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Wealth Management

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Disinflation, China and stock valuations

Foreword

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Six weeks into the new year and the point is already made: geopolitics *may* affect portfolios in 2024, but the business cycle certainly *will*. Bonds have gone backwards, while stocks have edged higher. The driver of both is the same – economic resilience.

With unemployment still low, central banks are in no rush to loosen policy, and as the rate cuts priced into money markets have receded a little (as we thought they might), bonds have given back some of their end-year rally.

'Higher for longer' is hardly good news for stocks. But the resilience which is stopping rates from falling so soon is also boosting corporate profitability, and has allowed stocks to again decouple positively from bonds.

We are still not out of the cyclical woods (this phrase should be programmed into strategists' keypads…). Geopolitics might yet affect supply more tellingly. Equally, it is possible that growth could be too resilient for comfort, causing inflation to rebound, and policy rates to hit new highs – something which would be more difficult for stocks to shrug off.

But the current favourable mix of healthy corporate profitability and ongoing disinflation can continue. This might further support stocks, and, when rates do eventually fall, bonds too – especially now that yields have backed up a little.

With this in mind, we take a close look below at the latest inflation trends. We also review the continuing disappointment that is China, which has lagged far behind the US and global stock indices.

But then we set tactical concerns aside, and ask why it is that stocks have outperformed bearish predictions not just for a year, but for a generation. We think it's all about EVA…

Kevin Gardiner / Victor Balfour / Anthony Abrahamian
Global Investment Strategists

Image sources: ¥50 note, detail © Getty Images.

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(Dis)inflation update

There have been five distinct inflation waves. Aside from the first, the Price Revolution of the 16th century, most of these episodes have been directly linked to conflict: the Napoleonic wars, the two World Wars, and the Arab-Israeli war during the 1970s (though the latter episode arguably had more deep-seated causes).

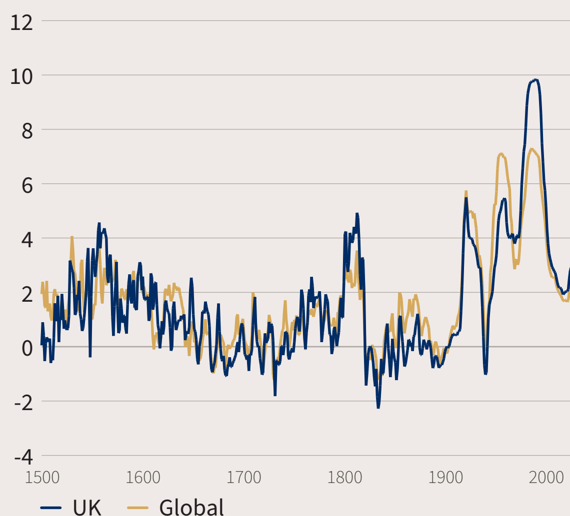
However, despite the fraught geopolitical landscape, today's episode looks unlikely to cement itself as a sixth wave (figure 1).

The inflation story has looked more promising in recent months. Headline inflation rates have been falling for more than a year and are now relatively close to central banks' 2% targets (figure 2). Core inflation rates, which exclude the more volatile food and energy components, have trended lower as well. Remarkably, the six-month annualised change in the Federal Reserve's preferred inflation measure, the 'core PCE deflator', was slightly below 2% in December.

Promisingly, this decline in consumer prices inflation (CPI) has been broad-based across its four main categories: energy, food, goods and services.

FIGURE 1: 500 YEARS OF INFLATION

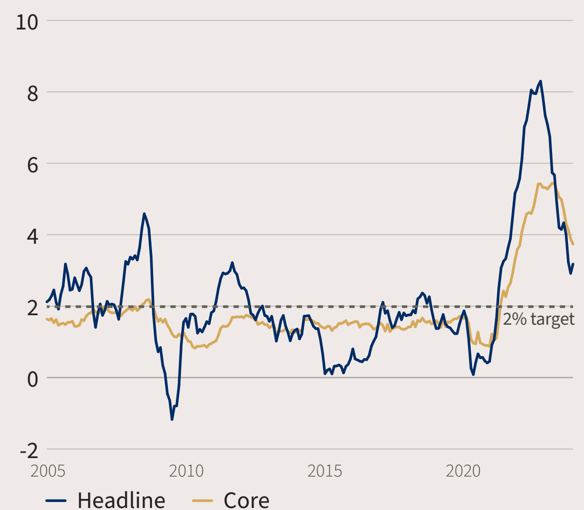
20-year moving average (%)



Source: Rothschild & Co, Bloomberg, Bank of England, IMF
Note: Global series is a GDP-weighted average of the US, UK, Germany, France, Italy, Spain, Holland and Japan data. The 2024-28 data are the IMF World Economic Outlook forecasts

FIGURE 2: DEVELOPED MARKET INFLATION

Year-over-year (%)



Source: Rothschild & Co, Bloomberg
Note: Developed market series is a GDP-weighted average of US, Canada, Eurozone, UK, Switzerland, Denmark, Norway, Australia, Japan, New Zealand and Singapore data

FALLING ENERGY AND FOOD COSTS

The energy CPI has actually been *deflationary* – prices have been falling – for some time in both the US and Europe.

