

Global Equity Strategy

Equities: 12% higher by end-22E; rewards outweigh risks

Investment Strategy | Strategy

We maintain our end-2021 target of 756 for the MSCI AC World and introduce an end-2022 target of 820, implying 12% potential upside from current levels. Our US equity strategists are targeting 5,000 for the S&P 500 for end-2022. There are many risks – ISM peaking, fiscal drag, tapering, China tightening, Delta variant, close to record-high US net margins and P/Es, credit deteriorating – but there are six main reasons why we see the rewards outweighing the risks:

- **Monetary conditions:** Even by the end of 2022, we see monetary conditions remaining looser than at almost any point during the global financial crisis despite the output gap by end-23 being the tightest in 20 years. Central bankers remain in reactive mode.
- **Equity risk premium:** The big surprise this year (to most) has been that real bond yields (TIPS yields) have stayed very low. This in turn keeps the ERP high at 6.1% (versus a warranted ERP of 4.1%) and indicates c10% potential upside even if nominal yields were to rise to 1.8% (which is the Credit Suisse house view). The key driver of P/E has been TIPS and high yield, which would imply a P/E of 22.5x.
- **Upside risk to EPS:** CS forecast EPS is c5% above consensus for 2022 in both the US and Europe (pointing to EPS growth of 9.5% and 14%). GDP in 2022 is likely to be above consensus (with US excess savings of 12% of GDP more than offsetting fiscal tightening) and the bulk of China's tightening and slowdown now behind us. Operational leverage has been underestimated and EBITDA margins ex tech are low, yet the interest charge should fall. We expect only a modest impact from a rise in corporate taxes.
- **Stage of the cycle:** Typically the troubling time is after unemployment falls below full employment. The true unemployment rate in the US is 8%.
- **Excess liquidity:** Central bank balance sheets in DM are likely to grow by 7% in 2022E (10% in 1H 22), leaving balance sheet growth above nominal GDP in DM in 1H 22, even assuming the Fed tapers late this year and finishes QE by late Q3 22.
- **Funds flow:** We continue to see a long-term bond-for-equity switch as we think bonds no longer diversify. Only 18% of flows into money market/bond funds have gone into equities since January 2020. Corporate net buying remains resilient, supported by PE dry powder of \$1.7tn and FCF being above High Yield for nearly half of US companies.

Tactical indicators have fallen from extreme levels to be close to neutral. Risk appetite is discounting a fall in ISM new orders to 58 (consistent with c2.8% GDP growth compared to consensus of 6.2% GDP in 2021 and 4.3% in 2022). We do not see the spread of the Delta variant as representing a long-term risk. The main risk is that credit spreads have started to widen (and credit tends to lead equity), which needs to be monitored closely.

First versus second derivatives. The second derivatives (excess liquidity, earnings revisions, MCI, ISM) have peaked and normally that leads to the first derivative turning negative, but we do not see that this time. We continue to believe the risks of melt-up are greater than risks of meltdown (only 4 of our 14 bubble indicators show a bubble/partial bubble, although ERP, TINA, funds flow, and MCI all point to bubble potential).

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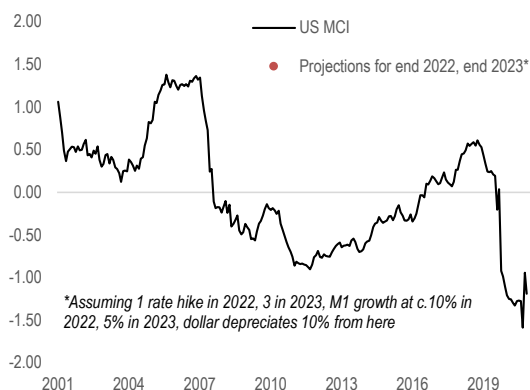
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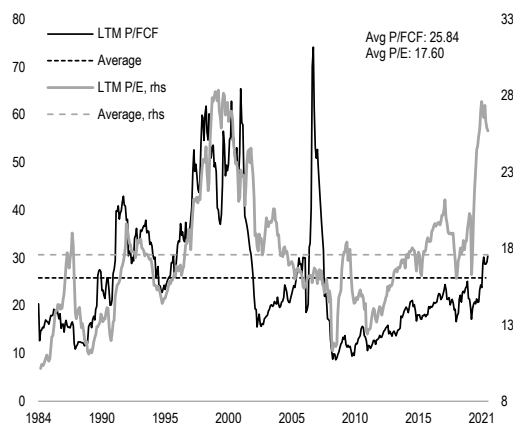
Key charts

Figure 1: Monetary conditions are projected to remain loose



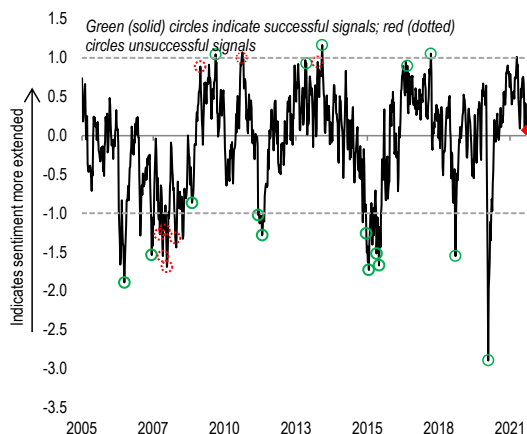
Source: Bloomberg Finance L.P., Refinitiv, Credit Suisse research

Figure 3: Price to FCF yields are only just above average levels despite elevated P/Es owing to better cash conversion



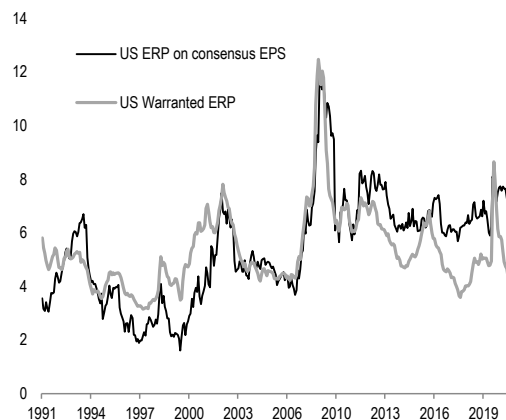
Source: Refinitiv, Credit Suisse research

Figure 5: Our aggregate tactical indicators are neutral



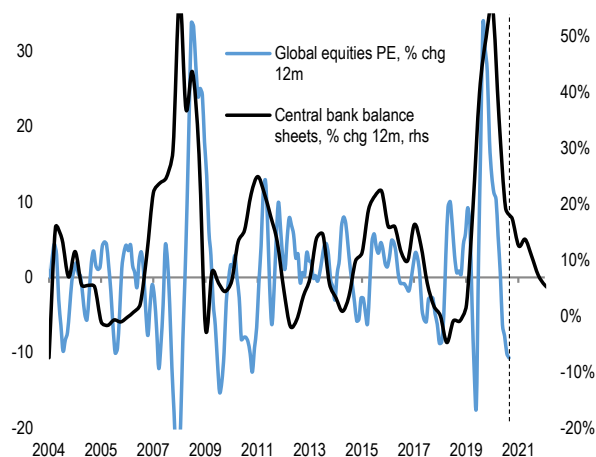
Source: Bloomberg Finance L.P., Refinitiv, Credit Suisse research

Figure 2: The ERP has significant room to fall



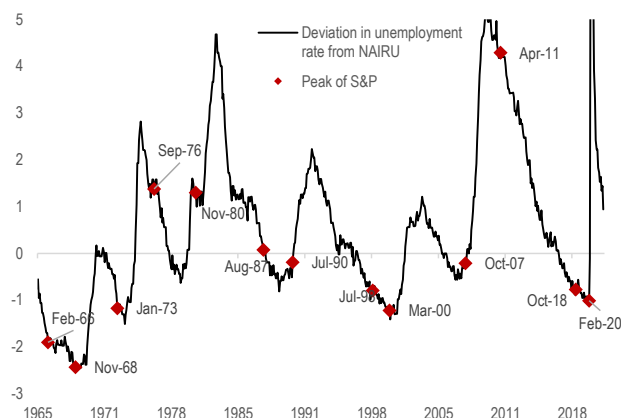
Source: Refinitiv, Credit Suisse research

Figure 4: The market de-rating implies a much larger slowdown in central bank printing than is likely to be the case



Source: Refinitiv, Credit Suisse research

Figure 6: Markets peak after unemployment falls below NAIRU



Source: Refinitiv, Credit Suisse research

Equities: 12% higher by end-2022E; rewards outweigh risks

We maintain our 2021 year-end target of 756 for the MSCI AC World and introduce our end-2022 target of 820, expecting markets to be 12% higher by end-2022. Our US strategist Jonathan Golub forecasts 4,600 on the S&P 500 by the end of this year and 5,000 by end-2022. We will publish a full set of regional targets when we publish our full regional update in the coming weeks.

Figure 7: Targets

Market	Current 24/08/2021	End-2021E target	End-2022E target	2021 forecast price return	Return to end 2022
S&P 500*	4,480	4,600	5,000	2.7%	11.6%
MSCI AC World ex USA	344	360	390	4.7%	13.4%
MSCI AC World	730	756	820	3.5%	12.3%

* Set by our US equity strategists

Source: Refinitiv, Credit Suisse research

There are of course many risks, however:

On the macro side, we have a fiscal drag, the hang-over of Chinese tightening (which appears to be close to completion), as well as acute supply shortages aggravated by the rise in the Delta variant.

On the policy side, we have Fed tapering and considerable uncertainty over the size of the Biden infrastructure package (which appears to be stalled in the House of Representatives).

On markets, we have US P/Es at the top end of their historical range at time when US net profit margins are close to all-time highs and many of the key variables (monetary conditions, excess liquidity, and earnings revisions) are in the process of peaking.

We are also seeing credit spreads starting to widen at a time when they are close to historical lows.

Against this backdrop, the key question is: Do the strategic rewards outweigh the risks?

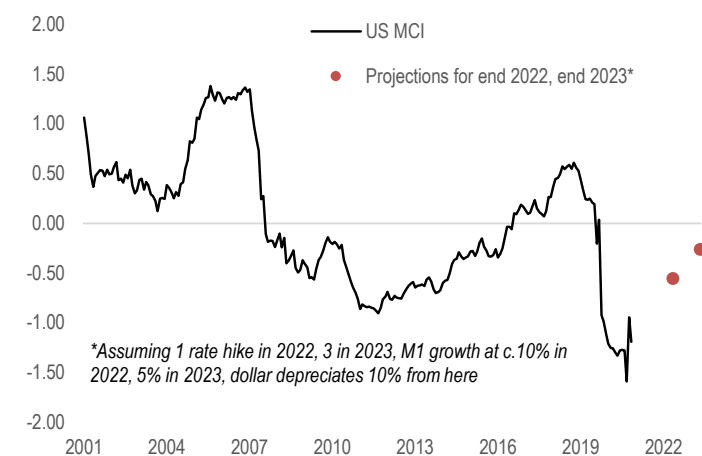
We believe the answer is still yes, but clearly the call is much closer than it was 6, 12 or 18 months ago.

What are the supports for the bull market?

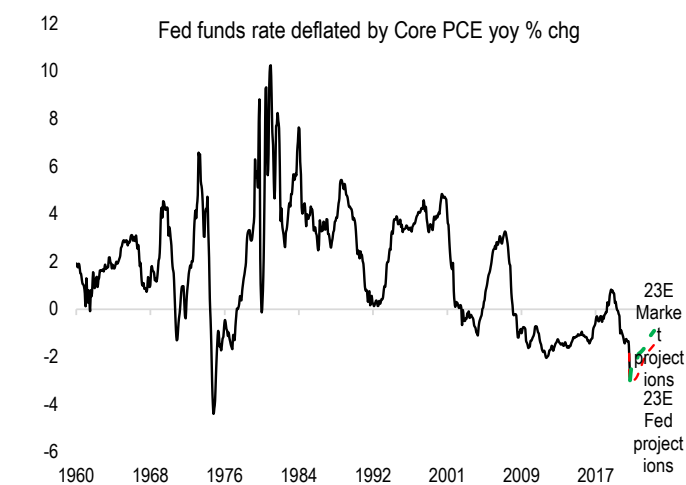
We see six key supports for equities:

1. Monetary policy remains pre-emptively loose

If we look at US monetary conditions, even by the end of 2022 they look looser than at almost any point during the GFC (even assuming one rate hike in Q4 22), despite US GDP already being back at its previous peak. Even in 2023, the real fed funds rate is projected to be close to a 50-year low despite the output gap in 2023 approaching a 20-year high.

Figure 8: We see monetary conditions at their loosest level in the past 25 years

Source: Refinitiv, Credit Suisse research

Figure 9: The real fed funds rate even by end-2023 is close to 50-year lows

Source: Refinitiv, Credit Suisse research

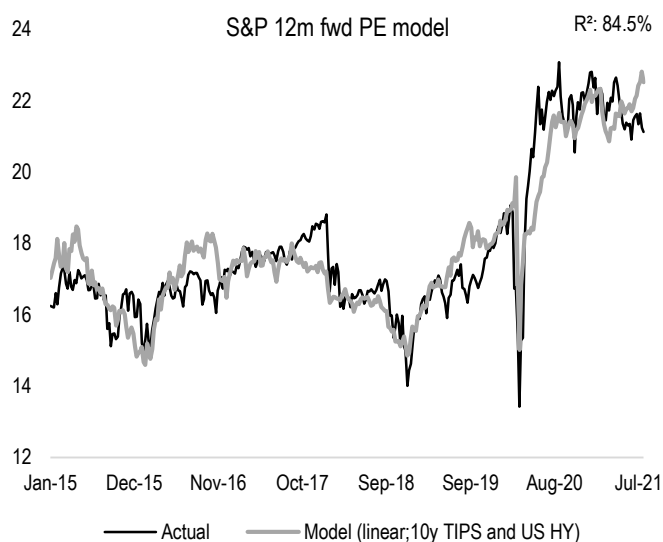
In simple terms, the Fed appears to be reactive and driven by outcomes rather than by forecasts. This is best summarised by Chairman Jerome H. Powell in late June saying, “we will not raise rates prematurely because we think employment is too high or because we fear the onset of inflation... instead we will wait for actual evidence of actual inflation”.

Moreover, he has suggested that Fed policy is not responsible for either equity prices or house prices. At the March FOMC press conference, Mr. Powell said, “We didn’t see an excessive build-up of debt, we didn’t see asset prices form into bubbles that would threaten the progress of the economy. We didn’t see a housing bubble.” Stressing that both MBS and Treasuries would be tapered together at the last FOMC potentially postpones tapering to late this year (there is clearly a strong case for tapering MBS purchases when house prices are up 17% year-on-year, according to the Case-Shiller index).

In Europe, the ECB now favours a symmetrical 2% inflation target (implying that an undershoot is as bad as an overshoot), yet forecasts just 1.4% core CPI by 2023, suggesting again a very loose monetary policy despite GDP reverting to its previous peak by Q1 22.

2. Still room for multiple expansion using ERP

The key driver of the P/E in the past five years on a quant model has been high yield and TIPS. On this basis, we are close to fair value, showing 6% potential upside.

Figure 10: On our P/E model, we are close to fair value...

Source: Refinitiv, Credit Suisse research

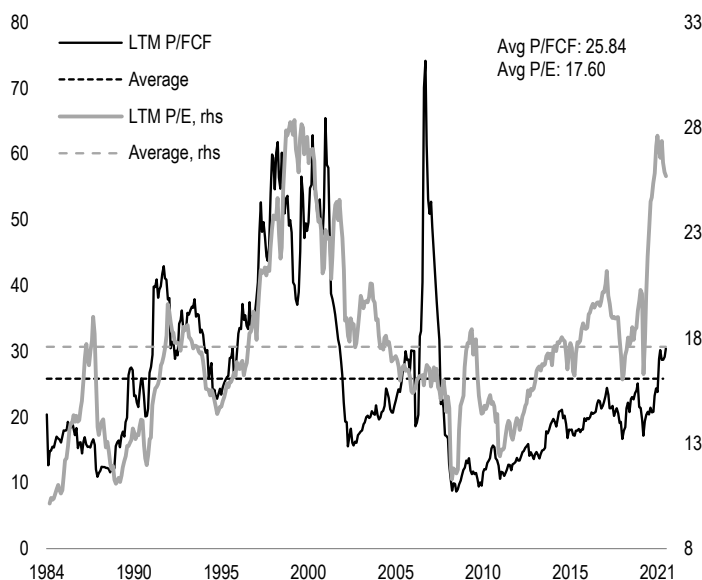
Figure 11: ... showing c6% upside for P/E ratios

12m fwd PE model (2015 to present)			
Variable	Coefficient	t-value	Current
TIPS (price)	0.26	29.63	111.0
US HY	-0.66	-13.64	4.7
Model	22.4	Intercept	-3.1
Actual	21.1	R^2	84.5%
Upside	6.0%		

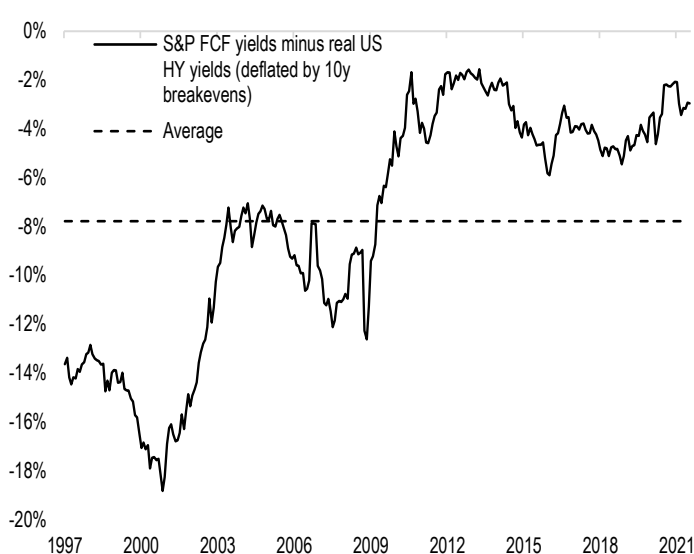
Source: Refinitiv, Credit Suisse research

We stress that we think this underestimates the potential upside to multiples because:

- i. Over time, the cash generation per unit of earnings has grown. Hence, although P/E levels are close to peak levels, the P/FCF ratio is just above average. The increase in cash generation has happened because of the growth in market cap in brand companies whose capex is A&P (which is typically expensed in Year 1), and tech companies, that tend to fully expense their R&D. This, along with the low real bond yield, has resulted in the FCF yield of the market remaining well above their average spreads to inflation-adjusted HY yields.

