CHAHINE CAPITAL
Performance Engineering

27/4/2019

STRATEGY OVERVIEW

Wall Street 9% overvalued, our models say

Summary

US equities have clawed back the losses they suffered during the correction late last year, and at 2,940 points at last Friday's close the S&P 500 was ahead of its previous peak in September 2018. This rebound stems from the Federal Reserve's U-turn on monetary policy in favour of renewed accommodation, together with an outbreak of peace in Donald Trump's trade war against China. The 30-year US Treasury yield has eased from a high at 3.48% to a recent low of 2.83% over the past seven months; although our own market valuation has been adjusted upwards as a result, prices have risen by even more despite the outlook of anaemic profits this year. Our latest valuation for the S&P 500 is 2,690 points, implying a market that is some 9% overvalued. We believe that part of the rally was technical: traditional investors have made $15 billion in net withdrawals from the market so far this year, but against that companies have been buying back their own shares at the rate of $230 billion every three months, boosting both their share prices and earnings per share. For example, Apple is expected to post a 23% drop in profits in Q1 but its EPS will fall just 12%. World markets have followed Wall Street; the MSCI World is up 17% so far this year and the S&P 500 18.2%. IT stocks have surged 27% despite virtually unchanged profits. In fact, the sector's share prices have risen 5.3 times over in the past decade, compared with 4 times over for their market index. And who knows how far the digital economy's outperformance can last?

Profits are running well behind share prices. Consensus analysts are banking on an average 1.8% increase in EPS this year, despite share buybacks at a rate equivalent to 3.5% of capital. Q1 results will be down 2% from a year ago, including a 32% drop in the energy sector. IT sector profits will be down 5%. The financial, healthcare, industrial and discretionary consumer sectors will all be up slightly. According to the guidance already out there, Q2 will see another drop in earnings. The 2019 PER for the S&P 500 is 17.7, and if we believe forecasts of an 11.4% rebound in profits next year it would be 15.5 in 2020. Our top-down calculations give us 9% for 2020 and 7% for 2021, assuming that no recession gets in the way. Our caution on profits reflects the slide in world GDP growth forecasts for this year to 2.9%, down from 3.3% in 2018. Notwithstanding good Q1 figures on activity, consensus and Fed forecasts for the US economy are also cautious, at 2.3% in 2019 and 1.8% in 2020. The 3.2% annualised gain in Q1 featured a sharp rise in stockbuilding that masked very sluggish consumption. The US yield curve has steepened slightly over the past month, and the 30-year yield that underpins our model has risen from 2.87% to 2.95%. All in all, our hypotheses give us an instantaneous valuation for the S&P 500 of 2,690 points and a year-end objective of 2,794 points. Our CAGR is 3.4%, which is below the potential growth rate because the model integrates a high probability of recession in the coming 8 years. In the event that materialises, the market would correct 18% initially but stabilise at -10%. We have been underweight the market for some time now, apart from a buying phase in late 2018, and that turned out to have been wrong. Our philosophy of sound management consists of maintaining exposure to equities at all times, but with marginal variations around the investor's benchmark. Right now, for example, we are 34% exposed against a benchmark weight of 40%. Current price levels are encouraging us to stay underweight, with a view to buying upon any marked correction.

The European market is virtually at our objectives and can be seen as fair value. Incredibly low interest rates work in its favour but mediocre structural profitability among European companies works the other way.

Jacques Chahine

The US market is rallying faster than our valuation objectives

Wall Street continues to rally, and has now fully recovered from the correction late last year. Last week the S&P 500 closed at a new high of 2,940 points, just over its 20 September 2018 peak at 2,931 points. This rebound stems from the Federal Reserve's U-turn on monetary policy in favour of renewed accommodation, together with an outbreak of peace in Donald Trump's trade war against China. The 30-year US Treasury yield has eased as a result from a high at 3.48% to a recent low of 2.83%. One often overlooked point is that this decline in long rates has generated a 13% gain for investors holding 30-year Treasuries. Naturally, our market valuations have taken account of the move and the resulting objectives have risen significantly. Unfortunately, the market has adjusted by even more, ignoring the prospect of anaemic profits growth this year after an exceptional 2018 based on a buoyant economy and tax changes that automatically raised profits by over 10%. Our latest estimates give us an instantaneous valuation for the S&P 500 of 2,690 points, implying a 9% overvaluation at Friday's close. We start this week by looking at the reasons behind this situation.

Companies as buyers of last resort – for their own shares

Investors look less than convinced by the recent rally. In fact, they have been net sellers of equities since the start of this year, to the tune of $15 billion. The net sale from traditional mutual funds has been some $40 billion, although this is offset by inevitable ETF switching into the US market. These numbers are not large in comparison with the market's overall capitalisation of $25,000 billion, but might have made a difference if it were not for massive share buybacks. US firms bought $230 billion worth of their own shares in Q4 2018, amounting to an annualised 4.2% buyback rate. In 2018, S&P 500 companies bought back an average 3.5% of their own shares, and that was itself a sharp increase on the 2.4% recorded in 2017. It seems that the correction in the last part of 2018 only encouraged this process. Donald Trump's tax amnesty for companies that had parked profits abroad allowed them to bring them back relatively cheaply, but they have been used for financial engineering rather than the investment they were intended for. For the companies involved, buybacks have two advantages: they support their share prices and raise EPS. Some of the buybacks have bolstered the value of stock options, on which all the major groups thrive and that spread a feeling of wealth among the senior and middle-ranking executives that own them.

