May 25, 2022

Markets on Target for further downside

- **Concerns about less growth and more inflation appear to be driving sentiments currently**
- **US retailing giant Target misses forecasts by a mile – a salutary lesson for investors**
- **The US consumer has rolled over and faces a worrying increase in gasoline prices**
- **The read-through for the rest of the market is further earnings disappointments and a lower equity market**
- **As more central banks tighten, there is an increasing feeling among currency strategists that most of the dollar gains are behind us**
- **China eases but is that really enough?**

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The obvious message from last week's corporate and macro data was that the slowdown in the global economy is far more significant than many had thought and that inflation pressures are intensifying. We remain extremely cautious on equities and believe that bond yields will eventually reclaim their recent highs.

Last week, the US market delivered a salutary lesson for investors on the downside risks to analysts' corporate profits forecasts for 2022. US retailers, particularly Target and Walmart, reported poor first-quarter profits and compounded the bad news by announcing cuts to their guidance. To us, this is just another lesson to the market that the current challenges to economic growth and inflation remain worryingly elevated and any conclusion about the outlook should be fluid at best. Waiting for signals from companies, central bankers, and governments to decide the next move could be fatal if one wants to avoid the genuine danger of the downside in equity and bond markets

The Target management's utter incompetence was reflected in its poor earnings show as its shares sank 25% on Wednesday. With all that's going on in the world, the big-box retailer's management was clearly found wanting on some prudent scenario analysis of future trading. Perhaps, they concluded that they needed to guide analysts to cut back their profits forecasts some weeks ago. Instead, only a few weeks ago, they – and even Walmart – were telling financial analysts that everything was fine. We wonder what made them see everything as just fine when the US was seeing the highest inflation levels in decades.

Target's first-quarter results in the train wreck were a 50% drop in year-on-year profits and a 43% increase in inventories as consumers pulled back from buying TVs and white goods. Was it utter complacency on the management's part that it failed to read the writing on the wall? Perhaps yes. The corporate US has become so conditioned to ongoing good news that when there is any bad news, it quickly 'disappears' as policymakers ride to the rescue. That was the past, but is certainly not the future.

The battering that Target received provided an important lesson to the broader market. If 2007-09 and the tech wreck of 2000 are anything to go by, investors must not wait for the corporates to tell how bad it is; what one needs is an incisive analysis to get ahead of the cycle of (disappointing) announcements. And on the macro side, waiting for the IMF to cut their GDP forecasts or for the Fed to tell that inflation is no longer transitory could be detrimental to the portfolios!

The scale of the drop in Target's share price also justifies our concern about the potential downside for the US equity market. We continue to believe that the S&P500 is headed for its 2011- 2020 trend line, which would indicate a level of 3100 compared with 3900 at the end of last week.

Chart 1: S&P500 at risk of falling back to its 2009-20 trend - 3100

Source: Bloomberg

A 20-25% fall in the S&P500 index would also bring the S&P500 back to the trend in corporate earnings seen since 2011. The market witnessed a sizeable re-rating largely because long-term interest rates were on average 2.0% over the past ten years and not around the 3.0% that's the building norm.

Chart 2: US equity market re-rating no longer justified. Risk of downside to trend of corporate profits

S&P price movement and corporate profits index

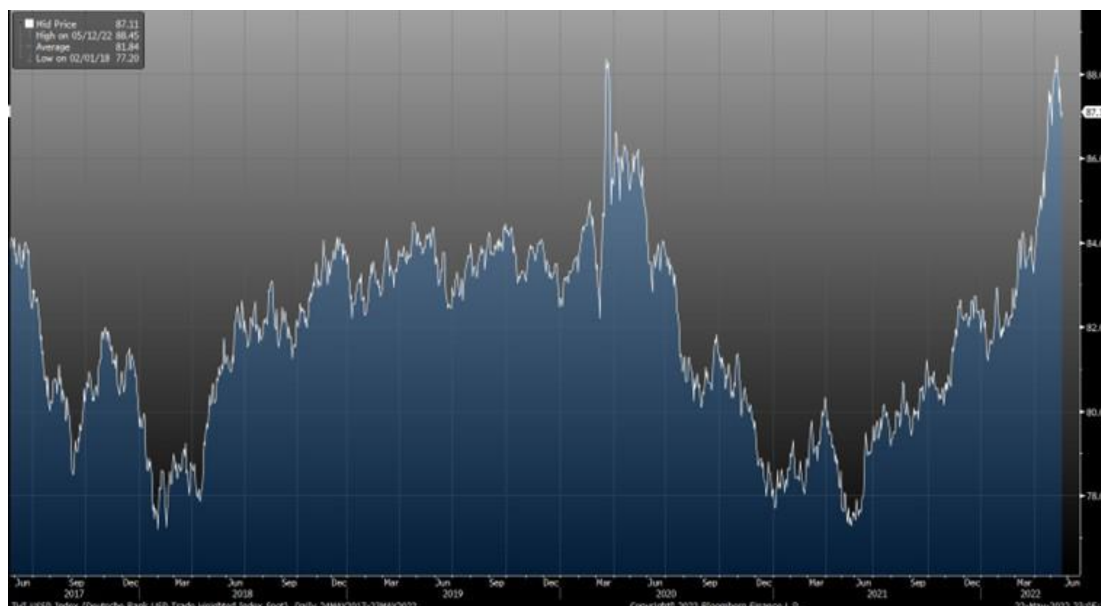
Source: Bloomberg

The strong consensus is that the Federal Reserve will raise rates by 50bps at each of the next

two meetings. For those hoping that the Fed might eventually signal that the pace of tightening could slow as the economy shows signs of weakness, we note that JPMorgan published a forecast last week that national gasoline prices could rise close to 40% on top of the 50% rise seen over the past year. Inflation is not on the wane.

Many other central banks continue to tighten monetary policy sharply. Both the Bank of Mexico and the Central Bank of South Africa increased interest rates by 50bps last week. The ECB appears to be minded to moving earlier to tighten policy than they previously signalled and even the Bank of Japan must be concerned about the pace of the pick-up in inflation. **The bottom line is that the market is starting to sense that the largest part of the dollar rally may be behind us.**

Chart 3: US dollar trade weighted



Source: Bloomberg

The bigger surprise was the Bank of China easing policy. Even though the cut in interest rates was very measured, it was still a positive surprise. The problem in China is that the policy easing is failing to arrest the slide in the economy. Dismal economic data have compounded the problems. Retail sales, which dropped 9.9% month-on-month, and industrial production, down 7%, only indicated the scale of the problem facing Asia's biggest economy. Asset markets can only have a sustained recovery when policy measures are seen as having a positive impact, which lifts growth forecasts; policy measures that only partially mitigate the loss of economic momentum are far less effective. Nevertheless, China's equity markets remain good value but the catalyst for any marked absolute performance remains modest.

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