Figure 12: While P/E ratios are close to peaks, P/FCF is just above average...

Source: Refinitiv, Credit Suisse research

Figure 13: ... while FCF yields remain well above their average spread to real HY yields

Source: Refinitiv, Credit Suisse research

- ii. The need to focus on the ERP.

We continue to believe that we should be focusing on the ERP. The real bond is being kept permanently low versus the terminal growth rate. We believe that investors should look at only the equity risk premium if the real bond yield is suppressed permanently relative to real EPS growth.

$$\text{Dividend yield} + \text{DPS growth} \equiv \text{Cost of equity} = \text{ERP} + \text{bond yield}$$

If we take inflation off both sides of the equation and re-arrange, we find that:

$$\text{ERP} \equiv \text{Dividend yield} + \text{Real DPS growth rate} - \text{Real bond yield}$$

Where the:

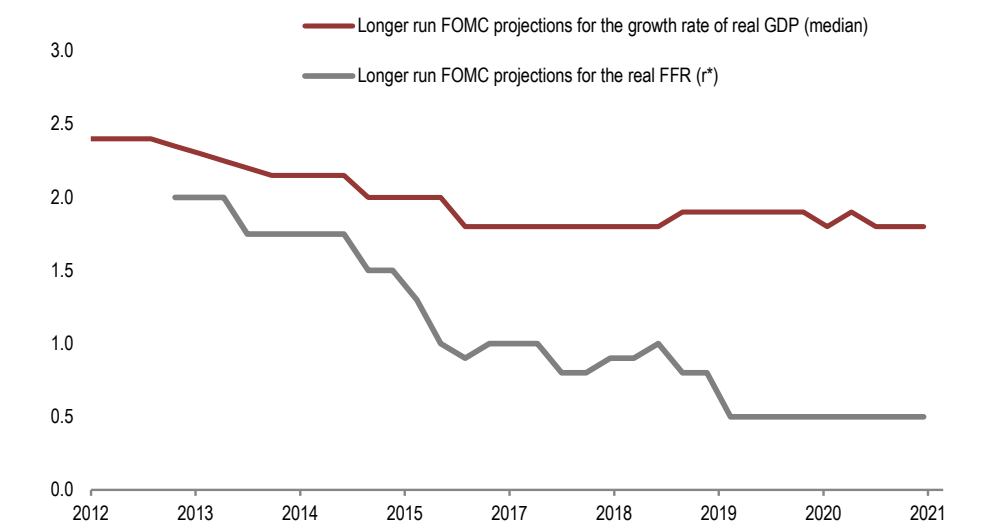
$$\text{DPS growth rate} \equiv \text{Return on equity} * (1 - \text{Payout Ratio})$$

If real DPS growth were equal to the real bond yield, then:

$$\text{ERP} \equiv \text{Dividend yield} \equiv k * \text{Earnings Yield} \equiv 1 / (P/E)$$

Since 2012, the Fed has consistently revised down its estimate of equilibrium real rates (so-called r^*) but has altered its estimate of the terminal growth rate only marginally. The latest estimate of r^* (the Fed's estimate of equilibrium real rates) is 0.5%, while the median estimate of the long-run terminal growth rate is 1.8%. Therefore, the equilibrium real rates are 1.3% below the terminal growth rate. This is even more so if we were to proxy real rates by looking at the 30-year TIPS yield, currently at -30bps, not the 0.5% of r^* .

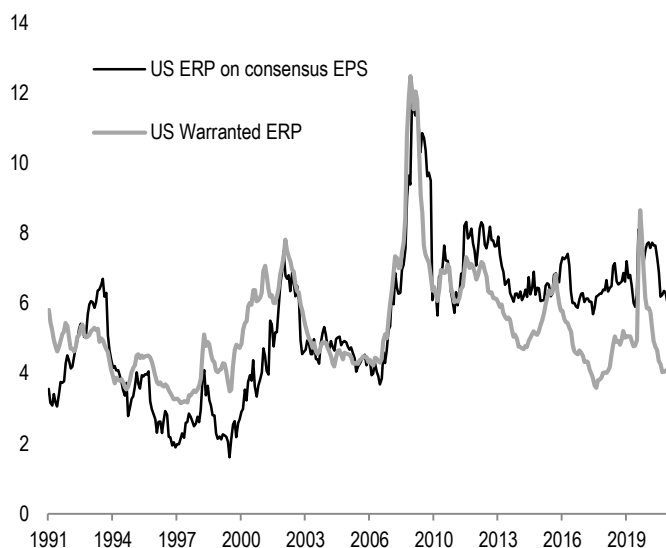
Figure 14: Fed's estimate of r^* (the median neutral real fed funds rate) has fallen by 100bps more than its estimate of trend GDP growth



Source: Refinitiv, Credit Suisse research

Using our shorter-term ERP model (based on a DDM using IBES numbers), we find that the ERP is 6.1%. It should be 4.1% (the warranted ERP depends on ISM new orders and credit spreads).

Figure 15: The ERP remains fairly elevated...

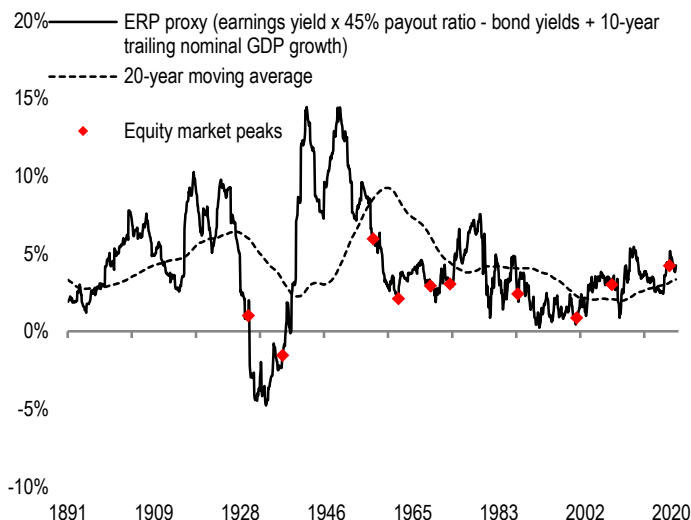


Source: Refinitiv, Credit Suisse research

Even if the bond yield were to rise to their old highs of close to 1.8% (our house view is 1.8% over the next 12 months), and this gap between warranted and actual ERPs were to close, it would indicate c10% potential upside for markets.

If we look at a longer-term model using nominal GDP to proxy earnings expectations, we find that the ERP is lower but still marginally above its average when 8 of 10 bull markets have peaked when the ERP has been below its average.

Figure 17: Long-term ERP proxy



Source: Refinitiv, Credit Suisse research

We continue to believe that there are structural factors driving down the ERP: better minority shareholder rights and better quality accounting (see [Why investors need to focus on the Equity Risk Premium, not PE](#), 27 August 2020 for details).

3. Excess liquidity

Figure 16: ...creating significant upside potential for markets

Current (S&P level: 4430)			
Actual ERP (on IBES EPS estimates)	6.05	Warranted ERP (ISM and credit spreads)	4.14
S&P on warranted ERP scenario (assuming average post-QE gap), 10y to 1.8%			
ERP falls to current warranted levels			
S&P level	4885	Upside	10.3%
*Average post-QE gap is 1.2% between warranted and actual ERP			

Source: Refinitiv, Credit Suisse research

Figure 18: ERP proxy at market peaks

ERP Proxy at Market Peaks			
Date	Spot	20y average	
Oct-29	1.0%	6.0%	150yr average 4.2% ERP on 22E EPS 4.3%
Feb-37	-1.5%	3.3%	
Jul-56	6.0%	8.5%	
Dec-61	2.1%	8.5%	
Nov-68	2.9%	6.1%	
Jan-73	3.1%	4.4%	
Aug-87	2.4%	4.1%	
Mar-00	0.9%	2.3%	
Oct-07	3.0%	2.1%	
Feb-20	4.2%	3.1%	
Average	2.4%	4.8%	
Current	4.2%	3.4%	

Source: Refinitiv, Credit Suisse research

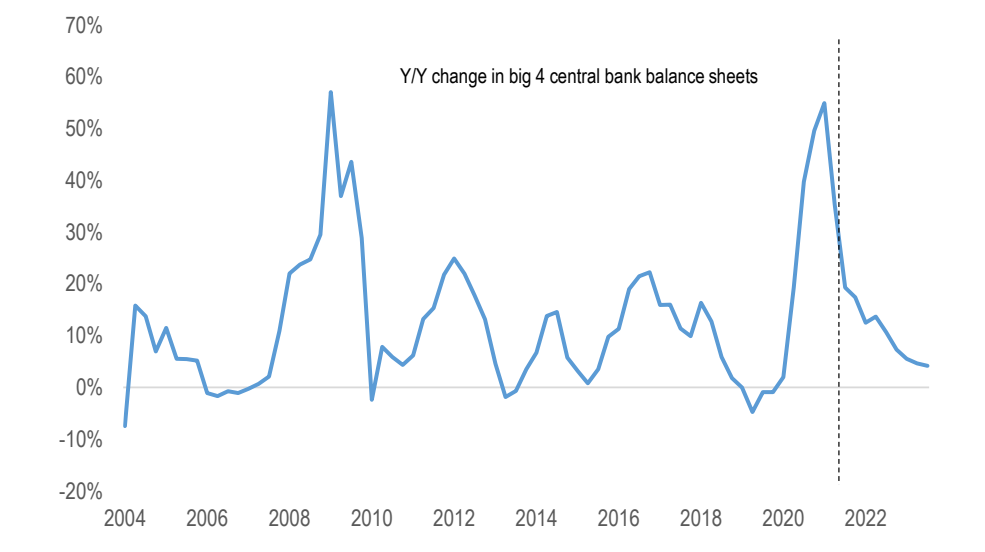
Excess liquidity is at a peak but still likely to remain above or equal to nominal GDP growth running in the first half of 2022.

We expect the Fed to commence a taper of purchases in late Q4 or early Q1 and end buying in late 2H 22. The ECB seems set to end the PEPP programme at the end of the first quarter of next year (which has been running at around €80bn per month), but retain the existing Asset Purchase Programme, which has continued at a pace of around €20bn a month. Indeed, should inflation be falling short of the ECB's now symmetrical 2% target, there is every possibility that the APP could even be increased in size. Thus, the ECB is likely to buy at least €500bn of assets in 2022, albeit front-end loaded.

In the case of Japan, we assume a return to 2019's pre-pandemic purchase pace.

Putting these assumptions together creates the outcome chart below, whereby central bank balance sheet growth slows to +7% by the end of 2022 (closer to 9% in 1H), falling to +5% in mid-2023. This compares with real GDP growth (using IMF numbers) in DM of 4.4% in 2022 and nominal GDP growth of c7.5%.

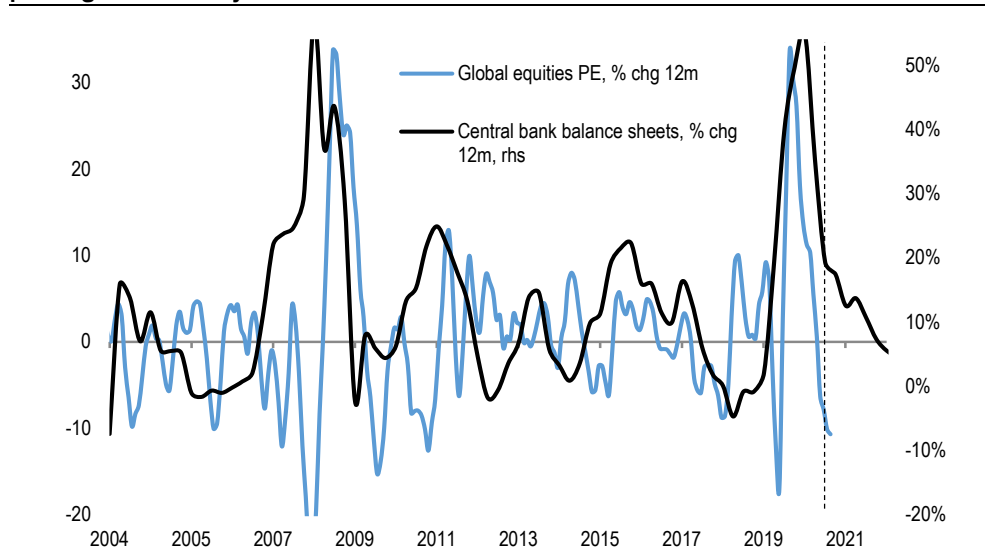
Figure 19: Central bank balance sheet expansion looks set to slow markedly, but remain in excess of nominal GDP growth for much of 2022



Source: Refinitiv, Credit Suisse research

We can see below that expansion in central bank balance sheet tends to correlate very closely to the change in P/E rating and currently would be consistent with no de-rating.

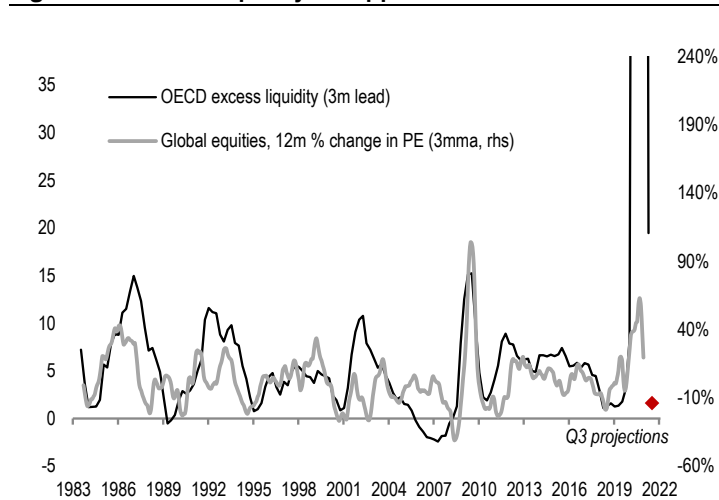
Figure 20: The market de-rating implies a much larger slowdown in central bank printing than is likely to be the case



Source: Refinitiv, Credit Suisse research

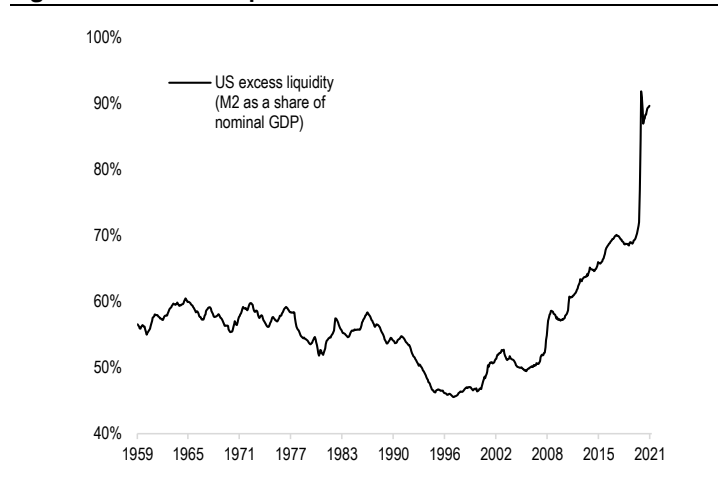
If we look at excess liquidity (M1 over nominal GDP), which is the Bank of England's preferred measure, this still looks supportive of market levels that are c10% higher.

Figure 21: Excess liquidity is supportive...



Source: Refinitiv, Credit Suisse research

Figure 22: ...on multiple measures



Source: Refinitiv, Credit Suisse research

4. Stage of cycle

Ultimately, we would remain strategically long of equities until we get to full employment. There are some exceptions (e.g. chronic overvaluation of equities versus bonds and a tightening of policy 1987 and concerns over the US debt ceiling in 2011), but generally this seems to work.

We admit that tactically the quarter in which the output gap closes (which is Q4) typically is more problematic for equities (given small negative returns), but strategically we can see that investors want to be long of equities until unemployment falls below full employment.

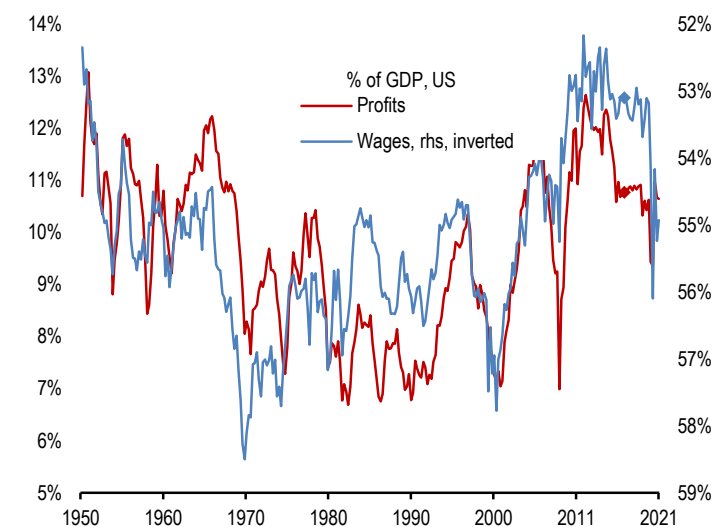
Figure 23: S&P performance following a closing of the output gap

Equity performance leading up to the closing of output gap by quarters				
Date of output gap closing	0Q	1Q	2Q	3Q
Q1 1989	4.7%	7.3%	7.0%	13.3%
Q4 1996	9.7%	11.5%	15.3%	22.4%
Q1 2005	-2.6%	6.0%	3.6%	4.9%
Q1 2018	-1.2%	4.8%	9.0%	11.8%
Average	2.6%	7.4%	8.7%	13.1%
Typical performance	3%	5%	8%	10%

Source: Refinitiv, Credit Suisse research

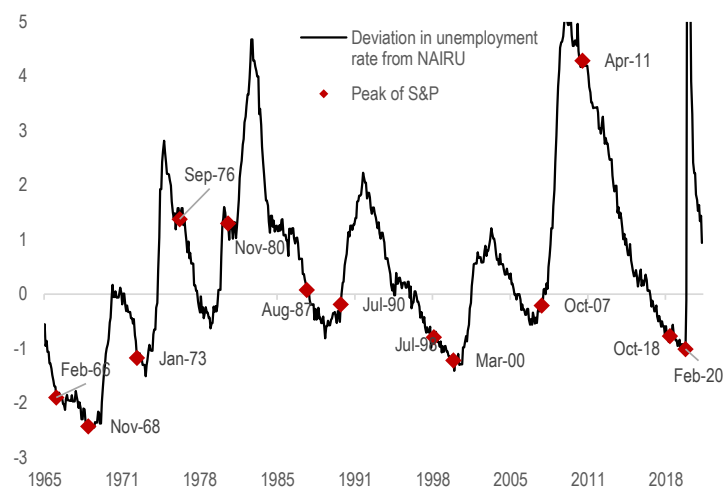
The reasons why major peaks tend to occur when unemployment is below full employment is because if the wage share of GDP rises, the profit share of GDP falls.