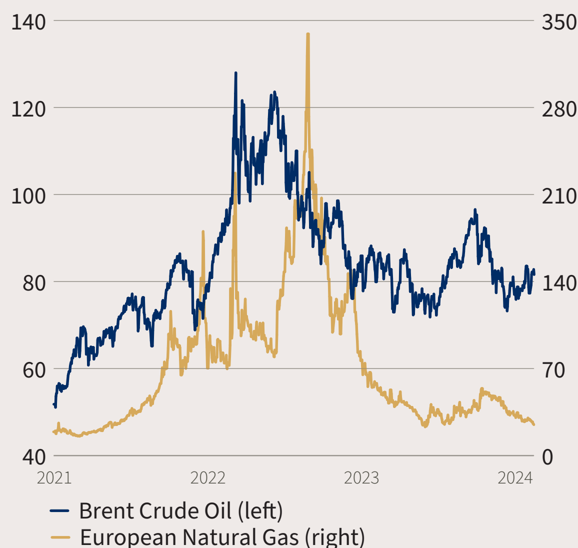
In the US, this component is largely shaped by gasoline prices, which in turn are highly sensitive to changes in the price of crude oil. The latter is still below last year's levels – and well below its highs from 2022 – which explains why the energy part of the inflation basket has been deflationary for so long (figure 3).

Escalation in the Middle East could of course push oil prices higher from here, though the context is very different to that of the 1970s. For one, the world is less dependent on oil as an energy source. It accounted for 40% of global primary energy consumption back then, but that figure is closer to 30% nowadays. In addition, production is more widespread, and so less vulnerable, following the sourcing from Alaska, Mexico, the North Sea and US shale – among other locations – over the past few decades. Despite ongoing production cuts from the Saudi-led OPEC+ cartel, there has not been a widespread oil embargo, and despite sanctions, Russian output does not appear to have been completely lost to the world.

In Europe, wholesale natural gas prices have collapsed from their post-invasion highs and, more recently, have nearly halved in the last three months (figure 3). Europe has admittedly been fortunate to experience a warm winter so far, but it has also adapted to the reduction in Russian pipeline imports, and maintained gas storage at high levels. Government-imposed energy price caps are still catching up with the fall in wholesale prices, and energy deflation will likely continue for some months yet.

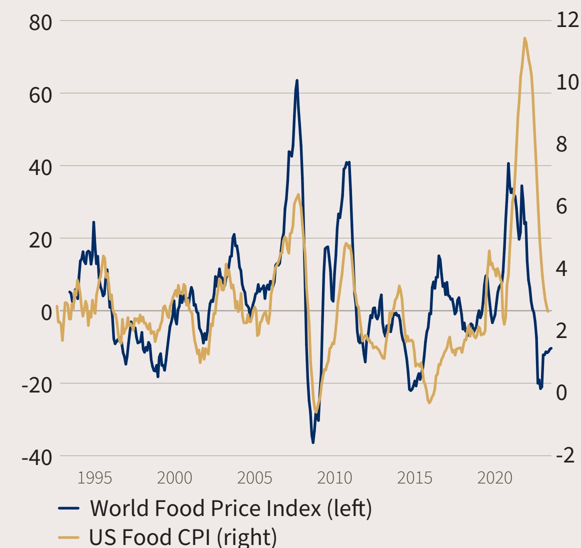
Meanwhile, global wholesale food prices continue to trend lower, and were roughly a tenth lower over the year to January. Changes in wholesale prices tend to lead changes in the prices we see on our supermarket shelves, and so food CPI inflation should continue to fade this year (figure 4).

FIGURE 3: WHOLESALE ENERGY PRICES
(USD, left axis; EUR, right axis)



Source: Rothschild & Co, Bloomberg

FIGURE 4: GLOBAL FOOD INFLATION
Year-over-year (%)



Source: Rothschild & Co, Bloomberg, UN Food & Agriculture Organization
Note: UN FAO World Food Price Index has been lagged by eight months.

GOODS INFLATION REMAINS SUBDUED

Following the relaxation of the pandemic-related restrictions in China, and the subsequent rebalancing of global supply and demand, wider goods CPI inflation has cooled significantly on both sides of the Atlantic. However, the recent disruptions in the Red Sea – a key Europe-Asia trade route, accounting for a tenth of global trade volumes – have cast doubts on whether this can be sustained.

Delivery times are lengthening as shipping fleets re-route. Global shipping container spot rates have already almost tripled since the start of December, which no doubt will hit profit margins, output – and consumer prices (figure 5).

They are rebounding from low levels, however – just a third of their late 2021 highs. Then, the supply shock was largely focused on China, the most important player in global trade and home to the world's largest ports. Western spending on goods was also being bolstered by generous pandemic support schemes. Since then, the services economy has reopened, while overall demand growth has cooled after the sharp rise in interest rates.

Some renewed goods-related inflation is likely because of today's trade disruptions, but in our view the impact is unlikely to be severe.

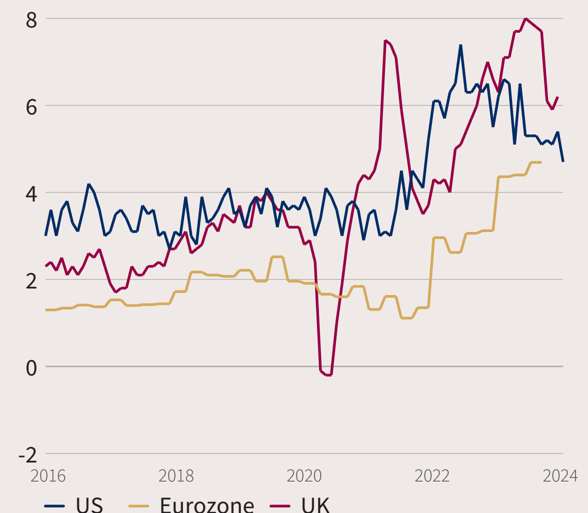
STICKY SERVICES INFLATION

Service prices, the biggest components of US and European CPI baskets, remain the stickiest part of the inflation equation, though they have been slowing gradually. Elevated wage growth is the main threat, particularly as labour markets still look tight. The US unemployment rate, for instance, remains close to a half-century low, while the eurozone equivalent is its lowest since the turn of the century, when the bloc was formed. The UK's rate is not quite so historically remarkable, but it is still very low and, after an initial uptick, actually *fell* over the second half of last year.

