# Round-up: Inflation triggers rising rates

7 June 2022

Kevin Loane

**Value investing returns as tech stocks falter**

**Why UK inflation could prove sticky**

**The UK is in the early stages of a wage-price spiral**

**Tough choices for the European Central Bank**

**Value investing returns as tech stocks falter** (11 May 2022)

- Equity markets have been under pressure since the turn of the year, and this week has been no exception, with the S&P 500 down almost 4% from its close last Friday
- The fall has been concentrated in tech stocks, which have come under pressure on two fronts: first, the earnings outlook is deteriorating, with almost 70% of companies with revised I/B/E/S* forecasts in the Nasdaq suffering downgrades this month; second, these companies tend to be long duration, and are more vulnerable to a period of higher interest rates, as we warned clients back in our *Global Outlook, Summer 2021: Inflation – deal with it, or roll with it?*
- But it is not all doom and gloom for equity investors. There are buying opportunities
- As our second chart shows, since the end of last year, so-called value stocks (cheap relative to fundamentals) have outperformed growth stocks (expensive, growth-promising companies, such as those in the tech sector), momentum stocks, and even safe-haven quality stocks (with far from stellar, yet reliable growth prospects)
- Value stocks might continue to do well, but only if the Fed maintains its hawkish outlook, and if the US economy continues to enjoy a positive cyclical upswing. We shall consider the prospects for just such an environment in next month's *Global Outlook, Summer 2022.*

*Institutional Brokers Estimate System



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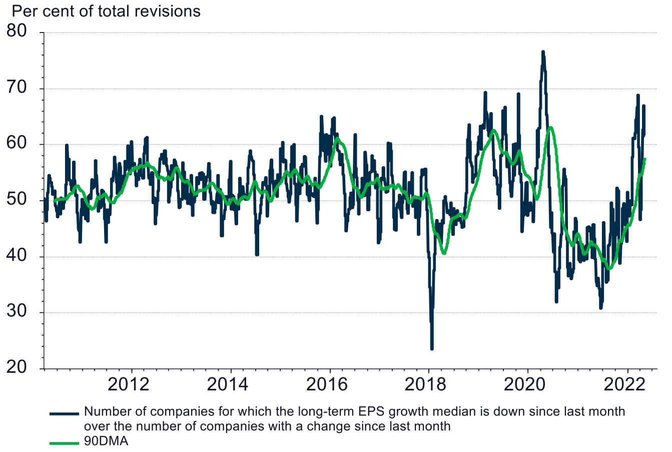
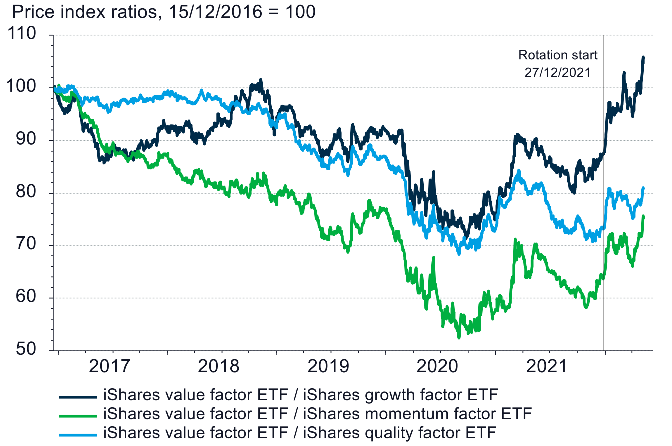
**Nasdaq downward revisions of long-term EPS growth**




*Source: Refinitiv Datastream / Fathom Consulting*

**US equity styles rotations**




*Source: Refinitiv Datastream / Fathom Consulting*

**Why UK inflation could prove sticky** (18 May 2022)

- UK inflation is soaring while growth is slowing: the classic hallmarks of a negative supply shock
- There are many sources of that shock: distortion of global supply chains during the pandemic, the deadening effect of Brexit on UK trade flows, and higher food and energy prices due to the war in Ukraine
- The right thing for policymakers (monetary and fiscal) to do in the face of such a shock is to ‘see through it’: the shock will drive prices up and aggregate demand down, but there is no impact on inflation in the medium term, so there should be no response of macroeconomic policy, even if some redistribution towards the worst-affected people is necessary
- But that logic only holds for as long as so-called ‘second-round effects’ are controlled



