May 1, 2022

CIO Strategy Bulletin

AS FARES AMAZON[1], SO FARES THE ECONOMY

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SUMMARY

- **Amazon[1] shares got crushed Friday. The company reported a 3% year-over-year drop in its online stores segment, including products and digital media. Flat sales, product inflation, a national labor shortage, higher wages and supply-chain disruptions crushed Amazon's earnings and its Q2 outlook**
- **This week, the US reported a 1.4% annualized contraction in real GDP for the first quarter of 2022, its first decline since 2Q 2020. Many are dismissing this 2022 "surprise" decline in GDP as an aberration. We are not. It is consistent with Amazon's results.**
- **In our RESILIENT scenario, the current employment and income recovery can possibly outlast macro policy tightening in the US and other economies. A reduction of inflation over the next 18 months without a recession would require a major shift at the Fed so that its tightening is neither rapid nor extreme. Central banks should understand that war-driven shortages don't signal lasting, excess demand for final goods and services.**
- **As markets see the Fed tightening into an economic slowdown, they are rationally pricing a greater risk of recession. There is still time for the Fed to recognize the economy's slowing momentum.**
- **With today's lower valuations and this eventual recognition, we would expect both the equity and bond market to find more stability as 2022 progresses. We also believe that when investors see that we have peak interest rates, a recovery in growth stocks may occur.**
- **Our special section on China covers the unusual economic consequences of its ineffective zero-Covid policies.**

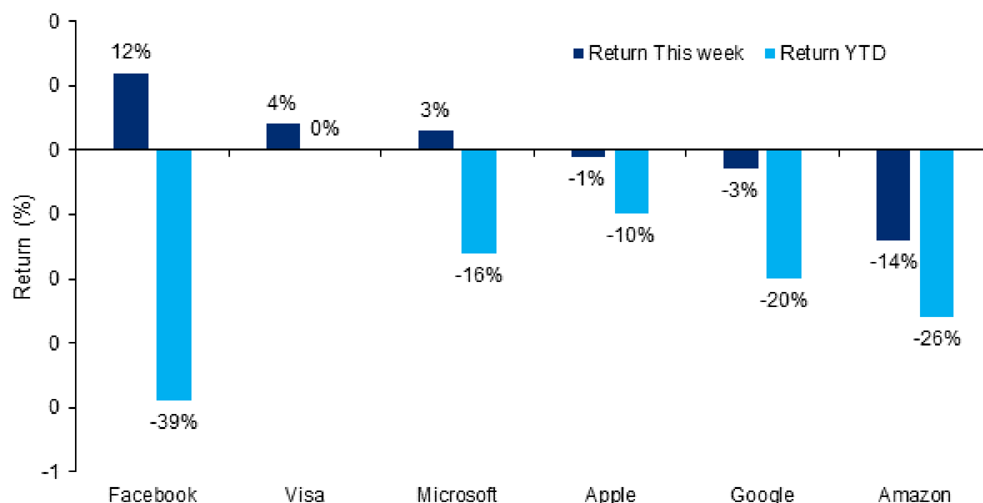
1 For illustrative purposes only. This should not be construed as an offer of or recommendation of the company discussed.

AS FARES AMAZON[1], SO FARES THE ECONOMY

Amazon shares tumbled 14% Friday and have fallen 27% year to date. Amazon reported a 3% year-over-year drop in its online stores segment, including products and digital media. In fact, the amount of products sold by Amazon was about even in 2022Q1 versus 2021Q1. Its losses in the quarter reflected the cumulative impact of flat sales, product inflation, a national labor shortage, higher wages and supply-chain disruptions. All this as US Census data showed March was the second slowest month for online retail spending since 2009.

US, European, Chinese and Japanese equity markets have all posted double-digit losses in the year-to-date, with global equities off 13% so far in 2022. Suffering under the pressure of higher interest rates and slowing sales growth, most technology stalwarts that carried portfolios ever higher in 2020-21 have retreated even more (see figure 1).

Figure 1: Notable earnings of Nasdaq Industry Leaders[2] ending April 29, 2022



Source: Bloomberg and Haver Analytics as of April 30

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All Eyes on the Fed

Earnings season and the results of the leading tech players highlights the markets singular focus on the Fed. The inflation that was ignited by COVID and inflamed by the economic effects of a major war in Eastern Europe is not the type of inflation easily mitigated by monetary policy. Yet, the Fed will become ever more important in deciding whether there is a soft landing for the global economy (our RESILIENT scenario) or a RECESSION, induced deliberately or not, to "fight inflation."