FIGURE 5: GLOBAL SHIPPING CONTAINER SPOT RATES
Per 40-foot container (USD, thousands)

Source: Rothschild & Co, Bloomberg, Drewry Research

FIGURE 6: NOMINAL WAGE GROWTH
Year-over-year (%)



Source: Rothschild & Co, Bloomberg, Federal Reserve Bank of Atlanta, Eurostat, Office for National Statistics

However, even if labour demand stays firm, a more dangerous wage-price spiral – a big driver of much Western inflation in the 1970s – seems unlikely. Labour markets have experienced many structural changes in recent decades. Working practices and pay bargaining are more flexible, unionisation is lower, globalisation has boosted the available pool of labour, and, most recently, remote working may have also further decentralised pay setting and made it less antagonistic. This is not another Winter of Discontent.

Real (inflation-adjusted) wage growth rates have turned positive, but only because headline inflation rates have decelerated faster than nominal wage growth – the latter is also rolling over (figure 6).

Elsewhere in the service sector, US shelter inflation – a gauge of housing and rental costs which accounts for more than a third of the entire CPI basket – has also been sticky. It has been moving lower, however – and should continue to do so. House and rental price growth have cooled significantly, and shelter CPI tends to lag these metrics by roughly a year due to the way it is calculated.

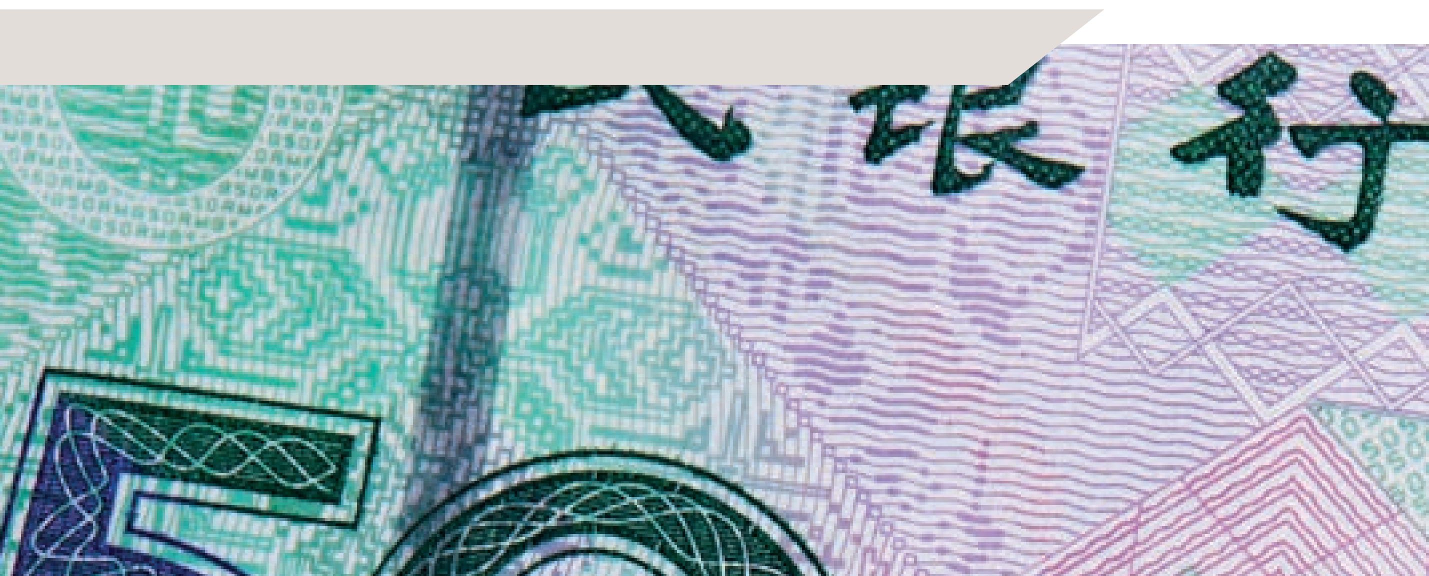
CONCLUSION

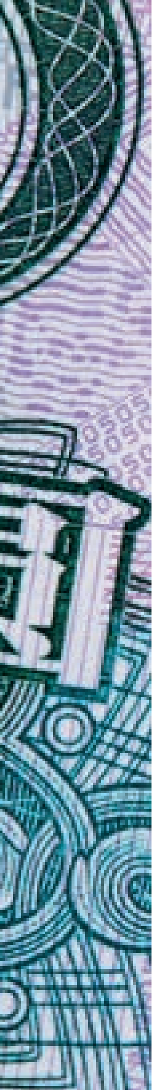
There are superficial similarities between the current inflation episode and the five historic waves – geopolitics and conflict are again playing a role. But arguably the two big drivers of the recent rise in core inflation – post-pandemic bottlenecks and central bank laxity – have been in reverse for some time.

Risks remain of course. Uppermost for us is the possibility of re-intensified US-China trade tensions if the geopolitical temperature around Taiwan were to rise again – and if 2025 does indeed see a second term for President Trump.

But for now, the current episode seems set to fall well short of being a historic 'sixth' inflation wave. We continue to see it settling in the above-target 2-4% range this year in developed economies, largely due to elevated wage growth rates keeping demand (and costs) firm. The major central banks will of course be uncomfortable with this – interest rates may not fall that quickly, as noted above – but business and portfolios can live with it.

We continue to see inflation settling in the above-target 2–4% range this year in developed economies.





Patience with China's stock market wears thin

"Patience is a tree with bitter roots that bears sweet fruits."
– Confucius

Lunar New Year is meant to usher in hope and revival. Yet this year's festivities coincide with a sobering backdrop – one that is testing the patience of the most committed Sinophiles.

