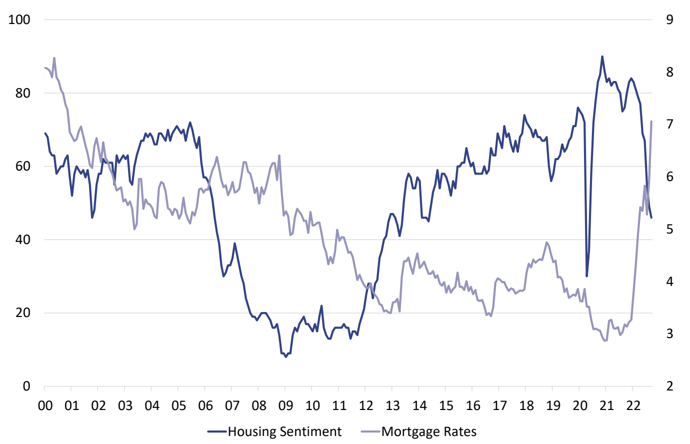
Having earned virtually no interest on cash balances across developed markets since the GFC, higher interest rates and a rise in risk aversion has sent investors scurrying for the safety of the US Dollar. The Dollar has always been viewed as a safe haven in times of stress and this time is no different. But currencies are a see-saw – strength on one side implies weakness on the other. As the Dollar has strengthened, all other currencies have come under pressure – some more than others. In order to limit currency weakness, central banks have been selling their holdings of US treasuries and repatriating the funds. This is occurring at the same time as the Federal Reserve is selling down its own treasury holdings that were accumulated due to quantitative easing. This is putting further upward pressure on US bond yields.

US DOLLAR INDEX

The Housing Market

Higher bond yields are feeding through to the real economy. Mortgage rates have soared. During Covid, the interest rate on a 30-year mortgage loan reached a low of under 2.9% - attractive in anyone's language. Now rates have breached 7%, pushing monthly repayments through the roof and making housing significantly more unaffordable for new buyers. Consequently, sentiment in the housing market has plunged to the lowest level since 2014 (apart from brief impact of Covid.) Housing is an important industry and sector for the US economy. It is a large employer and homes are a key element of the wealth effect. Falling property prices tend to make consumers much more cautious, which can exacerbate an already-slowing economy.

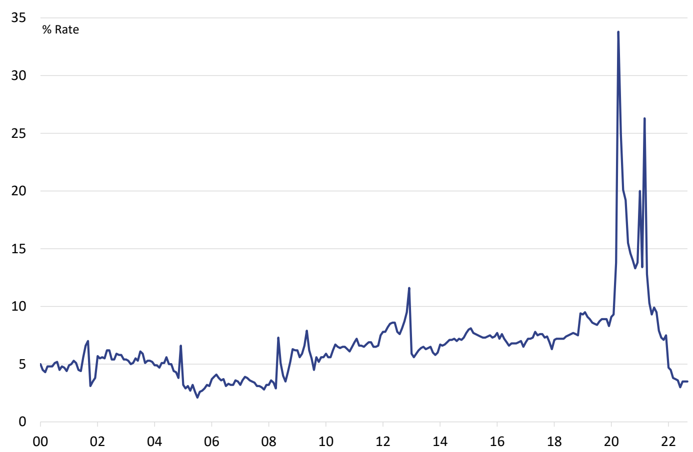
HOUSING SENTIMENT VS MORTGAGE RATES



Household Savings

Remember the savings glut? During Covid, Americans were showered with money as the government tried to encourage spending to prevent a recession. The result was a savings glut, and subsequent consumption boom as consumers rushed to spend money given to them for free. Unfortunately, those excess savings are a thing of the past. Far from normalizing, the savings rate has gone the other way, plunging to the lowest level since August 2008. It is true that Americans are still working, and employment is strong, so a collapse in consumer spending is unlikely. But Americans don't have much to fall back on if times do in fact get a bit tougher. More moderate levels of spending are visible in vehicles sales, amongst other things.

SAVINGS AS % OF DISPOSABLE INCOME



US Valuations

Taken together, higher inflation, rising interest rates, and concern about future consumer spending are weighing heavily on market valuations. Valuations for US stocks peaked in March 2021 at a PE Ratio of 32x. Today valuations are 17.6x, below the average of 19.6x that has prevailed since 2000. Fueled by the technology sector, there was no doubt that US stocks got expensive during the exuberance of Covid. That has now gone. Valuations are far more realistic. This chart is a sharp contrast to the situation in SA, where valuations peaked in January 2017 at 23.5x and now trade at just over 10x – almost a record low. Yet despite the protection that low valuations should offer, our market and shares continue to resemble flotsam on the global tide. Events in the US ripple out across the waves and we have little control over day-to-day movements. At some point, conditions in the US will stabilize – hopefully in Q1 2023 – at which point the value apparent on the JSE will be hard to ignore.

S&P 500 PE RATIO

The world and financial markets have lurched from one crisis to the next over the past few years.

Will 2023 be any different?

Join us as we look ahead to what the new year may hold.

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Topic: **The World in 2023**

Natal Midlands	
Date:	24th of November 2022
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg	
Date:	6th of December 2022
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am

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