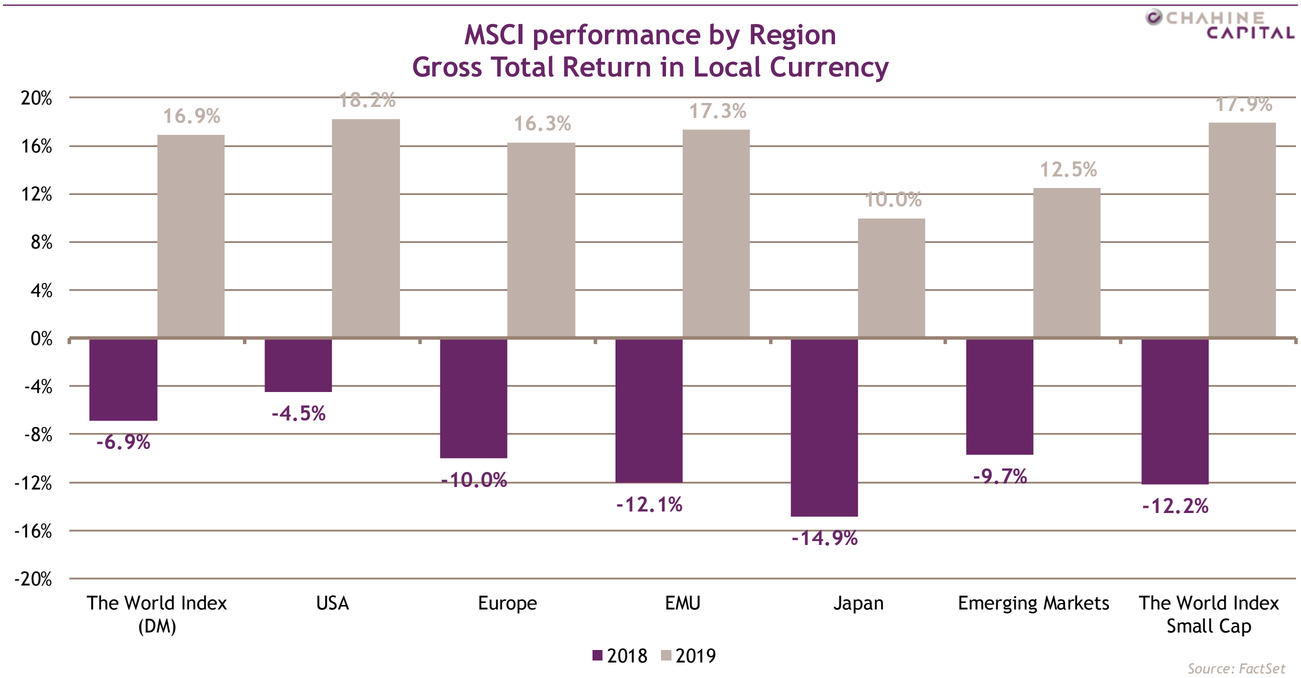
World markets just tagging along

World equity markets have followed Wall Street's lead, and in the euro zone have been sustained by extremely low or even negative interest rates. The MSCI World has progressed 16.9% since the start of the year, including gross dividends. US equities are up 18.2%, and as we have seen they have made up all their losses of late last year. Eurozone equities have also recovered their correction losses but the benchmark index is not yet back to its highs. Emerging markets and Japan have rallied by less than the average, while small and mid-caps are making up for the damage they suffered in 2018.

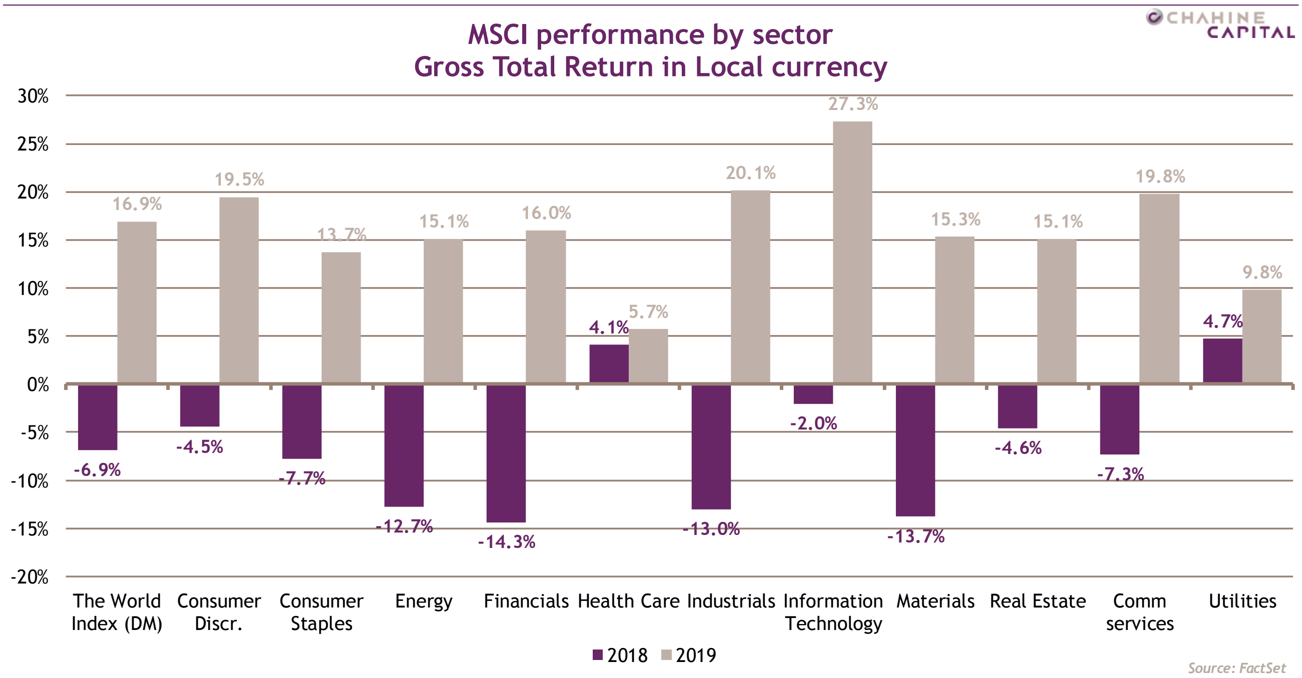
By sector, IT is up a staggering 27% and continues to outperform despite very poor earnings growth prospects in 2019. The sector has outpaced the S&P 500 ever since the 2008 financial crisis; its prices have risen 5.3 times over in the past decade, compared with four times over for the S&P 500. While it is difficult to say what will happen over the coming decade, we suspect that the presence of GAFAM and other giants will hamper innovation and US anti-trust laws could favour competition.

Industrials are performing strongly as well. Boeing has its problems but is still up 19%, while Airbus is up 44%. GE, Honeywell, United Technologies, Lockheed Martin, railway groups and Vinci are other conspicuous gainers. The dynamism of the US economy and its export sector are clearly major factors in the sector's rally.

