

<https://blog.en.erste-am.com/stock-markets-off-to-a-bumpy-start-in-2022/>

Stock markets off to a bumpy start in 2022

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The stock markets are off to a bumpy start this year. What are the reasons for this?

First of all, we have to take into account that equity markets posted very strong gains in 2021. In EUR-terms, MSCI World increased by 29% and the S&P 500 by 36%. Europe also performed well, with a 22% increase in the Stoxx 600 index. For the MSCI World and the S&P 500, it was actually their third straight year of double-digit percentage gains, when measured in USD. After such a strong performance, it should not come as a big surprise that equity markets are experiencing some declines. While there are certain market moving factors in place, simple profit-taking likely also plays a role.

The other important factor for the current weakness on equity markets is the sharp increase in yields. US and German 10-year yields climbed to post-pandemic highs, with the latter touching positive territory for the first time since 2019. In general, there is a negative correlation between yields and equity valuation, which can be broken down into two components. First, higher yields increase the discount rates applied in valuation models, thereby lowering the present value of a company's future earnings, cash flows and dividends.

Second, if investors can achieve a higher yield on risk-free investments such as US government bonds, they will demand higher yields also on their equity investments to be compensated for the risk they take on. For this to happen, valuation multiples such as P/E (=stock price divided by earnings per share) have to come down in order to offer investors a greater earnings yield, which is the reverse of P/E (= earnings per share divided by stock price).

The latter effect is called multiple compression and can lead to declining stock prices, even if the underlying fundamentals of the respective companies do not change.

Inflation has risen sharply and the first interest rate hikes are expected from the Federal Reserve in the USA. What impact could this have on stocks?

The current market volatility is a reaction to the tighter monetary policy in the US. As discussed recently (<https://blog.en.erste-am.com/investors-bought-the-dip-again/>), nervousity among investors increased at the end of last year, when elevated inflation numbers suggested that the world's major central bank will have to curb cheap money faster than anticipated.

The Fed minutes released in January confirmed this hawkish stance: Fed members raised their forecasts to three hikes in 2022, hinted towards faster tapering (=gradually lowering the amount of monthly asset purchases down to zero) and even discussed the possibility of quantitative tightening (=reducing the existing bond portfolio). Market participants adopted their expectations, which now point towards four rate hikes this year, with the first one taking place at the March Fed-meeting. This resulted in the above mentioned increase in yields.

In general, higher yields are most hurtful for stocks with lofty valuations and strong expected earnings growth in the future, many of which can be found in the tech sector (for more details on the negative correlation between yields and high-multiple stocks, s. also <https://blog.en.erste-am.com/how-are-global-equity-markets-doing/>).

Certain segments of the market, however, benefit from higher rates and higher but moderate inflation. A typical example for the former is the banking sector, since banks can pass on higher rates to their customers in the form of higher lending rates. Commodities and energy on the other hand are two examples of sectors which stand to benefit from higher inflation, as the price of their end-products increases as a result of general inflation.

This year's sector performance in Europe is a good illustration of this: basic resources, energy and banks kicked off the year with solid gains, whereas technology ranks on the bottom of the performance list.

In terms of regional performance, European equities are outperforming this year, thanks to their cyclical tilt. Compared to major US indices like the S&P 500, European indices have a higher exposure to financials and energy, and a lower exposure to technology. This gives them an advantage in an environment where inflation is high and interest rates are rising. In 2021, the performance gap between US and European equities narrowed, but US equities still finished in the lead. If the monetary tightening trends continue throughout 2022 without causing a major setback on equity markets, then Europe has a good chance to outperform this year.

What is the fundamental development of the companies? What are the earnings expectations for 2022?

Last week the big US banks kicked off the reporting season for the fourth quarter and in the coming weeks, we will receive more results also from European companies. While it is still early days, 78% of the US companies which reported earnings so far were able to beat analyst estimates. Consensus currently expects Q4 earnings for the S&P 500 companies to increase by slightly less than 22%, a figure largely unchanged since the start of the year. If this estimate proves to be correct, then total earnings growth for 2021 will be around 45%, giving proof of the strength of the post-pandemic recovery. For 2022, consensus expects net incomes to grow by roughly 10%.

The ongoing expansion in the global economy and in company earnings make us optimistic for this year. Certainly, tighter monetary policy all around the globe will leave equity markets less supported than they were in the last two years. Higher inflation poses a threat to corporate margins, which remained surprisingly resilient however in the last quarters. And the S&P 500 has gone without a 10% drop since the new bull market started in March 2020.

So while we understand the rationale behind the current correction, we do not expect broad equity indices to fall into a bear market (=a decline of 20% or more). In the end, increasing earnings and a growing economy will have the upper hand over higher yields. And as long as the latter does not rise materially, one has to bear in mind that in a historical context, money is still cheap. And until that is the case, the TINA argument for equities remains: for now, there is no real alternative.

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