CHAHINE CAPITAL
Performance Engineering

27/6/2020

STRATEGY OVERVIEW

Time to back gold

Summary

Covid-19 is still making its relentless way around the planet, and even where it was supposed to be done with it is showing a nasty tendency to return whenever restrictions are eased. Financial markets are now paying more attention to its progress than to monetary policies, and equities appear to be caught between a relatively successful normalisation process in Europe and obvious failures to contain the disease in the USA. Donald Trump's relaxed handling of the crisis has damaged his chances of re-election; the virus seems set to dominate the election campaign and Joe Biden is not considered to be a particular friend of equity markets.

The crisis has certainly emphasised the digital economy's domination and even acceleration. The IT sector accounts for 27.7% of US market capitalisation, and if we add communications services (where Google and Facebook are classified) we can raise that to 38.4%. IT accounts for only 2.6 million American jobs in a 152 million strong labour force, but has suffered little on that front. The US leisure and hospitality sector has dropped 7 million of its 19 million pre-Covid jobs, and its share of market capitalisation has dropped from 1.9% to 1.5%. Surging bankruptcies in retailing are causing difficulties for shopping malls and the real estate firms that operate them. Smaller oil companies are falling like dominoes, leaving heavy debts behind them. While the more fragile hotel chains have benefited from payment moratoriums, they cannot hold out forever and business failures will mean even more non-performing loans. The financial sector's share of capitalisation has sagged from 22.6% in 2006 to just 10.2%, but Federal Reserve liquidity injections and a $750 billion asset purchase programme that extends even to junk have saved their day. Credit spreads have reverted to normal for prime names but are still high otherwise. In terms of share prices, IT and healthcare have not suffered from the crisis and are trading at their highs. More than 100% gains have been recorded from biotech firms working on vaccines and for DocuSign, an electronic signatures specialist. Tesla is up 129%, reflecting its status as a four-wheeled computer. E-commerce is headed firmly upwards. Thanks to its digital bias, the US market is only 10% off its peak, with a massive performance gap between the real and virtual economies.

After liquidity injections worth as much in a few weeks as in the six years following the 2008 crisis, the Fed will press on with this policy. Nobody has objected to it so far, as it is all about confidence. Stagnant demand has prevented any rise in inflation, and additional liquidity has simply boosted savings. The current risk environment and absence of viable projects are limiting investment opportunities. Yields on government bonds are zero or negative, and triple-A corporates offer little more. The equity market may be deep but it looks increasingly expensive. It is worth remembering at this time that while central banks can continue to drown us in paper money, they cannot print gold! This asset has outperformed all other asset classes over the past 20 years; although it did miserably between 2011 and 2018, it has again outpaced the S&P 500 since the 2018 crisis. It is still some way off its highs associated with the 2008 crisis. We may be getting on this particular train a little late, but we are now recommending exposure to gold, whether in physical or paper form – or in mining, especially given where interest rates are.

