May 2022

The Lagging Effect of Consumption Habits on Markets

Richard Harris | May 2022

Markets have spent the past 5 months digesting new policies and commentary from Central Banks, together with the end to what has been a very accommodative decade. It, therefore, should not come as much of a surprise that Global Equity and Bond markets (with the exception of a few) have had one of the worst starts to a year in recent history with the **S&P500 down almost 20%** and the **NASDAQ100 Index almost down 30%** year to date.

The unprecedented monetary support that was used to shelter global economies from the effects of the COVID pandemic is now being reversed in an effort to try and cool down unacceptably high inflation; the inflation that has been borne from a combination of supply shortages resulting from the Russia/Ukraine war, and excess demand from an environment that has been "too accommodative" for too long. Central Banks are essentially doing a U turn on policy and instead of supporting economies and stock markets, they are hiking rates and reducing lending measures (tapering) until inflation slows and some form of market normalisation takes place.

This change in policy was first noted toward the end of 2021 and although it may seem that markets took a while to react, the broader market and less liquid stocks (especially in the technology space) had been warning investors of this reversal since mid-2021. No-one knows when this policy tightening will slow but Central Banks are currently stuck between a rock and a hard place, and the inflation reduction mandate is now at the top of their agenda.

It is difficult to predict spending habits of the general consumer, however, there is usually a lagging effect that takes place between the time contractionary policies are implemented and the time when the consumer feels the actual pinch on their wallet. When markets are rising, Central Banks are accommodative, and as people feel a relative increase in their wealth, incomes and lifestyles, their spending habits usually increase. This may be by buying nice consumer discretionary items like cars and clothes or taking on more debt at low interest rates.

However, when the music stops, inflation is printing above 8%, petrol has doubled, and Developed Market interest rates have increased exponentially, the consumer will have to start answering some serious questions regarding their spending and finances, and differentiate between what is considered a "need" and a "want".

Most global companies have recently reported their Q1 2022 results, which highlight the performance of said companies over the first quarter of 2022. In contrast to Q4 2021 financials that were reported in Feb/March, we started seeing hairline cracks in reported financials and although most came in line or slightly above consensus, many companies warned of tougher times to come in their guidance commentary.

Once again, and based on the above, this slowdown in guidance should come as no surprise, but based on the fact that many stocks are priced to perfection, any earnings revisions lower over the next few periods can lead to substantial re-ratings in stock prices.

I will use the Price / Earnings (P/E) ratio to try and illustrate.

Let's say TARGET (a large US retailer) is trading at a P/E ratio of 30 based on today's price.

o Price = $250; annual earnings = $8.30
o Target's historical average P/E ratio is 20

This entails that investors are willing to pay $30 for every $1 of earnings that the company makes or in essence, it will take 30 years of earnings to pay back the purchase price of the stock purchased.

If the price of Target reduces as a result of a market general sell-off and earnings remain constant, the P/E ratio will reduce, and the company will appear cheaper if it can maintain steady earnings (creating a potentially good buying opportunity).

However, if the 'earnings' side of this equation starts declining and global headwinds are calling for a continued decline over the next few quarters / years, the P/E ratio will increase and the company in question will appear more expensive.

I.e., Annual earnings reduce (25%) to $6; price will have to reduce to $180 to maintain the P/E ratio of 30.

A re-rating will have to occur by the price coming lower in order to once again normalise a "fair" P/E ratio.

If the true "fair" P/E ratio is actually 20 and not 30, then the price will have to drop to $120 in order to normalise.

In summary, a 25% reduction in earnings expectations and a reversion to mean P/E based on poor earnings guidance and a reduction in investor sentiment can lead to a massive drop in the share price (in this example: $250 to $120, or minus 52%).

High inflation doesn't generically impact companies that are able to pass the cost onto the consumer. For this reason, companies that sell consumer staples generally do well in times of inflation. The problem arises when we see inflation prints as high as we have seen recently, especially based on the fact that these inflationary forces seem to be sticky and here to stay. Although retailers do their best to pass costs on, the consumer will get to a point where they can no longer afford these elevated prices and companies will have to reduce their margins and thereby, reduce earnings. Obsolete stock can also become an issue for these companies if demand dries up significantly.

Although we have already seen a significant drawdown in global markets, the consumer itself has not yet shown a significant reduction in spending as a result of the tightening conditions. We have not seen this reduction in spending reflect entirely on company earnings and it is likely that these changes in consumer habits will only reflect in Q3 or Q4 2022, when companies produce their second and third quarter results.

Many companies have already started to report this deterioration in their earnings: Facebook, Netflix, and Amazon, to mention a few. And after seeing this deterioration, shareholders have sold out aggressively with all 3 being down between 35% and 70% year to date. We also saw weakness in earnings guidance in numerous other retailers like Walmart and Target this month causing daily moves of over 20% to the downside.