Worries about growth, geopolitics, and authoritarian government have dramatically dented sentiment. The stock market has been in a three-year slump, with prices having more than halved from their peak in early 2021 (figure 7). For many outside investors, China has simply become 'uninvestable'.

China's predicament is likely being overstated. Talk of excessive private sector debt, the collapse of the property market and a banking crisis is misplaced. The challenge that China faces is not systemic. Rather, the concern is how sustainable is current growth and how investors should navigate its increasingly politicised stock market.

For many outside investors, China has simply become 'uninvestable'.

FIGURE 7: MSCI CHINA AND WORLD (DEVELOPED MARKET) STOCK MARKET RETURNS
Rebased total return indices (Jan 2021 = 100, USD)

Source: Rothschild & Co, Bloomberg, MSCI

GROWING PAINS

China's economic growth over the past three decades has been nothing less than extraordinary. Real GDP growth has averaged almost 9% per annum since 1990 – far outpacing the likes of the G7 or any other member of the emerging Asia cohort (figure 8). China's output has grown 35-fold over this period, and its share of global output has grown from 2% to 17% (all in US dollar terms).

A decade ago, it was widely predicted that China would eclipse the US as the world's largest economy by 2030. But even if it does, will it do so for long? Overinvestment, elevated property prices and challenging demographics could be headwinds. China's long held aspiration to shift towards consumption-led growth has fallen short. There is (mistaken) talk of China's 'Japanification'.

Most of China's stellar growth can be attributed to very high rates of investment. But much infrastructure has now been built. Meanwhile, real estate development, intermediated through the state-owned financial system, worked when leverage was low and housing was in short supply – and when home ownership was still aspirational. But today, China has the highest rate of property 'ownership' (tenure is not what it is elsewhere) globally, and corporate debt – mostly leveraged property developers – is close to 166% of GDP (high even by western standards).

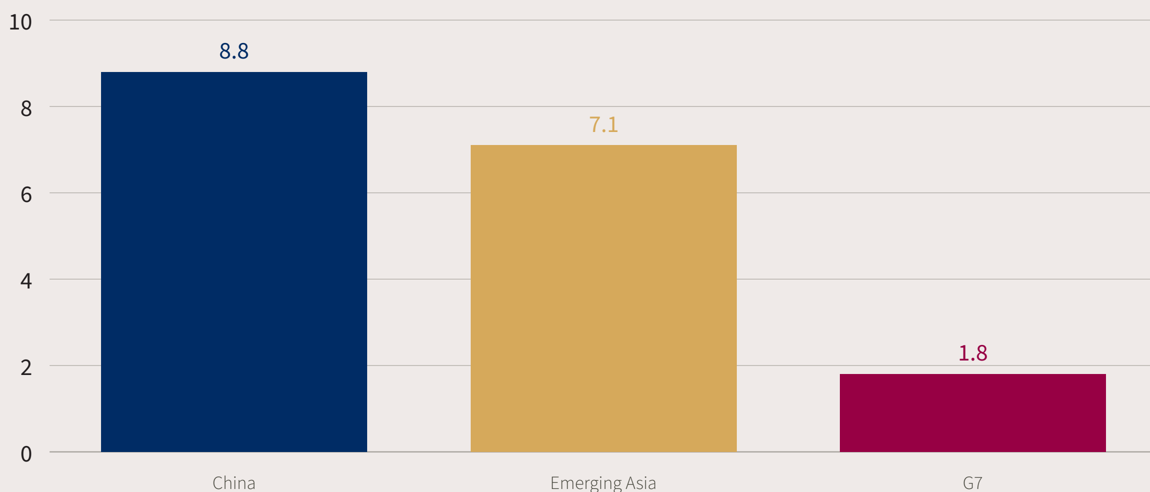
However, part of the reason that the property sector is going through a painful (and belated) readjustment is that policymakers are well aware that domestic debt-fuelled growth is not sustainable. Steps have been taken to address some of the lurking issues, such as the shadow banking system and excessive property speculation. The emphasis has shifted from unconditional growth to financial stability.

And the threat posed by the private sector's debt burden is likely exaggerated. Talk of a looming 'Minsky Moment' seems misplaced. China's state-owned financial system can prevent significant banks from failing – Beijing has recapitalised the banks before and it can do so again – and with foreign exchange reserves still some $3 trillion, China's international credit is good.

A collapse in house prices – such as Japan's experience in the 1990s – seems unlikely. China's high domestic savings, those FX reserves and a partially closed capital account, insulate the economy (and the banking system) from the risk of significant capital flight and a balance of payments crisis. With real estate accounting for close to 70% of household wealth (G7 averages are close to a half), a dramatic domestic rebalancing away from property seems unlikely.

FIGURE 8: REAL GDP GROWTH SINCE 1990

Average annual growth rate (%)



Source: Rothschild & Co, Bloomberg, IMF

The two-year recession in global manufacturing seems to be turning a corner. Meanwhile, China's mild deflation is largely a consequence of normalising food prices, not a collapse in domestic demand. The economy is not that fragile.

But if a hard landing for the economy seems unlikely, it is hard to imagine a renewed policy-led acceleration. Attempts to stimulate the economy to date have been modest and highly targeted.

By way of context, last year's 5% growth rate is still more than twice that of the developed world. In terms of additional output, this equates to a 20% growth rate back in 2010, when the economy was only a quarter of its current size. China may simply have less room – and need – to grow rapidly now. Slower, more stable growth may be no bad thing.