Some strong performances in 2019



IT up ahead

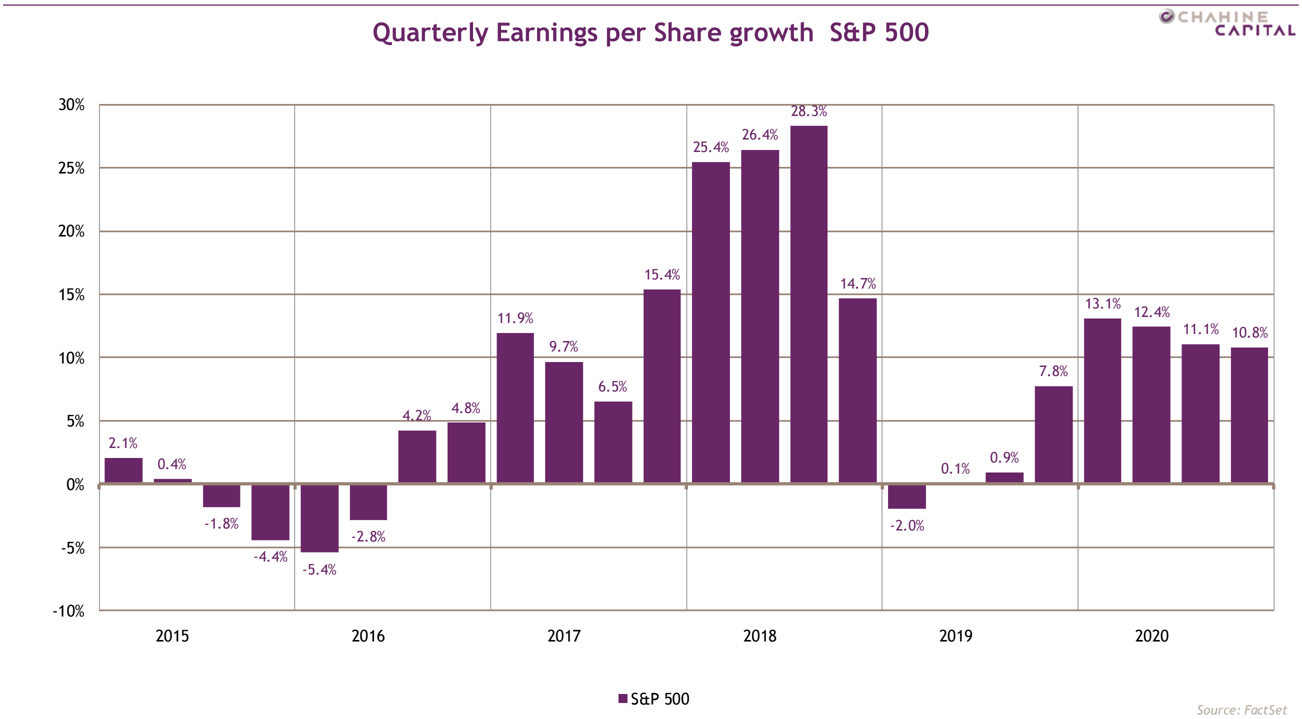


The new communications sector – which includes Netflix and Facebook – has started the year strongly, as have discretionary consumers such as Amazon. The financial sector has barely made up for its 2018 losses. Political efforts to reform the US social security system are affecting healthcare stocks, especially pharmaceutical companies charging Americans three to four times as much as can be charged elsewhere.

Profits running behind prices

Lower interest rates and share buybacks are the prime factors behind Wall Street's current rally, and the latest figures suggest that Q1 has seen no let-up on the latter. But corporate profits are going the wrong way this year. The consensus view is an average 1.8% increase in EPS in 2019, and when we take account of buybacks that cut the number of shares by 3.5%, profits growth will actually be negative this year.

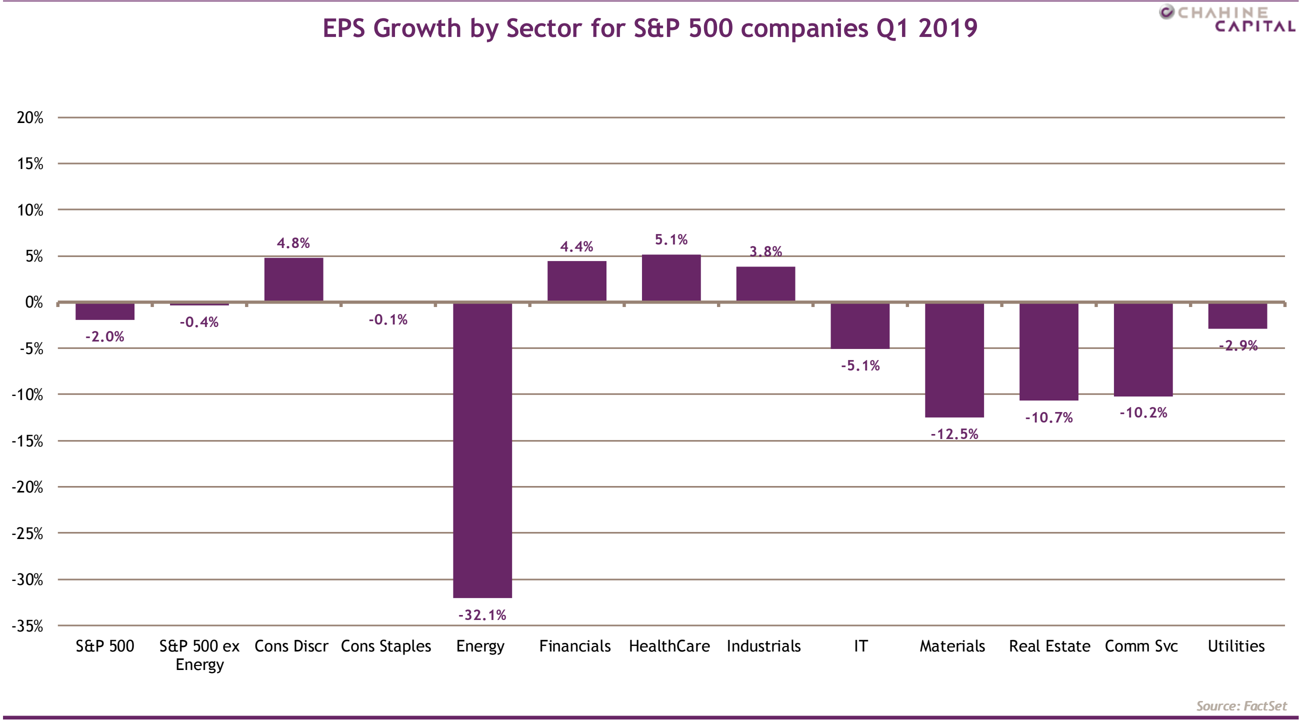
Share buybacks are buoying profits and share prices



US corporate earnings for Q1 are down 2% on a year ago, including a 32% drop across an energy sector affected by lower oil prices. Excluding oil, profits growth is more or less zero. IT sector profits are down, especially as Apple is expected to report a 23%, $3.2 billion drop in earnings in Q1. Sustained share buybacks will limit its EPS decline to just 12%, however. There are now 17% fewer Apple shares than there were three years ago! Other firms posting significantly lower profits include Micron, Western Digital, NVidia, Applied Materials, Qualcomm, Oracle and Seagate, but even so their share prices are up by between 30% and 50%. Microsoft and Visa are among the positive surprises.

