November round-up: Global outlook

15 December 2022

Kevin Loane

Last month Fathom's economists focused their attention on the global macroeconomic picture. We discussed how well Europe's economy was holding up despite energy supply shocks, the demise of a crypto exchange, the prospects for the world's most indebted advanced economy as yields start to rise, and how investors are reacting to the prospect of a Fed pivot. Read on for a round-up of some of the economic insights Fathom sent to clients in November.

EU gas use falls, but no recession — yet

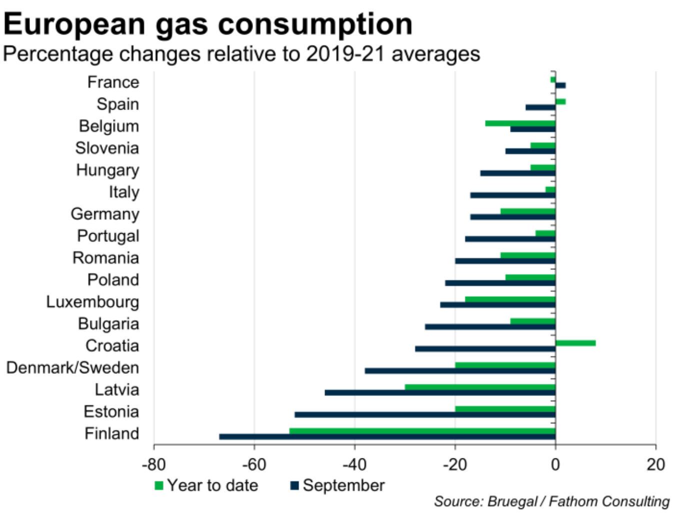
What the FTX

Japan inflation: have we reached a turning point?

Markets rotate to low-duration equities

EU gas use falls, but no recession — yet (9 November 2022)

- European gas consumption declined by a median of 20% this September, relative to 2019-2021 averages in 17 countries for which we have timely data — this was a greater decline than the EU target of -15%



- The drop has been more heavily concentrated in industry (median: -25%) than in households (median: -14%), as companies have found ways to substitute and reduce their consumption, including via reduced production in some cases

- Households have benefited from unseasonably warm weather, but research has identified falls of between 10% and 35% in German household consumption, even accounting for temperature[1]
- Countries with Russian land borders have experienced the largest falls, suggesting that reduction in supply was particularly acute — although this will be a topic of future work
- Despite this fall in gas consumption, EU GDP growth has thus far held up relatively well, avoiding contraction in 2022 Q3 and even growing by 0.2%
- In the coming weeks, we will also explore which European countries face the greatest financial risks from the current energy crisis, as well as providing detail about the role of temperature in driving different economic outcomes

1. https://www.econstor.eu/bitstream/10419/265522/1/Ruhnau%20et%20al.%202022.%20Gas%20demand%20in%20times%20of%20crisis.%20Working%20Paper%20Oct%202022.pdf

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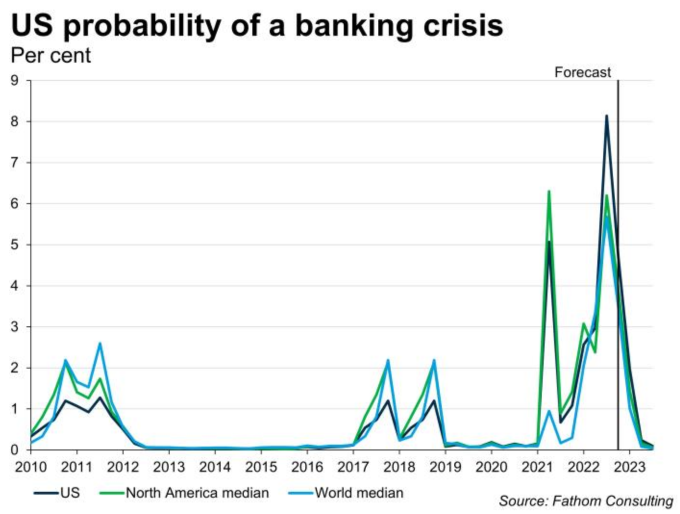
What the FTX (16 November 2022)

- The rise and fall of Sam Bankman-Fried and FTX make for a riveting story, but also raise questions about whether monetary tightening will 'break something', risking financial crises
- Indeed, Fathom's proprietary Financial Vulnerability Indicator has been indicating for several quarters that the risk of financial crises around the world would peak from now through to 2023 H2



- The FVI's heightened risk of a US banking crisis runs counter to the conclusion of researchers at the New York Fed,[2] who find that the sector remains extremely resilient
- The truth is probably somewhere in between, with both models biased in part from the historical data that they were trained on
- While the FTX saga does not necessarily portend wider financial risks, its story of leverage, large off-balance sheet activity, and risk management based on historical experience rather than on possible future risks, all have echoes of the GFC
- We cannot be certain when the next crisis will occur, and it will probably not look exactly the same as the last one; but like history, financial crises may not repeat themselves, but they do rhyme