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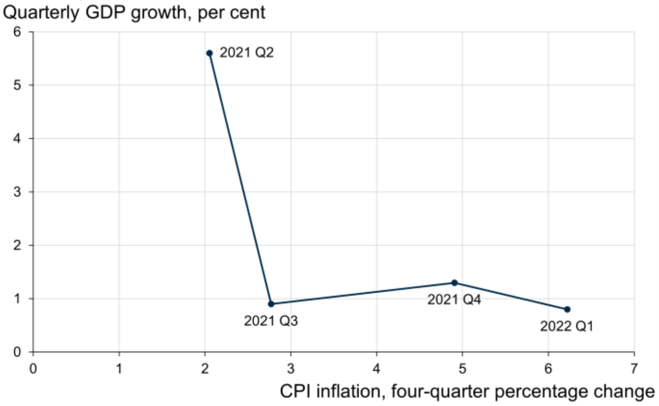
- The supply shock makes us all worse off, an effect that cannot be avoided, but it can be aggravated if wages respond: higher wages will drive prices up even further
- Over the last three quarters unemployment has fallen, but wage growth is accelerating, including real wages
- This could be the start of second-round effects taking hold, or it could be the result of a contraction of labour supply in the UK thanks to Brexit
- Either way, it means inflation is likely to be particularly sticky in the UK

**Growth/inflation trade-off points to negative supply shock**




*Source: Refinitiv Datastream / Fathom Consulting*

**Unemployment/wage growth trade-off points to second-round effects**


*Source: Refinitiv Datastream / Fathom Consulting*



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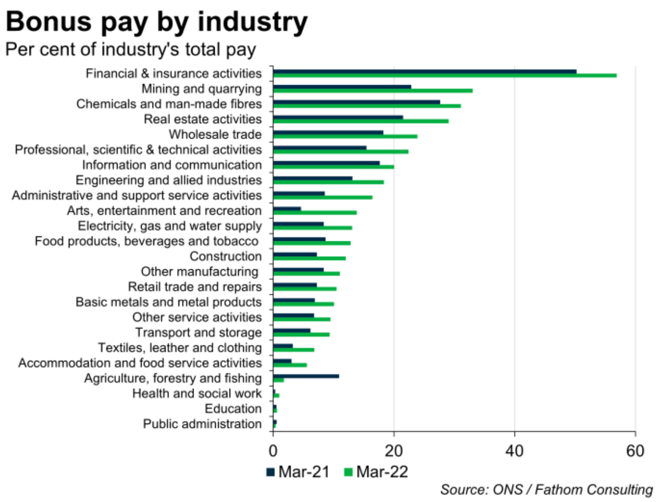
**The UK is in the early stages of a wage-price spiral** (25 May 2022)

- UK average weekly earnings including bonuses rose by 9.9% in the twelve months to March – significantly higher than CPI inflation over the same period, which was 7.0%
- Press stories have tended to focus on regular pay, excluding bonuses, which rose by a more modest 4.1%
- Bonus pay is a much more flexible component of aggregate pay, and can react quickly to changes in labour market conditions; empirically, we find that the difference between total pay growth and regular pay growth helps predict future regular pay growth
- To the extent that the share of bonus pay in total pay is an indicator of labour market tightness then conditions have tightened across all private industries with the exception of agriculture, as our first chart shows




- A better picture of underlying pay growth can be obtained if we smooth these payments across the preceding twelve months, which we have done in our second chart, which shows that underlying pay growth in the year to March 2022 was between 6.5% and 7.0%



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UK bonus-smoothed pay

Twelve-month percentage changes


*We define bonus-smoothed pay as the sum of regular pay and the average bonus payment over the past twelve months