The fact that markets are down in 2022 after just one Fed rate hike reminds us, in an odd way, of 2018. At that time, the Fed had already raised rates nine times and had already reduced its bond market lending by $600 billion to drain liquidity. The S&P had fallen by as much as 20% in Q4. And then the Fed reversed course. This time, it looks like markets have begun anticipating all of the Fed's actions, including the need for it to reverse course sooner than expected to avoid a recession – a recession that the market is now beginning to price in even before it occurs.

The Consensus on Growth and Inflation is Wrong

This week, the US reported a 1.4% annualized **contraction** in real GDP for the first quarter of 2022, its first decline since 2Q 2020. You will undoubtedly remember that in April 2020 the world shuttered economies to attempt, in vain, to stem the spread of Covid.

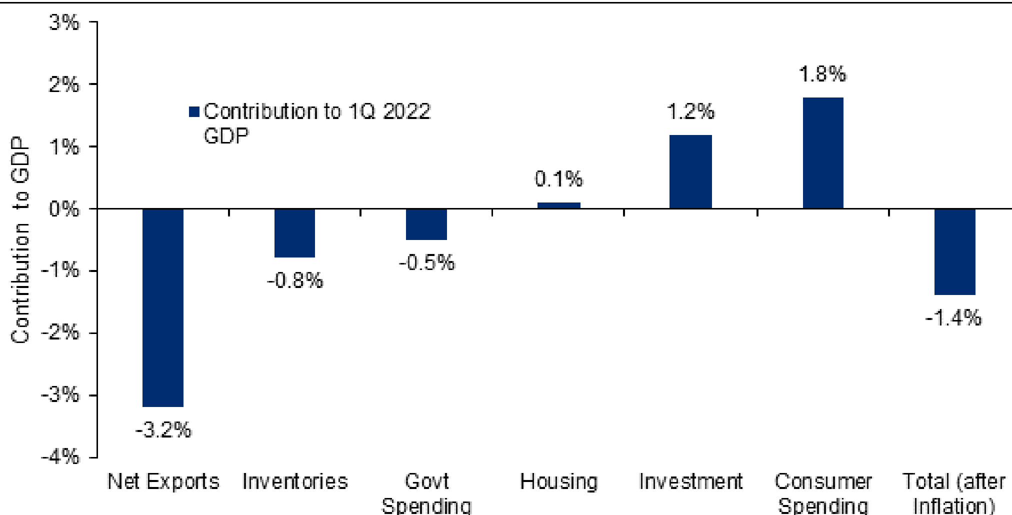
Many are dismissing this 2022 “surprise” decline in GDP as an aberration. We are not.

The negative GDP print was led by a sharp decline in exports (see figure 2). But consumer spending also decelerated throughout the first quarter. Broad retail spending volumes in March were lower than the average pace in the first quarter. In short, consumers began curtailing their purchases meaningfully in the face of rising inflation.

All this does not mean a recession is imminent. Employment grew throughout the first quarter as the production of goods and services rose. But in contrast to what many say, demand will not be stronger in the coming quarter. It will be weaker.

In our view, the current consensus for US real GDP growth in 2022 of 3.2% needs revisiting. Our own forecast for 1.9% growth this year anticipates moderating inflation and a recognition from the Fed that the boom is truly over. (See last week’s CIO bulletin and our April Quadrant for our revised forecasts).

Figure 2: Contribution to Q1 2022 GDP



Source: Bloomberg and Haver Analytics as of April 30

A “Silver Lining”?

There may be a sliver of “good news” in all this. There remains a route to lower inflation without destroying economic growth. Lower demand, higher imports and a moderate Fed tightening cycle can, over time, lead to lower inflation while keeping the economic expansion intact.

