Inflating market uncertainty

May 2022

Research Signals

Since the start of 2022, equity markets have given up substantial gains from their impressive run off the March 2020 pandemic low. Recent volatility has stemmed from anxiety surrounding upward pressure on inflation which was intensified by Russia's invasion of Ukraine and renewed supply chain disruptions from COVID-19-related lockdowns in China. As much anticipated, the US Federal Reserve initiated a tightening cycle, including a 50 basis point increase in the federal funds rate in early May and announcement of plans to begin shrinking its balance sheet in June. The Fed also added the sentence "The Committee is highly attentive to inflation risks" and, with this development, we study current market conditions from the frame of heightened inflationary strains.

- Factors favoring low risk and sales-based value metrics, including 1-Month Realized Stock Return Volatility and TTM Sales-to-Enterprise Value, respectively, outperformed on average during previous episodes of the sharpest increases in inflation, consistent with current market results

- The number of stocks trading well below their 52-week highs has steadily increased since November, recently reaching a quarter of our US Total Cap universe (3,000+ stocks), with the largest expansion associated with the long duration Information Technology and Consumer Discretionary sectors

- Analyst outlook has become increasingly negative, with nearly half of the US Total Cap universe recently experiencing net negative earnings revisions for the current fiscal year, affecting a high percentage of Communication Services and Consumer Discretionary constituents, while Energy and Materials sector outlook was more positive

Factor performance during prior periods of high inflation

We begin by investigating the relationship between rising inflation and factor performance across our 450+ Factor Library. For this analysis we use our Advanced Factor Search tool to filter for the top 20 months from January 1995 through April 2022 with the highest change in inflation. We then screen for the 10 factors with the highest and lowest contemporaneous average decile spread. The decile spread is computed as the difference in average returns of the top ranked 10% of names (D1) and the bottom 10% (D10). We break out results across our US

Contacts
Research Signals · MK-ResearchSignals@ihsmarkit.com

IHS Markit® now a part of S&P Global

Large Cap universe (Table 1), consisting of ~1,000 names with the highest market capitalization, and the US Small Cap universe (Table 2), comprising the next ~2,000 names.

Among large caps, factors with the highest average decile spread during periods of elevated increases in inflation include several measures of volatility which favor the lowest risk shares. These include 1-Month Realized Stock Return Volatility (2.46%) and At the Money Call Option Implied Volatility (2.41%). Management Quality and sales-based Deep Value factors which were favored include Cash Flow Return on Invested Capital (2.26%) and TTM Sales-to-Enterprise Value (2.14%).

Table 1

US Large Cap average decile return spread during high inflationary months, Jan 1995 - Apr 2022

Factor	Decile spread (%)	Factor group
Top performers		
1-Month Stock Return Interquartile Range	2.83	Liquidity, Risk & Size
20-Day Volume Volatility to Price Volatility	2.50	Liquidity, Risk & Size
1-Month Realized Stock Return Volatility	2.46	Liquidity, Risk & Size
At the Money Call Option Implied Volatility	2.41	Liquidity, Risk & Size
At the Money Put Option Implied Volatility	2.40	Liquidity, Risk & Size
Cash Flow Return on Invested Capital	2.26	Management Quality
6-Month Active Return with 1-Month Lag	2.21	Price Momentum
TTM Sales-to-Enterprise Value	2.14	Deep Value
Return on Equity	2.04	Management Quality
15/36 Week Stock Price Ratio	2.03	Price Momentum
Bottom performers		
Implied Volatility	-2.30	Liquidity, Risk & Size
Oil Prices Sensitivity	-1.79	Macro
Time Weighted Book Yield	-1.64	Deep Value
Housing Starts Sensitivity	-1.47	Macro
Leading 12 Month Book Yield	-1.42	Deep Value
14 Day Relative Strength Index	-1.33	Price Momentum
Slope of 5-yr TTM EPS Trend Line	-1.32	Historical Growth
Second Preceding 6-month Return	-1.29	Price Momentum
Slope of 3-yr TTM Cash Flow Trend Line	-1.12	Historical Growth
Slope of 3-yr TTM Sales Trend Line	-1.11	Historical Growth

Source: IHS Markit

Small cap results saw some overlap, including TTM Sales-to-Enterprise Value (3.96%) and 1-Month Realized Stock Return Volatility (3.61%) which were among the top average performers. In addition, Assets Turnover Ratio (3.68%) was represented from the Management Quality group.