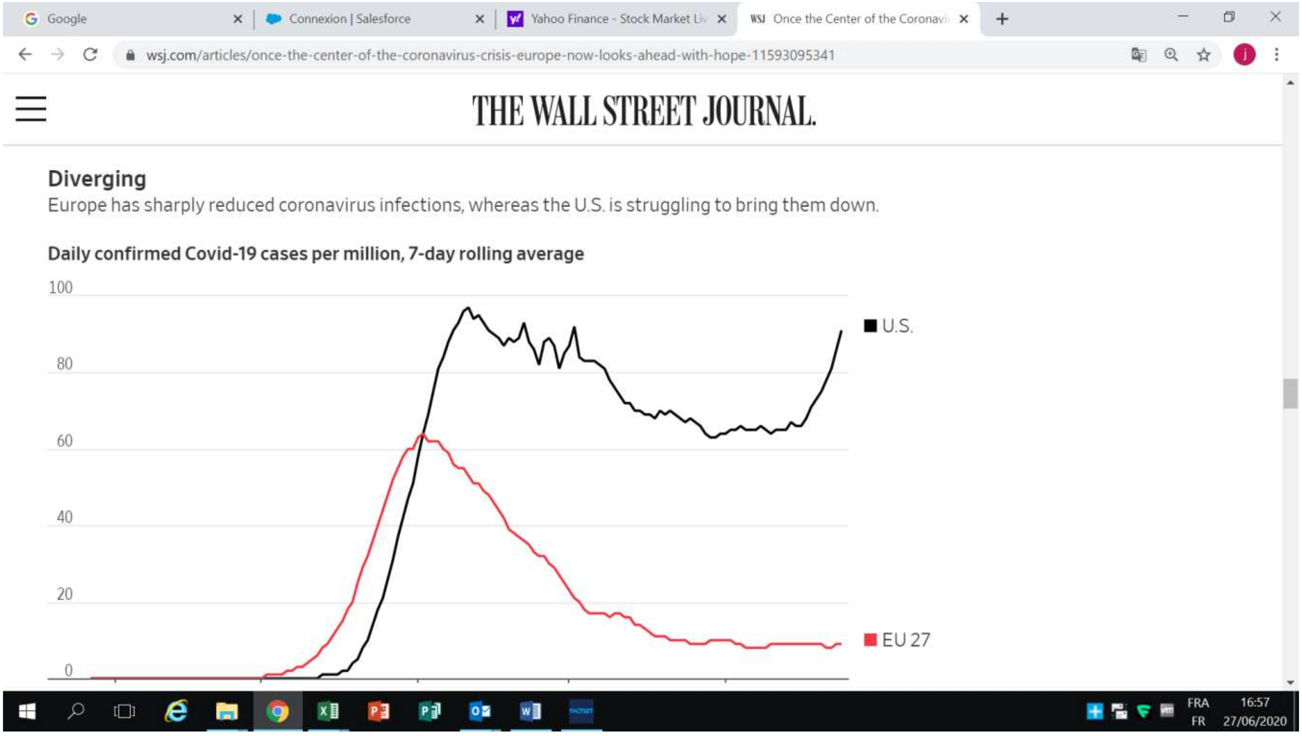
World GDP is expected to decline 3.9% this year. Eurozone GDP is set to drop 7.6%, with the worst numbers coming from Southern Europe including France. The USA is at -5%. Asia is still in positive territory, again outperforming the OECD. Earnings estimates are stable; our model is factoring in -26% this year and a 14% rebound in 2021 for the S&P 500. The market is valued at 18.6x 2021. Our S&P 500 valuation is a largely unchanged 2,935 points, compared with a close at 3,009 points, with a CAGR of -0.1%. We are maintaining our equities overweight recommendation and would be looking to increase our allocation in the event that the index corrects below 2,900 points. This is via short call position that could earn us 70 points.

Jacques Chahine

America's bungled coronavirus response shakes Wall Street

The world has become a far more uncertain place since Covid-19 burst onto the scene. Not only is the pandemic still spreading, but even where it has been contained it has a nasty habit of resurging again once restrictions are eased. It seems that sentiment is being pulled one way by good news on ending lockdowns and another by anguish over a second wave. The USA is the world's biggest economy and is not helping with its uncoordinated crisis response and an unbelievably dismissive president. His evident shortcomings in this regard could cost him an election that he once looked sure to win. His encouragements to States to end lockdowns early and without backup measures have resulted in a spike in new cases; several States have had to lock down again, aggravating the country's economic difficulties. The chart below shows the gap between the USA and Europe in terms of Covid-19 infections. That gap has widened since 24 June.