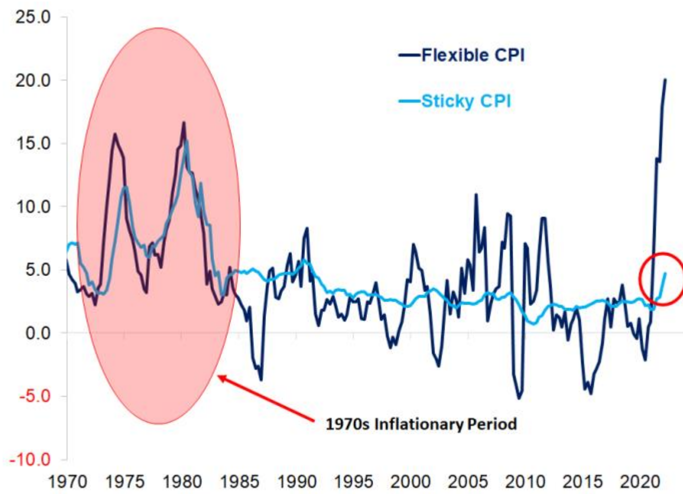
As consumer goods prices are far more flexible than services, it is more likely that inflation will fall more quickly than currently expected in the coming year. Take a look at “sticky” versus “flexible” components of US inflation (see figure 3). In the US, the components of consumer prices that tend to vary regularly are the ones that have posted the largest gains over the past year. This is unlike the 1970s-1980s when many contractually bound prices showed much larger and persistent gains.

Over the course of 2022, we expect the US consumer price index to rise 6.5%, decelerating from March’s 8.5% year/year pace. We would further expect CPI inflation to slow to 3.5% next year and slow further beyond. Nonetheless, even if inflation abates, it will cause slower economic growth this year and next.

This “silver lining” view – a reduction of inflation over the next 18 months without a recession -- would require a major shift in present Fed guidance. With Fed Chairman Powell citing “very strong labor markets” and “inflation that is much too high,” Fed officials have been cementing a view that the current economic recovery is proceeding faster than the last one, requiring a much more aggressive policy response.

But this is not 2021.

Figure 3: US Inflation: Atlanta Fed Measure of Flexible vs Sticky Price Components



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What's Changed from Last Year's Boom

In 2021, US real GDP rose 5.7% aided by an unprecedented $2.2 trillion in income support for US households. No previous stimulus package was remotely close to the US government's efforts to fight the pandemic. The stimulus was 13% of US GDP (see figure 4). These 2020 and 2021 payments were closely linked to huge upswings in consumer spending during the stimulus period (see figure 5). US government income support and the abatement of Covid generated a sharp upswing in economic demand that led to a blistering recovery in production, global trade and domestic employment.

Covid stimulus is now history. US federal spending is down 33% in the year-to-date. The government's spending slump in 1Q has reduced the US budget deficit by $843 billion compared to Q12021.

Figure 4: US Government Transfer Payments to Individuals, Billions of $

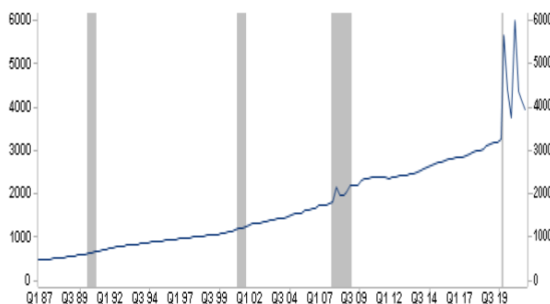
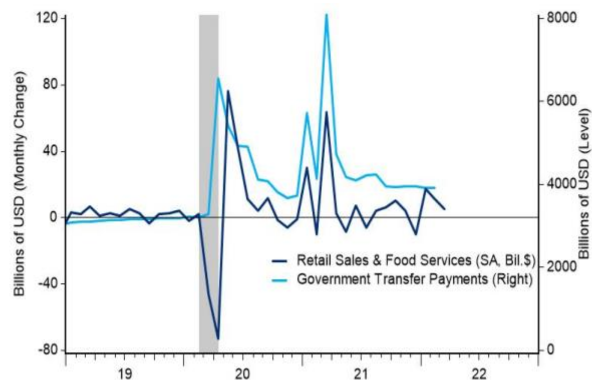


Figure 5: US Retail Sales Month/Month % Change vs Government Transfer Payments of Income



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Consumer Spending Leads (Not Lags) Labor Markets

In our RESILIENT scenario, the current employment and income recovery can outlast macro policy tightening in the US and other economies. But this can only be true if the tightening is not rapid and extreme.

To understand where we are in the cycle, it is critical to remember that ***demand leads employment.*** Demand growth is now weakening under the combined impact of high inflation and falling stimulus. In turn, this would suggest we are nearing peak employment in the US.

Almost without fail, history shows that recessions have begun when unemployment hits its lowest levels. In contrast, recoveries begin when unemployment is at its highest.