At the opposite extreme, we first remark that Implied Volatility was among the weakest average performers for both large caps (-1.79%) and small caps (-3.20%); however, this factor is ranked to favor high volatility, thus the results are consistent with our previously cited findings. We also note that Deep Value measures tied to book value also underperformed on average, including Leading 12 Month Book Yield for both large caps (-1.42%) and small caps (-1.92%).

Other common factors among the weakest performers on average include Housing Starts Sensitivity (large caps: -1.47%; small caps: -1.87%) and Second Preceding 6-month Return (large caps: -1.29%; small caps: -1.47%). Lastly, we comment on the underperformance associated with Credit Risk (-4.77%) among small caps that may be linked to outlier returns given this factor's low coverage.

Table 2

US Small Cap average decile return spread during high inflationary months, Jan 1995 - Apr 2022

Factor	Decile spread (%)	Factor group
Top performers		
TTM Sales-to-Enterprise Value	3.96	Deep Value
Capital Gearing Ratio	3.88	Liquidity, Risk & Size
1-Month Stock Return Interquartile Range	3.76	Liquidity, Risk & Size
Assets Turnover Ratio	3.68	Management Quality
Natural Logarithm of TTM Sales (USD)	3.62	Liquidity, Risk & Size
1-Month Realized Stock Return Volatility	3.61	Liquidity, Risk & Size
At the Money Put Option Implied Volatility	3.49	Liquidity, Risk & Size
TTM Sales-to-Price	3.23	Deep Value
Time Weighted Sales Yield	3.09	Deep Value
Natural Logarithm of TTM Sales	3.07	Liquidity, Risk & Size
Bottom performers		
Credit Risk	-4.77	Liquidity, Risk & Size
Implied Volatility	-3.20	Liquidity, Risk & Size
Advertising Intensity	-2.19	Management Quality
Leading 12 Month Book Yield	-1.92	Deep Value
Housing Starts Sensitivity	-1.87	Macro
3-Month Active Return	-1.85	Price Momentum
Time Weighted Book Yield	-1.59	Deep Value
3-yr MAD of TTM Sales	-1.53	Liquidity, Risk & Size
Second Preceding 6-month Return	-1.47	Price Momentum
Leading 1-Year Regular Dividend Payout	-1.45	Dividend Forecast

Source: IHS Markit

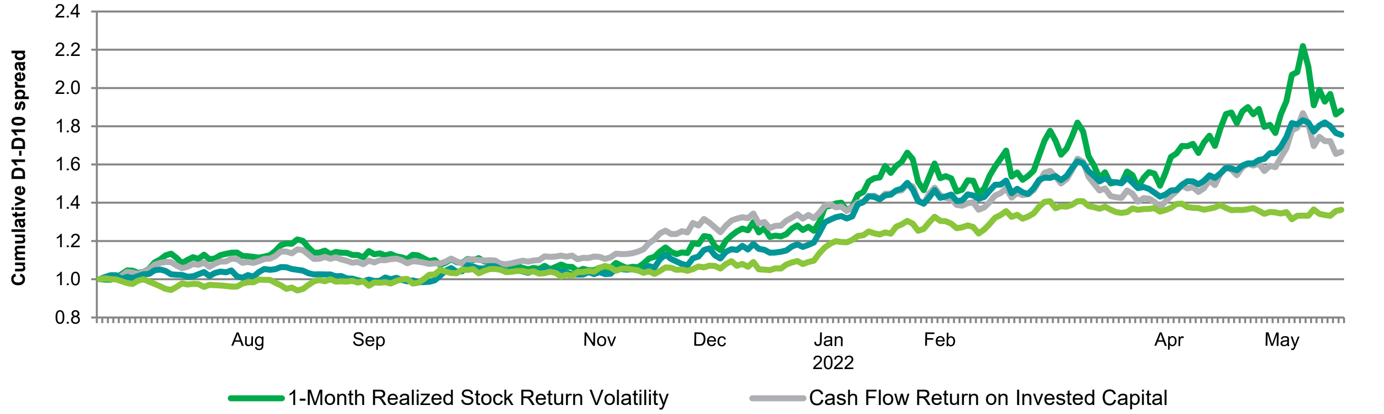
To provide more detail on the current inflationary environment, we track recent daily performance of several factors of interest. For large caps (Figure 1), the trend in performance for 1-Month Realized Stock Return Volatility, Cash Flow Return on Invested Capital, TTM Sales-to-Enterprise Value and Second Preceding 6-Month Return took on similar characteristics to prior episodes of spiking inflation.

