Beyond inflation: The impact of weaker global trade on global equities

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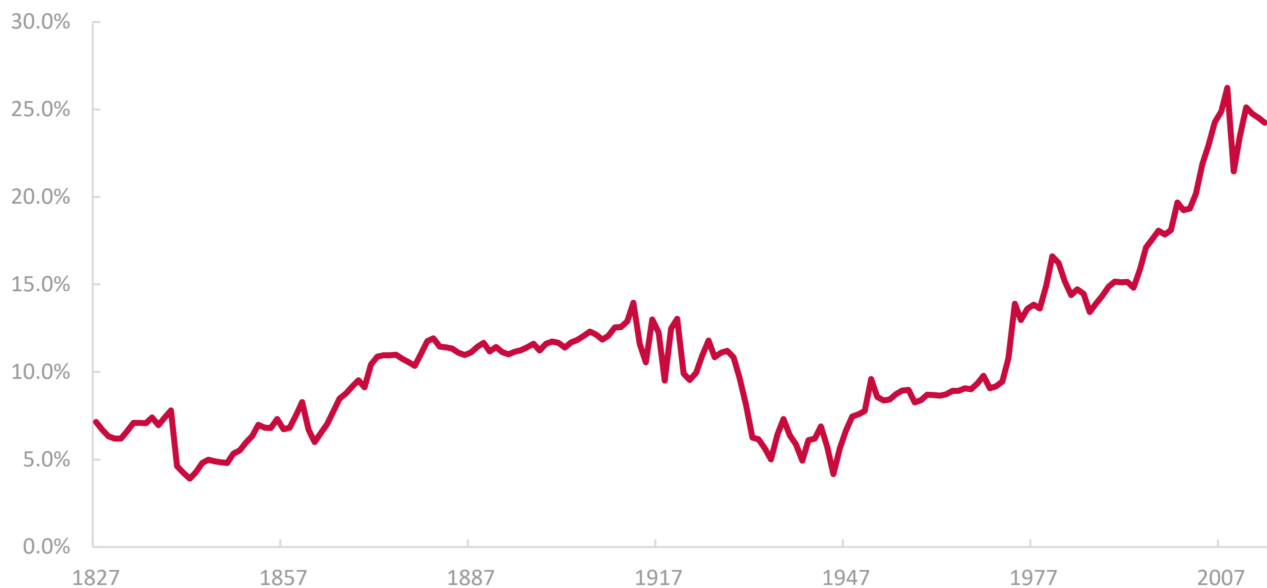
Whether deglobalisation is entrenched or a temporary phenomenon, the short-term impact on asset prices is profound. While US equity markets appear to be forecasting a fairly rapid normalisation of inflation, unusually high risks to inflation could potentially derail equity returns further, even after the latest correction.

While the latest global trade data does not suggest a slowdown in globalisation levels (trade interdependence), the impact of US-China tensions, the Covid-19 pandemic and more recently the War in Ukraine, have had a significant impact on global trade. These dynamics are likely to further weaken trade cooperation between countries as policymakers look to re-consider the balance between economic efficiency and supply chain security.
The impact on inflation and long-term equity prospective returns could be meaningful.

How entrenched is the deglobalisation trend?

Since the Industrial Revolution, world economies have sought to strengthen economic ties and work towards higher levels of economic integration. The level of globalisation experienced a strong acceleration during the three decades post World War II (1945-1975) as the United States and Western Europe in particular sought to improve economic ties, reduce trade protectionism and increase the scale and scope of trade agreements. From the 1980's, globalisation accelerated even further as China and India, historically closed economies, started to reduce trade barriers with the West. The collapse of the Soviet bloc in 1991 and its subsequent democratisation marked a further step in global integration with trade volumes as a percentage of GDP eventually peaking in 2008 (Chart 1).

Chart 1: Value of global exported goods as share of GDP, 1827 to 2014 (exports-to-GDP-ratio)



Source: Klasing and Milionis (2014), Penn World Tables 9.1, World Bank, Northstar AM | Data as at 2014

The global financial crisis (GFC) in 2008 marked a turning point in the level of global economic integration. Over the past decade we have seen significant shifts in policy such as the US withdrawing from the Trans-Pacific partnership, China refocusing its reform agenda on the promotion of local industries, and India developing a 'self-reliance' strategy.

Covid-19 pandemic and geopolitical tensions

There seems to be no consensus on whether deglobalisation trends are entrenched or rather temporary and aggravated by the Covid pandemic and the Ukraine conflict. However, the negative impact of these developments on inflation adds to already deep global supply chain disruptions and ongoing global production reconfiguration.

The long-term impact of these dynamics is complex to model, but over the short term there is clear evidence that the pandemic and the Ukraine conflict, in particular, have had a profound impact on asset prices. Inflation in the US (Chart 2) and Europe has spiked to multi-decade highs as the combined effects of supply chain bottlenecks, commodity price shocks and trade tensions have weighed on asset prices.