Units Matter

It is hard to see where demand is when the economy has been so distorted by stimulus. However, we can see that *unit consumer purchases* drive growth in demand for labor (figures 6 and 7) with a lag. In the US, more demand for consumer goods drives not only manufacturing employment, but also advertising, trade and finance positions, among many others.

As real retail sales slow - *the number of units consumers purchase* – we believe employment growth will also slow sharply.

Figure 6: Real Consumer Spending (6-month lead) vs Private Employment, Y/Y% 1979-2019

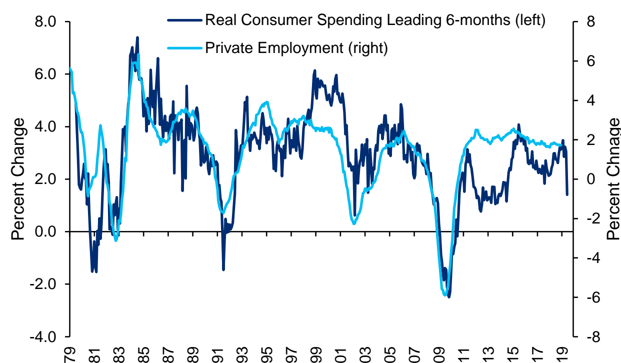
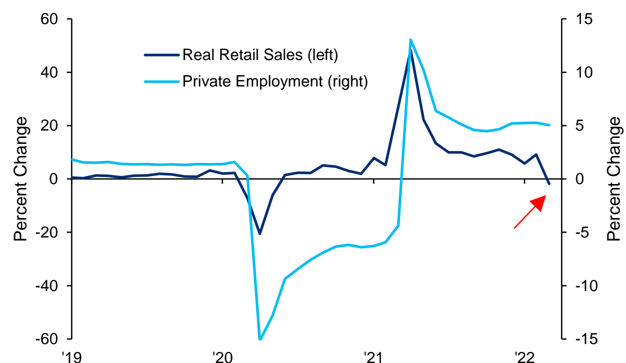


Figure 7: Real Retail Sales (6-month lead) vs Private Employment Y/Y% 2019-2022



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The War Extends Covid's Inflationary Pressures

The war in Ukraine is likely to result in lasting commodity supply shortages, from energy to agricultural products to rare metals, for at least two years (please see our April Quadrant for discussion). Shortages of Ukrainian and Russian export crops and fertilizer inputs have vaulted the price of food commodities. With the world's lower-income consumers spending a much larger share of their budgets on unprocessed food commodities, this will weaken many emerging market economies later this year.

While somewhat impactful in the short-term, news that Russia is shutting off natural gas exports to its Eastern European trading partners will exacerbate shortages and economic damage over the medium-term. The urgency of replacing gas imports with liquified natural gas (LNG) is one example. Such supplies can only expand marginally over a short period of time and will likely prove far short of Western Europe's needs in the coming year if Russia (or the EU) expands its embargo (see figures 8 and 9).

Figure 8: Global Natural Gas Use and Imports

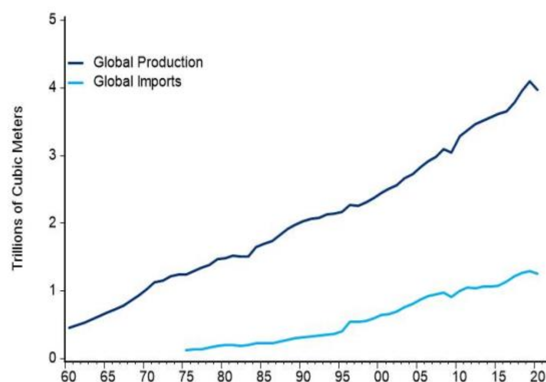
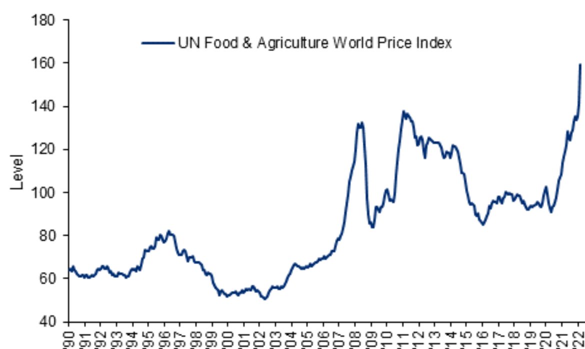