Confirmed cases per million inhabitants



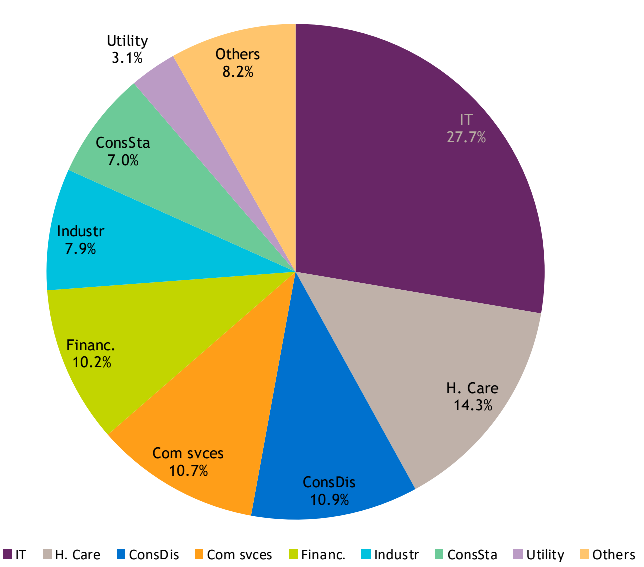
Hopes are focused on identifying an effective vaccine. Using different technologies, a dozen or so are already in test phase. But just as with 'normal' flu, any vaccine could prove only moderately effective and even then only for a short while. Progress in treating patients with the disease and setting up health infrastructures better able to cope with any second wave are more tangible, having reduced death rates all on their own. In the worst-case scenario, we may have to live with this coronavirus as we already live with the flu, as widespread lockdowns have already destroyed significant parts of the economy.

Even more emphasis on the digital economy

The S&P 500 is trading both ways, buffeted by the very mixed news flow on the pandemic and its economic impact. The index close we used in our previous letter was 3,044 points; last Friday the market closed at 3,009 points on the back of accelerating cases in the USA and some local spikes in Europe. Central banks are still pumping in apparently unlimited liquidity, however, and interest rates are zero or negative. Investors are starting to get jittery over the state of the real economy and are all too aware that financial asset values have been inflated by the wall of money that just hit them. The crisis has highlighted the dichotomy between the virtual and real economies, and it is the latter than provides most people with their jobs. The IT sector has gone from strength to strength in stock market terms, even though some of its heavyweights (most obviously Google and Facebook) have been reclassified as 'communications services'. If we put those two sectors together, they account for 38.4% of US market capitalisation (of which 27.7% for IT). But they employ only 2.6 million people, out of a pre-crisis labour force of 152 million. In labour market terms, the IT sector covers not just IT itself but also the press, entertainment and telecoms; it has shed 300,000 jobs (mainly from entertainment) and the 'pure' IT part employs no more than 700,000.

The virtual economy has increased its market weight substantially…

Sectors weights in S&P 500



Source: FactSet

… while jobs in the real economy are disappearing

	May-20	Apr-20	Mar-20	Feb-20	Jan-20
Total nonfarm	132 912	130 403	151 090	152 463	152 212
Total private	111 732	108 638	128 362	129 718	129 498
Goods-producing	**19 382**	**18 713**	**21 086**	**21 205**	**21 149**
Mining & logging	**632**	**652**	**706**	**714**	**712**
Construction	**7 043**	**6 579**	**7 574**	**7 639**	**7 593**
Manufacturing	**11 707**	**11 482**	**12 806**	**12 852**	**12 844**
Private service-providing	**92 350**	**89 925**	**107 276**	**108 513**	**108 349**
Trade, transportation & utilities	**24 866**	**24 498**	**27 723**	**27 830**	**27 832**
Information	**2 578**	**2 616**	**2 888**	**2 894**	**2 894**
Financial activities	**8 596**	**8 563**	**8 827**	**8 845**	**8 823**
Professional & business services	**19 394**	**19 267**	**21 456**	**21 550**	**21 523**
Education & health services	**22 242**	**21 818**	**24 408**	**24 586**	**24 534**
Leisure & hospitality	**9 824**	**8 585**	**16 124**	**16 867**	**16 808**
Other services	**4 850**	**4 578**	**5 850**	**5 941**	**5 935**
Government	**21 180**	**21 765**	**22 728**	**22 745**	**22 714**

Even more damage to the real economy

In contrast with IT, America's leisure and hospitality sector has shed 7 million of its former 19 million jobs, which represented 7.5% of the labour force. Its market capitalisation has dipped from 1.9% to 1.5%. Non-food retailing is another serious casualty: half of the jobs in its clothing sub-sector have disappeared. Retailing was already in serious difficulty before the crisis, and bankruptcy rates have simply accelerated. Knock-on effects on shopping malls have led in turn to problems in the wider real estate sector.