We are far from full employment currently. We find that the true unemployment rate is around 8% (this is the unemployment rate that Chairman Powell referred to in his 10 February speech that adjusts for those people who have left the workforce).

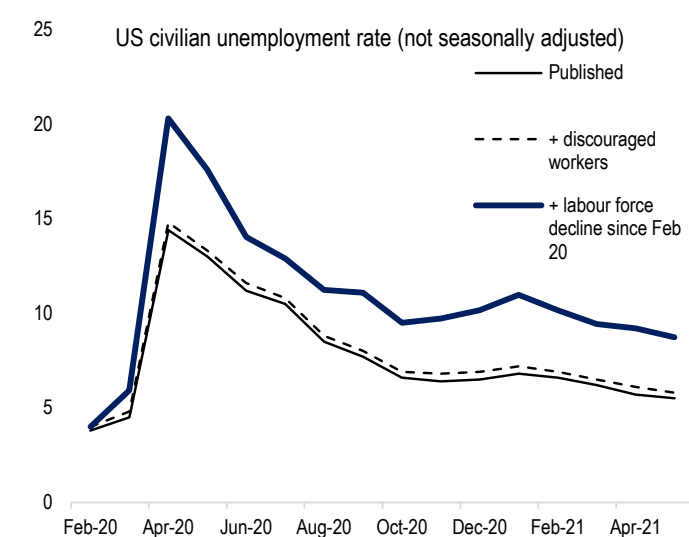
Figure 25: When the wage share of GDP rises, the profit share falls

Source: Refinitiv, Credit Suisse research

Although the proportion of companies looking to raise wages is very high, much of this is temporary (owing to the COVID-19 pandemic and unemployment benefits that are due to end in September). The wage component of the ECI (which is the most reliable measure of wage growth) has picked up only modestly.

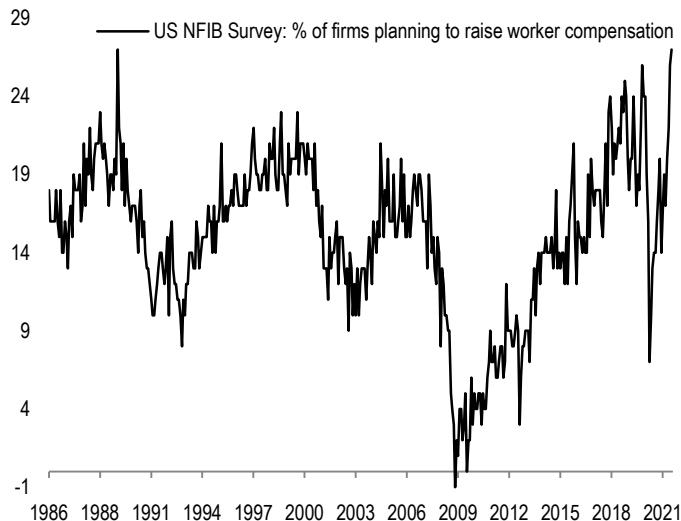
Figure 24: Market peaks tend to occur when unemployment falls below full employment

Source: Refinitiv, Credit Suisse research

Figure 26: Alternative unemployment measures remain high, suggesting spare capacity in the US labour market

Source: Refinitiv, Credit Suisse research

Figure 27: The percentage of US firms intending to raise wages is at record highs...



Source: Refinitiv, Credit Suisse research

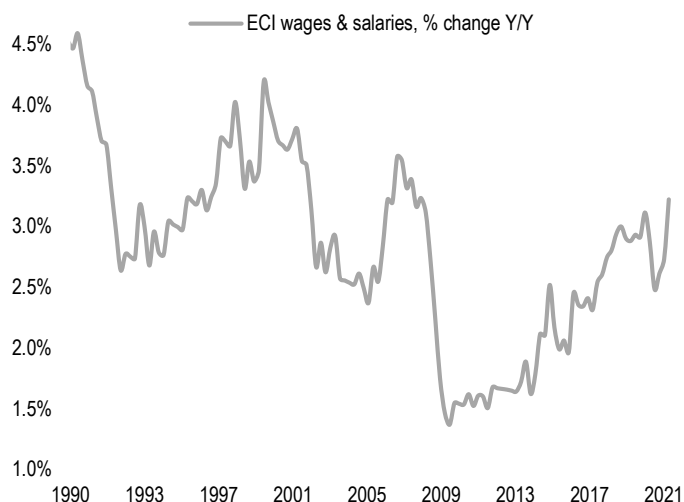
Even if we look at the wage component of the ECI, we can see the rise is in sectors that have been the hardest hit by the pandemic (particularly hospitality). Alternative measures of wage growth – such as the Atlanta Fed's wage growth tracker – show only a modest pickup in wage growth, all of which has been concentrated in the low-skill segment.

Figure 29: Leisure, transport and construction have been the areas of wage growth strength

Category	Y/Y %	Q/Q ann. %
Leisure & hospitality	6.1%	11.6%
Transportation	4.3%	7.4%
Construction	3.2%	5.4%
Manufacturing	3.2%	5.2%
Retail	4.7%	4.9%
Private workers	3.6%	3.9%
Health care	3.5%	3.7%
All workers	3.2%	3.7%
Management	2.5%	3.1%
Services	3.2%	3.1%
Government workers	1.6%	2.1%
Education	1.5%	1.8%
Sales and office	4.2%	1.6%
Finance	4.0%	-11.0%

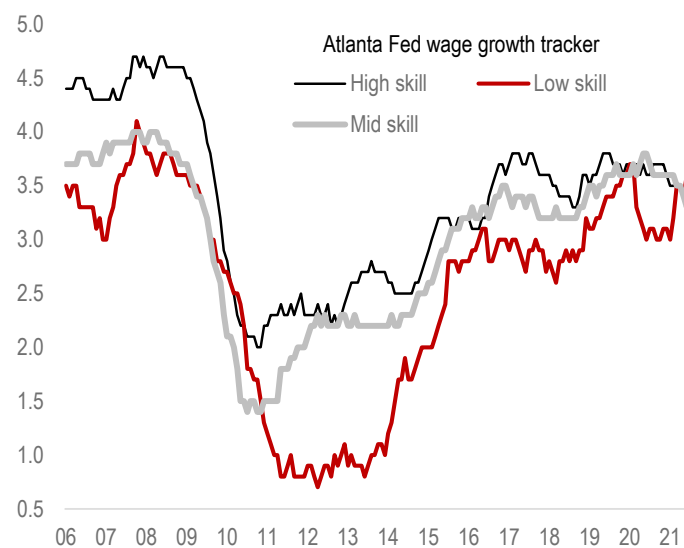
Source: Refinitiv, Credit Suisse research

Figure 28: ... but there has been a far more muted rise in wage growth



Source: Refinitiv, Credit Suisse research

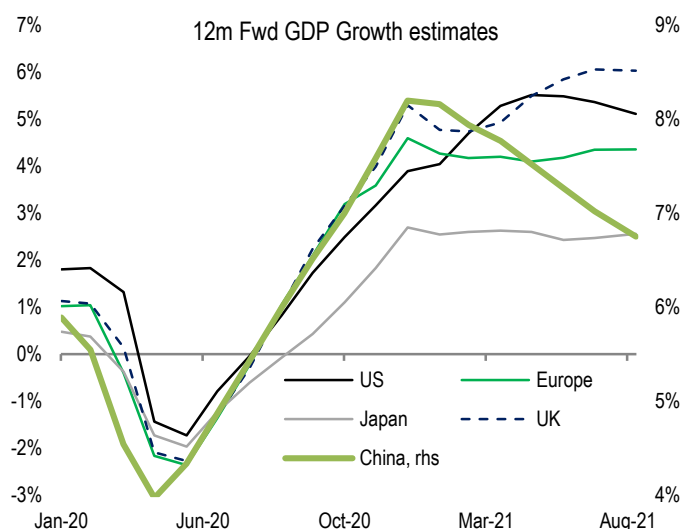
Figure 30: More broadly, wage growth has been muted outside of low-skill professions



Source: Refinitiv, Credit Suisse research

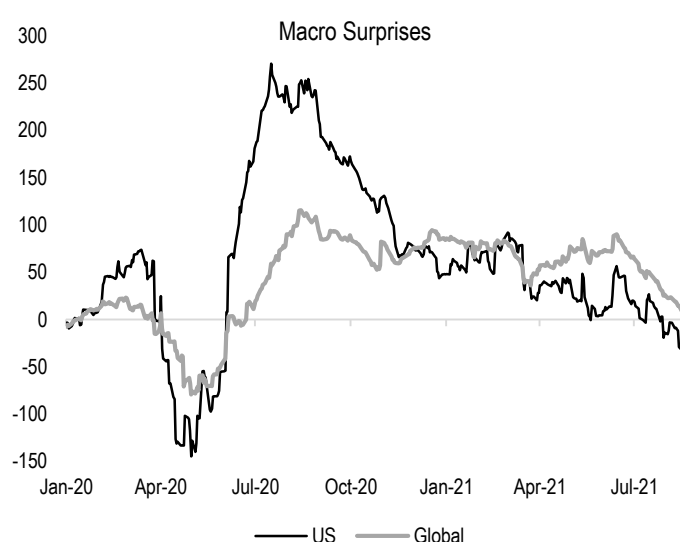
5. High probability that 2022 GDP is above expectations

We can see that consensus 12-month forward GDP, especially for China, has stopped being revised up since Q1. This is compounded by global and US macro surprises rolling over.

Figure 31: 12m fwd GDP growth estimates

Source: Bloomberg Finance L.P., Credit Suisse research

In real terms, only the US has surpassed its previous level of output, with other major economies still between 3% and 4% below their previous peaks.

Figure 32: US and global macro surprises are rolling over

Source: Refinitiv, Credit Suisse research

Figure 33: Only in the US is GDP now above its previous peak

	Real GDP & components vs pre-COVID peak			
	US	EU	UK	Japan
GDP	0.8%	-3.0%	-4.4%	-3.4%
Consumption	3.1%	-9.5%	-7.7%	-5.4%
Government	1.9%	2.8%	7.0%	3.7%
Capex	4.1%	-10.6%	-6.4%	-5.1%

Source: Refinitiv, Credit Suisse research

We think there are four key considerations for GDP next year:

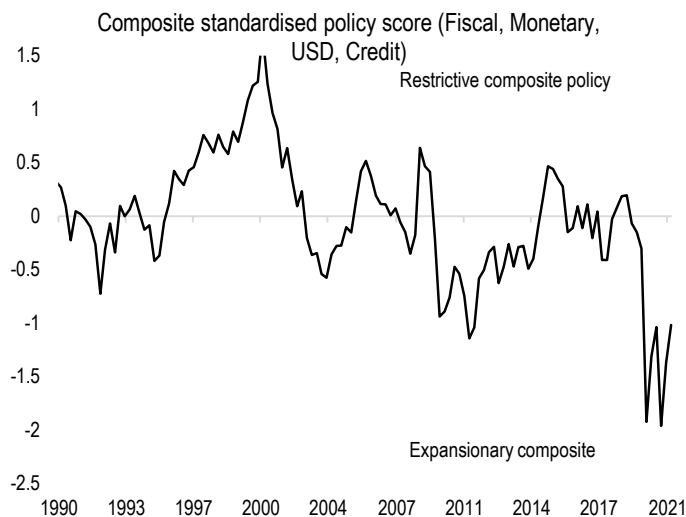
- Whether excess savings can more than offset fiscal tightening
- The short-term inflation threat
- Policy in China
- The Delta variant

i. Excess savings run-down can more than offset fiscal tightening

Clearly, the big debate next year is whether the run-down in excess savings in the private sector more than offsets fiscal tightening.

Our aggregate policy indicator (fiscal, monetary and lending conditions to corporates) is now loose but looks set to tighten quite sharply. This is because of the extent of fiscal tightening that the IMF/OECD pencil in, at nearly 6% of GDP in the US.

Figure 34: Our aggregate policy measure is still very loose but looks set to tighten in 2022



Source: Refinitiv, Credit Suisse research

We think the fiscal tightening will be closer to 4% of GDP rather than 6%. Our Washington team thinks that a \$3trn to \$4trn spending package can be achieved in Q4. Reconciliation can be used once a fiscal year (so it can be used again after 1 October 2021). The initial package – a bipartisan \$1trn infrastructure package focused on traditional infrastructure spending amounting to \$550bn of new money over five years – has been passed in the Senate (with the support of 19 Republicans).

The current blockage is that some progressive House Democrats are refusing to bring that bill to a vote unless it is part of a much larger \$3.5trn 'social infrastructure' package, which has already passed the Senate under reconciliation. Meanwhile, the more moderate Democrats such as Joe Manchin and Kyrsten Sinema want a smaller package and at least nine House Democrats have said they want to vote on infrastructure first (FT, 23 August). Our Washington team still believes that a package can be passed in Q4 but that it will probably be closer to \$2trn to \$3trn in size.

We also find that the multiplier on spending increases will be much higher than the multiplier on tax hikes on the rich and that the tax hikes will be back-end loaded.

This degree of fiscal tightening should be more than offset by the run-down of excess savings, which stands at 12% of GDP in the US and 5% of GDP in Europe.

Figure 35: Next year will see fiscal tightening, although we think not as much as predicted by the IMF

Fiscal impulse: change in cyclically adjusted primary balance, % of GDP, IMF				
Year	US	Japan	UK	Eurozone
2020	5.7%	8.7%	8.7%	4.6%
2021	1.5%	-2.6%	-1.8%	-0.2%
2022	-5.9%	-4.8%	-4.1%	-2.1%
2023	-1.6%	-1.1%	-1.4%	-0.5%

*A positive fiscal impulse is loosening of fiscal policy

Source: Refinitiv, Credit Suisse research

Figure 36: Boost to demand from fiscal, real wealth effect and excess savings

Source of pent up demand	as % of GDP
US excess savings, \$2.52 trn	12.0%
Increase in household equity wealth (\$14.8 trn) and housing wealth (\$3.8trn), 3-5% get spent	2% - 4%
Euro area excess savings, €0.52trn	5%

Source: Refinitiv, Credit Suisse research

Figure 37: US disposable income has risen significantly as a share of GDP

Source: Refinitiv, Credit Suisse research

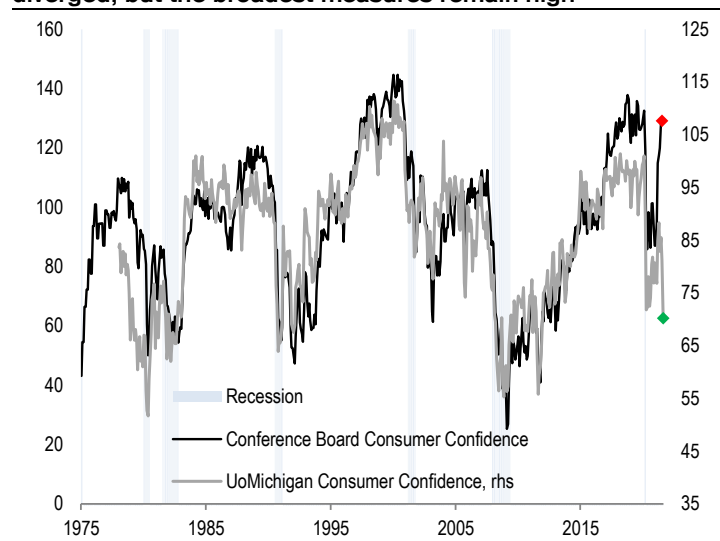
The Bank of Canada has suggested that its models point to 25% of the excess savings held by Canadian households being spent, or around 3% of GDP in the US. We think most of the savings will be spent. We believe the key drivers of savings are:

- i. Whether prices of goods/services are likely to rise or fall. The one-year forward U of M inflation expectations at 4.6% show that consumers believe prices will rise (thus they are spending now);
- ii. Wealth effect: There has been a c\$15trn positive wealth effect since the start of 2020 (one-third via the housing market and two-thirds via the equity market). The Greenspan rule of thumb assumes that 3% to 5% of the increase in household wealth is spent;
- iii. Employment prospects. The level of vacancies is 9.5m, well above pre-pandemic levels.
- iv. Consumer confidence. Global consumer confidence at the end of Q2 was at record levels. The broadest measure of consumer confidence in the US, namely the Conference Board measure, showed a very different picture to that of the University of Michigan. The former tends to focus on employment prospects, the latter on spending intentions.

Figure 38: Global consumer confidence has surged higher

Source: Refinitiv, Credit Suisse research

The spread between the high and low of consensus US GDP for 2022 is large (with Bloomberg suggesting forecasts range from 2.6% to 6.6%), but CS forecasts 4.6% compared with consensus of 4.3%. In the Eurozone, our house forecasts are for 4.6% compared with 4.4% on consensus.

Figure 39: Measures of US consumer confidence have diverged, but the broadest measures remain high

Source: Refinitiv, Credit Suisse research

Figure 40: Consensus GDP vs CS forecasts

GDP Forecasts	CS Economists		Consensus		CS deviation from Consensus (pp.)	
	2021	2022	2021	2022	2021	2022
Global	6.0	4.6	6.0	4.5	0.0	0.1
US	6.4	4.6	6.2	4.3	0.2	0.3
Eurozone	5.0	4.6	4.8	4.4	0.3	0.2
China	8.2	6.1	8.5	5.6	-0.3	0.5
Japan	2.0	1.7	2.5	2.5	-0.5	-0.8

Source: Bloomberg Finance L.P., Credit Suisse research

We also show in Figure 33: Only in the US is GDP now above its previous peak above that consumption in Europe and Japan is still 10% and 5% below pre-pandemic levels, respectively, again suggesting scope for catch-up.

