Daiwa Securities

Daiwa's View

Risk factors in 2022: Part 1

➢ Inflation, China, BOJ/ECB, fallacy of composition, and valuations

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Daiwa Securities Co. Ltd.

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How will the year 2022 develop? As the first day's price movements show, the market consensus is a continued rise in stock prices and a rise in yields. However, it would be worth considering both positive and negative factors. On the assumption that an examination of positive factors is being covered by many other reports, we focus here on certain risk factors. (We will touch on COVID-19 variants, geopolitical factors, and political schedules in other *Daiwa's View* reports, as needed.)

Summary of Opinions at BOJ's December Monetary Policy Meeting (disclosed on 27 Dec 2021)
・Risks to the global economy include the spread of variants, inflation developments and the effects of policy responses in the United States, the slowdown in economic growth in China amid concern over private debt problems, and geopolitical risks.

1. US inflation trends and Fed falling behind the curve
   Equity investors and some bond investors seem to have strong expectations that inflation will be brought under control by mid-2022 and the Fed will shift to a dovish stance. It is certainly highly probable that the price of 'goods' will be brought under control in line with improvements in supply constraints. Meanwhile, as we have repeatedly indicated in these reports, a surge in rents may lead to a steep rise in the price of services. Ultimately, the greatest risk is that former US Treasury Secretary Larry Summers' comment that "we are already reaching a point where it will be challenging to reduce inflation without giving rise to recession" might prove to be correct. The currently observed 'overheated labor market' entails the possibility of sustained high inflation. Depending on inflation trends, however, the Fed may fall behind the curve and need to respond in a way that will shock the market. That would pose the greatest risk to the global economy.

2. China Credit Impulse
   In our report *Another factor behind US yields' continued lack of upward momentum* dated 3 June 2021, we pointed out the possibility that a drop in the China Credit Impulse index had an indirect impact on the decline in US yields. The China Credit Impulse index was -0.4% at that time, but it has now declined to -8.46%, the lowest level since 2011 (chart on next page). The slowdown in economic growth in China amid concern over private debt problems and geopolitical risks were pointed out as some of the risks to the global economy in the Summary of Opinions at the BOJ's December Monetary Policy Meeting. We should keep monitoring developments with this very large economy. The China economic surprise index seems to have surfaced to positive territory now, but we may need to keep an eye on it from the perspective of a slightly longer cycle.

China Credit Impulse, US Federal Funds Target Rate

Source: Bloomberg; compiled by Daiwa Securities.

3. Hawkish pivot by ECB
   Although the ECB is maintaining a hawkish stance (at least superficially), there are some members who are very cautious about the risk of inflation. In relative terms as well, the Fed's hawkish stance makes financial conditions in the eurozone more accommodative, mainly via a forex channel. In addition to this, while the Fed is taking a tightening stance, speculation can easily grow that policymakers might want to secure future policy tools. If both the Fed and ECB take a tightening stance together, the impact on the market could be larger than the combined impact of each one occurring separately. Therefore, we need to watch the ECB more carefully this year than before. If the ECB pivots suddenly, the impact could be larger than that from the Fed, whose hawkish stance has been well known.

4. Hawkish pivot by BOJ
   Trends with the BOJ could be a wild card in 2022. The Summary of Opinions at the BOJ's Monetary Policy Meeting in December 2021 (released on 27 Dec 2021) included the opinion of one member that "In the next *Outlook for Economic Activity and Prices* (*Outlook Report*) to be released in January 2022, it is necessary to examine whether the current assessment that risks to prices are skewed to the downside will remain appropriate, considering, for example, the recent rises in inflation expectations and raw material costs." Among those who are involved in yen bonds, no one would ignore the wording "examine" in formal BOJ documents. It is clear that the January meeting and *Outlook Report* will have different significance than usual, regardless of whether the impact will be the same as that in July 2018, when the fluctuation range of the long-term interest rate was widened, or that in March 2021, when the fluctuation range was clarified.

Summary of Opinions at BOJ's December Monetary Policy Meeting (disclosed on 27 Dec 2021)

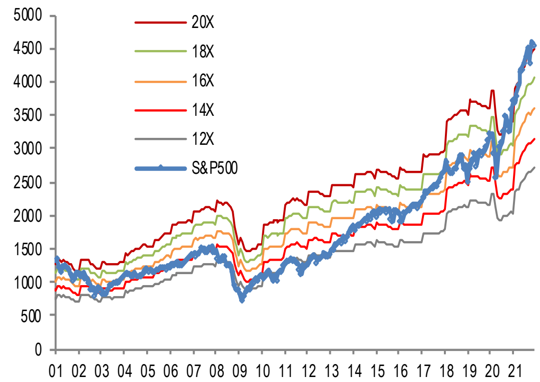
- Corporate profits could be negatively affected not only by deterioration in the terms of trade but also by logistics disruptions and prolonged supply-side constraints. If cost increases are not fully passed on to selling prices under the circumstances, there is an increasing risk that profits will not be distributed to capital or labor smoothly.
- Since Japanese firms have pushed forward with "local production for local consumption" in overseas markets, the positive effects that the yen's depreciation exerts on business performance and stock prices have become smaller compared with the past.
- In the next *Outlook for Economic Activity and Prices* (*Outlook Report*) to be released in January 2022, it is necessary to examine whether the current assessment that risks to prices are skewed to the downside will remain appropriate, considering, for example, the recent rises in inflation expectations and raw material costs.