As discussed in last month's newsletter, when markets rise, participants are usually buying as euphoria is the name of the game. The same is true on the reverse, when markets start selling off, participants are concerned and net sellers. This creates opportunities for picking up good companies with strong fundamentals and growth prospects that can enhance investment returns over the long term.

Market Review

May was no different to the first 4 months of 2022 with global markets remaining incredibly volatile and news-driven. As mentioned above, most companies reported their first quarter 2022 financials and 10-20% down days for those that missed or guided poorly were almost a norm. The US Fed raised interest rates by 0.5% and signaled aggressive monetary tightening to come in an attempt to slow inflation.

We also saw a slurry of weak macroeconomic data prints globally from high inflation numbers at both a producer and consumer level to deteriorating numbers coming in on Manufacturing, Labour, Retail, and New Home sales.

US markets once again led the rest lower with the NASDAQ and S&P500 down 5.6% and 2.8% respectively and commodities in general struggled as growth concerns from China remained at the forefront.

The Rand also remained volatile and ended the month slightly stronger at R15.65/$ while local markets also felt the pinch of a reduction in commodity demand and as a result of the SARB raising rates by 0.5%. The Allshare and Top40 Indexes were down around 1% each.

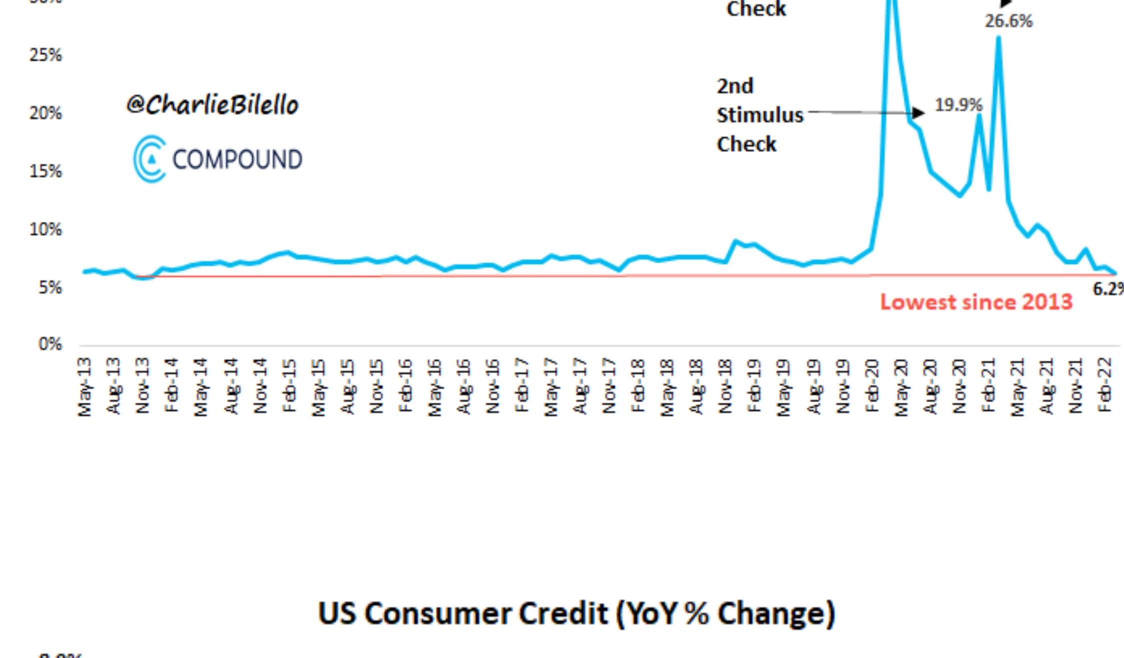
Our market outlook, both locally and offshore, remains cautious as we continue to monitor ongoing global developments and commentary from Central Banks. We are defensively positioned with maximum offshore exposure and relatively high levels of cash and defensive allocations among our portfolios.