The financial sector's capitalisation has dropped from 12.6% before the crisis to just 10.2%, and we recall that it was at 22.6% at the end of 2006! For its part, the real estate sector accounted for 3% of market capitalisation and 8.8 million jobs before the crisis. It still creates massive value added but not on the scale of the early 2000s. The worst is still to come for this sector, given soaring bankruptcies elsewhere. In the hospitality sector, for example, the banks have accepted a 3-month moratorium on loan repayments but empty hotels promise no way out unless the Fed intervenes with government-backed refinancing deals. Debt service companies that collect on loans packed up as bonds (commercial mortgage-backed securities, for example) are less accommodating than the banks are and will not hesitate to foreclose.

The biggest names have not been spared from retail collapses, especially in clothing: J.C. Penney, Neiman Marcus, J.Crew and Ann Taylor. Zara will close 1,200 outlets in the USA and is pressing ahead with its online business, which it wants to increase from 14% to 25% of its turnover by 2022. American retailers at least have the advantage of Chapter 11 bankruptcy procedures, which can help some of them rebound by saving healthy branches.

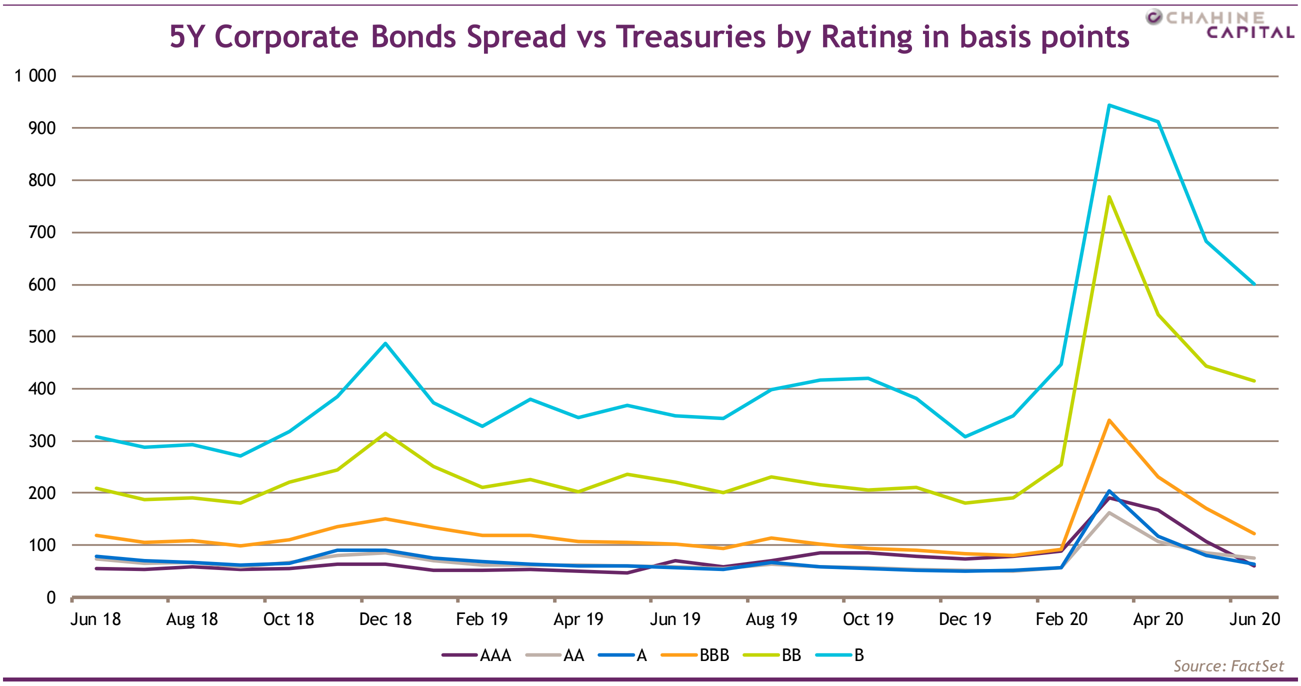
The 'Others' section of our pie chart includes basic materials and energy. The energy sector used to be a Wall Street favourite and accounted for 10.4% of its capitalisation at end-2006; it is now down to 2.8% and scores of smaller oil companies are going under, leaving debts that will never perform. The list of US firms losing over 80% of their market value consists mainly of energy stocks, although Hertz is a big-name exception. Hertz has billions of dollars of outstanding debt, packaged as asset-backed securities using its 500,000 cars as collateral. Deutsche Bank is one of it creditors. Chesapeake is a shale oil pioneer with $10 billion in debt and that lost $9 billion in Q1 as a result of asset write-downs. Dozens of smaller operators have failed, again with substantial debts. The Fed is trying to help by buying up all sorts of corporate debt via ETFs and is preparing direct purchases.