Indeed, leading up to November 2021, performance of all four factors moved in a relatively tight trading channel. Subsequently, however, as investors began to react to signs of increasing inflation, factor performance diverged and by the end of the period the risk off trade captured by 1-Month Realized Stock Return Volatility logged an impressive cumulative spread of 81%, while the momentum trade lagged far behind (Second Preceding 6-Month Return: 31%). Quality and value results were also consistent with historical trends, with strong performance since the beginning of November for Cash Flow Return on Invested Capital (51%) and TTM Sales-to-Enterprise Value (71%).

General trends were similar for small caps (Figure 2), with 1-Month Realized Stock Return Volatility performance (91%) far outpacing that of Second Preceding 6-Month Return (44%) since the start of November 2021. Asset Turnover Ratio (74%) and TTM Sales-to-Enterprise Value (86%) also turned in robust cumulative spreads over the same period, agreeing with our filter results for factors that outperformed during prior months with the highest change in inflation.

Figure 1

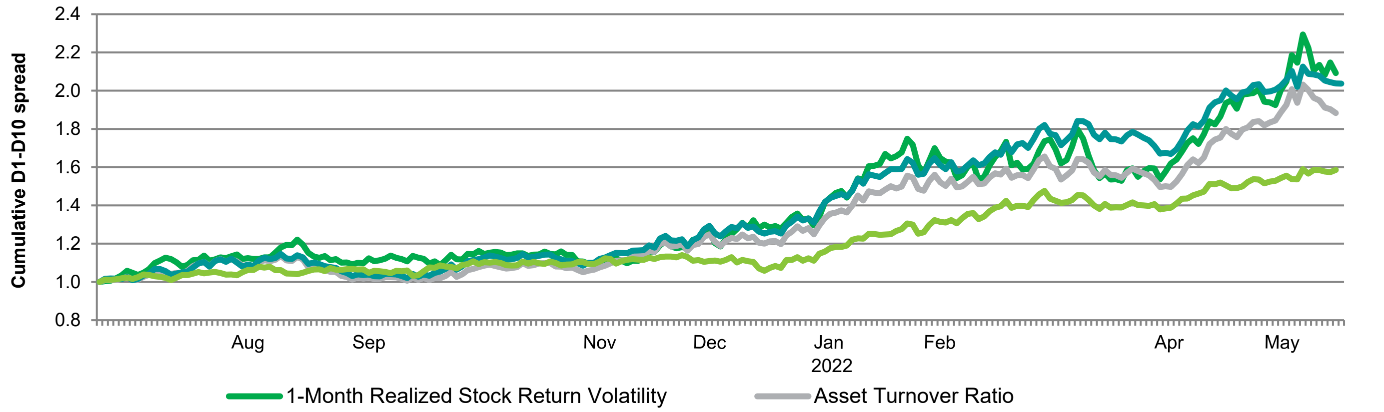
US Large Cap factor cumulative decile return spreads, 30 Jun 2021 - 20 May 2022