2. https://libertystreeteconomics.newyorkfed.org/2022/11/banking-system-vulnerability-2022-update/

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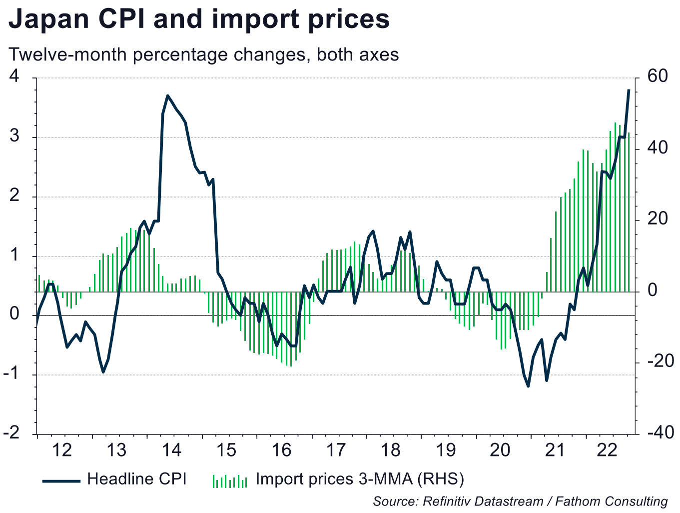
Japan inflation: have we reached a turning point? (23 October 2022)

- The Bank of Japan (BoJ) has a yield-curve control policy, which consists of buying unlimited amounts of 10-year government bonds to limit their yield to 0%, with a cap of 0.25%, in an effort to sustainably hit its 2% inflation target

- The current global environment of high inflation and rising interest rates has put this policy under severe pressure. The JPY has fallen to 24-year lows against the USD, which has caused import prices to soar; and inflation is now at a 40-year high



- This policy is currently creating distorting effects, as high imported inflation is taking a toll on economic growth through lower household consumption and investment

- Meanwhile, core price pressures are also rising, and inflation expectations are at record levels, which increases the risk of inflation getting entrenched in the economy and the BoJ missing its target

- Such an outcome would heighten the risk of a crisis, including in the public finances, as higher yields would increase the burden of interest expenses significantly. The BoJ now owns half of the outstanding bonds in the market. Would investors be willing to purchase these bonds?

- Japan was the first country to enter a permanent state of zero interest rate policy and to undertake QE – how events unfold there may offer clues about a possible eventual endgame for other highly indebted DM economies. We will soon be covering this issue in more depth in our weekly Recession Watch research note

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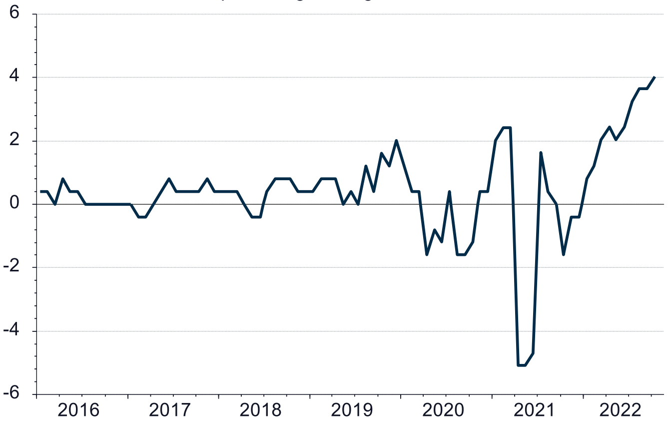
Japan core CPI

Three-month annualised percentage change



Source: Refinitiv Datastream / Fathom Consulting

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Markets rotate to low-duration equities (7 December 2022)

- Like bonds, shares have a measure of duration that reflects the average time to maturity of cash flows — i.e., how long an investor has to wait to pocket all future benefits.[3] The overall US market duration closely follows the business cycle

- When the cycle is slowing duration get shorter, reflecting the fact that corporate longevity has deteriorated and those companies with bad business models may not survive for long — 'zombies' ripe to be slain. This time in the business cycle is when investors rotate to low-duration sectors, such as utilities, as they promise cash flows (even small ones) in the near term

- When the cycle is expanding, however, duration gets longer, reflecting the fact that corporates are likely to live longer, and ambitious business models have a chance to survive and thrive. In this scenario, equity prices can soar and over-valuations can be more acute than normal. It is the time when investors rotate to high-duration sectors, such as technology, as they promise high — often outrageous — future growth and the opportunity to own the next Alphabet, Amazon, or Tesla

- 2021 proved to be a rotation year, leaving the market with significantly lower duration: the result of inflation-related, squeezed profit margins and increased interest rates. By the end of 2021, low-duration utilities, raw materials and energy were looking attractive, while high-duration technology, computer hardware and pandemic-battered travel/leisure and apparel were all areas to 'avoid'