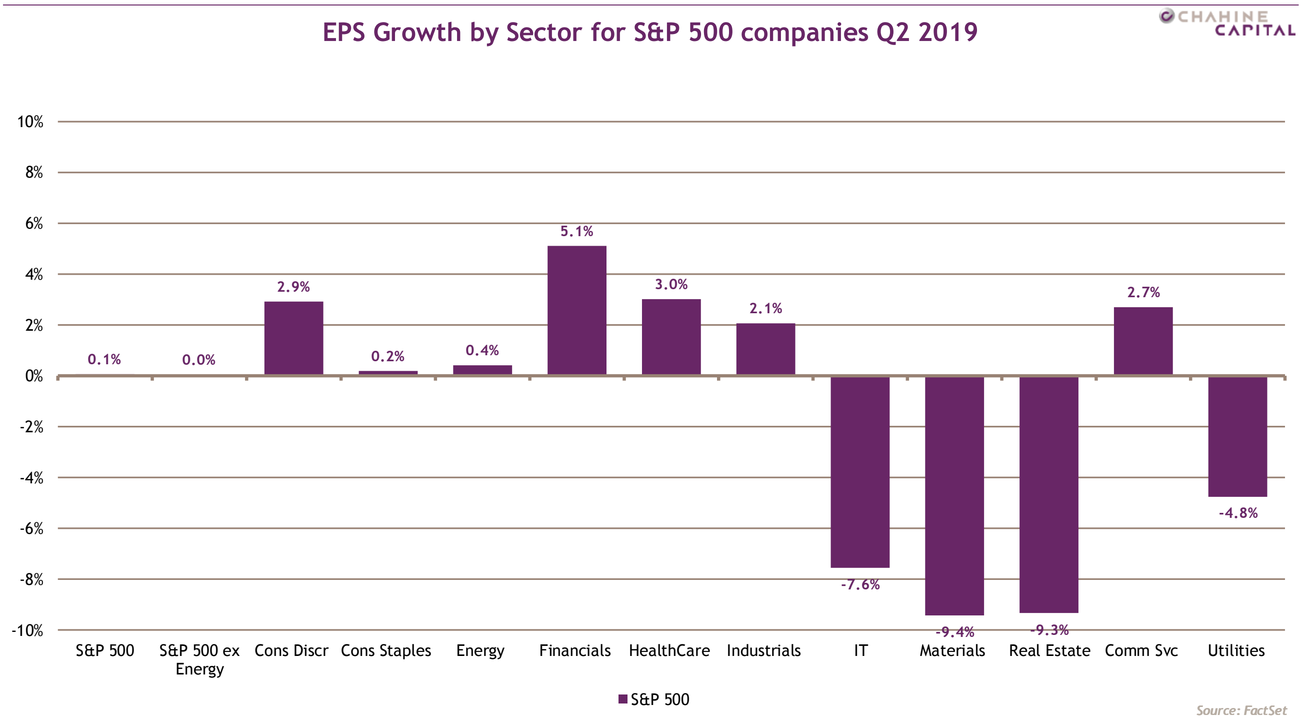
The communications sector, which of course includes telecoms, is set to post a 10% drop in profits in Q1. Facebook came with a positive surprise by reporting profits down 'only' $1.9 billion from a year ago; Google and Disney are due out this week and are expected lower. Netflix has been a slight disappointment and there is no shortage of potential competitors, including Amazon Prime, Hulu and a forthcoming initiative from Apple.

A bad Q1 for most…



Slowing profits in the discretionary consumer sector partly reflect the situation in tourism, leisure and in department stores, where Amazon is still gaining market share. Financials are posting higher EPS in spite of an unhelpful yield curve.

… and no improvement on the cards for Q2



Q2 earnings growth is pretty much a known quantity after Q1 results, and given more negative numbers from IT will be zero overall. Banks are relatively confident, while Boeing will suffer the consequences of its 737 Max issues. More companies will post positive than negative earnings growth, but the magnitude of profits declines will be greater than the increases. Earnings estimates have been revised 0.7% lower, or 2.5% if we focus exclusively on companies that have reported Q1 results.

The table below shows the main ratios for the S&P 500, which however you look at it remains the key index. It accounts for 59% of MSCI World capitalisation, for example. Its PERs are 17.7 for 2019 and 15.5 for 2020, at least if we believe the consensus forecast of an 11.4% increase in earnings that year. Thanks to swings in oil prices, energy sector earnings have been volatile in recent years and are now pointing higher. Tax reform and a relaxation of banking regulations boosted financial sector profits last year, and unless some new crisis strikes the outlook is good for 2019. US banks are far stronger than their European counterparts.

Low interest rates justify high PERs

	Weight vs	Perf		Weighted P/E		% Wted EPS Chge			Div Yield	Revision vs M-2%	
	S&P500	2019	2018	2020	2019	2020	2019	2018	2019	Fiscal 20	Fiscal 19
S&P 500	100.0%	17.2%	-6.2%	15.9 x	17.7 x	11.4%	3.2%	21.7%	1.98%	-0.3%	-0.2%
S&P 500 ex Energy	94.9%	17.3%	-5.2%	16.0 x	17.7 x	10.6%	4.0%	18.8%	1.90%	-0.5%	-0.4%
Consumer Discr.	10.8%	22.5%	0.7%	20.0 x	22.6 x	13.0%	7.0%	18.2%	1.30%	-0.3%	-0.1%
Consumer Staples	7.8%	12.3%	-11.3%	18.2 x	19.5 x	6.9%	1.5%	12.1%	2.97%	-1.5%	-1.1%
Energy	5.1%	15.6%	-20.2%	14.5 x	18.2 x	26.1%	-9.4%	105.5%	3.43%	2.9%	4.8%
Financials	12.7%	16.2%	-14.8%	11.3 x	12.3 x	8.9%	7.9%	28.3%	2.21%	-0.8%	0.0%
Health Care	13.4%	2.8%	4.6%	14.1 x	15.5 x	10.0%	5.8%	12.8%	1.83%	0.3%	0.3%
Industrials	9.5%	20.5%	-15.0%	14.8 x	16.8 x	13.5%	6.2%	19.3%	1.96%	-1.3%	-2.8%
IT	21.5%	26.7%	1.9%	17.9 x	20.0 x	11.7%	1.2%	19.4%	1.49%	0.0%	-0.2%
Materials	2.5%	12.9%	-16.3%	15.5 x	17.3 x	11.0%	-7.3%	28.7%	2.21%	-6.5%	-4.9%
Real Estate	2.9%	15.8%	-5.6%	40.4 x	43.7 x	8.2%	-17.7%	15.4%	3.32%	-0.2%	1.4%
Comm Services	10.7%	22.4%	-7.8%	17.3 x	19.3 x	11.9%	4.7%	18.5%	1.34%	0.8%	0.5%
Utilities	3.1%	10.3%	0.6%	17.7 x	18.7 x	5.7%	0.8%	7.9%	3.38%	0.3%	-0.2%