	Sector	Price	Company Market Cap.	% Change YTD
Chesapeake Energy Corporation	Energy	11.85	116	-92.8%
Hertz Global Holdings, Inc.	Industrials	1.49	212	-90.5%
Tellurian Inc.	Energy	1.05	281	-85.6%
Whiting Petroleum Corporation	Energy	1.26	115	-82.8%
CorEnergy Infrastructure Trust, In	Real Estate	8.74	119	-80.5%
Centennial Resource Development	Energy	0.92	255	-80.1%

Massive Fed intervention avoids the worst

Energetic responses from the Federal reserve and the government have so far managed to reassure the markets and avoid a major financial crisis. Credit markets have picked up, and as the chart below indicates spreads have come in significantly. The better the rating, the bigger the improvement, and spreads for single- to triple-A names are back to their pre-crisis levels. B credits are still under pressure, however; junk issues are still trading at 600bp after a high at 900bp. The Fed has set aside $750 billion for possible additional intervention.

A calmer credit market



After a review of all of the most vulnerable sectors, we note a striking contrast with some of the digital economy stories out there. This is highlighted in the table below, which lists the best and worst US market performers among the $1 billion-plus category. The best performers are up between 100% and 1,800% (!), while the worst are down between 60% and more than 70%. Unsurprisingly, firms engaged in coronavirus vaccines and treatment are the big winners. Moderna – the favourite on vaccines – has more than doubled its capitalisation to $23.8 billion, and at one point was valued at $32 billion even though it has no turnover. A promise of an effective vaccine was enough. There are questions around the financial affairs of its head, businessman Armeno Libanais Afeyan, and no end of criticism about the success of an unproven technology. Apart from healthcare, the stars include IT firms such as DocuSign (we are subscribers), which enable recognised, secure electronic signatures. Completely out of kilter with the rest of the car industry, Tesla is up 129% and capitalised at an extraordinary $178 billion. The stock is effectively valued as a computer on wheels and followed by IT analysts rather than auto specialists. Its lead in driverless technology and innovation makes it a sort of Apple of the car world. Cyclicals such as Wayfair are specialised sorts of Amazon.