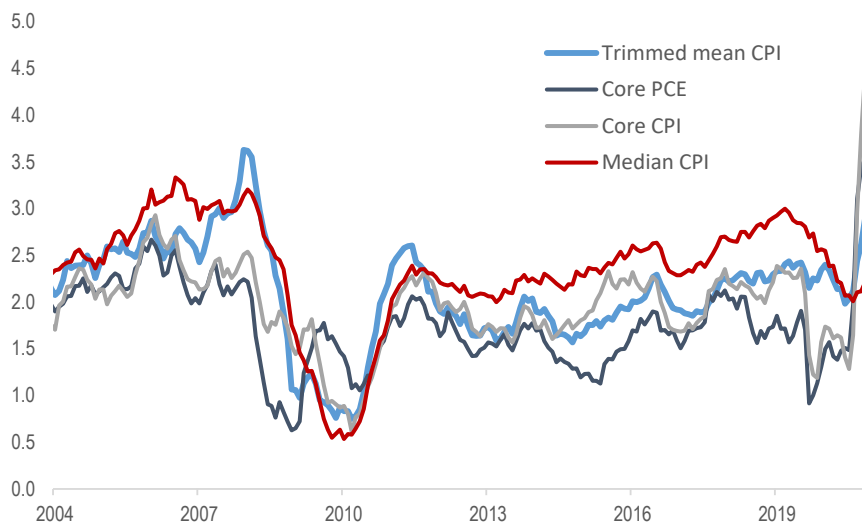
ii. The inflation threat is becoming more manageable

We continue to believe that the 10-year breakeven inflation rate will rise to 2.5% by year-end and 3% by end-2022. For now, most of the rise in CPI inflation has been down to one-off factors. In particular, as shown above, the rise in wage growth (on measures that adjust for the mix effect) has been far more muted than survey data implies, suggesting that some wage pressures should dissipate when unemployment benefits end on 6 September and as vaccination rates rise. Indeed, the 10-year breakeven inflation rate has fallen from its mid-May peak of 2.6% to 2.28% currently.

We believe that the 10-year breakeven would have to rise above 2.7% to threaten the Fed's make-up inflation target (because to get an overshoot that compensates for the undershoot in

core PCE, the core PCE would need to rise to 2.4%, which is consistent with a c2.7% inflation breakeven).

Figure 41 Median inflation remains much better behaved than CPI, showing the impact of one-off factors

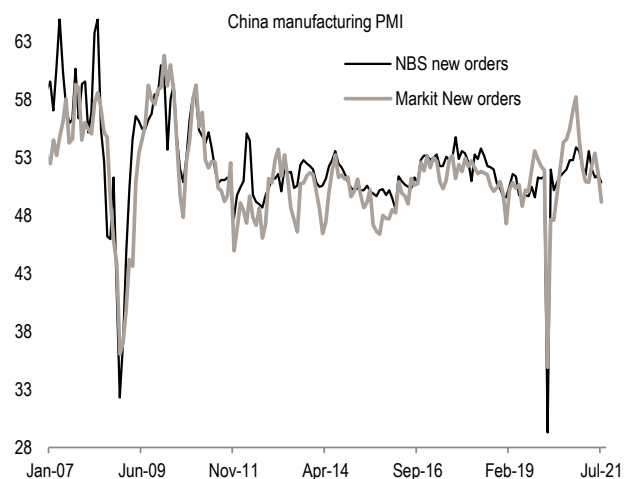


Source: Refinitiv, Credit Suisse research

iii. We might have already seen the bulk of policy tightening and PMI slowdown from China

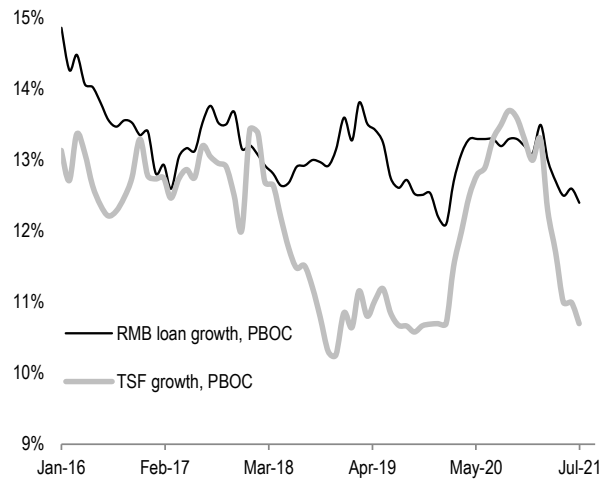
We think we have seen most of the bad news in China in terms of China PMI (which, on Markit's measure, is now in the bottom quartile of its historical range) and policy tightening (total social financing growth, which is back to pre-pandemic historical lows). Moreover, on 9 July, we saw the first RRR cut since April 2020 with the Politburo meeting saying they wanted to maintain "reasonably ample" liquidity (30 July, Reuters).

Figure 42: PMIs have peaked



Source: Refinitiv, Markit, Credit Suisse research

Figure 43: Total social financing growth may have troughed



Source: Refinitiv, Credit Suisse research

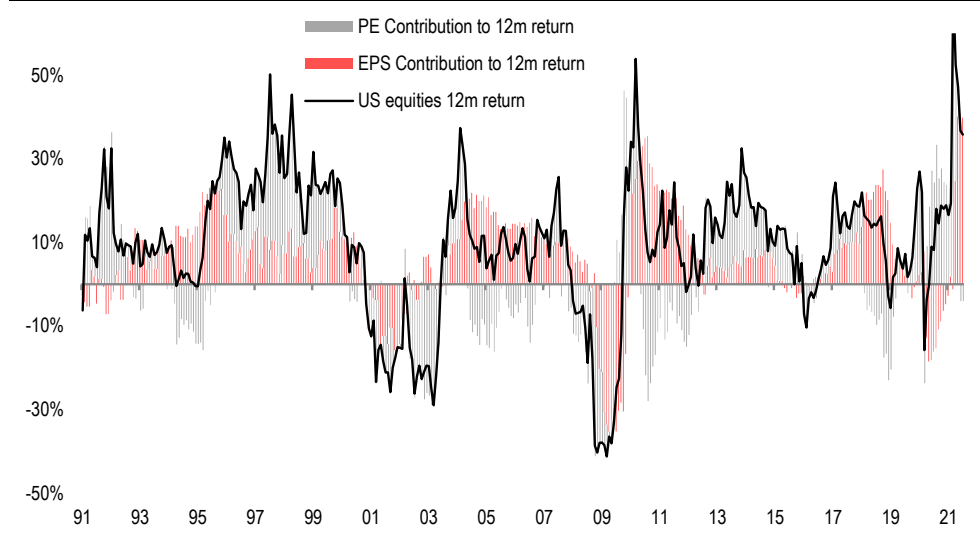
iv. The Delta variant

The rise in the Delta variant in the US is leading to downgrades to Q3 GDP forecasts (which merely postpones the recovery), but as we highlight under the near-term risks section, we do not see the Delta variant altering the medium-term economic outlook meaningfully.

6. The earnings driven phase; with above-consensus earnings growth

We wrote about this in our report looking at 2022 earnings (see [Thinking about 2022 earnings – reasons to be cheerful](#), 26 July 2021). This typically is the phase of the market that is driven by earnings (although we can see a higher multiplier based on the ERP analysis).

Figure 44: Recoveries from crises tend to see multiple expansion pass the baton to earnings as the key driver of returns



Source: Refinitiv, Credit Suisse research

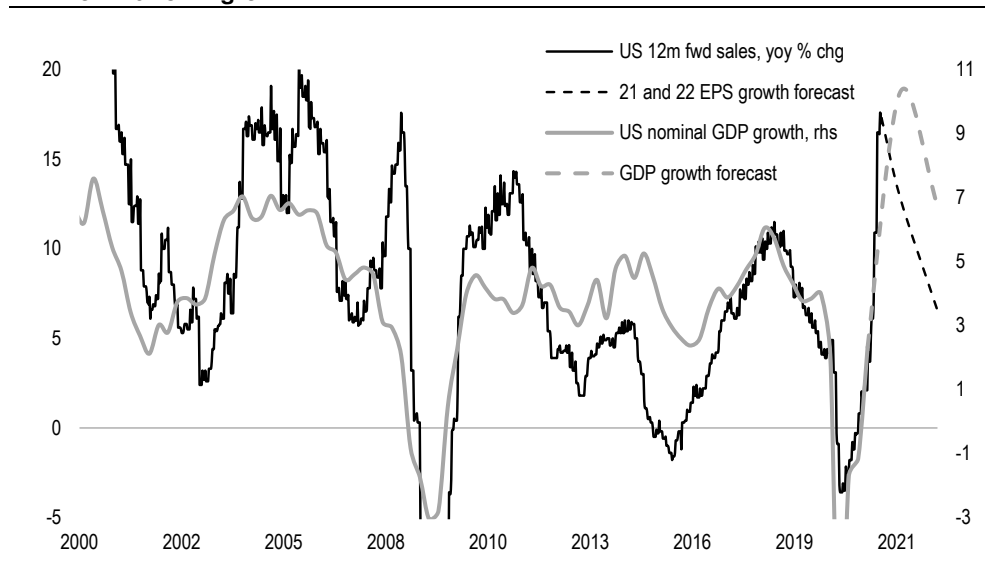
Our models would imply EPS growth of 12.5% in the US and 14% in Europe for 2022 (in line with consensus growth in the US, and above in Europe). From a levels perspective, our US equity strategy team led by Jonathan Golub forecasts EPS of \$230 for the S&P 500 for 2022, which is 5% above consensus (and the team's forecast is 4.5% above consensus for 2021).

We are above consensus because:

- i. The operational leverage has been underestimated, in our view

Revenue growth estimates (IBES consensus) next year are just 6%, versus nominal GDP growth of 7%. Normally revenue growth has a beta of 2 to GDP growth, and thus this historical relationship would seem consistent with revenue growth of closer to 9%.

Figure 45: Sales consensus expectations seem a little below their typical relationship with nominal GDP growth



Source: Refinitiv, Credit Suisse research

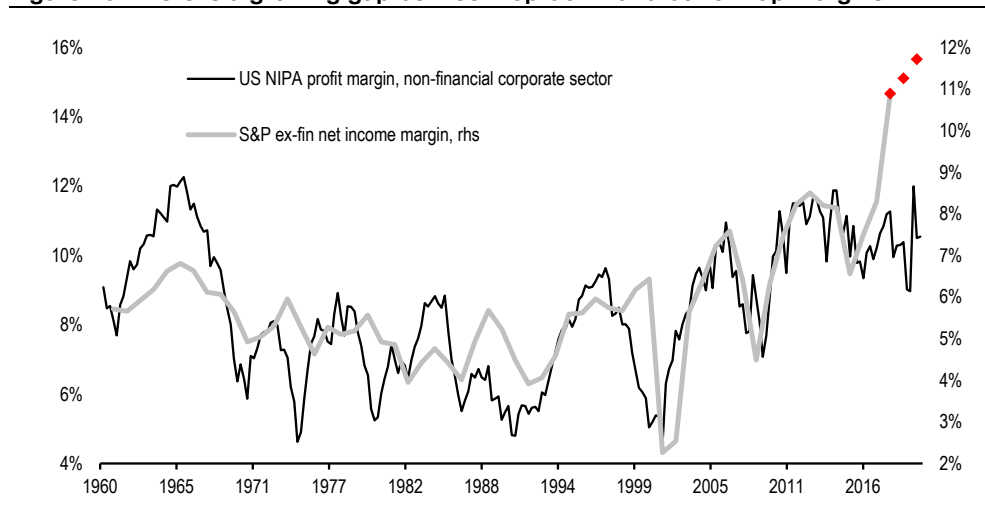
- ii. Consensus GDP growth estimates could be a little low

As discussed above, we think the run-down of excess savings will more than offset fiscal tightening. Low bond yields ensure housing remains strong.

- iii. EBITDA margins do not seem extended

The net margin is very high compared with either history or the profit share of GDP, but the EBITDA margin is not extended and ex tech it is low. This shows that the margin improvement has been because of rates, tech and tax. The profit share of GDP is mid-range compared to net margin estimates.

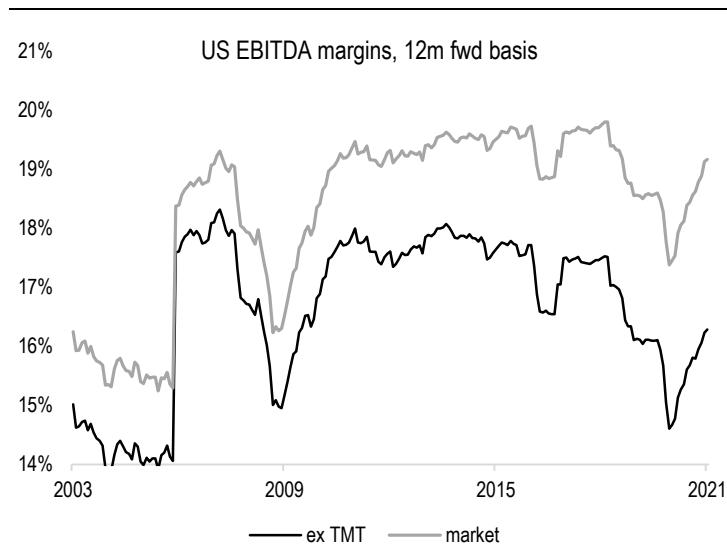
Figure 46: There is a growing gap between top-down and bottom-up margins



Source: Refinitiv, Credit Suisse research

- iv. We see the interest charge actually falling given the refinancing of corporate debt.

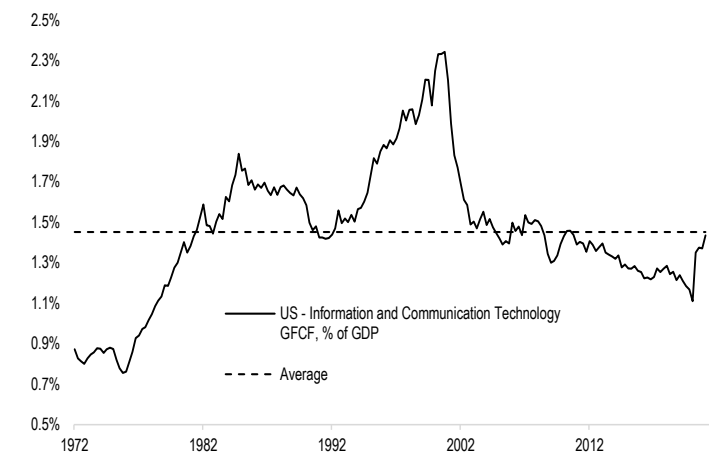
The average maturity of corporate debt in the US is 8.4 years for investment grade and 5.2 years for high yield.

Figure 47: EBITDA margins are not extended ex tech

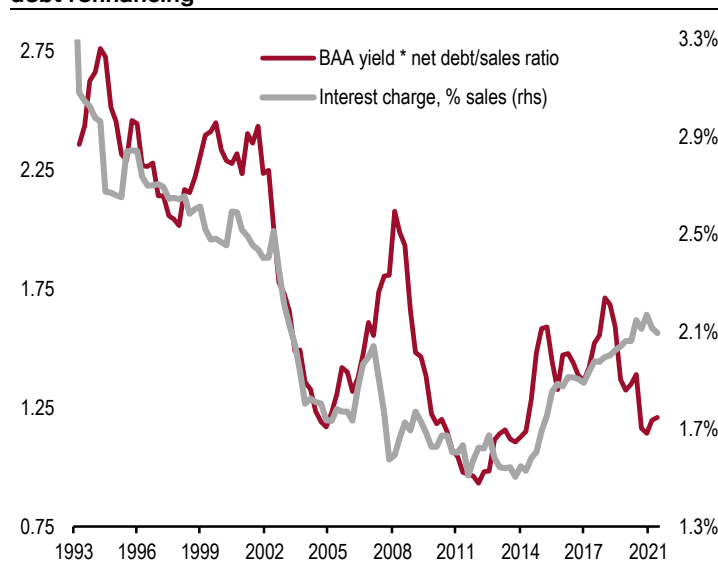
Source: Refinitiv, Credit Suisse research

The warning signals on margins are either overinvestment or labour getting pricing power, but neither condition is fully present.

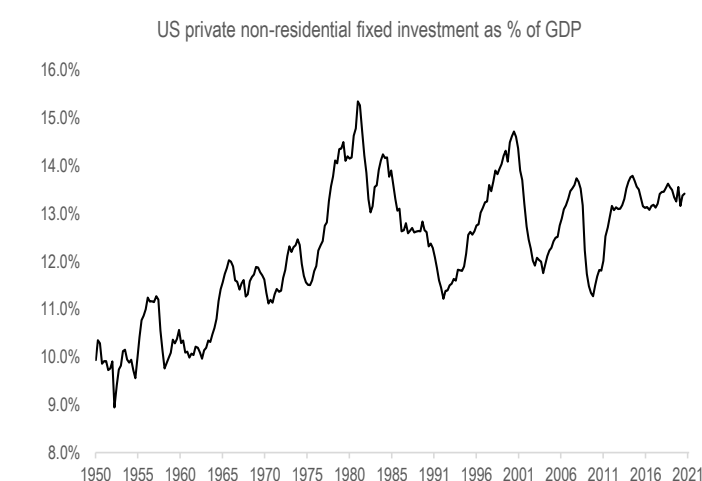
If companies overinvest, again margins fall. If we look at either the investment share of GDP or capex to sales, we can see that corporates are not overinvesting. As we show above, in the EU and Japan, investment is 11% and 5% below pre-pandemic levels, respectively.

Figure 49: The tech investment share of GDP is only in line with its average...

Source: Refinitiv, Credit Suisse research

Figure 48: Interest charge has been falling given corporate debt refinancing

Source: Refinitiv, Credit Suisse research

Figure 50: ...with the same true of investment in aggregate

Source: Refinitiv, Credit Suisse research

Tax is a headwind, but not a substantial one

Both our US strategist Jonathan Golub and our Credit Suisse HOLT® tax specialist team highlight that if President Biden's corporate tax proposals were fully implemented (i.e. a rise in the corporate tax rate to 28% along with a GILTI tax etc.), that would take 6-7% off EPS (see [Biden Corporate Tax Proposals](#), 16 Apr). The issue is that we think tax changes are likely to be

relatively moderate as some moderate Democrats have announced that they do not want the statutory rate to be raised to more than 25%.

Even a global minimum corporate tax rate of 15% might not be that problematic. It is meant to raise \$150bn (for the 100 largest companies), which compares with a global market cap of c.\$60trn and we assume as with most tax changes there is a corporate offset of around one-third. Already there are large legal hurdles—for it to pass in the EU, there needs to be unanimous agreement, but three countries (Ireland, Estonia and Hungary) have been holding out, and it might not pass in Congress.

Moreover, the *quid pro quo*, of countries abandoning their unilateral attempt to have a digital sales tax (on tech) might more than offset the tax hit to tech (this for example was found to be the case by the UK Tax Council).