Figure 9: UN Food and Agricultural Price Index



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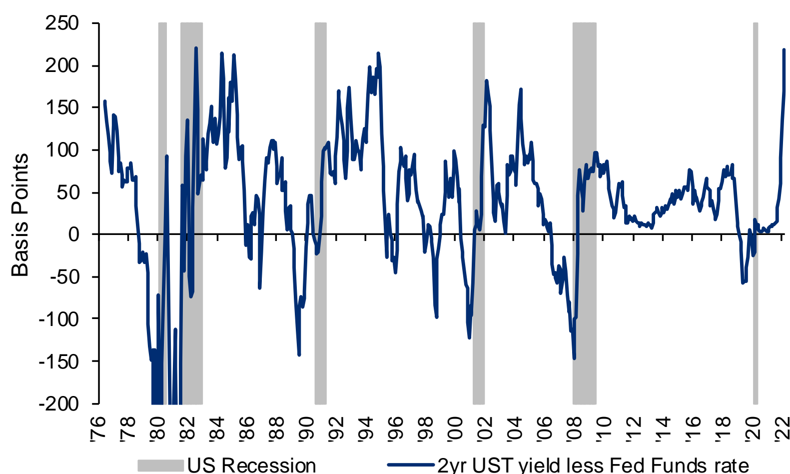
Do We Really Need Huge Fed Rate Hikes?

Central banks should understand that war-driven shortages don't signal lasting, excess demand for final goods and services. Producers could never have planned for the boom in goods demand that followed the 2020 COVID shock and stimulus. The capacity to import sufficient supplies at high double-digit growth rates was simply never there.

We do not think that the Q12022 GDP contraction will cause the Fed to back off its near-term guidance and raise policy interest rates by 50 basis points at one or more meetings in coming months. However, a highly likely slowing in US output (GDP) and lower employment growth makes us doubt whether the Fed can maintain its hawkish stance in the face of economic weakness to come (see figure 10).

And, as we previously noted, this is precisely what happened in 2018, when the Fed misjudged the policy rate level that was consistent with constraining the economic expansion without derailing it. The Fed believed it would raise short-term policy rates by 75 basis points in 2019; instead, it cut rates 75 basis points that year. Whether the Fed will even be able to raise rates enough to cut them in mid-2023 is also still in question.

Figure 10: Record Tightening Predicted: US 2-Year Treasury Yield Less Fed Policy Rate



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Final Thoughts

2022 is no 2021. As markets see the Fed tightening into a supply shock, markets are rationally pricing a greater risk of recession. The Fed's very early stages of tightening – just a single 25 basis point rate hike, so far – suggests there is still time for it to recognize the economy's slowing momentum.

While last week's US GDP data for the first quarter were unexpectedly dour, the data on imports and domestic production both suggest that supply/demand equilibrium can be met effectively without the need for a new and lasting economic contraction. With lower valuations and this eventual recognition, we would expect both the equity and bond market to find more stability as 2022 progresses.

On the other hand, if the Fed remains aggressive in its attack on inflation, it may tighten too aggressively and generate unexpected outcomes and risks. As we highlighted in our "three scenarios" last month (see "Three Scenarios for the Economy and Markets"), we see the probability of a RESILIENT economy (one that slows more naturally to a sustainable path) as most likely. Yet, we see this preferred scenario at only a slightly higher probability than RECESSION (40% vs 25%).

Equities, Earnings, Valuations and Growth Shares

Even with steady earnings expectations, multiples on the S&P 500 have contracted 15% YTD. We do not believe long-term multiples are excessive relative to current interest rates (figure 11). And when we look at valuations outside the US, current multiples are in line with historical norms (figure 12). Thus, in the absence of a Fed-induced recession, we believe a bottom in bond prices is likely to provide support for equities.

We also believe that when investors see that we have peak interest rates, a recovery in growth stocks may occur. While volatility in some of our Unstoppable Trends is higher than the broader market, we have identified areas like fintech, clean energy, electric vehicles, and biotech that deserve high valuations due to their growth and long-term value creation. But we do not expect them to outperform quarter to quarter.

In our view, significant selloffs among industry leaders in these thematic areas provide rare opportunities to add exposures at more reasonable valuations. Additionally, these firms tend to benefit from low rates. While "peak rates" may not coincide with a bottom in the shares of innovative leaders, we can foresee an opportune time to begin accumulating positions in secular growth leaders in the not-too-distant future.