CHINESE CAPITALISM: THE VISIBLE HAND

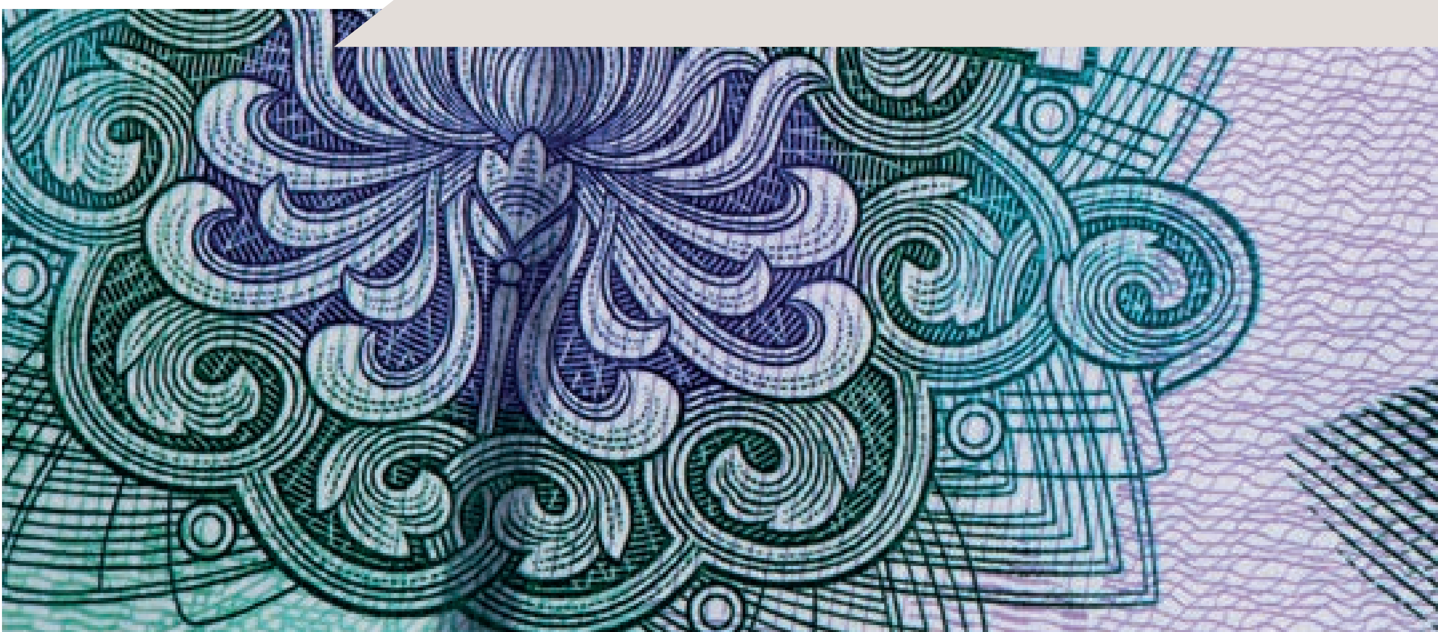
Recent stock market weakness is broad based: most sectors are down more than a fifth over the past three years. However, two big 'technology' stocks (Alibaba and Tencent) – which are a fifth of the index – account for a quarter of the market's drawdown.

We think stock market weakness can be largely attributed to non-economic developments – namely regulatory pressures and ongoing trade frictions with the US. Tensions around Taiwan are important of course – but such stress affects global markets, not just China's stocks.

Regulatory pressures have emerged where social objectives and market power fail to align. Although they have cooled over the past year, the recent clampdown on the video games sector suggests it would be premature to conclude that President Xi's aggressive stance has run its course.

Until recently, China actually had relatively loose regulation in some sectors – for example, in its attitude towards anti-trust concerns in the technology sector. More generally, it allowed companies in many sectors to prosper in what effectively has been a walled garden without any real competing foreign players. Its recent toughening partly reflects an effort to recalibrate the regulatory landscape, not a wholesale attempt to constrain China Inc.

That said, there is no doubt that the 'visible hand' of China's state capitalism has muted corporate profitability. Expectations – including our own – that it would stop doing so have been disappointed. A few numbers illustrate this starkly. Since China joined the World Trade Organisation at the end of 2001, and excitement spread, its nominal GDP growth, in USD terms, has indeed outpaced that of the US by some 6 percentage points per annum. MSCI China's earnings per share, however, again in USD, have over the same period grown 2 percentage points per annum more slowly than MSCI US's. China's stellar economic growth has not made it to the corporate bottom line.



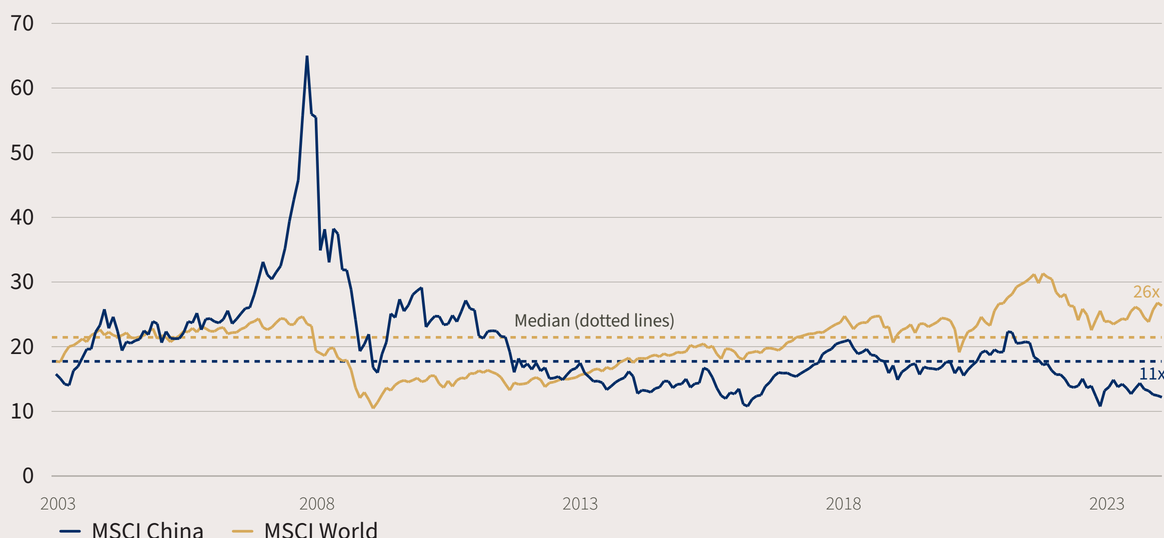
We think this will change, and a more conventional capitalism will slowly take deeper root (even as the Chinese Communist Party remains in power). But we have also long felt the same about Japan's model – which also continues to disappoint (the stock market's recent bounce notwithstanding). We carry few macro torches for non-US regions, and are slowly losing our appetite for carrying one for China.