7. Dividend expectations still appear too conservative

Dividend futures can be traded and thus might give a more accurate guide than earnings expectations. We can see that dividend futures remain cautious. In the US, expectations for end-2022 dividends are only 7% above the previous realised peak, while consensus earnings are 34% above previous peaks. In the UK, end-2022 dividends are still expected to be 20% below the previous peak while consensus earnings are 4% above the previous peak.

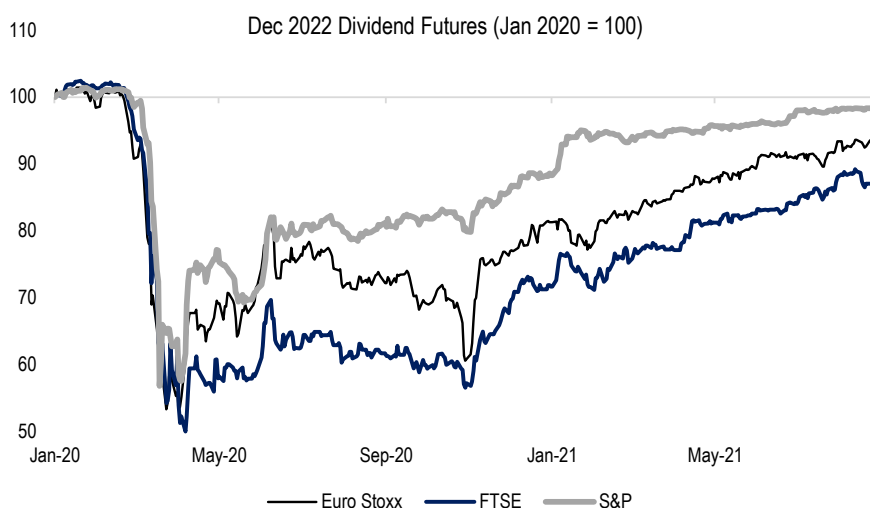
Figure 51: Dividend futures are more pessimistic than consensus EPS

Dividend Futures	Euro Stoxx	FTSE 100	S&P	Consensus Earnings	Euro Stoxx	FTSE 100	S&P
2020 chg %	-32.0%	-35.0%	-0.5%	2020 chg %	-30.5%	-45.2%	-15.3%
Implied 2021 chg %	21.2%	13.7%	3.0%	Implied 2021 chg %	56.1%	80.0%	45.5%
Implied 2022 chg %	10.5%	8.1%	4.5%	Implied 2022 chg %	8.4%	5.0%	9.1%
Implied change from end-19 to end-22	-8.9%	-20.1%	7.1%	Implied change from end-19 to end-22	17.6%	3.6%	34.4%

Source: Refinitiv, Credit Suisse research

Looking at end-22 dividend futures compared to their pre-pandemic levels, we can see that they have yet to recover to the levels seen in January 2020 across the world.

Figure 52: Dividend futures for end-2022 remain more pessimistic than before the pandemic



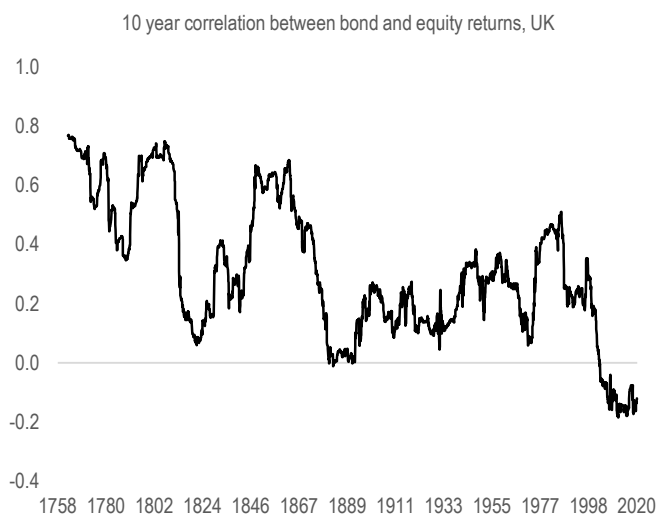
Source: Bloomberg Finance L.P., Credit Suisse research

8. Fund flows are still supportive

i. A bond-for-equity switch

We continue to see that the bond-to-equity correlation has ceased to be negative (i.e. bond and equity prices are tending to move in the same direction). This we think causes something of a bond-for-equity switch.

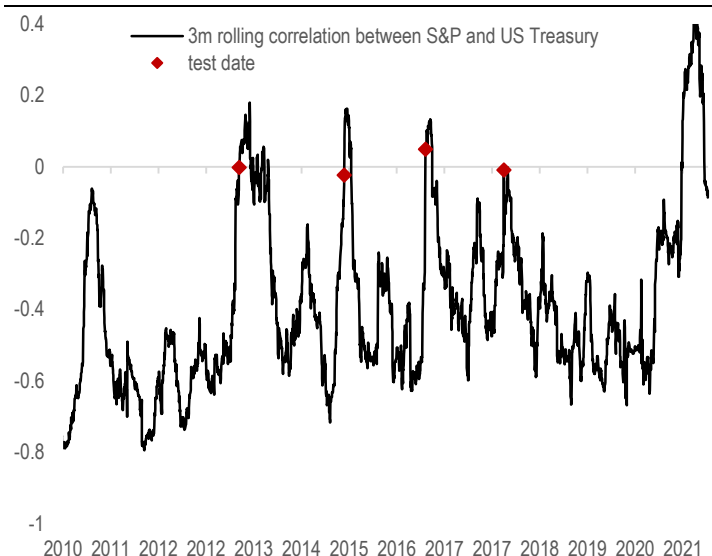
Figure 53: Bond and stock returns have been negatively correlated since 1998 but less so...



Source: Refinitiv, Credit Suisse research

Points when the correlation has turned positive have tended to precede periods of reasonably strong performance for the S&P 500.

Figure 54: ...with this correlation now turning positive on a shorter time horizon



Source: Refinitiv, Credit Suisse research

Figure 55: Points when the bond/equity correlation have turned positive tend to see positive equity performance subsequently

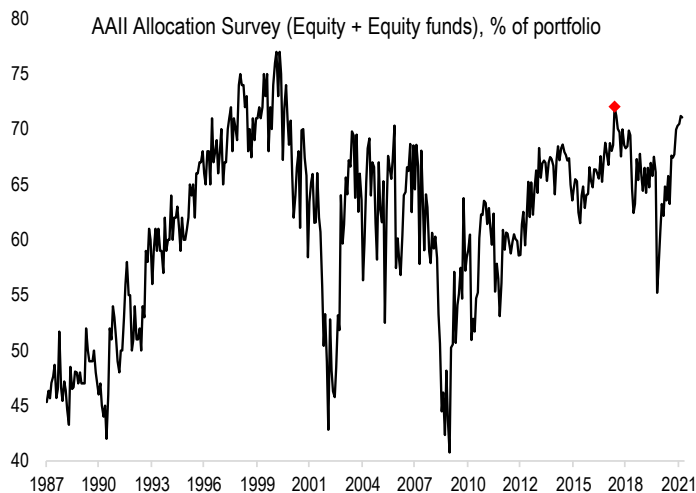
S&P performance when 3m correlation turns positive			
	3m	6m	12m
Jul-13	1.4%	9.7%	17.1%
May-15	0.2%	1.0%	-1.8%
Sep-16	5.0%	9.2%	16.1%
Feb-18	-3.6%	2.8%	-2.0%
Average	0.8%	5.7%	7.3%
Typical performance	3.1%	6.1%	12.3%

Source: Refinitiv, Credit Suisse research

If we look at combined weightings in equities, they are high (at levels last seen in 2017) but not extreme. This is at a time when credit is becoming abnormally risky and bonds have become a non-diversifying riskless return (with \$16.5trn on a negative yield).

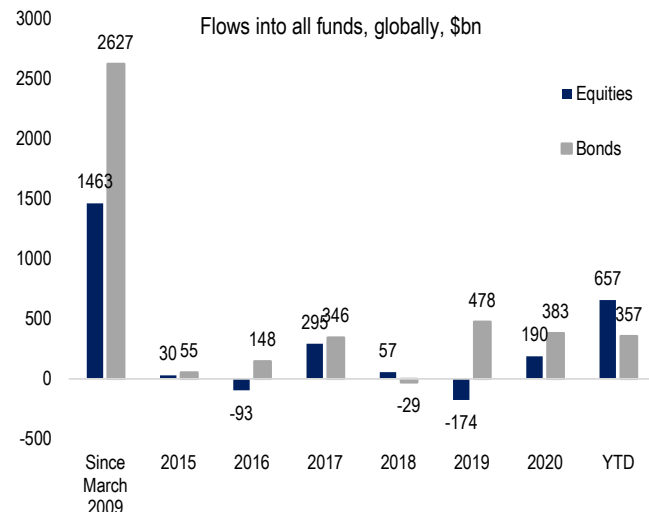
We can also see using EPFR data that flows into bonds have far exceeded flows into equities since the start of the current bull market in 2009 and over the past six years, only in 2021 have equity flows surpassed bond flows.

Figure 56: Equity allocations are at the peak levels seen in 2017 but not yet extreme



Source: Refinitiv, Credit Suisse research

Figure 57: Flows into bonds have far exceeded flows into equities since the start of the bull market

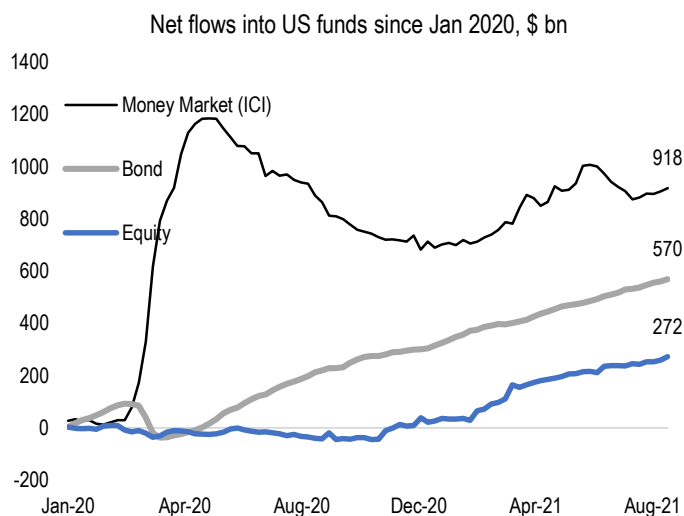


Source: Refinitiv, Credit Suisse research

- ii. Only 18% of flows into money market and bond funds have gone into equities since 1/20

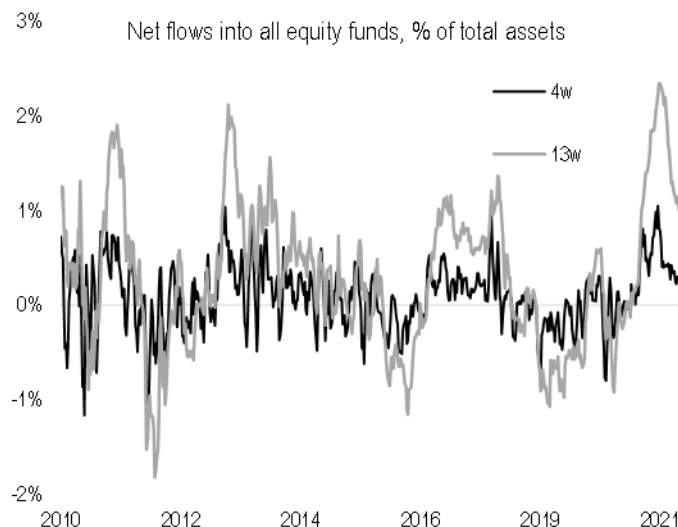
We can also see that equity buying is well below January levels.

Figure 58: Only c18% of the flows into money market and bond market funds have gone into equities since Jan 2020...



Source: EPFR, Credit Suisse research

Figure 59: ...with the pace of inflows down significantly from January levels

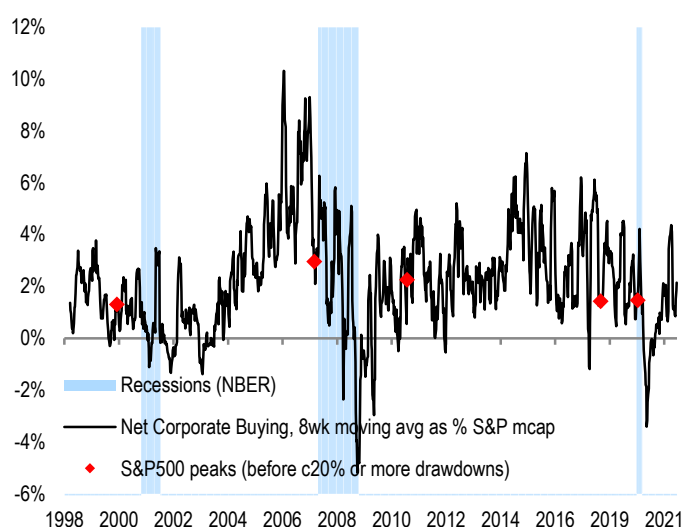


Source: EPFR, Credit Suisse research

- iii. The corporate sector looks set to remain a substantial net buyer

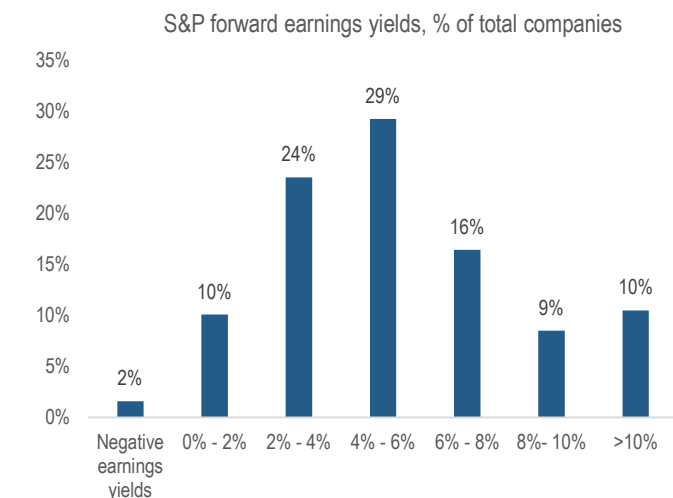
Corporate net buying has slowed a little but we see this increasing because:

- Buybacks as a style have outperformed YTD, incentivising managements to pursue them;

Figure 60: Net corporate buying is picking up again

Source: Refinitiv, Credit Suisse research

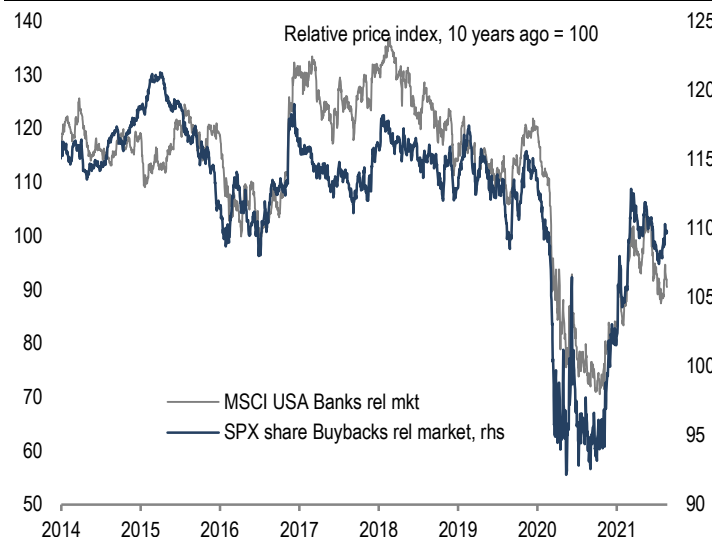
- Buybacks are earnings-enhancing. Over half of companies have an earnings yield above the junk bond yield;
- FCF is still above both dividends and buybacks.

Figure 62: More than half of companies still have a forward earnings yield above the junk bond yield

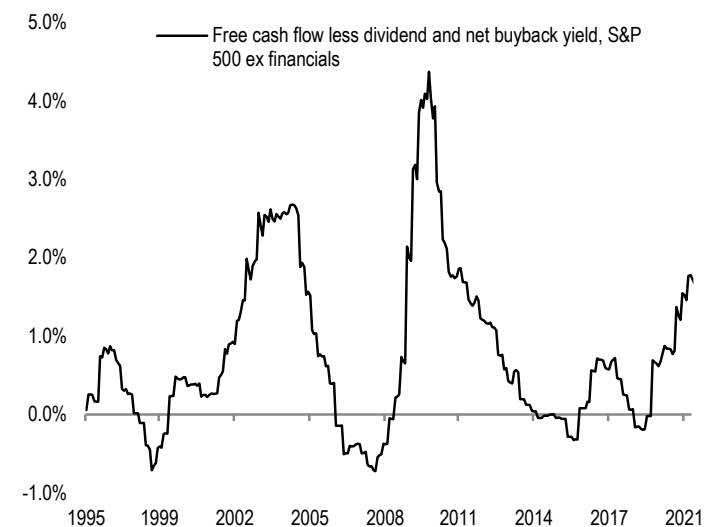
Source: Refinitiv, Credit Suisse research

■ Dry powder

Last, there is \$1.7tn of private equity dry powder, which in turn is bidding for quoted equity at big premiums. This can leveraged up to 3x.

Tactical signals are in general less worrying**1. The tactical signals are off extremes****Figure 61: With buybacks as a style outperforming this year**

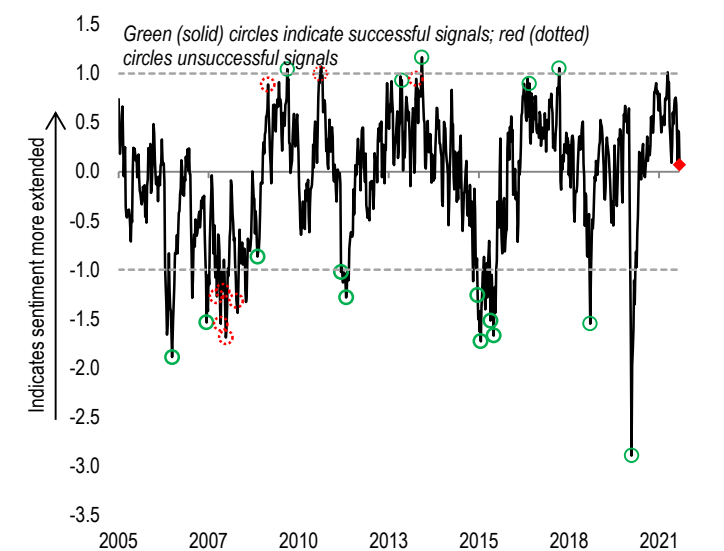
Source: Refinitiv, Credit Suisse research

Figure 63: FCF is still well in excess of dividends and buybacks

Source: Refinitiv, Credit Suisse research

Our aggregate tactical indicators gave a weak sell signal at the end of April, but are off extremes.