Figure 11: S&P 500 Fwd P/E vs Real Interest Rates

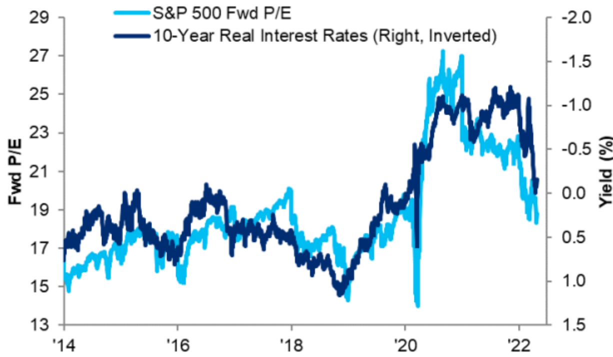
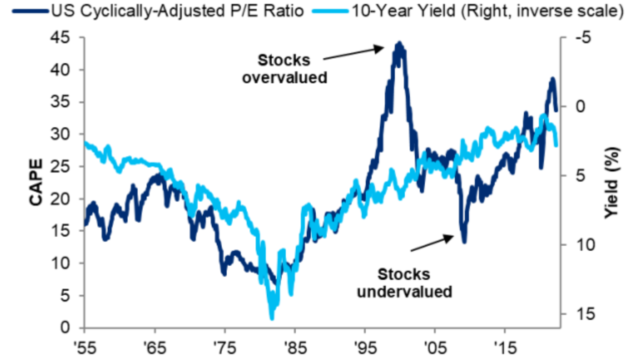


Figure 12: S&P 500 CAPE vs 10-Year Yields



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CIO Bulletin: SPECIAL REPORT ON CHINA

A Delayed Recovery Amid Broader Lockdowns

Lockdowns have extended into their second month across many parts of China. Some fine-tuning has been made to allow for survival, and for production in "closed loop" operations. But a return to normal life still doesn't seem imminent. Domestic Chinese mobility measures have fallen to levels not seen since 1Q 2020, and there are sure to be further supply (export) disruptions, as well (figures 13 and 14).

Figure 13: Subway passenger volume in shanghai and others reached a low level akin to Wuhan lockdown

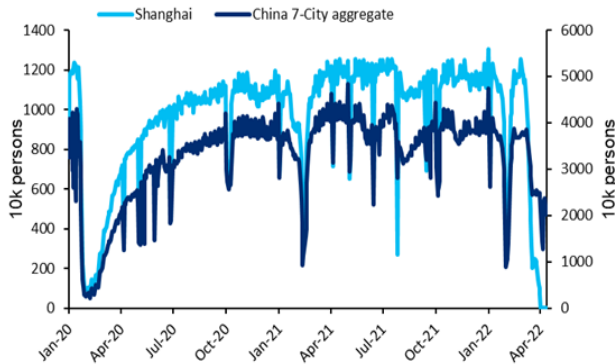
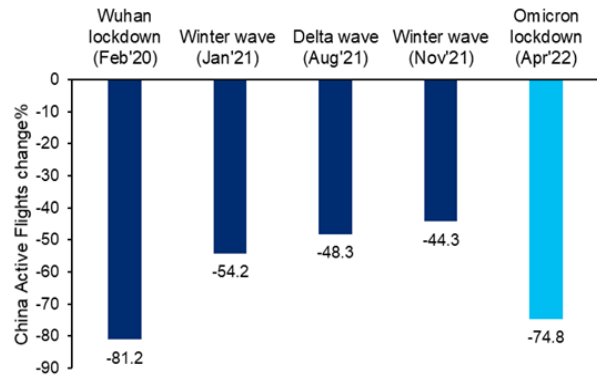


Figure 14: China's air traffic in April dropped to the level reached at the Wuhan lockdown in February 2020



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Two additional risks to Chinese assets have emerged in recent weeks: the currency and the politics. The policy divergence between US and China is contributing to these hurdles. While we continue to see Chinese equity valuations as compelling, the eventual recovery is likely delayed even further by the lockdowns and their impacts.

More Stimulus

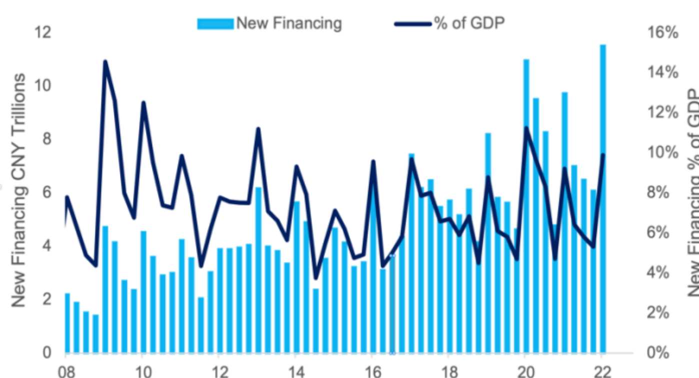
On Friday, China's Politburo reiterated its call for dynamic clearance for Covid and called to minimize its impact on people and businesses. It also announced it will expand macro stimulus, cut taxes and fees, protect jobs stabilize property and stock markets among other financial measures.