The Summary of Opinions mentioned above also included the opinion that "the positive effects that the yen's depreciation exerts on business performance and stock prices have become smaller compared with the past" and the view that "corporate profits could be negatively affected … by deterioration in the terms of trade," and that "there is an increasing risk that profits will not be distributed to capital or labor smoothly." These comments are in line with explanations about a "foreign exchange rate channel" in BOJ Governor Haruhiko Kuroda's speech on 23 December 2021, implying that the BOJ is shifting its stance from prevention of excessive appreciation of the yen to prevention of excessive depreciation of the yen. It may be more appropriate to express this as a revision to a dovish stance, rather than as a hawkish stance. In any case, interpreting this, as well as the meaning of the wording "examine" mentioned above, will become important in 2022.

5. Fallacy of composition
If major central banks were to become more hawkish in order to achieve partial equilibrium for their own nations, it would be difficult to discern the general equilibrium impact. If the BOJ and the ECB were to make a hawkish pivot, in addition to the Fed, the market impact would be large and it could be difficult to interpret the impact.

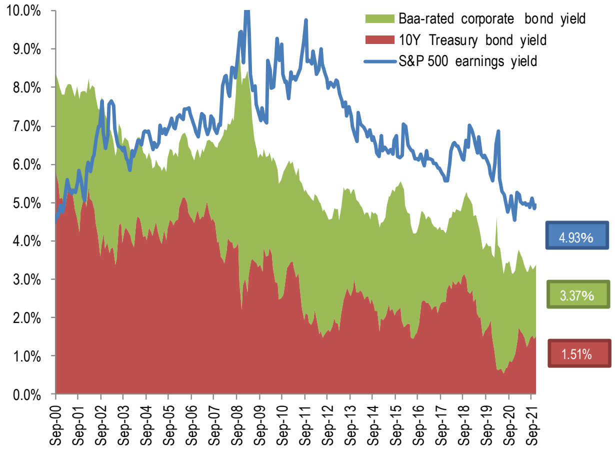
6. Asset valuations
Are current asset valuations sustainable? Based on current EPS estimates, the P/E stands at around 20X, almost in line with the ratio during the tech bubble. That said, at that time, the US long-term yield and BBB-rated corporate bond yields were about 5% and 8%, respectively. However, they are now at 1.51% (down 3.5%) and 3.37% (down 4.6%), respectively. If we look at the equity earnings yield alone, it appears to be approaching a dangerous zone. However, its movements seem to be achieving a balance with low yields (government bonds and corporate bonds, etc.). If US yields do not rise and the corporate bond spread remains low, we think valuations will be sustainable.

S&P 500 Index



Source: Bloomberg; compiled by Daiwa Securities.

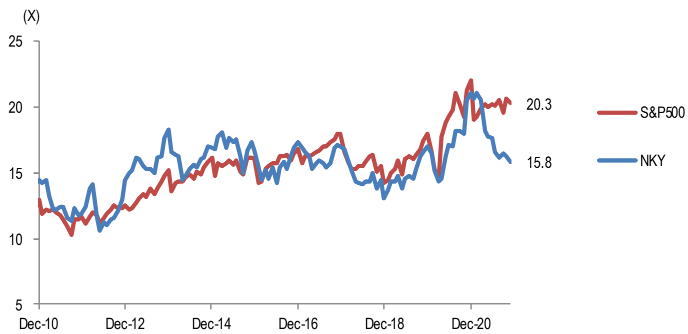
10Y US Yield, BBB-rated Corporate Bond Yield, S&P 500 Earnings Yield



Source: Bloomberg; compiled by Daiwa Securities.

That said, there are questionable points regarding the above logic. For example, low yields (government bonds and corporate bonds) are characteristic of Japan, and not the US. Regardless, the earnings yield of the Nikkei Stock Average is 6.3%, and the logic of low yields leading to stretched valuations does not apply. Currently, valuations of the Nikkei Stock Average are high as shown by a P/E of 15.8X vs. 20.3X for the S&P 500 (chart below). Based on this, we can point out that Japanese stocks are undervalued. However, it is possible that US blue chips, such as GAFAM, have been bought aggressively, being seen as similar to safe assets during times of excess money. Of course, it may be that, this year, investors continue to buy issues that have been bought blindly. If so, we may need to gradually adopt a stance that views a 'risk premium of US stocks.'

P/Es of S&P 500 and Nikkei Stock Average Index (NKY)



Source: Bloomberg; compiled by Daiwa Securities.
Note: Based on EPS estimates at end-next fiscal year.

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Benchmark index: TOPIX for Japan, S&P 500 for US, STOXX Europe 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

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