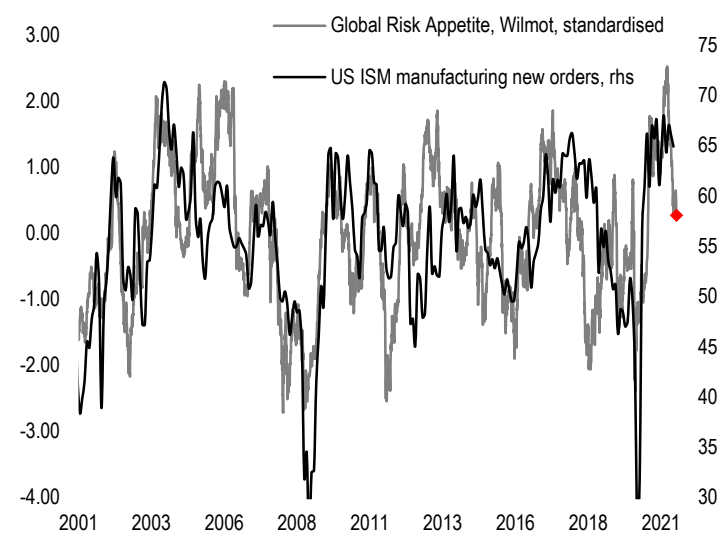
Figure 64: Our composite tactical indicator has fallen back close to its historical average



Source: Bloomberg Finance L.P., Refinitiv, Credit Suisse research

Risk appetite is now consistent with an ISM of 58, which would be consistent with GDP growth of c2.8% (consensus forecasts 6.2% this year and 4.3% next year). There have been a number of hurdles that the market has passed; at end-April, we had extreme bull-bear ratios and extreme single stock call-to-put buying, which has now passed.

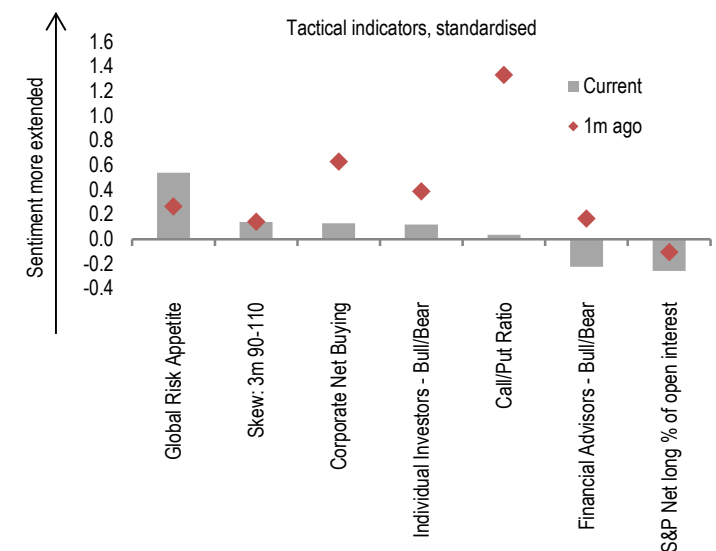
Figure 66: Risk appetite is consistent with ISM of 58...



Source: Refinitiv, Credit Suisse research

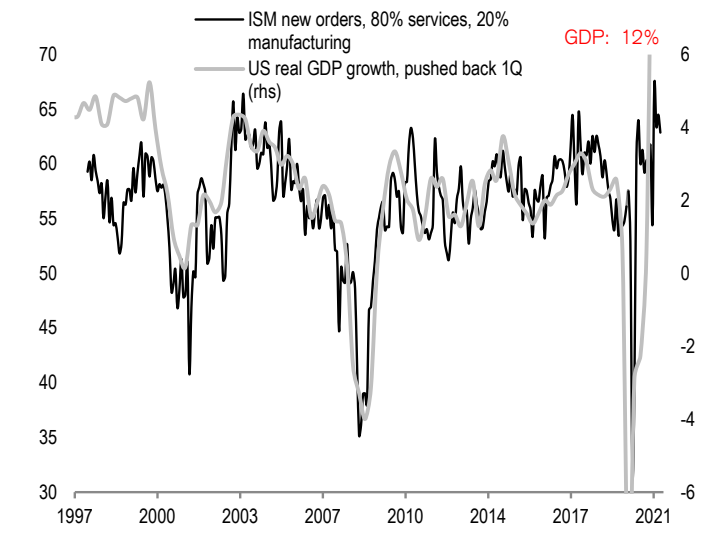
We also had a bear market in IPOs without a correction in equity markets for the first time.

Figure 65: Risk appetite is a little extended, but other measures have corrected

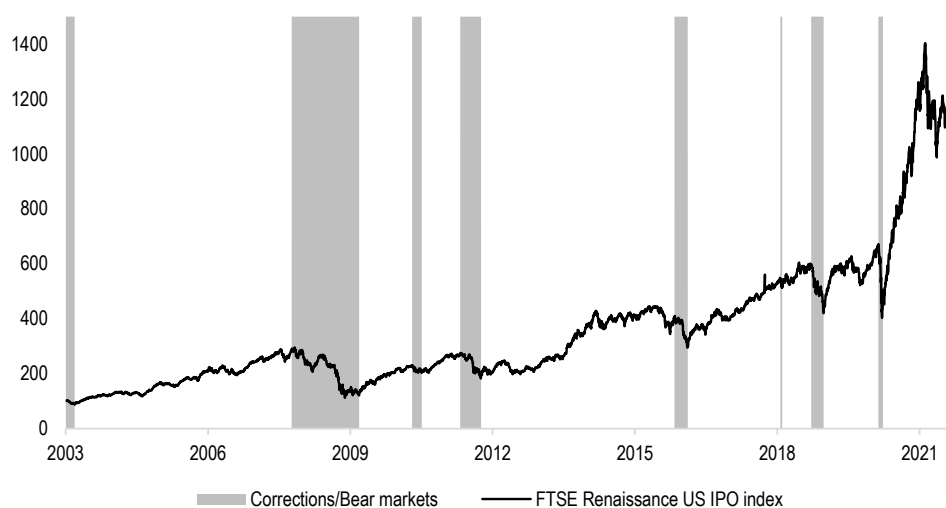


Source: Refinitiv, Credit Suisse research

Figure 67: ... consistent with GDP growth of c2.8%



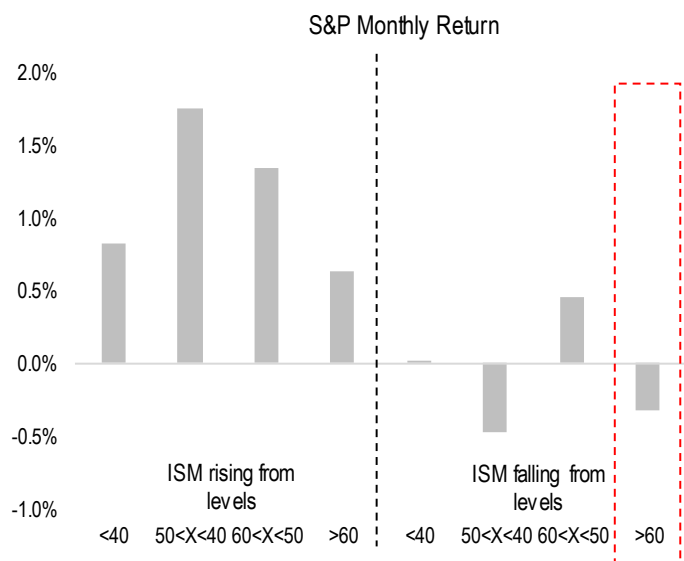
Source: Refinitiv, Credit Suisse research

Figure 68: We have seen a bear market in IPOs without a correction in equity markets

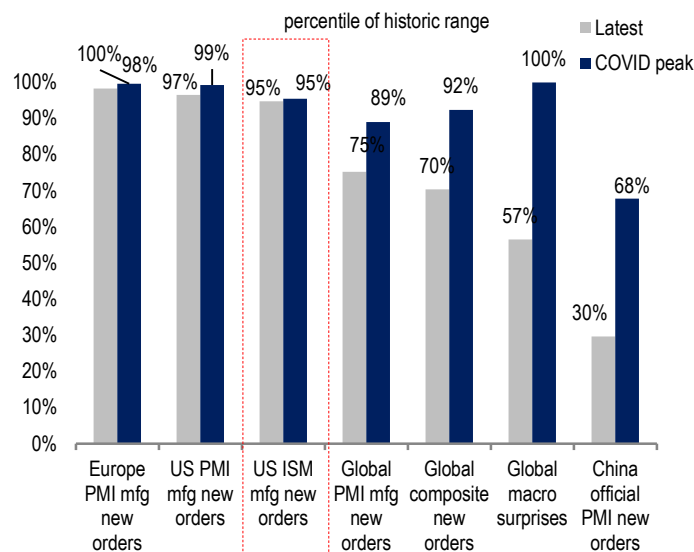
Source: Refinitiv, Credit Suisse research

2. ISM passed its peak but less problematic than normal

We see that monthly returns are more problematic when ISM new orders are high and falling. We can see that ISM new orders (which is a mean reverting series) is at the top end of its historical range.

Figure 69: An ISM which is high and falling tends to present the most challenging backdrop for S&P performance

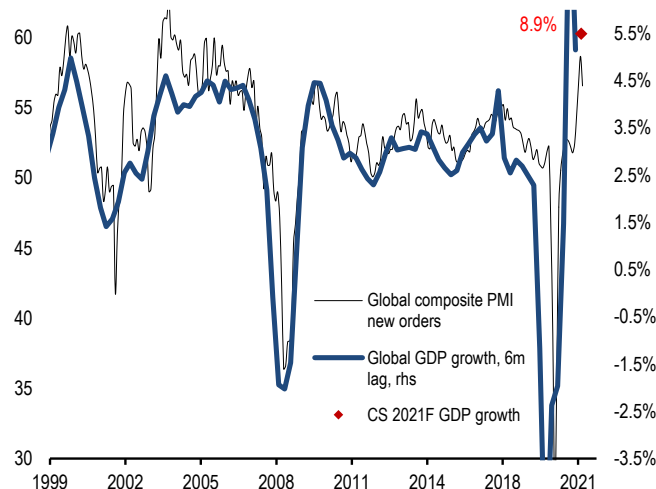
Source: Refinitiv, Credit Suisse research

Figure 70: Manufacturing ISM new orders are close to the top of their historical range

Source: Markit, Refinitiv, Credit Suisse research

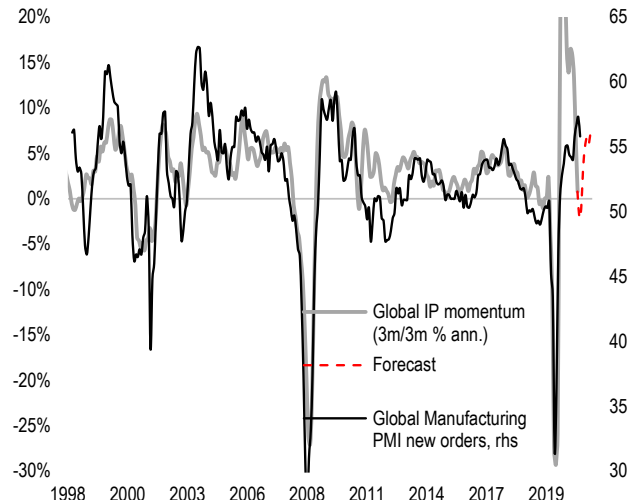
We still think global composite PMIs can rise (after a near-term COVID hit) as 6% global GDP growth (which is our economists' forecast) is consistent with global composite PMI new orders of 63. CS economists see an acceleration in IP momentum to c7% by October from a mini slowdown. Even if we take the CS house view for 2022 global GDP of 4.6%, that would also not be a consistent with a fall in global composite PMI new orders (clearly the risk is that the rise in COVID-19 cases pushes some of the 2H 2021 GDP into 2022).

Figure 71: 5.5% GDP growth would be consistent with composite PMI new orders of 63



Source: Markit, Refinitiv, Credit Suisse research

Figure 72: Global IP is expected to accelerate after a mini-slowdown

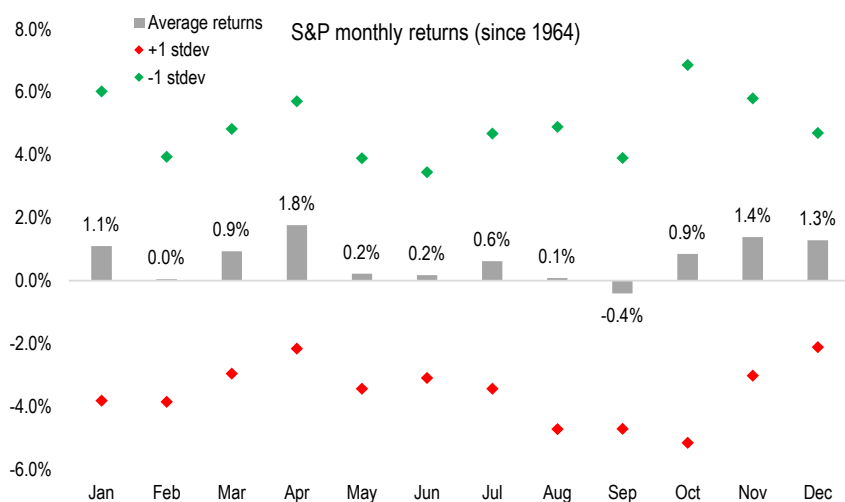


Source: Markit, Refinitiv, Credit Suisse research

3. Seasonality getting close to the end of the weakest months

We have now had 10 months without a correction of more than 5%, while August and September tend to be two of the weakest months of the year for returns.

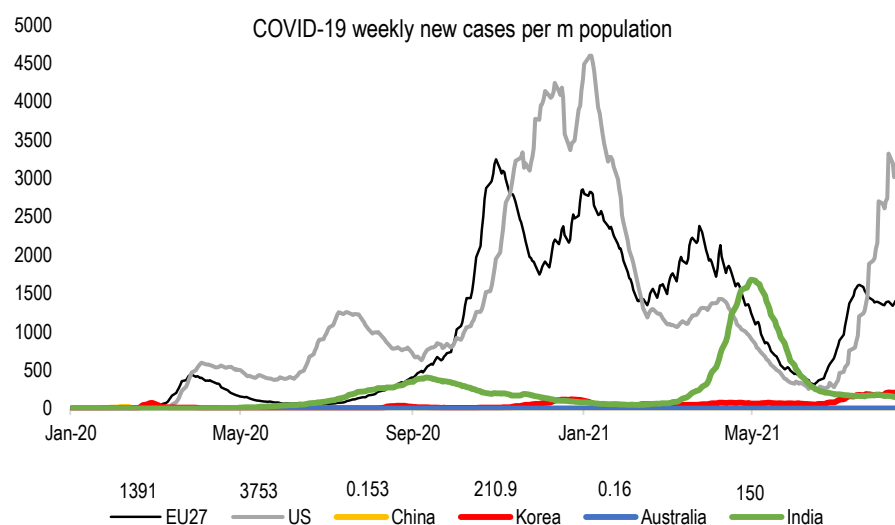
Figure 73: August and September tend to be seasonally weak months, after 9 months without a 5% correction



Source: Refinitiv, Credit Suisse research

4. Delta variant risk

There has been a rise in infection rates in the US, particularly worrying in some southern states where hospitals have come close to peak ICU capacity, and parts of Asia have once again started to see a rise in cases as well. This in turn has led to further semis supply shortages (for example, Vietnam and Malaysia semi production problems owing to the pandemic were cited as a reason by Toyota as to why auto production in September would be 40% lower).

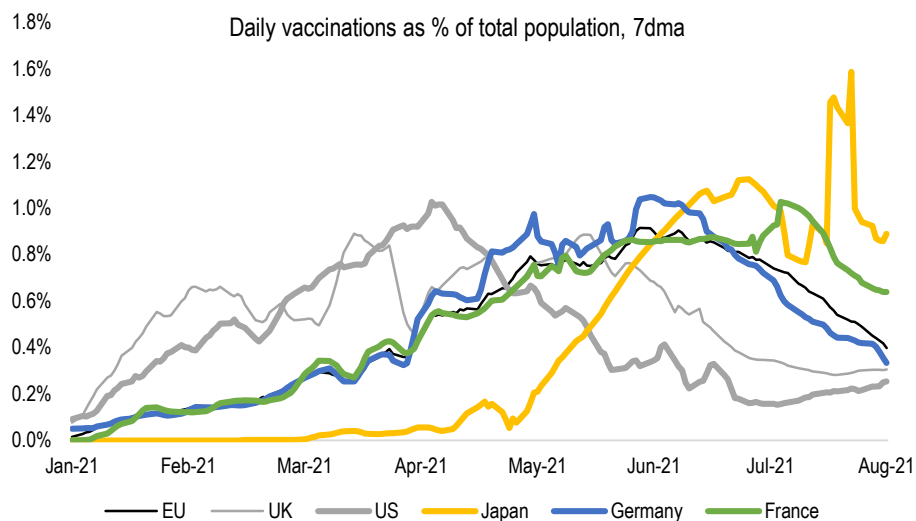
Figure 74: COVID-19 cases are still rising in some parts of the world

Source: Refinitiv, Credit Suisse research

We struggle to alter our fundamental view of equities on the back of this because:

- i. There is enough capacity

Our pharma team believes that by year-end there will be enough vaccine capacity to vaccinate nearly 6.8bn people (close to 90% of the world's population). Obviously, the problem is the logistical issue. We can see at peak vaccination rates were 1% of European/US population a day. In China, close to 2bn doses have been administered and in India an estimated 70% of the population now has sero-prevalence.

