Quant insight

12.09.2023

Credit > Inflation. Regime shift for US equities?

In some quarters, there are arguments that the inflation debate is losing significance. The bigger macro theme is the unfolding tightening of credit conditions.

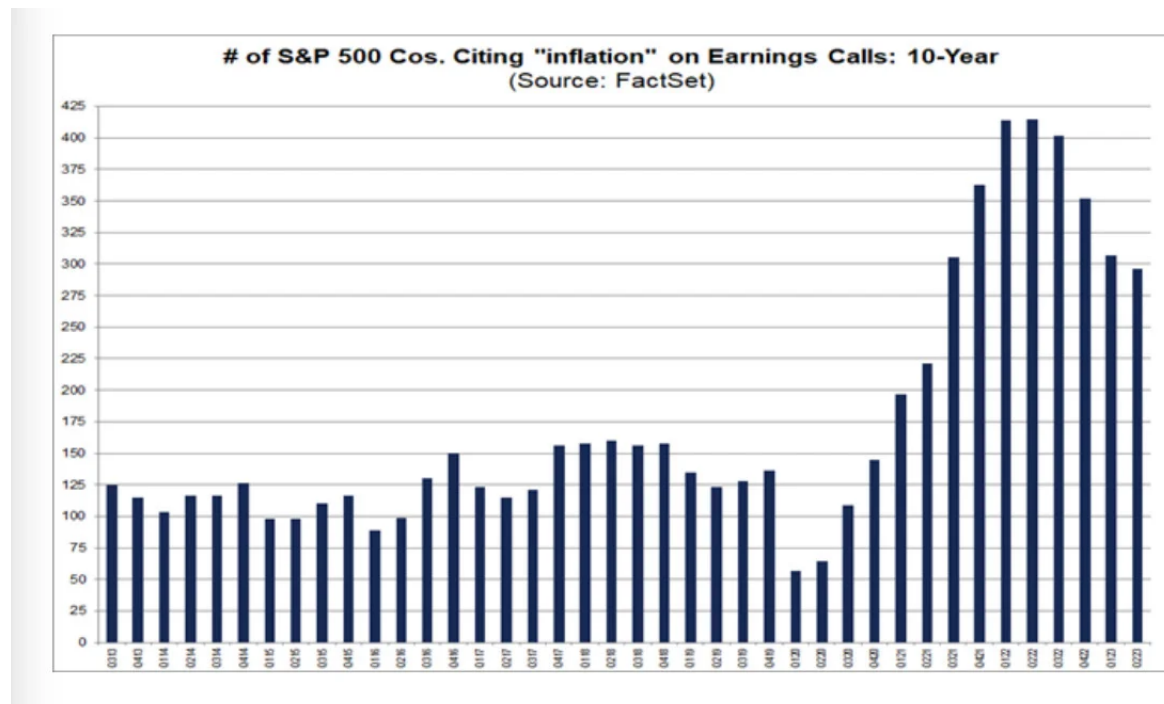
That is partly right. The slow motion credit crunch is indeed critical but it is premature to argue inflation's importance has dwindled in any way.

Qi's macro factor sensitivity data can provide a real-time demonstration of what matters most. Inflation and credit are both critical, and it is Technology that is most reliant on a Goldilocks mix of reflation plus easy credit.

When a blue chip commentator like Yardeni Research ponders whether the recent New York Fed survey of consumers carries an important message, it is worth taking note.

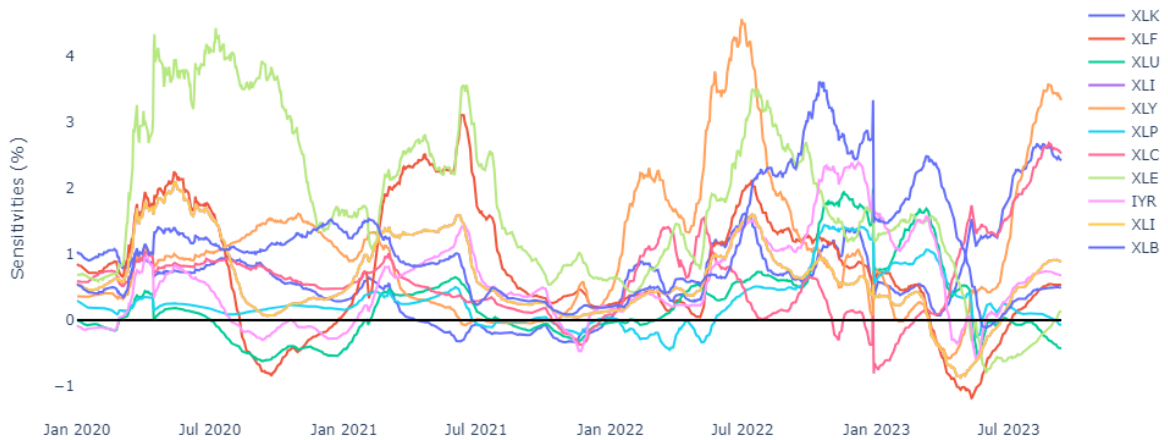
They noted that inflation expectations are subdued but fears about the availability of credit continue to move higher. The conclusion might therefore be the inflation debate is losing traction; the bigger risk for financial markets are credit conditions.