Despite its poor earnings record, China's stock market is at least now inexpensive. Its cyclically-adjusted price-earnings (CAPE) ratio is nearly a third below its long-term trend, whereas the rest of the world is above its trend (figure 9). In terms of levels, China's valuations have traded at a discount of around a fifth to its developed market peers: that discount today is close to *half*. And some of the latest disappointment in earnings partly reflects the global manufacturing cycle.

And this is not the first time China investors have been frustrated. Between 2015 and 2016 the stock market (and its earnings) suffered a similar rout. Back then, in China's 'Black Monday', stock prices fell nearly a tenth in a single day. Despite Beijing's interventions, the domestic stock market nearly halved and it took two and half years for stocks to regain their high watermark. Growth and real estate worries were prominent then too. But while we are patient investors, and do not share the view of so many international investors that China is 'uninvestable', we would feel more encouraged if stability were to break out soon. Otherwise, global equity investing will revolve even more around the US than it does now.

Despite its poor earnings record, China's stock market is at least now inexpensive.

FIGURE 9: MSCI CHINA AND WORLD CAPE RATIOS
(X)



Source: Rothschild & Co, Bloomberg

US stock valuations: it's all about EVA

STOCKS HAVE CLIMBED THE WALL OF WORRY SEVERAL TIMES OVER…

We have written often about the 'wall of worry' that investors face. It looked particularly daunting in late 2022, but it's always out there. There has seemingly never been a good time to invest – at least, according to the established macro view embodied in our favourite financial periodicals.

And yet stocks have effectively climbed the Eiger several times over, led by the US market (which is, by the way, the least badly regulated and the most liquid of the big markets: so much for the notion of 'risk' and 'illiquidity' premia…).

The MSCI index of US stock prices has risen 30-fold since February 1984 (it is up roughly 10-fold since the GFC low point in March 2009). As a matter of arithmetic, most of its ascent since 1984 can be attributed to corporate earnings, which have risen more than 10-fold in nominal terms (they have more than quadrupled in real terms). But a further more-than-doubling is attributable to an increase in its trailing price-to-earnings (PE) ratio.

(Note: we use the MSCI indices in our work for reasons of international comparability. The most visible US index is probably the S&P500, which has performed similarly).

The market's ascent has been viewed disbelievingly – and disparagingly – all the way up. The pitch led by the PE ratio in particular has been disdainfully scrutinised through all sorts of lenses by the armchair climbers at Kleine Scheidegg. Books have been written about why the market is unsustainably expensive. And yet multiples have stayed above earlier trends, and the market's climb has continued.

… BUT MAY HAVE A SOUNDER FOOTING THAN FEARED

We've long felt that US stocks may be less exposed than is feared. Specifically, there could be a sound footing for much of that PE expansion, and it has been hiding in plain sight all along.

The valuation of stocks is inevitably a subjective (and imprecise) process, but if it is about anything, it is about trying to estimate the net present value (NPV) of the cashflows they generate. One key driver of this is the profitability of the businesses concerned. But we also need to compare that profitability with the return which our capital might make elsewhere, and so a second key driver is that hurdle rate.

In practice, this means comparing the return on the equity capital used in the business (RoE) with its cost (CoE). RoE is easily computed as earnings divided by book value. CoE is more difficult to gauge, but its biggest moving part is the time value of money, the discount rate, usually proxied by long-dated bond yields.

The gap between the two is the major contributor to what we used to call economic value added (EVA). The phrase largely disappeared from regular use after the 2000s, because for much of that time market values were not being driven by discounted cashflow but by swings in risk appetite and institutional fashion (such as liability-driven investing, or LDI). The idea has nonetheless always underpinned our notions of stock market value.

EVA should be positive, otherwise capital would be better employed elsewhere. There have however been times when estimates of aggregate market EVA have been negative, and the quoted sector has seemingly been destroying value. This has usually happened briefly, at the trough of a business cycle, when profits are unusually low. But there were longer value-destroying periods in the stagflationary 1970s and 1980s. A recovery from this long-ago sorry situation is arguably what has been driving higher PE ratios.

That recovery in EVA has been in place now for pushing forty years. And this is not just Professor Hindsight speaking: it was very visible for at least half that time. It reflected both rising profitability and falling capital costs (figure 10).

COMPANIES ADD MORE ECONOMIC VALUE...