Source: IHS Markit © 2022 IHS Markit

Figure 2

US Small Cap factor cumulative decile return spreads, 30 Jun 2021 - 20 May 2022



Source: IHS Markit © 2022 IHS Markit

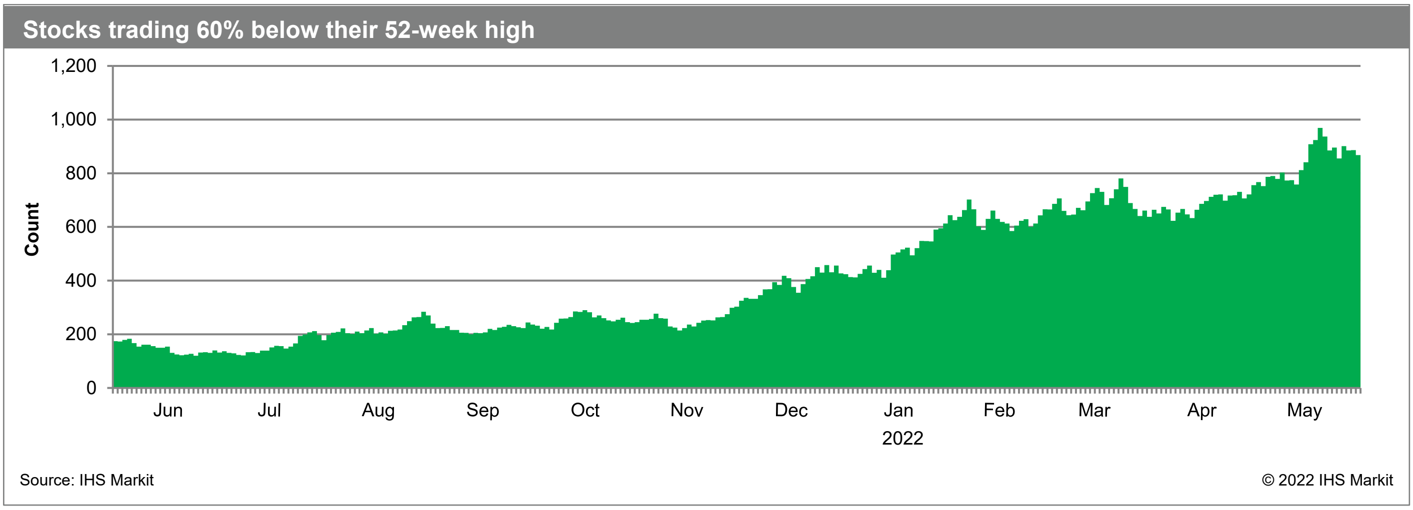
Other signs of inflating market stress

Beyond factor performance, we capture additional indications of developing pressures plaguing the markets. First, we analyze the magnitude of market weakness from the perspective of individual stock price movement.

For this examination, we use our Stock Screener to filter for stocks trading below 60% from their 52-week high, implemented by setting a cutoff for the 52-Week High factor to values less than 0.40 (Figure 3). To expand our coverage, we screen across the broader US Total Cap universe, which is a combination of both the large and small cap constituents.

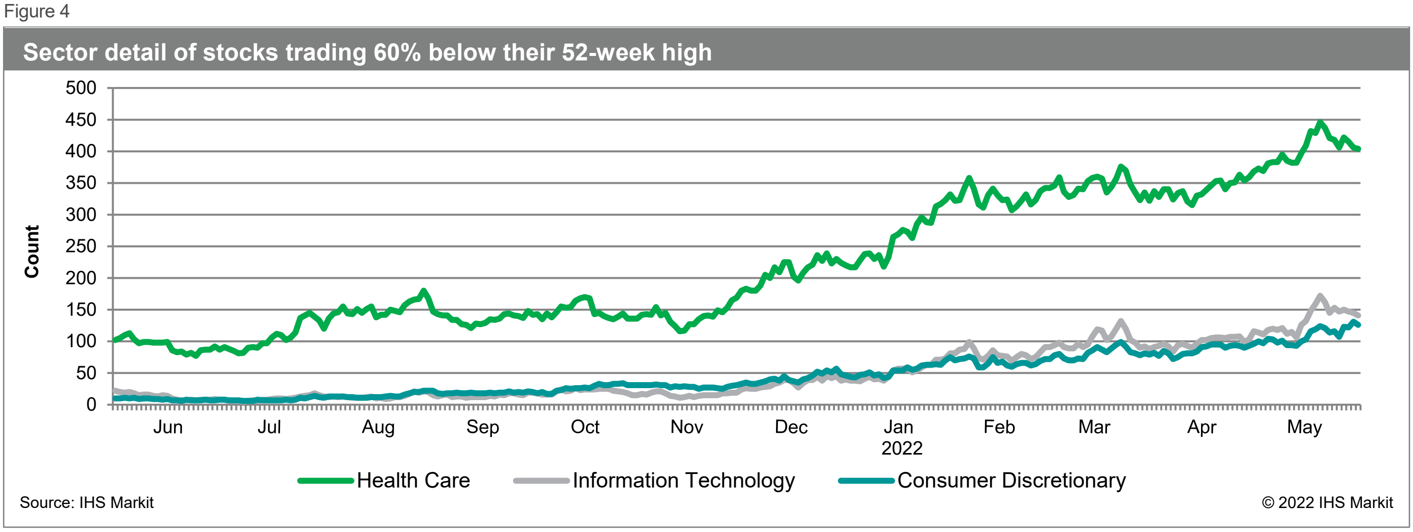
Over the past year, the number of stocks trading at this extreme was relatively low, averaging around 200 names between May through October. However, in November, the trend steadily picked up, reaching an apex of 969 on 11 May 2022, over a quarter of the universe.