Benchmarks source iShares ETF - Data as of 26/04/2019

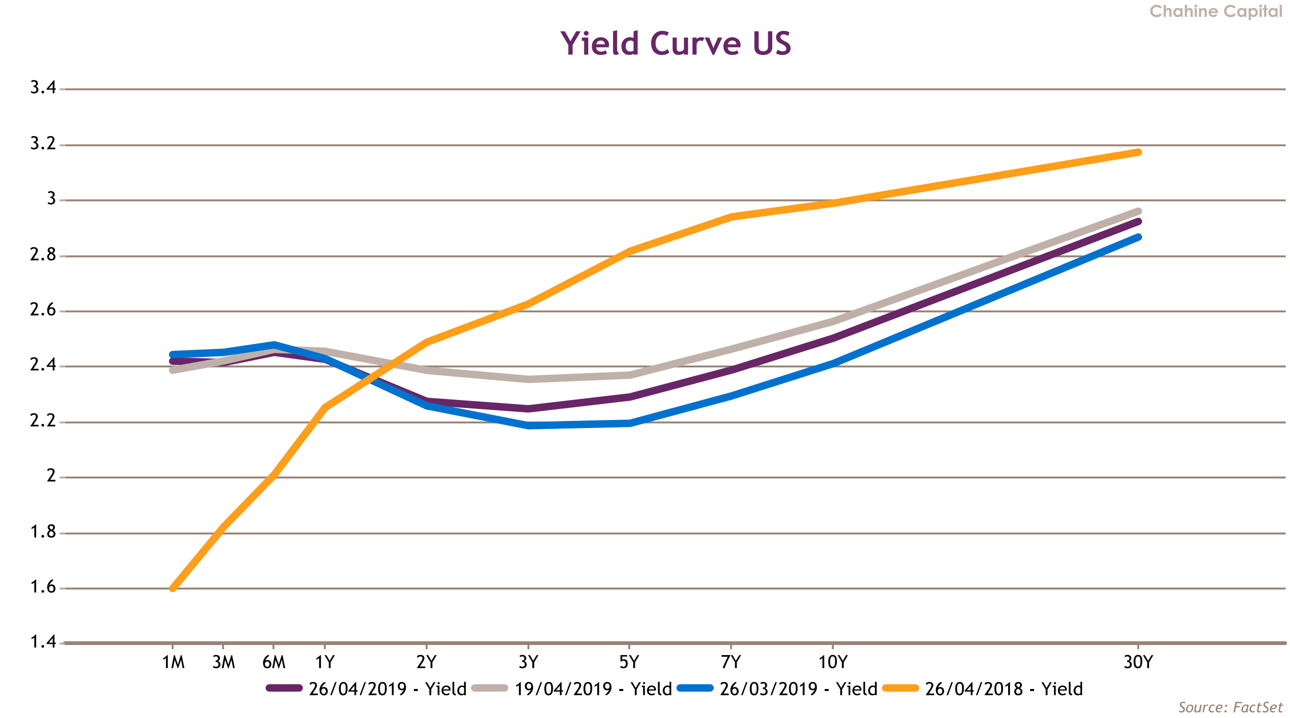
The hypotheses underpinning our valuation model

While the market appears to have priced in 2019 earnings fairly well, we are perplexed by consensus estimates for 2020. Analysts assume a substantial 11.4% increase in profits next year, and 10.6% excluding energy. The outlook for US GDP growth is not great – 1.8% growth in 2020, for example, against a backdrop of weaker world activity – and estimates are already being shaded down. The GDP numbers are in line with the Fed’s own forecasts.

Analysts are basing expectations of slower growth on Trump-inspired trade wars, although if the president wants to be re-elected he will have to find some sort of landing zone with both China and Europe. We are pencilling in earnings growth of around 9% in 2020 and 7% in 2021.

The US yield curve has steepened slightly over the past month. The 30-year yield we use in our model has climbed from 2.87% to 2.95%.

A slightly steeper yield curve



When we integrate these hypotheses into our base scenario, our S&P 500 objective for end-2019 is 2,794 points. This takes account of a 3% risk premium and dividends. Our instantaneous valuation is 2,690 points, or 8.5% below Friday's close.

An overvalued market

S&P 500 - Valuation end 2019 except implied scenario					
CAGR Compounded Annual Growth Rate from 2018	**30 Years Gvt bonds**				
	2.50%	2.75%	**2.95%**	3.00%	3.25%
Mild recession: -2.8% in 2019, and 6% in 2020 - CAGR =2%	**2 745**	**2 602**	2 498	2 473	2 354
Implied Scenario CAGR 3.9% over 8 years	3 226	3 053	**2 926**	2 896	2 751
Base scenario: 2.1% in 2019 and 9% in 2020 - CAGR = 3.4%	3 072	**2 912**	**2 794**	**2 766**	2 632
Current Index S&P 500			**2 940**		

Last September we said that the market was some 11% overvalued, and it went on to correct. It is important to note that the 8-year CAGR of 3.4% reflects an inflation rate of 1.9% and annual GDP growth of 1.5%. That may not look like very much, but we would bank on a recession at some point in the coming eight years with a consequent slump in profits. It takes a 3.8% CAGR to justify the market's current level. Every 25bp variation in long rates has a 5% impact on the market's valuation.