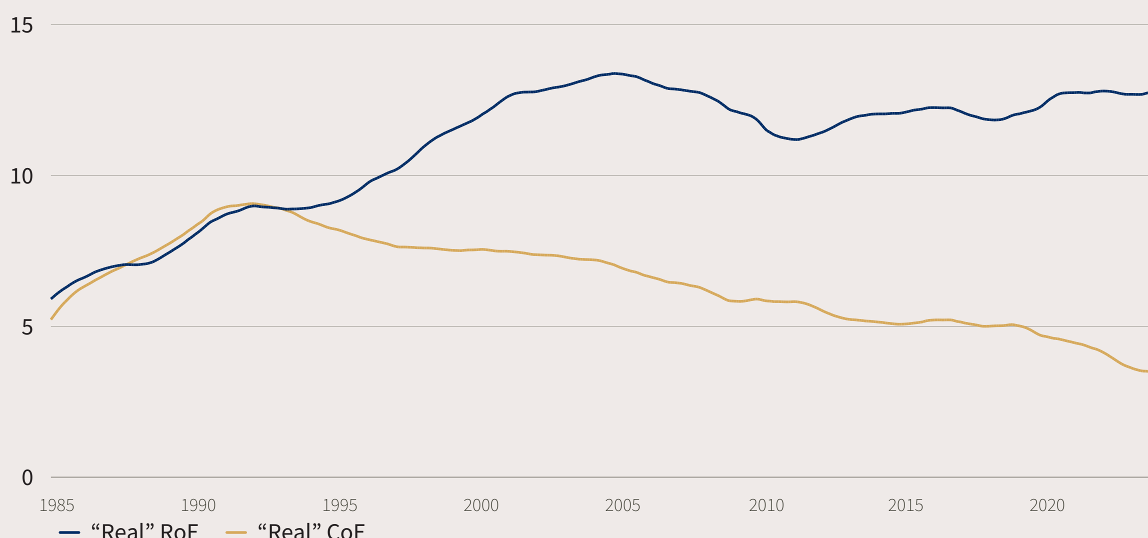
Why has this trend been so overlooked or distrusted? Some argue that the rise in profitability is not real, but reflects financial engineering (such as stock buy-backs, or leverage more generally). Others believe it is purely cyclical, or transient (even after several decades), and that operating margins are about to revert to a lower mean. Still, others assert that interest rates have nothing to do with security valuation, period.

Economists, who often like to show that something which works well in practice can't possibly work in theory, like to suggest it's all a mirage. If EVA were indeed to have reached such high levels, they say, competition would surely have quickly eroded it back to 'normal' as we all replicated Microsoft in our lofts.

But if the reasons for scepticism have varied, the confidence with which it is expressed hasn't. Much of the finest financial rhetoric comes from the short side. World-weary cynics who know exactly why it will all end in tears sound smarter – certainly more entertaining – than less passionate but more open-minded (and less PR-oriented) observers.

We are *not* surprised at the drivers of EVA, and our valuation models have been using levels of RoE – and bond yields – similar to today's since the 2000s.

FIGURE 10: PROFITABILITY UP, CAPITAL COSTS DOWN
Inflation-adjusted US RoE and CoE (10-year averages, %)



Source: Rothschild & Co, Datastream, MSCI

Figure 11 illustrates how the improvement in our estimate of the RoE-CoE gap has coincided with the rising PE ratio. The two variables are not directly comparable (the units are different), and to calculate exactly what level of PE is warranted requires an estimate of likely earnings growth too (when we do that, we typically estimate a 'fair value' forward-looking US PE at around 19x). But the chart illustrates the point: something meaningful has been going on: expanded PEs may not be just fluff.

That said, the easy gains in EVA are surely long behind us now, and the trend is likely to flatten from here. We are happy to defend recent PEs, but are not willing to argue that the ascent should continue.

… PARTLY BECAUSE THEY ARE DIFFERENT COMPANIES

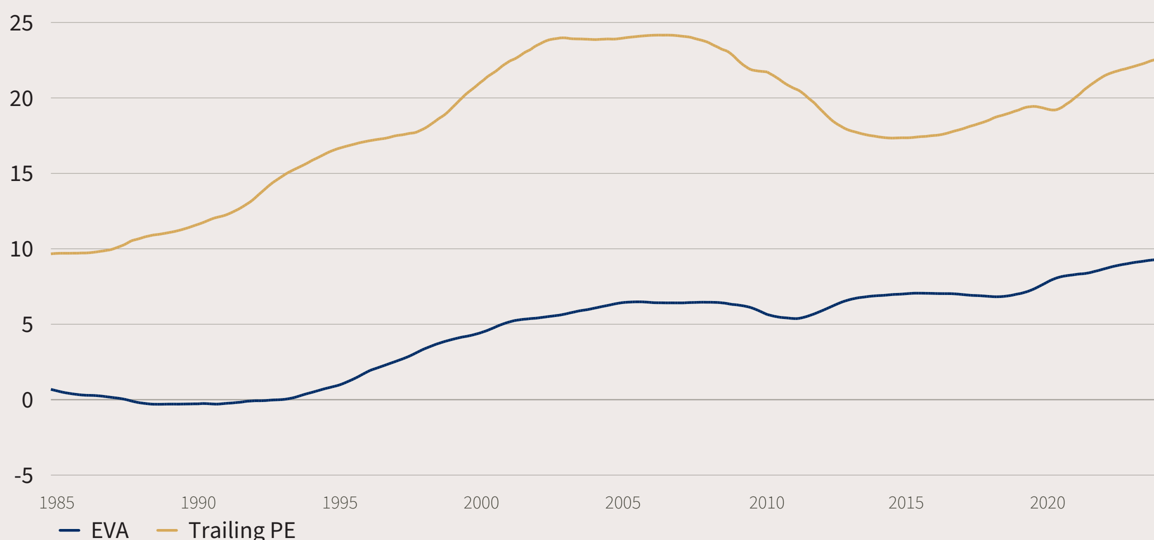
The two drivers of EVA each owed a lot to their starting points. Corporate profitability in the stagflationary 1970s and early 1980s was pretty depressed, while real interest rates in the early 1980s had risen sharply as monetary credibility was rebuilt. Neither of these starting points was 'typical', a mean to which we had one day to revert.