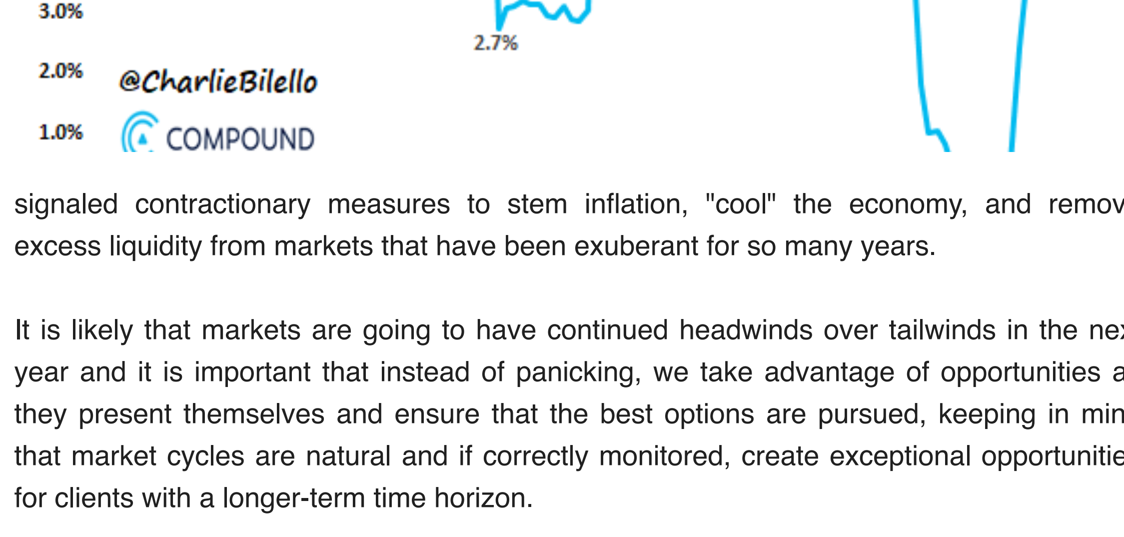
Although we believe that there is more volatility to come, we have started deploying capital to certain opportunities and will look to deploy further into higher return (alpha) generating investments that offer adequate risk-adjusted returns at favourable entry points in the near future.

Charts for the month:

The two charts below show personal savings rates and consumer credit in the United States. If we observe the movements in the past 2 years (since COVID), we can see that savings rates and perceived "wealth" of the consumer rose significantly when the Federal Reserve (Central Bank) started using accommodative policy to help the economy.

We can also see that savings rates have now diminished significantly as Central Banks have started tightening and ironically, consumer credit has increased substantially, in line with projected higher interest rates. Consumers have taken on more credit for various reasons, and this is something that should be closely watched in the coming months as a leading indicator.

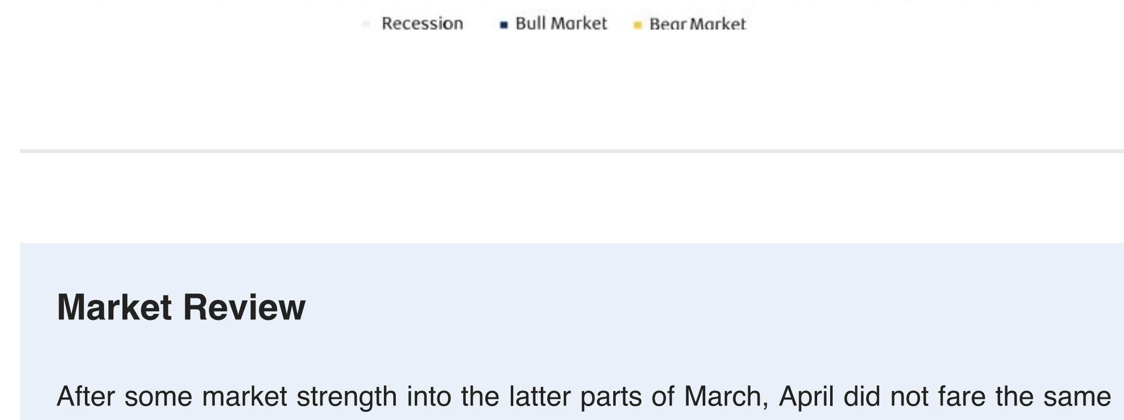




signaled contractionary measures to stem inflation, "cool" the economy, and remove excess liquidity from markets that have been exuberant for so many years.

It is likely that markets are going to have continued headwinds over tailwinds in the next year and it is important that instead of panicking, we take advantage of opportunities as they present themselves and ensure that the best options are pursued, keeping in mind that market cycles are natural and if correctly monitored, create exceptional opportunities for clients with a longer-term time horizon.

In times of market adversity, individuals need to remain level-headed and if they have selected the best managers to look after their wealth, trust that these managers will protect their investments. Wealth protection in down markets is as important as return generation in bull markets. Markets don't rise forever and periods of drawdowns like we are seeing now are necessary. If capital is allocated correctly when opportunities present themselves it provides client portfolios with excellent tailwinds for significant returns into the future.



Market Review

After some market strength into the latter parts of March, April did not fare the same with notable market indexes all in the red. US indexes led the way down with the Nasdaq (Technology) Index falling 11.9% and the S&P500 Index falling 7.9%. Asian indexes also fell substantially as commentary of growth concerns and a weakening economy in China made headlines.

US companies reported their Q1 2022 earnings over the course of April and, with the exception of a few, further confirmed that we are indeed in a slowing growth