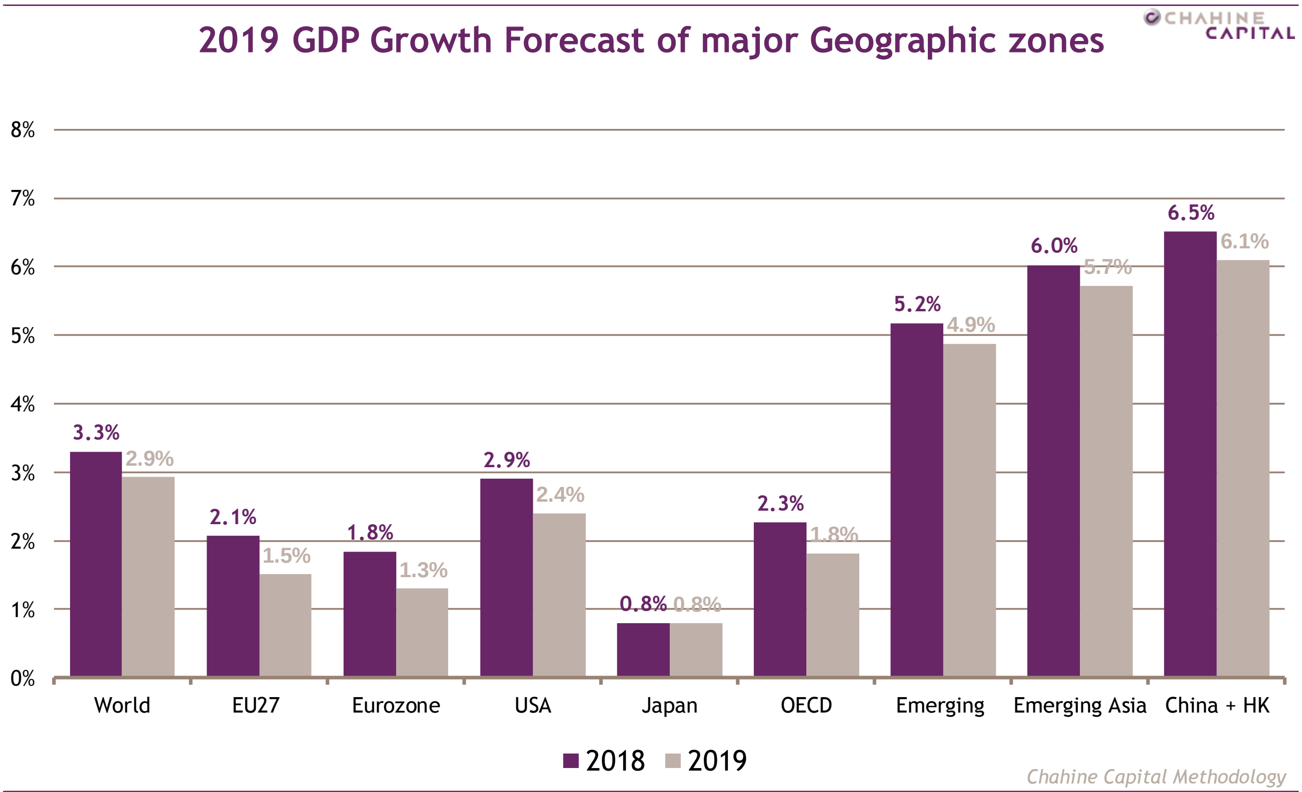
Our 'mild recession' scenario could be no more than a serious slowdown in growth, and in it we assume a fall in long rates to 2.5%. Were that scenario to materialise overnight, our instantaneous valuation would involve an 18% correction that would stabilise to a 10% loss as long rates come down. Leaving aside the 2008 correction, many recessions have not had an impact as marked as that.

Apart from a buying phase at the end of 2018, we have been underweighting equities for some time now. We turned out to have been wrong to have done so. Our philosophy of sound management is not about swinging between zero and 100% equity allocations but playing marginal variations around the investor's benchmark. Right now, for example, we are 34% exposed against a benchmark weight of 40% and our largest allocation is in direct real estate. Current price levels are encouraging us to stay underweight. Highly liquid investors might consider setting a long-term equities benchmark and awaiting any correction to buy into the market. Psychologically, it makes sense to define an investment programme over 12 months, for example, to reach a set threshold.

World GDP growth to slow to 2.9%

According to our model, world growth will slow to 2.9% this year amid weakening activity in Europe and to some extent in the USA. Good American figures for Q1 make no difference, as the 3.2% annualised gain just published masks a 1.2% increase in consumption rather than the average 2.5% recorded in the four preceding quarters. The bounce in investment is misleading, as it consists almost entirely of stockbuilding.