Not surprisingly, global equities and bonds alike have come under significant pressure, with central banks around the world becoming increasingly hawkish and markets more negative on the prospects of a 'soft landing'.

Chart 2: US inflation

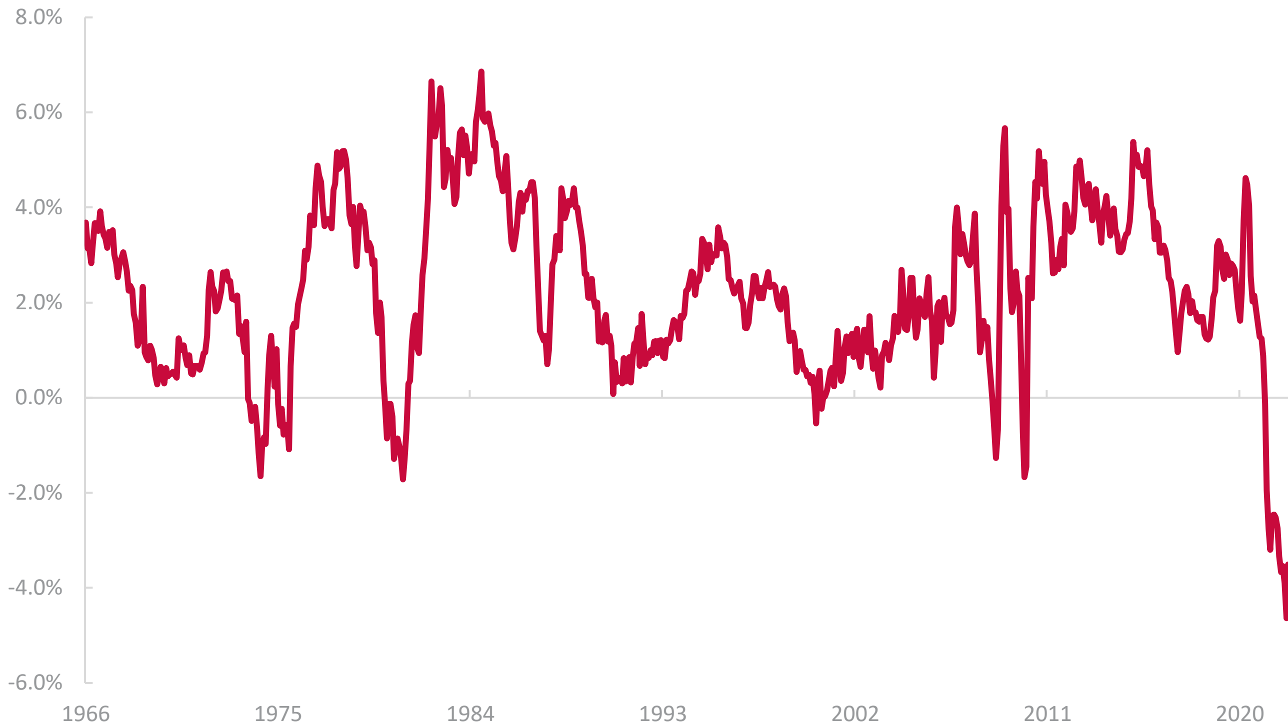
Source: Bloomberg, Northstar Asset Management | Data as at May 2022

Impact on equities

The relationship between inflation and corporate earnings is not always straightforward. An analysis of US earnings cycles reveals that corporate earnings will generally benefit from increasing inflation levels as input cost pressure is passed on to consumers to some extent. During periods of extreme and protracted pricing pressure however, such as those experienced during the 1970s, earnings have seldomly grown ahead of inflation and thus contracted in real terms.

Negative real earnings growth is in our opinion the key risk equity markets face at present as this significantly increases the likelihood of further market multiple deratings. An analysis of the S&P500 real earnings yield highlights such risks.

Chart 3: S&P 500 real earnings yield



Source: IRESS, Northstar AM | Data as at May 2022

Based on current inflation levels, the S&P 500 is trading on a real earnings yield of -3.5% – far off a long-term average of 2.3% (Chart 3). Based on our calculations, and assuming that Bloomberg consensus earnings growth for the index materialises, the S&P 500 would require inflation to be closer to 3% in 2023 and 2% in 2024 to justify its current rating.

In other words, the equity market appears to be discounting a fairly rapid normalisation in inflation levels broadly in-line with consensus economic forecasts. In the event that global inflationary pressures remain stubbornly higher for longer, even if a recession is avoided, we think that equity markets could come under further pricing pressure. While we believe the risk-return prospects for global equities are more balanced after the latest correction, we remain of the view that unusually high short- and long-term risks to inflation could potentially derail equity returns further.

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