A world of difference between the real and digital economies

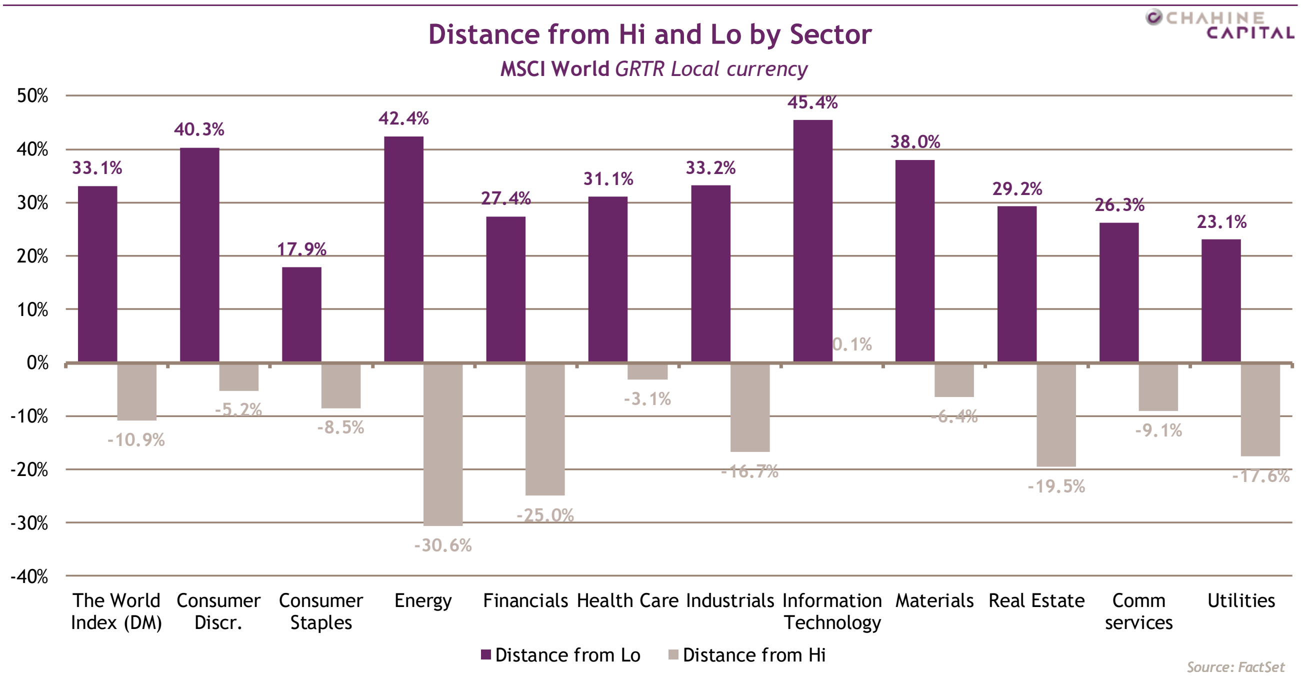
	Sector	Price	Company Market Cap.	% Change YTD
Transocean Ltd.	Energy	1.78	1 094	-74.1%
Norwegian Cruise Line Holdings Lt	Consumer Discretionary	15.28	3 917	-73.8%
Service Properties Trust	Real Estate	6.58	1 083	-73.0%
ChampionX Corporation	Energy	9.35	1 918	-72.3%
Macerich Company	Real Estate	8.05	1 869	-70.1%
MFA Financial, Inc.	Financials	2.30	1 042	-69.9%
PBF Energy, Inc. Class A	Energy	9.57	1 148	-69.5%
Spirit AeroSystems Holdings, Inc. (	Industrials	22.32	2 356	-69.4%
Carnival Corporation	Consumer Discretionary	15.78	9 463	-69.0%
Cinemark Holdings, Inc.	Communication Services	11.39	1 339	-66.4%
Sabre Corp.	Information Technology	7.57	2 086	-66.3%
Two Harbors Investment Corp.	Financials	5.08	1 390	-65.3%
Royal Caribbean Cruises Ltd.	Consumer Discretionary	46.41	9 718	-65.2%
Macy's Inc	Consumer Discretionary	6.02	1 864	-64.6%
Nordstrom, Inc.	Consumer Discretionary	14.69	2 307	-64.1%
Noble Energy, Inc.	Energy	9.11	4 370	-63.3%
Ryman Hospitality Properties, Inc.	Real Estate	31.81	1 749	-63.3%
Park Hotels & Resorts, Inc.	Real Estate	9.50	2 238	-63.3%
Kohl's Corporation	Consumer Discretionary	18.77	2 961	-63.2%
Coty Inc. Class A	Consumer Staples	4.18	3 190	-62.8%
United Airlines Holdings, Inc.	Industrials	32.89	9 552	-62.7%
Capri Holdings Limited	Consumer Discretionary	14.37	2 146	-62.3%
Alliance Data Systems Corporation	Information Technology	42.87	2 042	-61.8%
Howard Hughes Corporation	Real Estate	50.42	2 770	-60.2%
Novavax, Inc.	Health Care	77.39	4 485	1844.5%
Inovio Pharmaceuticals, Inc.	Health Care	29.98	4 740	808.5%
Mersana Therapeutics, Inc.	Health Care	22.38	1 498	290.6%
BioXcel Therapeutics, Inc.	Health Care	55.60	1 124	280.6%
Moderna, Inc.	Health Care	61.28	23 827	213.3%
Vir Biotechnology, Inc.	Health Care	38.83	4 578	208.8%
Livongo Health, Inc.	Health Care	74.99	7 335	199.2%
Quidel Corporation	Health Care	221.00	9 282	194.5%
MacroGenics, Inc.	Health Care	27.99	1 375	157.3%
DocuSign, Inc.	Information Technology	177.58	32 588	139.6%
Translate Bio, Inc.	Health Care	19.48	1 280	139.3%
Bill.com Holdings, Inc.	Information Technology	89.74	7 056	135.8%