Figure 75: Daily vaccinations as a share of total population

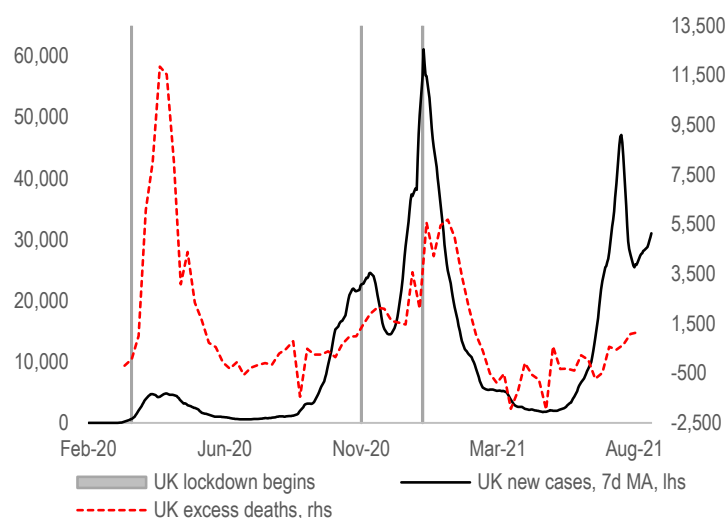
Source: Refinitiv, Credit Suisse research

- ii. There has been a clear breakdown in the link between deaths and infections as a result of vaccinations

The clearest example is the UK, where there is a full opening up and excess deaths are close to their normal levels. The efficacy of the vaccines against hospital admissions is 90% to 95% once people have been fully vaccinated (FT, 19 Aug) though this seems to have fallen to 55%

in Israel (FT, 23 Aug) for over 65 year olds who were vaccinated in January, according to the Health Ministry (with the Pfizer vaccine having a higher fade after four months than the Astra vaccine)-hence the requirement for a third dose. Moreover, the treatment for those infected are getting much better. For example, AstraZeneca will seek regulatory approval for an antibody cocktail that showed a 77% reduction in the development of symptomatic COVID-19 (FT, 20 August).

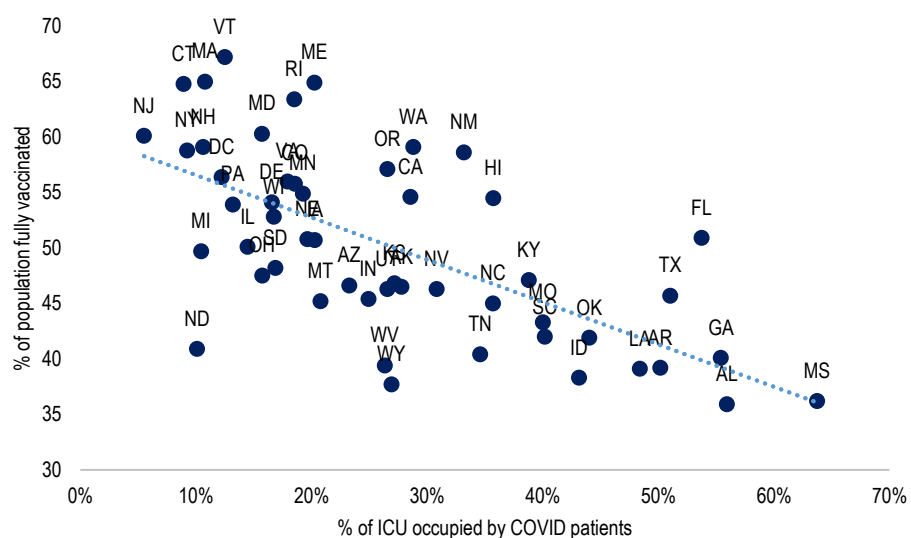
Figure 76: UK new COVID-19 cases versus excess deaths showing that excess deaths remain close to normal levels



Source: PHE, Credit Suisse research

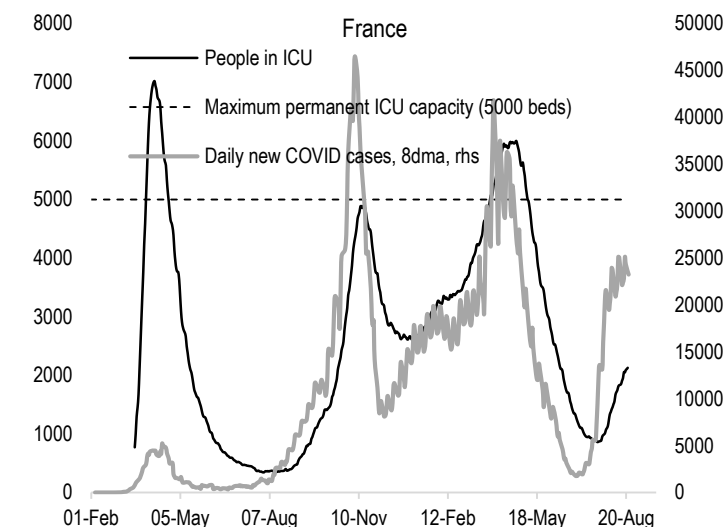
The concern is that in the US, nine states still have less than 50% of adults who have been fully vaccinated. This is largely due to vaccine hesitancy. Those states that have the lowest vaccination rate tend to have a higher proportion of ICU beds occupied by COVID-19 patients (with 6 states having over 50% of ICU beds occupied by COVID-19 patients).

Figure 78: US states' vaccination progress against ICU occupancy rate by COVID-19 patients



Source: HealthData, Refinitiv, Credit Suisse research

Figure 77: France ICU daily new cases vs maximum ICU capacity



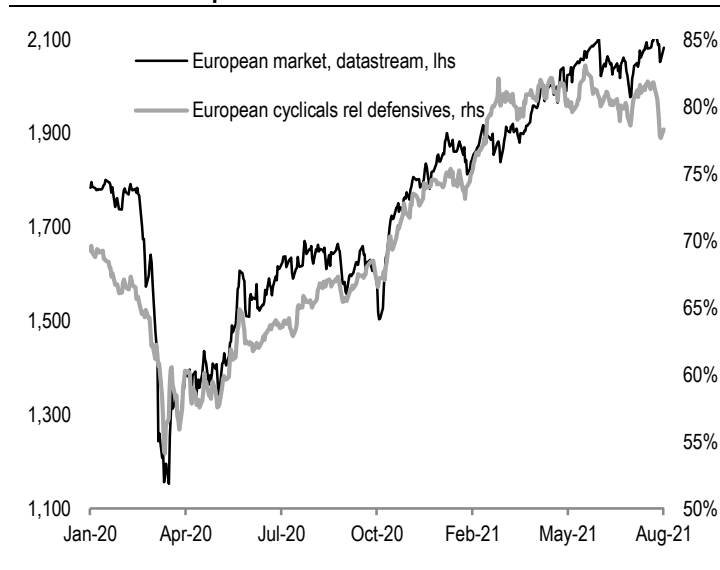
Source: ECDC, Refinitiv, Credit Suisse research

The key is so far there have been no calls for widespread or even local lockdowns because of this. We think that over time, vaccine hesitancy will diminish (for example, in France a year ago nearly 60% of the population was concerned about getting a vaccine and now this is down to 20%). Moreover, there will be both a stick (i.e. requiring a vaccine certificate to enter entertainment venues or to have jobs in the healthcare sector) and carrots (e.g. fiscal incentives). Public attitudes might change now that FDA has given the Pfizer vaccine full approval (as opposed to emergency authorization).

5. Market direction and non-financial cyclicals tend to be correlated, but less so this year.

We can see below that market direction and non-financial cyclicals tend to be correlated, more so in Europe than the US.

Figure 79: Cyclicals tend to outperform as the market rises and vice-versa in Europe...

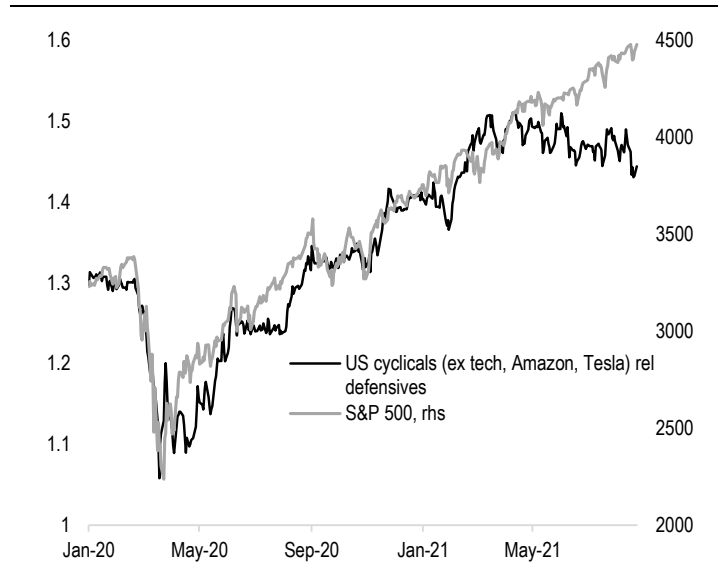


Source: Refinitiv, Credit Suisse research

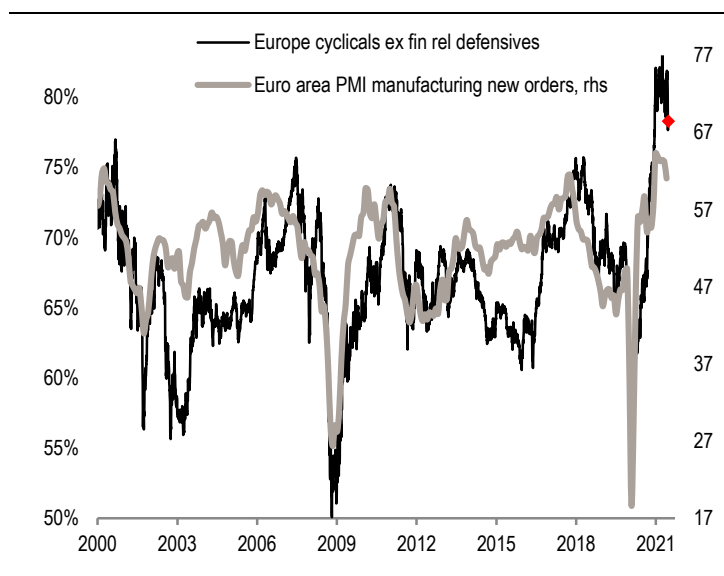
Non-financial cyclicals in Europe are still pricing in a very high level of PMIs and are looking expensive and hence we are a small underweight of the group.

However, the good news is that in recent months this correlation seems to be breaking down, particularly in the US.

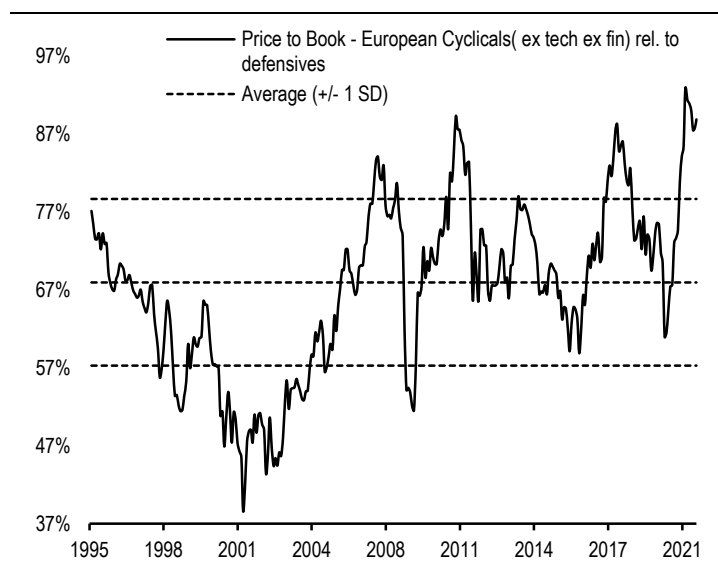
Figure 80: ... and the US



Source: Refinitiv, Credit Suisse research

Figure 81: The price ratio of non-financial cyclicals to defensives in Europe is pricing in PMIs of 67

Source: Markit, Refinitiv, Credit Suisse research

Figure 82: Cyclical P/B relative

Source: Refinitiv, Credit Suisse research

The biggest concern is credit

Credit spreads no longer making new lows

Credit tends to lead equity at major turning points by 3-6 months.

Figure 83: Credit usually leads equity into a bear market...

HY spreads trough date	US HY spreads (bps)	S&P500 peak date	S&P500 level	Credit spread trough rel. market peak (m)
22-Dec-99	466	29-Mar-00	1509	-3.3
13-Jun-07	273	10-Oct-07	1562	-4.0
16-Feb-11	362	27-Apr-11	1356	-2.3
18-Jun-14	313	20-May-15	2126	-11.2
03-Oct-18	334	22-Jan-20	3322	-15.9
19-Feb-20	427	19-Feb-20	3386	0.0
Average	362			-6.1

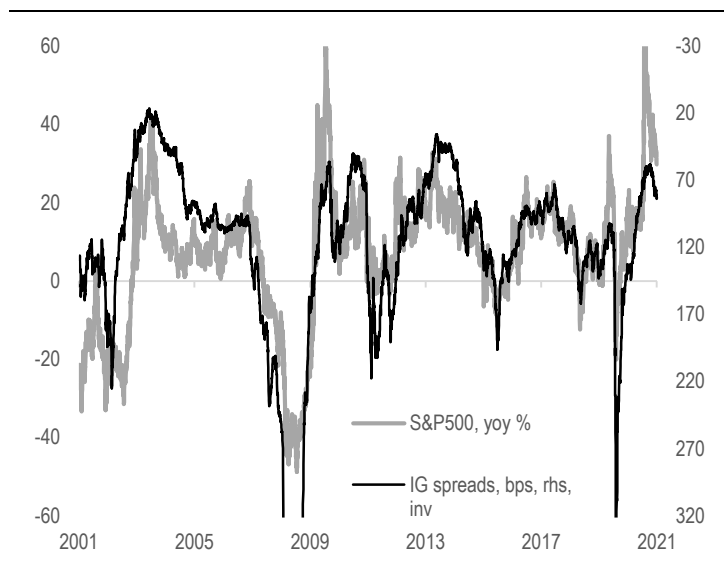
Source: Refinitiv, Credit Suisse research

We have seen credit follow equity over the past 20 years; and we can see that credit is no longer making new lows as equity is making new highs.

Figure 84: ... and into a bull market

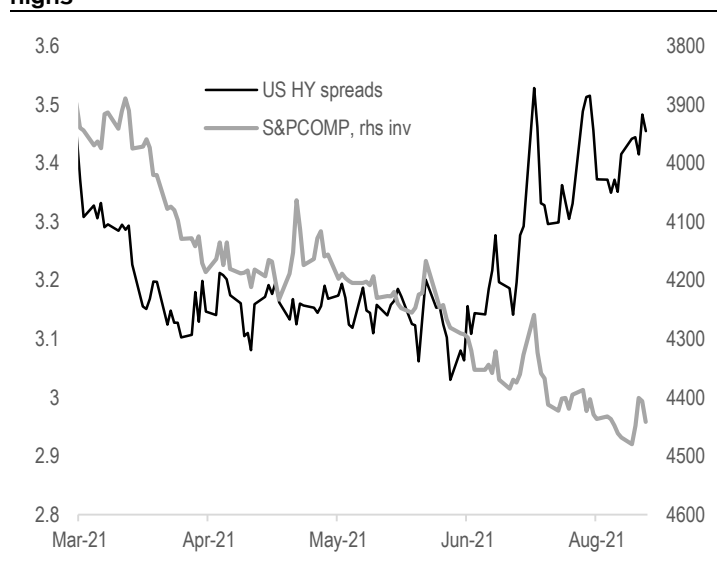
IG spreads peak date	US IG spreads (bps)	S&P trough date	S&P500 level	Credit spread peak rel. market trough (m)
29-Aug-86	268	04-Dec-87	224	-15.4
07-Dec-90	158	12-Oct-90	300	1.9
02-Oct-98	175	09-Oct-98	984	-0.2
11-Oct-02	215	04-Oct-02	801	0.2
05-Dec-08	562	06-Mar-09	683	-3.0
Average	276			-3.3

Source: Refinitiv, Credit Suisse research

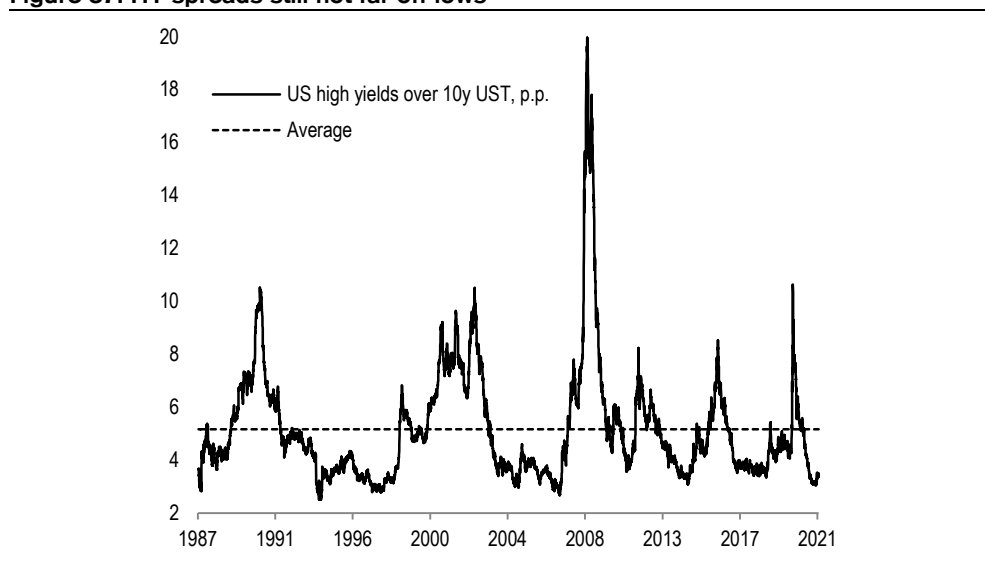
Figure 85: Spreads are widening slightly

Source: Refinitiv, Credit Suisse research

This is at a time when credit spreads are very close to historical lows.

Figure 86: Spreads have widened even as equities make new highs

Source: Refinitiv, Credit Suisse research

Figure 87: HY spreads still not far off lows

Source: Refinitiv, Credit Suisse research

We need to keep a careful eye on this.

Still a bigger risk of melt-up than meltdown

When we assess the risks to our view, we believe the balance of risks is tilted more to the upside than to the downside. The four supports we see for a potential 'melt-up' are:

- Pre-emptively loose monetary conditions;
- Excess liquidity;
- A reasonable ERP;

- TINA (There is No Alternative): Real yields are close to an all-time low and negative.
On our aggregate indicators, we still have only 4 of the 14 characteristics of a bubble in place.