To a degree this is backed up by FactSet's observation that inflation is becoming less frequently mentioned in earnings calls. They note that 296 companies cited "inflation" during Q2 earnings calls - the fourth consecutive quarterly decline and the lowest number of mentions since Q2 2021.



This is where Qi's factor sensitivities come into their own. We capture the **independent relationships** between asset prices and a host of macro factors. By tracking these historical patterns we can observe how key macro drivers ebb and flow in terms of importance. In effect, how macro regimes shift.

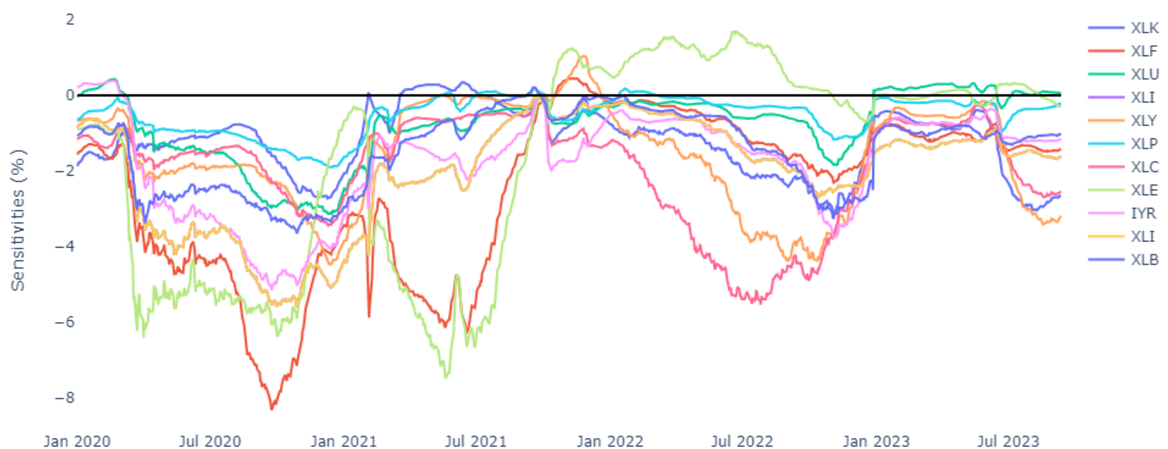
Below we take the eleven S&P500 GICS Level 1 sectors and their relationship with US inflation expectations.



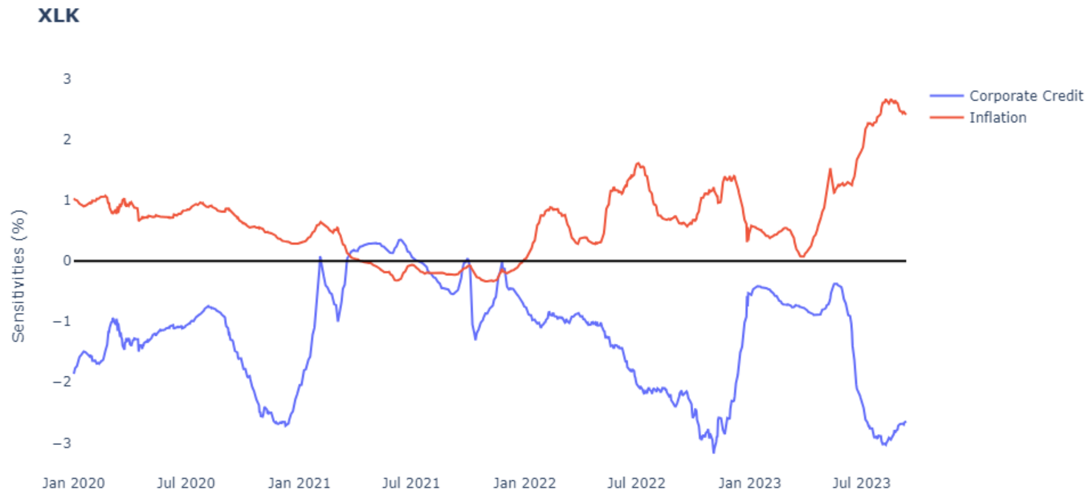
The clear standout is US Technology. All three tech sectors (Tech itself XLK, Communication Services XLC and Consumer Discretionary XLY) have seen strong increases in their sensitivity to inflation, and sensitivity now sits near recent highs. Sectors with a more value and cyclical bias are comparatively insensitive.

So, while respecting the commentary from CFOs during the most recent earnings season, on our metrics **it is too early for investors to think inflation no longer matters**. Tech, the clear leader of US equity markets, is reliant on reflation.

Yes, strong inflation that induces policy tightening is a negative for risky assets; but it's the policy reaction equities fear, not reflation itself. Put another way, deflation is a bigger evil.



We then repeat the exercise looking at sensitivity to corporate credit spreads and the same pattern is repeated. It is tech (XLK, XLC, XLY) that screens as the most reliant on credit spreads remaining tight. The other sectors also want a well behaved credit market; it is just that sensitivities are notably less.



The clear pattern therefore is that **Technology is beholden to Goldilocks**. It is most reliant on rising inflation expectations (sensitivity is at it's highest levels since the pandemic) and tight credit spreads (sensitivity is at the wide end of the range).

Goldilocks or bust.

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