We would caution, however, that the easing so far was already signifiicant. For example, aggregate new financing amounted to CNY12 trillion in 1Q, larger than 1Q 2020 during the first round of pandemic stimulus (figure 15). As a share of GDP, it is smaller, but this reflects how it is becoming marginally more difficult to stimulate with additional leverage.

Moreover, fiscal stimulus had also been visible already. In 1Q, infrastructure investment grew by 10.5%y/y, which was the fastest since 2017, excluding the immediate recovery from pandemic (figure 16). The strength in manufacturing investment also contained signs of fiscal support in areas like clean energy and public education. These are taking place amid weak real estate investment. But the evidence is clear that fiscal resources are already feeding activity in 1Q.

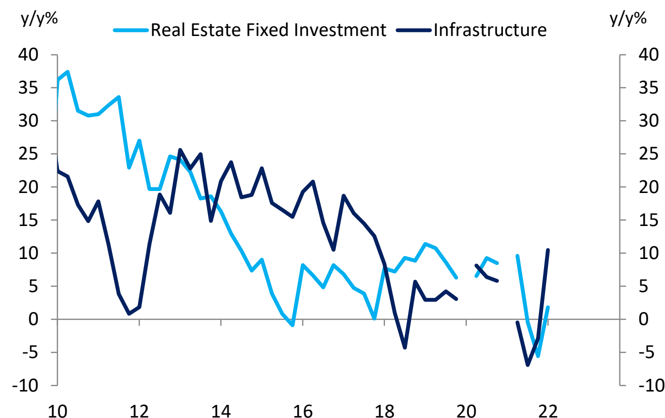
While any new stimulus is helpful, only getting beyond the COVID lockdowns – which remain unclear in timing and scope – can allow for expansion to resume.

Figure 15: Aggregate new financing amounted to a record 12 trillion in 1Q, already larger than 2020



Source: Haver Analytics, Q1 2022

Figure 16: Fiscal stimulus is also visible as infrastructure investment rebounded by 10% 1Q, the highest since 2017 (aside from the immediate pandemic recovery)



Source: Haver Analytics, Q1 2022

Policy Divergence May Lead to CNY Depreciation

The CNY had appreciated against the USD by 13.6% from May 2020 to March 2022 and has only begun to reverse recently. Last week, the CNY saw its largest weekly fall over the last four years.

We believe the downside risk of the RMB exchange rate will continue to build in the near term, led by a recessionary outlook in Q2, and more importantly, the monetary policy divergence between the US Fed and the People's Bank of China. As currencies often overshoot, we see a faster USDCNY depreciation towards 6.80 in the near term, but the CNY could regain stability in the second half.

The divergence of US-China monetary policy is the fundamental factor at play**.** Even before the recent failed Covid containment, the CNY has already been under pressure from surging US Treasury yields. Portfolio capital outflows have started to take place (see figures 17-18). We think the sharp sentiment shift, together with tacit official encouragement, could easily cause a 3-5% depreciation against the USD in the near term.

Figure 17: US Treasury yields exceed that of Chinese government bonds for the first time in 13 years, creating substantial pressure for CNY to depreciate