Figure 88: Only around 4 of our 14 characteristics of a bubble are in place

Measures for an equity bubble	Now
Paradigm shift - 'it's different this time around'	Modest-ESG
Earnings become irrelevant	No
ERP falling to extreme levels	No
A collapse in market breadth	No
Buying becomes retail dominated	Yes, but not extreme
Pick up and peak in M&A activity	Small, as % market cap
NIPA profits fall while consensus EPS rises	No
Overinvestment	No
Extreme price performance	No
Tactical indicators very extended	No
Unsustainable macro dislocations	No
Credit spreads rise while market rises	Modestly so
Corporates become net sellers	No
Bonds look cheap	No

Source: Refinitiv, Credit Suisse research

We stress that in the two years ahead of a bubble peak, equity returns are significantly higher.

Figure 89: Price action before bubbles

Index	Perf leading upto the peak				Max Drawdown in prior 18m
	6m	1yr	2yr	3yr	
KOSPI 1989	49%	54%	162%	396%	-10%
TOPIX 1990	18%	22%	67%	84%	-7%
TAIEX 1990	28%	99%	299%	930%	-45%
Hang Seng 1994	69%	124%	183%	300%	-23%
Bangkok SET 1994	98%	98%	146%	188%	-18%
NASDAQ 2000	77%	111%	193%	285%	-13%
OIL 2008	59%	92%	97%	157%	-13%
Average	57%	86%	164%	334%	-18%
MSCI AC World to date	8%	30%	44%	42%	-34%

Source: Refinitiv, Credit Suisse research

Typically we end up in extreme overvaluation for growth stocks (P/E at 45x to 75x compared to 39x for the NASDAQ today) at a time when bond yields were much higher.

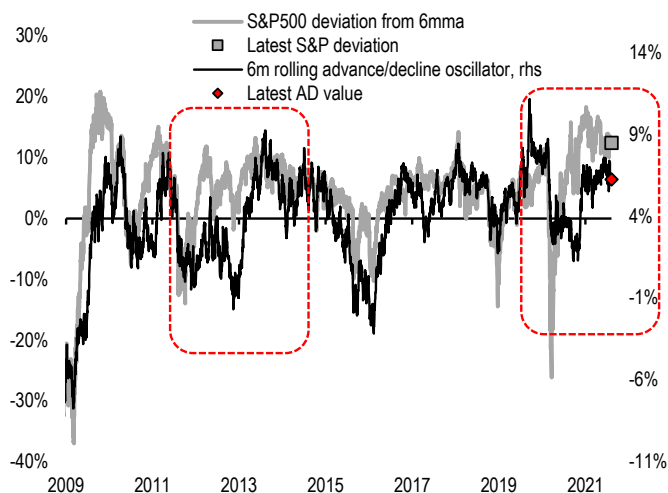
Figure 90: The P/E growth in Nifty 50, TMT and Japan ended on 45x, 60x and 72x earnings compared with 40x currently for the NASDAQ

		S&P	Treasury yields	P/E
Nifty Fifty	01/12/1970	87	6.5	
	05/01/1973	120	6.4	45x
	Change (% , bps)	37%	-6	
TMT Bubble	31/08/1998	957	5.0	
	24/03/2000	1527	6.2	60x
	Change (% , bps)	60%	122	
		TOPIX	JGB yields	P/E
Japanese stock bubble	04/01/1998	1690	4.5	
	18/12/1989	2885	5.5	72x
	Change (% , bps)	71%	97	

Source: Refinitiv, Credit Suisse research

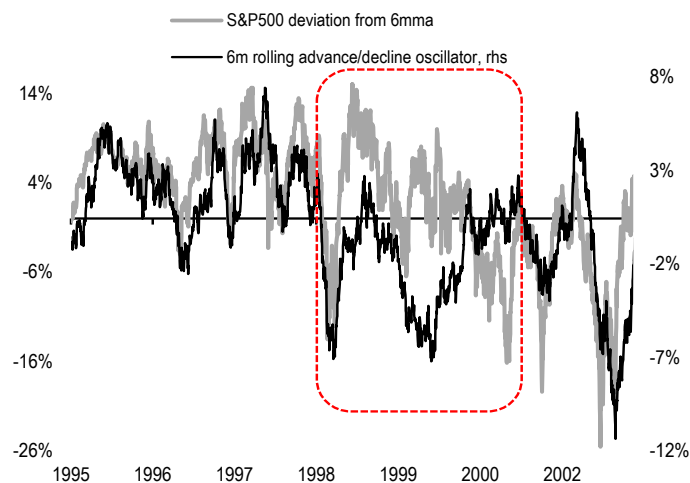
Ordinarily, there is a large loss of breadth at a bubble peak that is not being seen today.

Figure 91: We saw the early rally as lacking in breadth, but that has partially resolved...



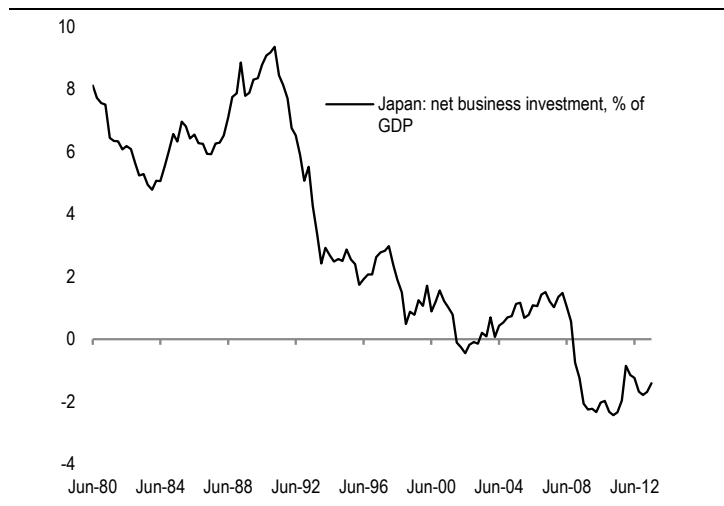
Source: Refinitiv, Credit Suisse research

Figure 92: ... and the disconnect became much larger in the TMT bubble

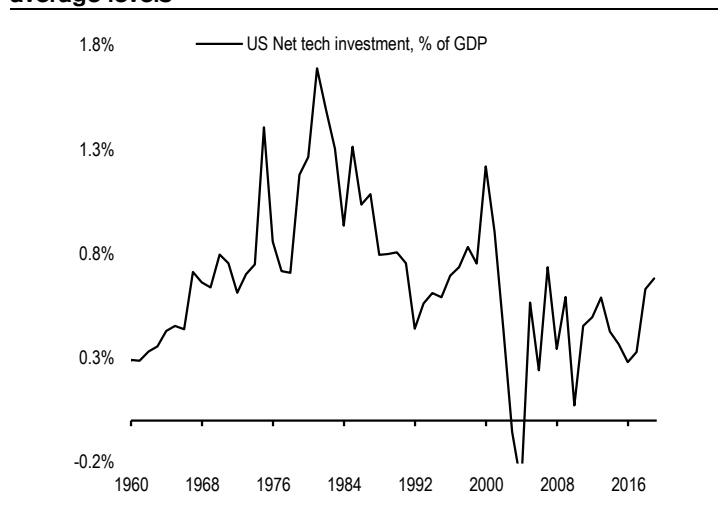


Source: Refinitiv, Credit Suisse research

At bubble peaks, we also saw clear-cut overinvestment, which again we are not seeing now.

Figure 93: Japan clearly overinvested in the late-1980s

Source: Refinitiv, Credit Suisse research

Figure 94: Net investment share of GDP has recovered to average levels

Source: Refinitiv, Credit Suisse research

What are investors' main concerns currently?

We note four main concerns raised in our conversations with investors, namely: ISM is at a peak; excess liquidity is at a peak; earnings momentum is at a peak; and policy settings are going to get tighter. We believe, however, that there is a pushback on each of these.

- ISM may peak, but global PMIs look set to stay high

ISM might be at a peak but we see global PMIs new orders staying high (given our view that consensus GDP in the US of 4.1% next year could be too low).

Moreover, when we look at risk appetite (as shown above), it is pricing in ISM new orders of c58. This would equate to c2.8% GDP growth compared with consensus of 4.2% next year.

- Earnings momentum may roll over slightly, but the market has not fully priced in this year's earnings strength

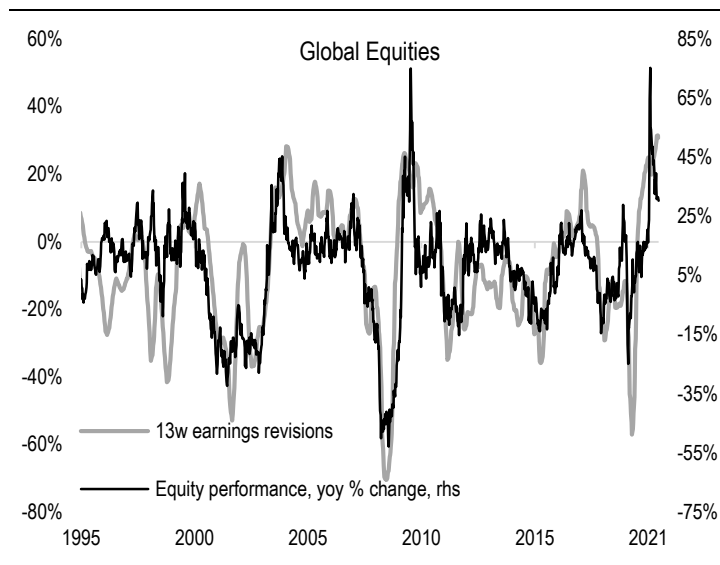
Earnings revisions are peaking and normally we can see that when the second derivative peaks, the first derivative very frequently ends up turning negative.

There are three counter-arguments this time.

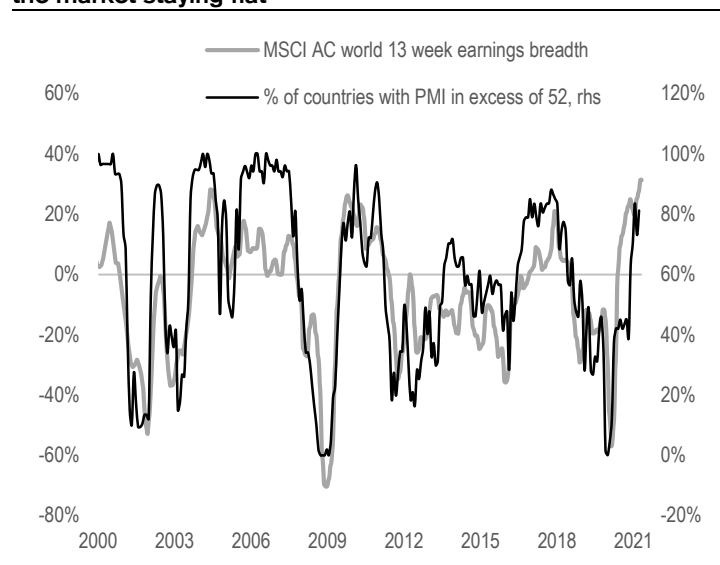
- First, market performance does not reflect current earnings revisions.

- Second, as above, we think EPS will come in above consensus. We need to see c70% of PMIs above 52 to get a level of earnings revisions consistent with flat markets by year-end. We think this is fair.

- Third, as above, dividend expectations seem too low.

Figure 95: Earnings revisions are still pointing to superior returns

Source: Refinitiv, Credit Suisse research

Figure 96: The proportion of PMIs above 52 are pointing towards a level of earnings revisions broadly consistent with the market staying flat

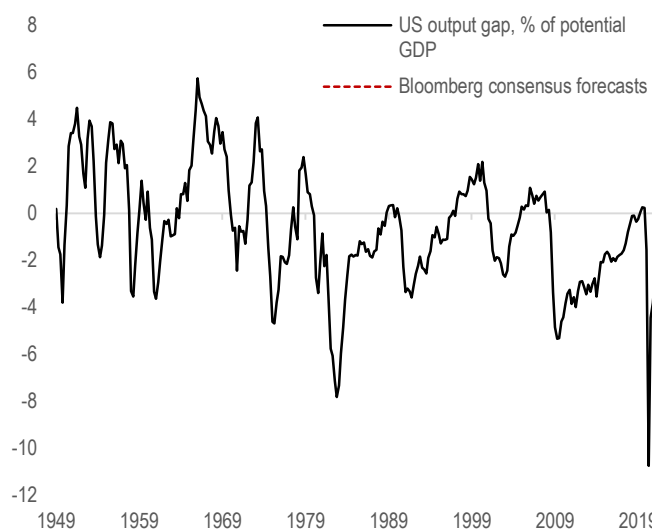
Source: Markit, Refinitiv, Credit Suisse research

■ Tapering but excess liquidity stays supportive until 2H 2022

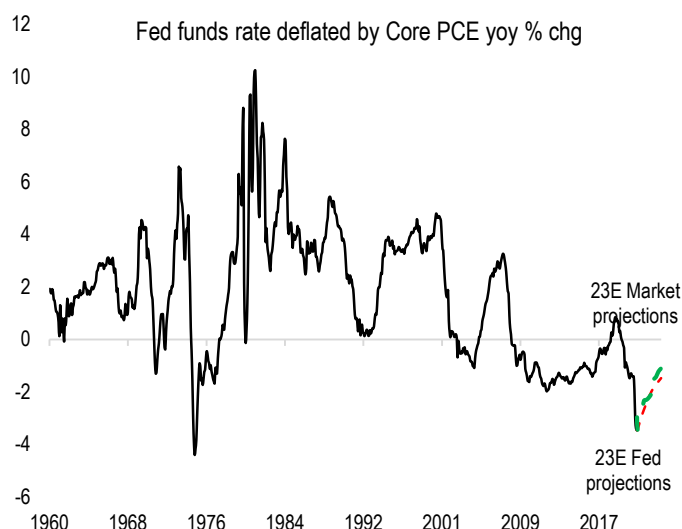
Aggregate policy setting is getting less loose, but in terms of monetary conditions is still very loose. We think that the Fed will start to taper in late Q4 or Q1 22. This would not be a surprise as the latest FOMC minutes suggested that a majority of the Fed favour tapering. The fact that Powell pushed back at the last FOMC against tapering MBS before Treasuries suggests, if anything, a slightly later timeline. If the timeline is similar to last time, taper talk precedes tapering by seven months and in turn tapering lasts 10 months.

This would imply the first rate hike would then be around 18 months after taper talk (i.e. end-2022 or early-2023). The first rate rise is now being priced in for late 2022. We think the Fed will be very cautious in its guidance and talk of tapering has been so well discounted that the actual talk will have little impact (in passing, we have already seen the BOC taper by 25% and the RBNZ stop QE completely with little impact).

We worry that the crunch time will come when rates rise because of the degree of leverage in the system. Our concern is that even for end-2023, both monetary conditions and the real fed funds rate are still very loose given an output gap that is potentially the highest since the late-1990s.

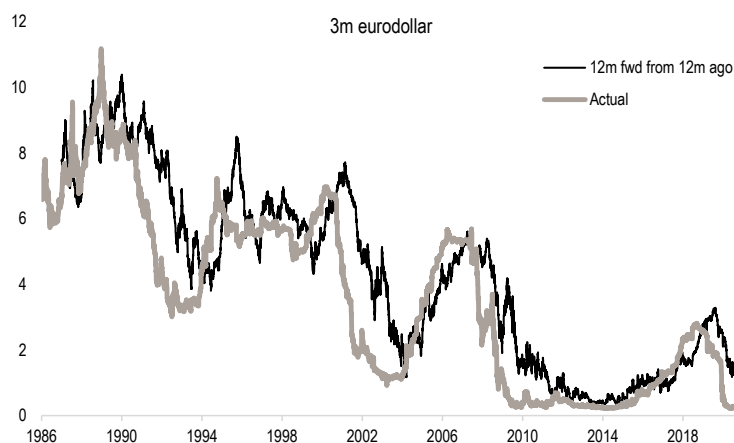
Figure 97: US output gap

Source: Refinitiv, Credit Suisse research

Figure 98: Real fed funds rate

Source: Bloomberg Finance L.P., Refinitiv, Credit Suisse research

This in turn means we believe that once rate hikes start, more tightening will need to be priced in. This is similar to the rate hike cycles of the 1990s (when the market underestimated the degree to which rate tightening was required).

Figure 99: In the 1994, the market underpriced the path of Fed tightening

Source: Refinitiv, Credit Suisse research

■ Inflation

We will not go into our views on inflation, but we still believe that inflation breakevens will rise to 2.5% by the end of this year and 3% by the end of 2023 (see [What is happening in the bond market?](#), 12 Jul). We worry when inflation expectations exceed the Fed's 'make-up' target (of having an overshoot to compensate for the undershoot). This would probably imply that the Fed would tolerate core PCE rising to c2.4% (since the Fed came out with its 2% inflation target in 2012, core PCE has averaged 1.68% and thus an overshoot to compensate for the undershoot would imply an average of 2.2% core PCE over the next 10 years). In turn, this would require the 10-year breakeven to rise to c2.7%).

Figure 100: Market-implied inflation rates

Market implied inflation rates	
Current US 10 year breakeven inflation	2.28
Implied level of core CPI	2.23
Implied level of core PCE	1.92

Source: Refinitiv, Credit Suisse research

We also think the Fed will de-emphasise the 10-year breakeven. Using the Common Inflation Expectations measures promoted by Fed Vice Chair Clarida, only 1 of the 8 measures is market focused and the CIE is currently at 2.05%.

Figure 101: CIE index

Source: Refinitiv, Credit Suisse research

Figure 102: Inflation expectation indicators used in CIE

	Relevant inflation concept	Forecast horizon
Blue Chip survey	CPI	1 year ahead; long horizon (7-11 years ahead)
Conference Board Survey	Prices in general	1 year ahead
Consensus Economics	CPI	6 to 10 years ahead
TIPS	CPI	5 year; 10 years; 10y10y fwd; 5y5y fwd
Livingston	CPI	1 year ahead; 10 years ahead
Michigan survey	Prices in general	Next 12 months; next 5 to 10 years
Michigan survey (25, 75 percentile)	Prices in general	Next 5 to 10 years
Survey of Professional Forecasters (SPF)	CPI	1 year ahead; 6 to 10 years ahead; next 10 years
	PCE price index	1 year ahead; 6 to 10 years ahead; next 10 years
	Core PCE price index	1 year ahead

Source: Refinitiv, Credit Suisse research

Companies Mentioned (Price as of 22-Aug-2021)

AstraZeneca (AZN.L, 8731.0p)

Toyota Industries (6201.T, ¥8,650)

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