A marked slowdown in the EU

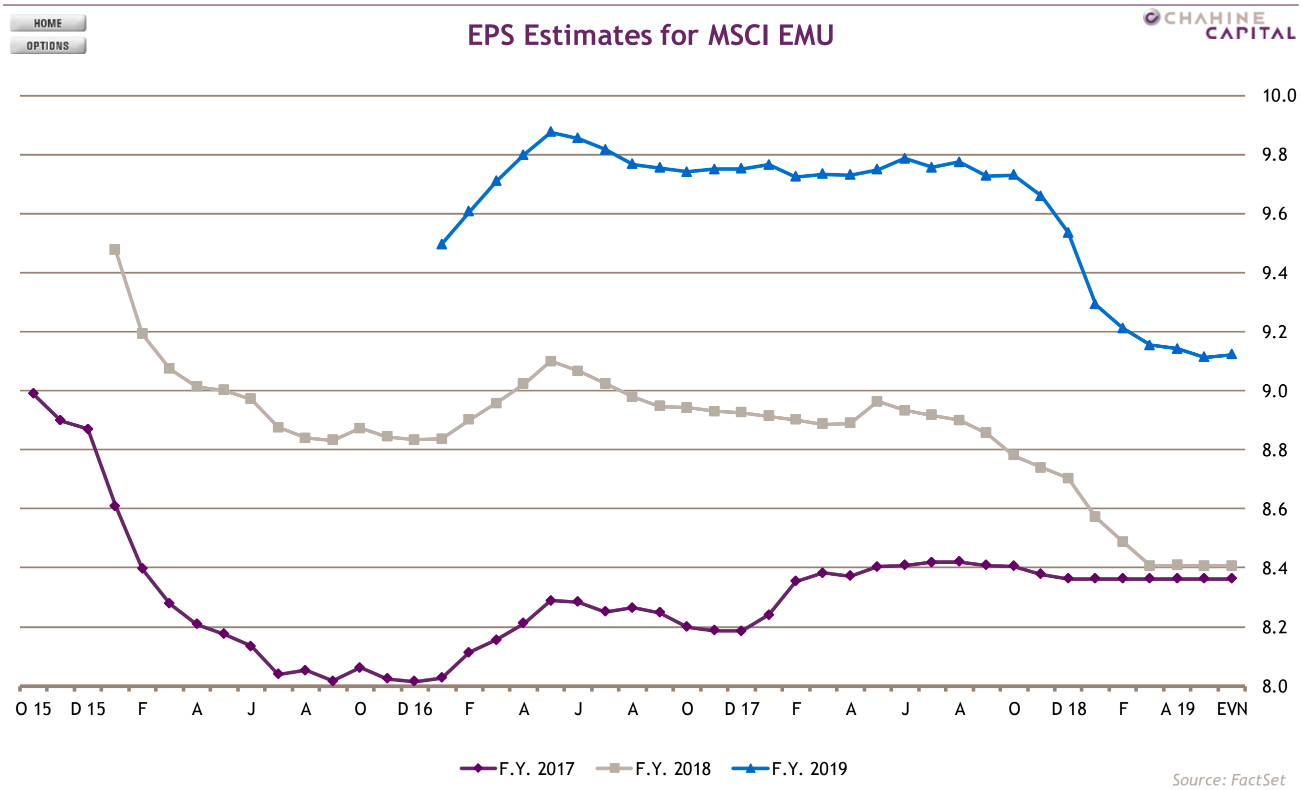


A stabilisation of world growth at its current level would be good news as interest rates are still very low. Expectations are running high of a trade agreement with China, but disappointment cannot be ruled out. Beijing has a strong track record in promising rather than actually conceding ground. Europe is labouring under Brexit and the deadline for UK participation in European elections is fast approaching. Will the EU wake up after the elections? Could it forge consensus over the need for a common front against American and Chinese hegemony?

European equities more or less fair value

European consensus estimates keep following the same old pattern. Absurdly upbeat forecasts for 2018 profits growth persisted for months before the year fizzled out at the same level as 2017. We are again in the fairyland phase for this year, and according to our top-down estimates EPS will rise just 3%. American institutional investors looking to the euro zone with hedged currency exposure are looking at an almost 3% premium, which is the spread between negative European rates and 2.5% in dollars. A US investor long dollar units in our own Digital Stars Europe fund would have made 20% so far this year, compared with 19% for an investor in euros.

Estimates revised down, again



Our base scenario gives us a year-end objective of 126 points for the MSCI EMU compared with last Friday's close at 125 points, but with substantial dividends to come. Dividends alone would largely cover the 3% risk premium plus long rates, as it happens. This is an enigma for actuaries, although the model continues to indicate lower profits over the long term as noted in the past. Index EPS is still 15% below its 2007 level!

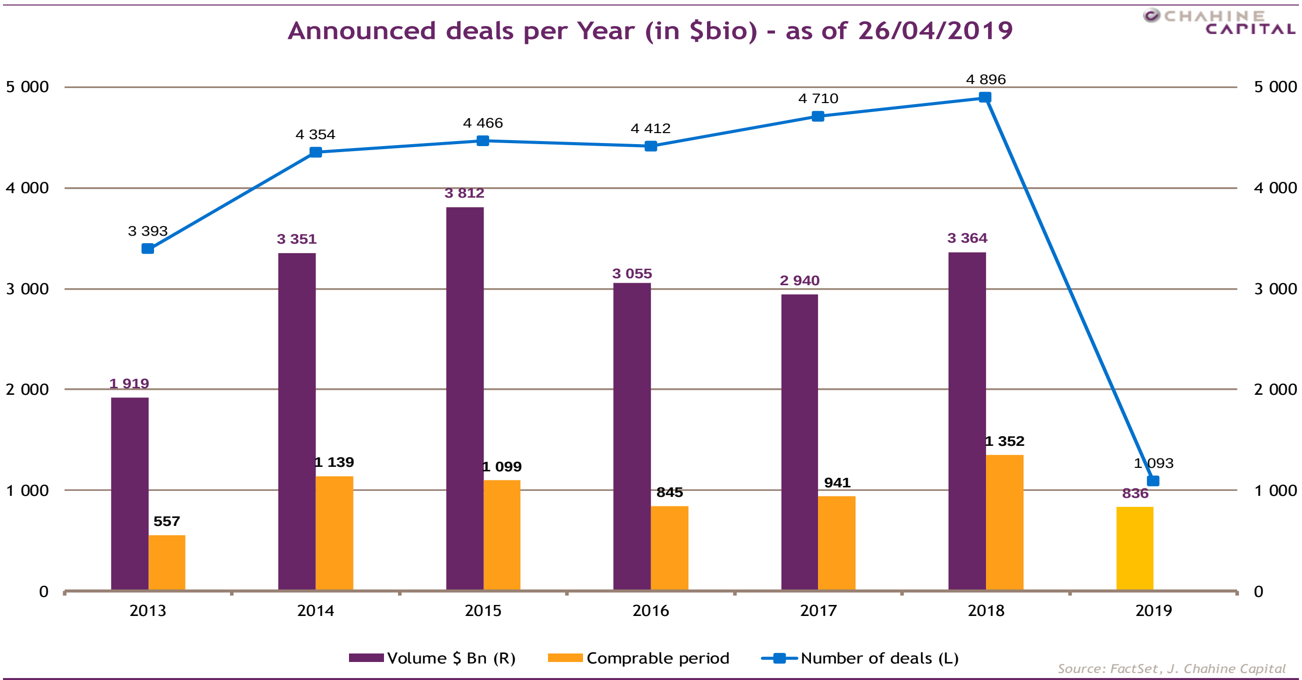
Europe close to our objective

MSCI EMU - Valuation end 2019					
CAGR Compounded Annual Growth Rate from 2018	30 Years Gvt bonds				
	1.00%	1.25%	**1.34%**	1.50%	1.75%
Depression scenario: -10% in 2019, and +5% in 2020 - CAGR =-6.8%	**114**	**107**	105	101	96
Implied Scenario: CAGR -4.9% over 8 years	136	128	**125**	120	114
Base scenario: 3% in 2019, and 5% in 2020 - CAGR = -4.6%	137	129	**126**	**121**	**115**
Current Index MSCI EMU			**125**		

A drop in M&A

Mergers and acquisitions amounted to a robust $3,364 billion in 2018, up from $2,940 billion the year before. Most of it came in the first few months of the year, when share prices were rallying strongly. M&A activity has been substantially lower in the first four months of this year than in the comparable period in 2018, contracting from $1,352 billion to $856 billion. It may well be that higher share prices have discouraged new initiatives. The biggest deals tend to be found among IT and healthcare, where the majors are looking to buy into biotech to secure their own future. There are not as many heavyweight oil companies as there used to be, but the battle around Anadarko Petroleum shows that M&A is no means over in the sector. The combination of very low interest rates and cash-rich predators points to more M&A up the road, although concentration can run up against anti-competition rules.

