Cornelian

Comment on recent market volatility

The rapid recent decline in equity markets from their highs was triggered by an higher than expected average hourly earnings number, which suggested that wage growth in the United States is accelerating faster than expected.

Whilst we have some issues with this interpretation, it is important to point out that in the last two economic booms (see white blocked out areas in Figure 1 below), strongly accelerating wage inflation (as measured by the Average Hourly Earnings of Production and Nonsupervisory Employees in the Private sector (white line)) did not result in significantly higher core inflation (using either the Core Consumer Price Index (green) or the Federal Reserve's preferred measure of inflation the Personal Consumption Expenditure Core Price Index (yellow)).

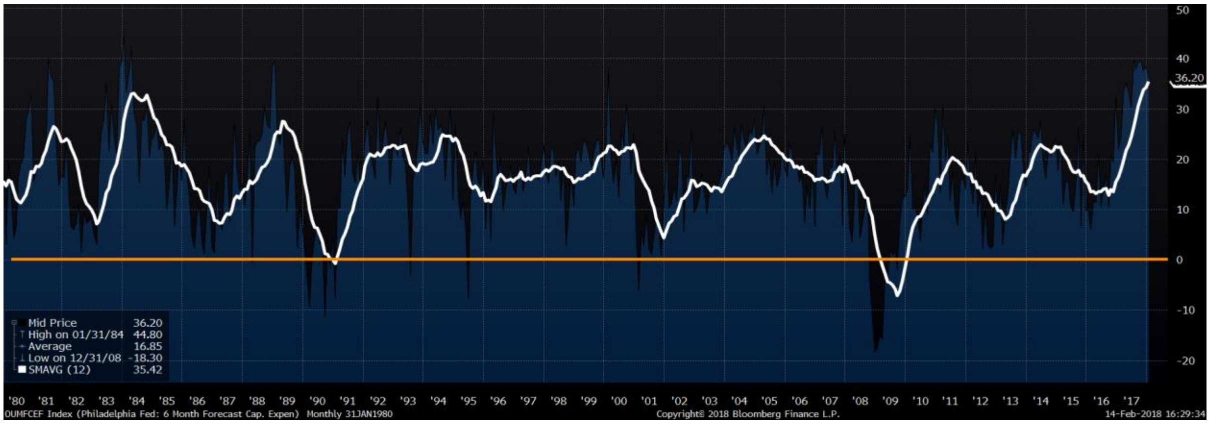
Fig 1. Average Hourly Earnings vs Core CPI and Core PCE

Source: Bureau of Labor Statistics; Bureau of Economic Analysis

The above suggests strongly that it is not a given that higher wage inflation leads to core inflation getting out of hand. We believe that in this cycle as wage inflation rises, companies will be incentivised to invest in productivity enhancing plant and machinery which will enable companies to accommodate higher wages, whilst maintaining, or indeed, improving margins.

This belief is underscored by the US tax reforms enacted late last year which incentivise capital expenditure and there is compelling evidence that US companies are about to act. Figure 2 below shows the 12 week moving average of the Philadelphia Federal Reserve's survey of the intention of CEOs to increase capital expenditure during the next six months. It has never been higher at any time during the past 35 years.

Fig 2. Philadelphia Fed: 6 month forecast capital expenditure diffusion index (12 week moving av.)

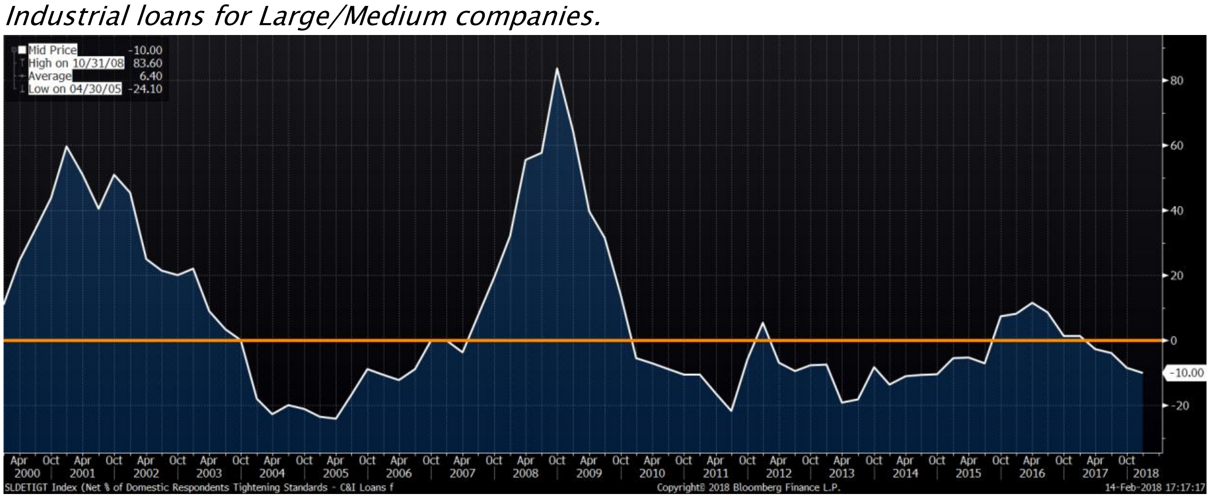


Source: Philadelphia Federal Reserve

Should announcements of increased capital investment start to build in the United States, investors are likely to buy into the productivity story, at least in the short term, and current inflation concerns will recede.

This view is supported by the credit cycle. Figure 3 below is a chart showing whether banks in the United States are making it easier or more difficult for companies to borrow from them. A reading below the horizontal orange line tells us that banks are easing lending standards to medium and large companies.

Fig. 3. Net percentage of domestic respondents tightening lending standards – Commercial and Industrial loans for Large/Medium companies.



Source: Senior Loan Officers Survey; Federal Reserve.

This could clear the way for the final leg of the equity bull market to unfold, whereby core inflation remains well behaved and increased end demand from rising wages, increased confidence and increased investment results in a profits boom which draws retail investors to the stock market, encourages company management teams to undertake aggressive merger and acquisition activity and unlisted companies to list on the stock market in far greater numbers than we have seen in the recent past.

However, given the risks to asset prices from the withdrawal of quantitative easing which will inevitably accompany the recovery one should be somewhat circumspect and not be too ‘risk on’, however being too defensively positioned today would be expensive if the scenario above does indeed play out. On balance, we are inclined to add to risk following the pull back.

This view is supported by an increasingly positive end demand picture that we are hearing about from company management teams that are exposed to the economic cycle. It is telling that many of the stocks that we use as indicators of how investors view the economic outlook have not led the market down and, indeed, a number of these stocks (such as Rio Tinto (basic materials), Ashtead (US construction equipment hire) and Croda (specialty chemicals), source: Cornelian, 14/02/18) have been making new relative highs during the sell-off.

H.Kilpatrick
Chief Investment Officer
Cornelian Asset Managers Limited
February 2018