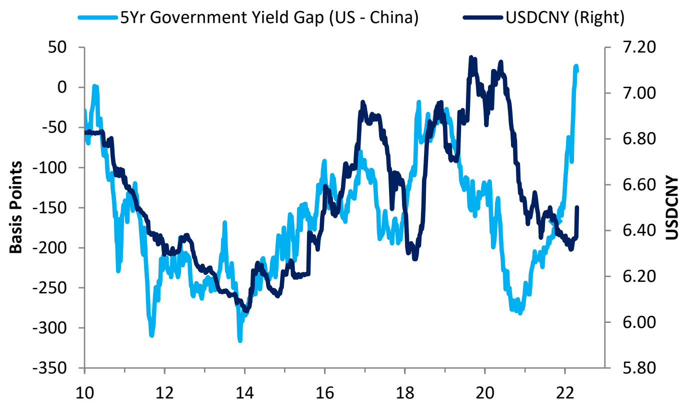


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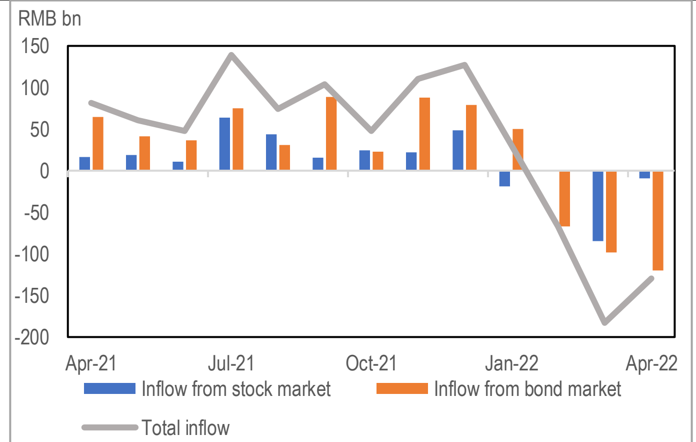
Figure 18: Net capital outflow in both bond and equity markets has started turning negative from February onwards



Source: WIND and Citi Private Bank estimates as of April 29, 2022. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

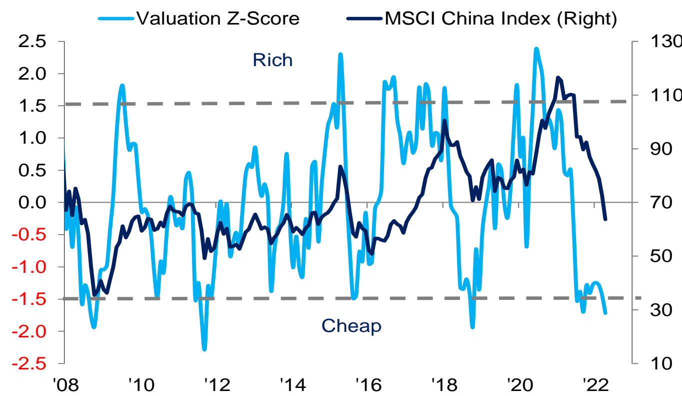
Short-term CNY overshooting is more likely than not, but capital control measures will likely limit the risk of a one-way, runaway depreciation.

As we see a 70% of probability that long term US Treasury yields will peak this year, the yield differential could even turn positive in the second half of the year in China's favor. While CNY depreciation could add another hurdle to a sustained recovery in China's equity market**,** Chinese equity valuations have already reached historical lows since 2008, we think there is the potential for limited downside risk ahead.

Restoring confidence in the Chinese corporate earnings outlook would require several critical conditions, including an exit from lockdowns, additional depreciation of the CNY into a range close to equilibrium, and a clarification that the political transition into the 20th Party Congress is on track. These may take until 4Q.

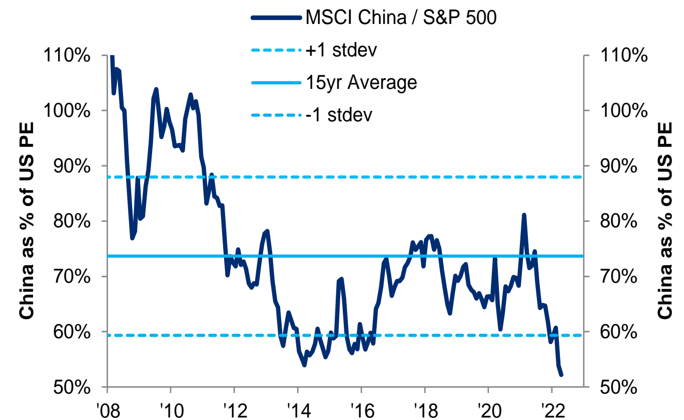
Until then, valuations are likely to remain at distress levels. Indeed, our valuation z-score shows that MSCI China is currently 1.7 standard deviations below mean. The forward PE of MSCI China index is about half of the S&P 500. This "two for one sale" is likely to continue until more clarity is seen (figures 19-20).

Figure 19: MSCI China Consensus EPS growth estimates



Source: Bloomberg, as of 25 April 2022

Figure 20: CSI 300 Consensus EPS growth estimates



Source: Bloomberg, as of 25 April 2022

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