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OUT OF THE ORDINARY

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Earnings Ahoy!

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The big rip upwards in risk assets that characterised the first two weeks of the year ran into the old uncertainties about central bank intentions and earnings risk. As I observed in the last Weekly Digest, it's one thing to price out the left tail risks of an energy crisis and a severe recession, but it takes more conviction to price in the right tail of a strong recovery. Michael Hartnett, Chief Investment Strategist at Bank of America, puts it more poetically:

"[We are] trading the twilight zone, [...] the trickiest part of the investment cycle: tightening ending but easing far from beginning, inflation over but recession not yet begun, China re-open vs a US recession... little wonder Wall St narratives [are] changing quicker than a TikTok video".

When will we see central bank action?

We should learn a lot more about both central bank intentions and corporate health in the next couple of weeks. The US Federal Reserve's members have entered a blackout period ahead of their next meeting, the decision of which will be announced on 1 February. Fed policy will be a key determinant of market outcomes this year. Market expectations are moving towards a further tapering of increases, with an increase of 0.25% now almost universally expected, down from 0.5% in December and a punchy 0.75% for the previous four meetings. This downward shift has been trailed by several Fed speakers since the start of the year, with the latest being the influential Vice Chair, Lael Brainard. Even so, they have stopped short of suggesting a lower peak in US interest rates than the 5.1% that was the median projection in December's "dot plot".

The Fed has a strong relationship with a journalist called Nick Timiraos at the Wall Street Journal. (His nickname is the "Fed Whisperer".) In a piece released on Sunday 22 January he seemed to endorse the slowdown to 0.25%, which is as close as one can get to a rubber stamp on the deal. Even so, we still have to get past this week's fourth quarter US GDP announcement as well as the latest reading of inflation as defined by the Core PCE Deflator.

What can we expect from earnings results?

Then there is the earnings season to contend with. The highlight so far (at least in financial circles) has been the performance wedge between Goldman Sachs and Morgan Stanley, the two heavyweight US investment banks. Their shares were running neck-and-neck (+8% year-to-date) until they released 2022 results last Tuesday. As of the close last Friday, Goldman was down 0.5% for the year, while MS was up 13%. (Market data to close of business 20/1/22) The former announced a disappointing performance from its trading and capital markets divisions, whereas the latter was buoyed by its wealth management arm. I suspect that during results season we will see more of these idiosyncratic outcomes from companies that are categorised as being in the same industries. Once again, the average might be misleading.

A closely watched element of the results season will be profit margins, which remain close to all-time highs in aggregate. There is an opinion, with which I am sympathetic, that margins will come under more pressure this year as lagged and sticky costs cannot be offset by higher prices as inflation falls from its peak, at least not without some impact on volumes. We noted during the third quarter earnings season the big gap between Consumer Staples' revenue and volume growth, with price increases making up the greatest share of revenue growth. We were concerned then that consumers would resist higher prices either by consuming less or by trading down. There is some evidence of that happening, with, for example, discount retailers and supermarkets often outperforming higher end competitors over the Christmas period.

US giant Procter & Gamble (maker of Fairy Liquid, Crest toothpaste, Gillette razors and Head & Shoulders shampoo amongst a host of other

popular household brands) was the first big consumer company to report, and disclosed quarter-on-quarter revenue growth of 4%, made up of a 6% volume decline and 10% price increases. As our research analyst Eddy Hargreaves observed: “This is not a good trend if it continues because with lower volumes comes negative operational gearing. Meanwhile elasticities are getting more stretched, meaning consumers will trade down in higher numbers unless the pressure on consumer finances eases.” P&G’s shares are -5% year-to-date against generally rising markets.

The US tends to get out of the blocks faster when it comes to reporting, and so the tone will be set from across the pond. In terms of S&P 500 companies, this week is the second biggest reporting week by market capitalisation, with 26% of the index scheduled (Microsoft being the standout contributor). Next week is the bumper week, with 31%.

Job cuts in the Technology sector have been a big feature of late, with the Financial Times reporting more than 200,000 layoffs since the start of 2022. So far it is being largely viewed as a retrenchment from an over-optimistic hiring and expansion phase rather than a major cyclical (or, worse, secular) downturn. Revenue and margin outcomes as well as outlook statements will be given extra scrutiny now.

If economic growth and liquidity (as defined by interest rates) remain the key combination of factors driving markets, how do they interact in different environments? I spotted an interesting report from the quantitative strategy team at Citigroup last week, which landed just as investors’ mood seemed to shift from believing that “bad news is good news” to thinking that bad news really is bad news. The theory behind the former assertion is that poor economic or corporate data portends looser monetary policy which supports financial assets. But there are times when that doesn’t work. According to Citi’s work, the best time for investors, unsurprisingly, is when rates are falling alongside good news. And not far behind is when bad news is released during the latter stages of a rate-hiking cycle, because it means that the pain of tighter policy is about to stop. That is the phase we have been in recently.

But the inconvenient next leg could be the one where rate cuts are priced in, but the bad news just keeps coming, and so there is no re-rating to offset lower earnings. Futures markets are already expecting rates to be cut in the second half of this year, something which no major western central bank is currently endorsing. Almost as difficult could be a period where the news gets better but this forces central banks to tighten financial conditions further, and so better earnings run into a derating headwind. As convoluted as all this might seem, it all makes sense, and the team concludes that the recent rally is going to struggle to continue.

I often comment that there is a lot more going on in markets than meets the eye of the average investor. We remain very much of the opinion that longer term performance will be defined by investing in good companies that grow consistently while generating a positive return relative to their cost of capital. But other, more technical, stuff can drive markets in the shorter term.

There is evidence of a heroic short squeeze unfolding this year. Goldman Sachs’s prime broking unit calculates that short-covering by

long-short equity funds is in the 98th percentile of historical experience (i.e. it's only been greater in 2% of observed periods). And it's instructive to look at which have been the best performing of Goldman's proprietary theme baskets year-to-date. The winner so far is High Retail Sentiment, which is +18%, with Liquid Most Shorted (+16.3%), High Beta Momentum Short (+13.5%) and Non-Profitable Tech (+13.3%) not far behind. These were all dreadful performers in 2022, and probably had a final tax-loss selling washout at the end of the year. The exceptions that sneak into the Top 5 are China ADRs (+17.7%) and Go Outside (+14.3%), both influenced by the reversal of China's zero-Covid policy. Interestingly, the worst performer has been one of last year's big winners, Defence Spending (-7.5%), with only Expensive Defensives (-0.6%) and Bond Proxies (-0.5%) in the red too. That does look like some sort of mean reversion trade.

Economic Commentary

FTSE 100 weekly winners

SSE plc	5.0%
Auto Trader Group PLC	4.3%
Rightmove plc	4.0%
Burberry Group plc	4.0%
Entain PLC	4.0%
InterContinental Hotels Group PLC	4.0%
International Consolidated Airlines Group SA	3.5%

FTSE 100 weekly losers

Ocado Group PLC	-7.9%
Hargreaves Lansdown plc	-6.6%
Berkeley Group Holdings plc	-6.1%
Scottish Mortgage Investment Trust Plc	-5.5%
Melrose Industries PLC	-4.6%
Admiral Group plc	-4.1%
AstraZeneca PLC	-3.9%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

All data shown in GBP.

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