*Source: ONS / Fathom Consulting*

- That suggests to us that the UK is in the early stages of a classic ‘wage-price’ spiral, with bonuses seemingly the first to respond to an increasingly tight labour market, as one might expect
- UK consumer confidence has fallen to levels that would typically signal the start of recession, and yet high-frequency indicators of consumer spending, including table reservations, time spent in retail and recreation premises, and payments data collected by the Bank of England, show no signs of a slowdown – yet
- As we shall argue in our forthcoming Global Outlook, Summer 2022, the outlook for consumer spending in the UK and elsewhere – and therefore for wage inflation, consumer price inflation and interest rates – turns on whether consumers perceive the fall in their real incomes as temporary, and dip into their pandemic savings, or whether they view it as permanent, and retrench

**Tough choices for the European Central Bank** (1 June 2022)

- Fear is rising regarding the European Central Bank’s ability to balance a hawkish monetary policy that would bring inflation under control with the monetary accommodation the euro area periphery still needs to keep borrowing costs manageable
- Fathom’s Probability of Exit and Default for peripheral EA economies has risen to levels that haven’t been witnessed since 2018; there is increasing belief among investors that tightening would increase the risk of losing countries such as Greece and Italy as member states
- Looking under the bonnet, Fathom’s Financial Vulnerability Indicator suggests that the inherent weaknesses of the Greek and Italian banking sectors are coming back to the fore, and the evolving interplay of the war and inflation is reinforcing those vulnerabilities
- The ECB’s dovish monetary policy is keeping a lid on these risks for now; abandoning it may be necessary to maintain price stability, but at the potential cost of a Greek and Italian banking crisis



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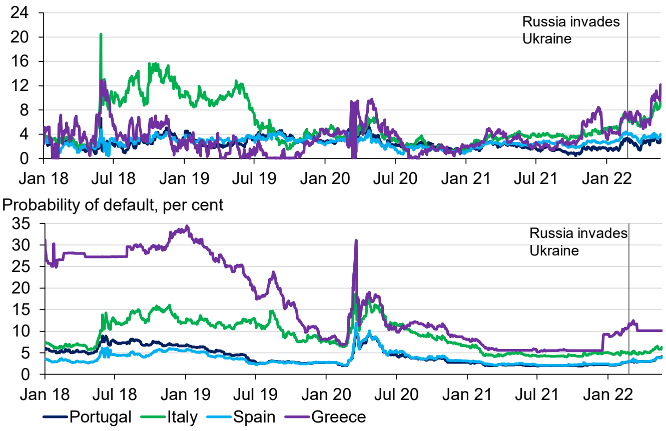
## Market-implied euro area probability* of exit and default




*probability of event within five years based on CDS spreads

*Source: Refinitiv Datastream / Fathom Consulting*

| Change in probabilities of financial vulnerability indicators for the euro area periphery | | | | | |
|---|---|---|---|---|---|
| By percentage point change in driver component contribution, 2022 Q1 to 2022 Q4 | | | | | |
| | | Component contributions and overall | | | |
| County | Crisis type | Flows | Imbalances | Reversals | Overall |
| Greece | Banking | 1.17 | 1.23 | -1.91 | 0.49 |
| Italy | Banking | 0.33 | 0.38 | -0.30 | 0.41 |
| Portugal | Banking | 0.16 | 0.48 | -0.29 | 0.35 |
| Spain | Banking | -0.21 | 0.24 | -0.42 | -0.38 |
| Greece | Currency | 0.53 | 0.42 | -0.75 | 0.21 |
| Italy | Currency | 0.10 | 0.01 | -0.08 | 0.04 |
| Portugal | Currency | 0.45 | 0.12 | -0.15 | 0.42 |
| Spain | Currency | 0.17 | -0.04 | -0.10 | 0.03 |
| Greece | Sovereign | 0.25 | 0.24 | -0.39 | 0.09 |
| Italy | Sovereign | 0.07 | 0.00 | -0.03 | 0.05 |
| Portugal | Sovereign | 0.09 | 0.03 | -0.08 | 0.04 |
| Spain | Sovereign | 0.11 | 0.03 | -0.07 | 0.07 |

*Source: Fathom Consulting*

***Chart authors: Dimos Andronoudis, Erik Britton, Andrew Brigden***



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**Further reading:**

Global Outlook, Spring 2022: Update

Why UK inflation could prove sticky

Back to the 1970s

Global Outlook, Spring 2022: Fake it till you make it

**In case you missed it, here's last month's round-up:**

*Handling the green transition*

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