- Most of 2022 offered more of the same, with traditional, high-duration shares underperforming low-duration stocks. But high-duration shares rebounded in October and November, as the Fed stance on further rate hikes appeared to soften and inflation started to surprise to the downside

- The rebound is likely to prove short-lived, no matter whether rates remain higher for longer or if they start to be cut as the macro cycle slows towards recession — both very plausible outcomes, as Fathom discusses in its Global Outlook, Winter 2022

3. Implied equity duration is a concept developed by Dechow et al (2004), who came up with a measure that resembles the Macaulay duration of bonds. Unlike bonds, shares do not have a well-defined finite maturity, and cash flows are not known in advance. To deal with the first complication, the measure splits the duration into a finite, detailed forecasting period and an infinite terminal value, assuming the latter is paid out as level perpetuity. To tackle the second complication, the authors assume clean surplus accounting, start from an accounting identity, and forecast cash flows via forecasting return-on-equity (ROE) and growth in book equity. The ratio of summed discounted cash flows to current market capitalisation determines the part of value that is predicted to be distributed during the detailed forecasting period, and the part left as terminal value.

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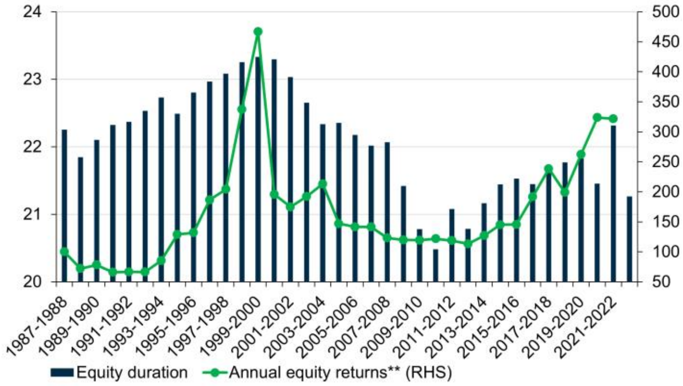
US implied equity duration and duration style rotations

Years to cash flow maturity High-duration vs low-duration sectors*, 30/06/1988 = 100

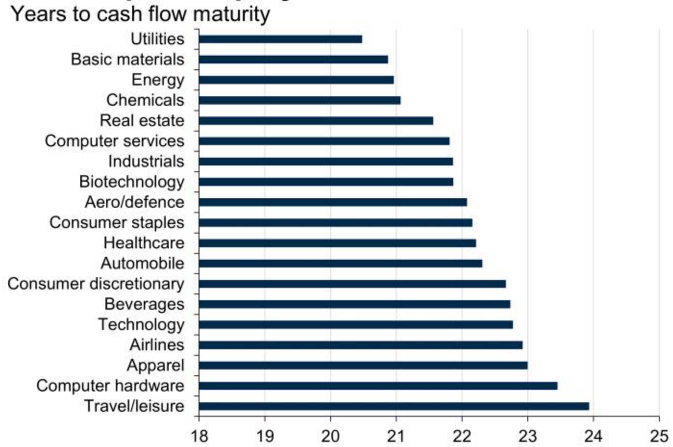


*Relative price indices of the DS technology index against the DS utilities index
**Annual returns are measured from July through June next year. We start in July to allow accounting data required for the estimation of the duration to become available

Source: Refinitiv Datastream / Fathom Consulting

2021 implied equity duration for US sectors

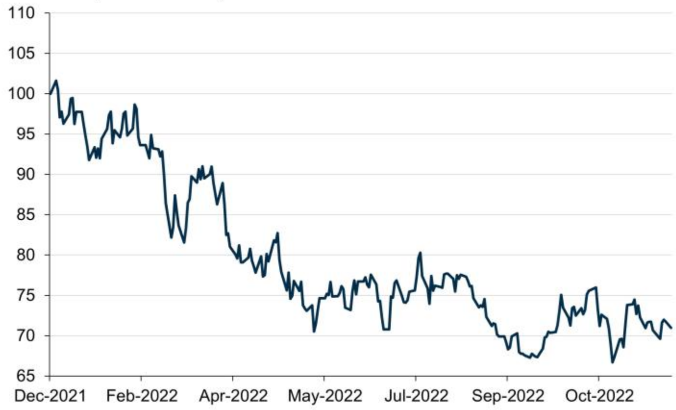
Years to cash flow maturity



Source: Refinitiv Datastream / Fathom Consulting

High-duration sectors vs low-duration*

Relative price indices, 31 December 2021 = 100



*DS technology index minus DS utilities index

Source: Refinitiv Datastream / Fathom Consulting

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Chart authors: Kevin Loane, Juan Orts, Dimos Andronoudis

Further reading:

Global Outlook, Winter 2022: Preview

Recession Watch: what if Japan releases the brakes?

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

Climate economics

Fathom Consulting
47 Bevenden Street
London
N1 6BH
Tel: +44 (0)20 7796 9561

Contact information
kevin.loane@fathom-consulting.com
www.fathom-consulting.com