Figure 3



The Health Care sector has the largest representation of stocks trading 60% below their annual high, capturing 47% of those passing the screen, nearly a four-fold increase over the past year. However, Information Technology and Consumer Discretionary, two long duration sectors that are expected to suffer to a greater extent from interest rate increases as the Fed fights inflation, saw larger increases in their counts, with approximately six-fold and twelve-fold expansions, respectively. In total, these results highlight the breadth and depth of the market downturn.

Figure 4

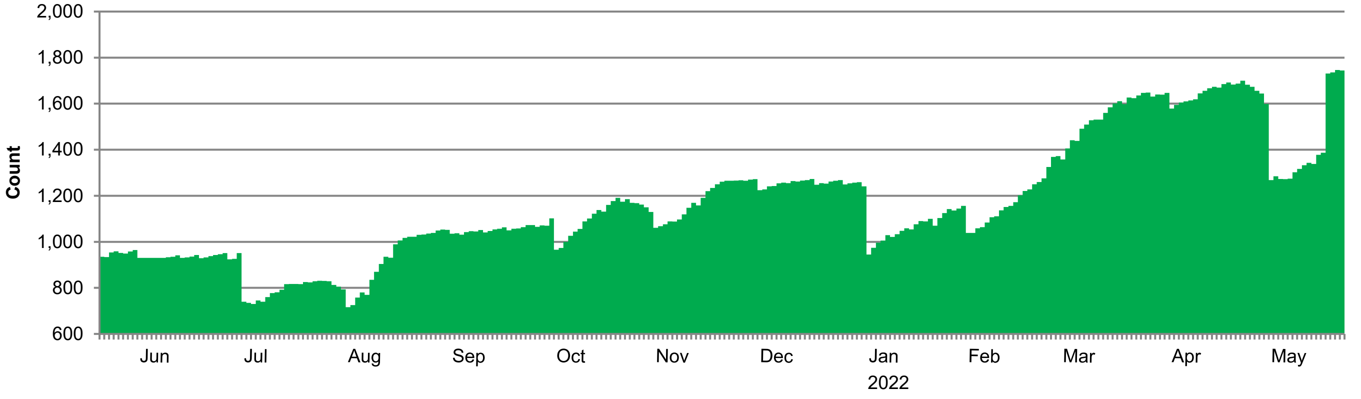


Given that stocks tend to trade based on forward-looking expectations, we also look at the market from the vantage point of analyst outlook and check for increasing uncertainty on firms' future prospects in the current higher inflation setting. Again, using our Stock Screener, we filter for stocks in the US Total Cap universe with negative Net # of Revisions for Fiscal Year 1 (Figure 5), indicating a higher number of negative versus positive earnings revisions in the current fiscal year.