Corporate profitability has subsequently been boosted by a healthier macro climate, better industrial relations, and – the most intriguing contributor of all, we think, because it may be the most structural but least noticed – by a big change in what US Inc does.

In round numbers, in 1970 perhaps 30% of the US economy comprised private goods-producing industries – mostly manufacturers – while private services accounted for roughly 50%. Recently, those figures have been around 15% and 70% respectively, alongside a new category, accounting for roughly 5%, called 'Information and Communication Technology'. A similar but less pronounced shift will have occurred across the developed world.

If most of the modern economy makes intangible things, does it still need so much plant and equipment? If balance sheets are smaller, does that make it easier to reward the capital they do contain? Especially if – to return to the example above – the 'going concern' component of Microsoft is not quite as easy to replicate as the textbooks suggest. Profitability can persist.

FIGURE 11: IS IT ALL ABOUT EVA?
A proxy for US EVA (10-year average, pp) and a trailing US PE (10-year average, X)



Source: Rothschild & Co, Datastream, MSCI

Meanwhile, US corporate leverage actually appears to have changed little over this period, at least if national accounts data are anything to go by.

Interest rates and bond yields declined from the record levels seen in the early 1980s to reach record lows (in much of Europe, they turned negative) in recent years. The fall was less dramatic in real terms, but still pronounced.

Those lows always looked unsustainable. Despite a heroic analysis of 800 years' worth of global data at the Bank of England, we have not been convinced of a secular downtrend in real rates. Current levels of nominal and real rates look more normal (we think), but are still well below their highs some four decades back.

HIGHER PE RATIOS ARE NOT SUCH A SURPRISE

If recent levels of return on equity are sustainable, and interest rates are not headed still higher, then our proxy for economic value added will remain historically elevated. The starting point may have been more remarkable than the destination.

Valuations are only an infrequent driver of stock market returns, and matter most when they have been at extreme highs or lows, and so ripe for a reversal. But as we see it, a significant portion of the last three decades' expansion in US PE ratios is plausibly based.

This does not mean, of course, that the rest of 2024 need be plain sailing.

If recent levels of return on equity are sustainable, and interest rates are not headed still higher, then our proxy for economic value added will remain historically elevated.

Economy and markets: background

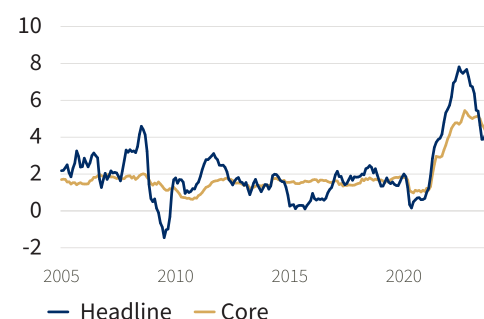
GROWTH: MAJOR ECONOMIES

Business optimism: standard deviations from trend

Source: Bloomberg, Rothschild & Co
Composite of the forward-looking components of manufacturing surveys from China, Germany, Japan, UK and US loosely weighted by GDP

G7 INFLATION

Year-over-year (%)



Source: OECD, Bloomberg, Rothschild & Co

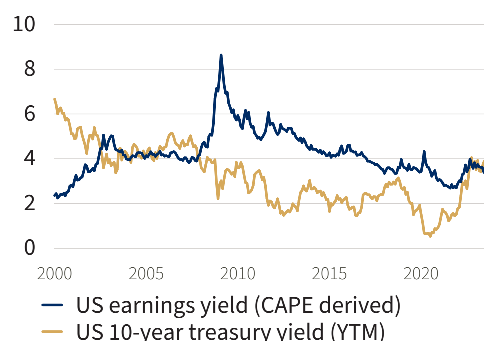
DEVELOPED MARKET STOCKS AND GOVERNMENT BOND RETURNS

Relative returns since 2005 (%)

Source: MSCI, Bank of America Merrill Lynch, Bloomberg, Rothschild & Co

STOCKS/BONDS — RELATIVE VALUATIONS

(%)



Source: MSCI, Datastream, Bloomberg, Rothschild & Co

EQUITIES

MSCI indices, USD terms

	2023 (%)	YTD (%)
Global	22.2	2.6
US	26.5	4.9
Eurozone	22.9	-0.4
UK	14.1	-3.5
Switzerland	15.7	-4.3
Japan	20.3	3.4
Pacific ex Japan	6.4	-5.6
EM Asia	7.8	-2.4
EM ex Asia	17.6	-2.1

FIXED INCOME

Current yields and returns, local currency terms

	YIELD	2023 (%)	YTD (%)
Global Govt (hdg, USD)	3.19	6.7	-1.1
Global IG (hdg, USD)	5.00	9.1	-1.4
Global HY (hdg, USD)	8.41	13.7	0.1
US 10 Yr	4.26	3.6	-2.5
German 10 Yr	2.34	7.0	-2.2
UK 10 Yr	4.04	5.6	-3.6
Swiss 10 Yr	0.92	8.0	-1.4

CURRENCIES

JP Morgan Trade-Weighted Nominal Effective Exchange Rates

	2023 (%)	YTD (%)
US Dollar	-0.9	2.4
Euro	4.3	-0.6
Pound Sterling	5.2	1.2
Swiss Franc	8.2	-2.9

COMMODITIES

	LEVEL	2023 (%)	YTD (%)
Gold (USD)	1992	13.1	-3.4
Brent Crude (USD)	82	-10.3	5.9
Gas (EUR)	25	-57.6	-23.2

Data correct as at 14 February 2024.

Past performance should not be taken as a guide to future performance.

Table sources: Bloomberg, Rothschild & Co

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