Higher share prices have slowed M&A



Conclusions

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Main ratios for markets and sectors as of 25/4/2019 (in local currency)

Data as of	Weight vs	Perf		Weighted P/E		% Wted EPS Chge			Div Yield	Revision vs M-2%	
25/04/19	MSCI World	2019	2018	2020	2019	2020	2019	2018	2019	Fiscal 20	Fiscal 19
MSCI The World Index	**100.0%**	**15.0%**	**-10.3%**	**14.7 x**	**16.1 x**	**10.1%**	**4.2%**	**12.5%**	**2.54%**	**-1.1%**	**-1.0%**
MSCI USA	61.0%	17.1%	-6.5%	15.9 x	17.8 x	11.7%	3.3%	21.8%	1.96%	-0.3%	-0.2%
MSCI Japan	8.1%	8.6%	-15.8%	11.8 x	12.4 x	4.9%	0.3%	3.1%	2.65%	-1.9%	-2.1%
MSCI EMU	14.1%	15.9%	-14.5%	12.5 x	13.7 x	9.6%	8.7%	0.5%	3.60%	-0.6%	-0.8%
MSCI Europe	25.6%	15.2%	-13.0%	12.9 x	14.1 x	9.1%	9.0%	5.5%	3.85%	-0.6%	-0.7%
MSCI Europe ex Energy	23.6%	15.4%	-13.7%	13.2 x	14.3 x	8.4%	9.6%	2.3%	3.71%	-0.7%	-0.8%
MSCI Austria	0.1%	18.8%	-26.7%	9.6 x	10.3 x	7.2%	-9.5%	9.2%	3.97%	1.3%	0.8%
MSCI Belgium	0.6%	20.7%	-24.9%	15.1 x	16.2 x	7.4%	13.2%	-0.5%	3.19%	-1.1%	0.1%
MSCI Denmark	0.7%	12.5%	-12.4%	17.4 x	20.0 x	14.8%	1.3%	-1.1%	2.45%	0.4%	0.1%
MSCI Finland	0.4%	9.5%	-1.5%	14.4 x	16.2 x	12.1%	8.7%	2.4%	4.70%	0.0%	0.2%
MSCI France	5.2%	17.1%	-9.7%	13.3 x	14.7 x	10.4%	8.6%	6.6%	3.37%	0.0%	0.0%
MSCI Germany	3.7%	15.4%	-20.2%	11.8 x	13.0 x	10.0%	10.6%	-9.6%	3.35%	-1.0%	-2.0%
MSCI Great-Britain	5.9%	10.0%	-12.7%	12.0 x	13.1 x	8.3%	3.0%	10.1%	4.77%	-0.2%	-0.2%
MSCI Ireland	0.2%	14.5%	-23.5%	14.2 x	15.3 x	7.6%	-3.3%		1.99%	-0.8%	-0.8%
MSCI Italy	1.0%	17.2%	-15.5%	9.9 x	10.8 x	8.4%	7.0%	14.5%	4.71%	-1.2%	-0.3%
MSCI Netherlands	1.3%	17.5%	-10.9%	14.1 x	15.6 x	10.1%	3.0%	7.8%	3.23%	-1.0%	-0.7%
MSCI Norway	0.5%	8.6%	-6.0%	12.5 x	14.4 x	15.8%	1.1%	19.4%	4.55%	-0.8%	-0.7%
MSCI Spain	1.4%	11.5%	-15.0%	11.2 x	12.0 x	7.0%	12.9%	-5.5%	4.65%	-0.5%	-0.3%
MSCI Sweden	1.1%	20.2%	-8.1%	15.1 x	15.3 x	1.4%	34.4%	-7.2%	3.96%	0.9%	0.8%
MSCI Switzerland	3.1%	15.8%	-10.1%	15.6 x	17.0 x	9.3%	11.8%	25.5%	3.30%	0.3%	-0.4%
MSCI Europe Consumer Discretionary	3.0%	20.6%	-17.5%	11.9 x	12.9 x	8.2%	11.6%	-7.7%	3.30%	-1.0%	-2.4%
MSCI Europe Consumer Staples	3.8%	16.6%	-11.3%	17.0 x	18.4 x	8.2%	10.0%	7.6%	3.06%	-0.6%	-0.4%
MSCI Europe Energy	2.0%	13.2%	-5.0%	10.5 x	12.2 x	16.0%	3.0%	48.9%	5.46%	0.3%	-0.4%
MSCI Europe Financials	4.6%	14.7%	-21.8%	9.7 x	10.3 x	6.9%	11.9%	6.2%	5.20%	-1.3%	-1.4%
MSCI Europe Health Care	2.9%	7.9%	-2.5%	14.5 x	15.8 x	9.1%	5.6%	5.1%	3.27%	0.6%	1.1%
MSCI Europe Industrials	3.5%	20.7%	-15.0%	15.3 x	16.9 x	10.5%	9.0%	2.9%	2.79%	-0.9%	-1.3%
MSCI Europe Information Technology	1.3%	25.7%	-8.2%	18.4 x	21.9 x	19.1%	12.5%	12.2%	1.49%	-0.2%	-0.4%
MSCI Europe Materials	1.8%	18.4%	-16.4%	13.0 x	13.7 x	5.6%	11.9%	1.8%	3.89%	1.3%	1.6%
MSCI Europe Real Estate	0.3%	12.1%	-17.5%	14.6 x	13.9 x	-4.7%	-15.8%	12.3%	4.73%	-2.1%	0.6%
MSCI Europe Communication Service	1.3%	2.1%	-10.7%	12.9 x	13.9 x	8.3%	5.6%	-4.2%	5.16%	-2.5%	-1.4%
MSCI Europe Utilities	1.2%	9.6%	-1.3%	13.2 x	14.8 x	12.0%	15.0%	-13.6%	5.18%	-1.3%	-1.5%

Benchmarks source iShares ETF - Data as of 25/04/2019

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