Since August 2021, we find an increasing number of stocks with net negative revisions, with the observation that a drop off in counts occurs at the turn of each quarter (June, September and December 2021) and fiscal year (April 2022) due to analysts' general tendency for positive outlook for the coming fiscal period. For observations through April 2022, prior to the most recent fiscal period turn, the series reached a maximum of 1700 on 22 April, spanning nearly 50% of all stocks. Moreover, while the new fiscal period saw the usual drop off in net negative revisions, the series abruptly picked back up to the prior levels, just surpassing the previous high at 1746 on 20 May.

Figure 5

Stocks with negative fiscal year 1 revisions

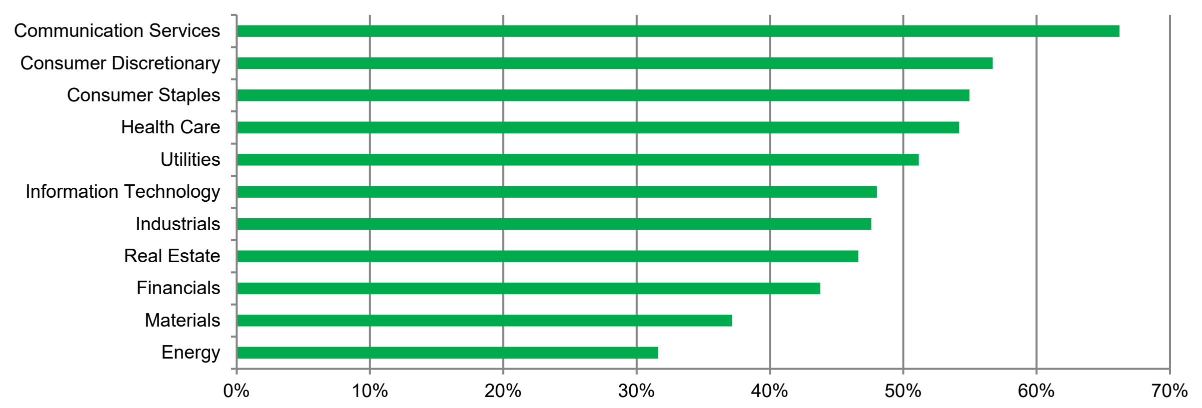


Source: IHS Markit © 2022 IHS Markit

By sector (Figure 6), Communication Services (66%) has the highest percentage of constituents experiencing net negative revisions for fiscal year 1 as of the latest observation. Consumer Discretionary (57%), Consumer Staples (55%), Health Care (54%) and Utilities (51%) also had net negative revisions for more than half of their constituents. Energy (32%) and Materials (37%) were the only two sectors to see less than 40% of constituents with lower net negative revisions for their current fiscal year estimates. Overall, as the Fed continues on its inflationary-fighting path of quantitative tightening and firms face the potential for a rising cost of capital, profits may be negatively impacted, which may beget further stock price declines.

Figure 6

Sector exposure to stocks with negative fiscal year 1 revisions, 13 May 2022



Source: IHS Markit © 2022 IHS Markit

In summary, concerns that the Fed will overshoot and push the economy into recession in its efforts to control inflation have played out in equity markets. Stock prices have struggled in this environment, as confirmed by the increasing trend in stocks trading at least 60% below their 52-week highs, particularly in the long duration Information Technology and Consumer Discretionary sectors. Analyst outlook has also reacted to rising uncertainty in the new regime of higher interest rates, with nearly half of our coverage stocks experiencing net negative earnings revisions in the current fiscal year. We study prior episodes of increasing inflation since 1995 and find that factors favoring low risk, high quality and sales-based value metrics, tended to outperform, while momentum underperformed. These findings were corroborated by recent performance for factors including 1-Month Realized Stock Return Volatility, TTM Sales-to-Enterprise Value and Second Preceding 6-Month Return across both large caps and small caps.

Customer Care

CustomerCare@ihsmarkit.com

Asia and the Pacific Rim

Japan: +81 3 6262 1887

Asia Pacific: +604 291 3600

Europe, Middle East, and Africa: +44 1344 328 300

Americas: +1 800 447 2273

IHS Markit®

now a part of

S&P Global