Etsy, Inc.	Consumer Discretionary	102.54	12 169	131.5%
Teladoc Health, Inc.	Health Care	193.26	14 389	130.8%
Tesla Inc	Consumer Discretionary	959.74	178 008	129.4%
Zscaler, Inc.	Information Technology	106.00	13 835	128.0%
Arcus Biosciences, Inc.	Health Care	22.76	1 298	125.3%
Twilio, Inc. Class A	Information Technology	221.15	30 973	125.0%
Cytokinetics, Incorporated	Health Care	23.77	1 414	124.0%
Wayfair, Inc. Class A	Consumer Discretionary	201.94	19 111	123.5%
Stamps.com Inc.	Consumer Discretionary	185.81	3 175	122.5%
Plug Power Inc.	Industrials	6.83	2 215	116.1%
Smith & Wesson Brands, Inc.	Consumer Discretionary	19.41	1 078	109.2%
Kiniksa Pharmaceuticals Ltd. Class	Health Care	23.03	1 387	108.2%
Simulations Plus, Inc.	Health Care	58.50	1 039	101.2%
Green Dot Corporation Class A	Financials	46.20	2 448	98.3%

The astonishing resilience of equities

Given the prospect of the most severe economic downturn since 1929, equities are proving incredibly resilient. The market's initial 35% correction was nothing if not steep, but the rebound has been almost as impressive. Following a 33% bounce, the world index is only 11% below its 19 February high. Crisis or no crisis, the IT sector is above its previous high; the Nasdaq beat its previous high at the beginning of June and has gone on to break the 10,000-point barrier. Healthcare is not far behind, and again is close to its own highs. Energy, finance and real estate are nowhere near.

In the meantime, the consensus estimate for US corporate earnings this year is a 22% decline; our model gives us 26%. This divergence between earnings and market performance reflects a lack of alternative homes for massive central bank liquidity injections. High-visibility stocks are prime beneficiaries, hence soaring prices in the digital sector. With central banks prepared to step in again at any point, investors are starting to feel invulnerable. But can central banks save every struggling firm and shore up every non-performing loan? And do we have any idea just how much money would have to be printed to deal with a second wave of the pandemic and sustain firms and their employees indefinitely?

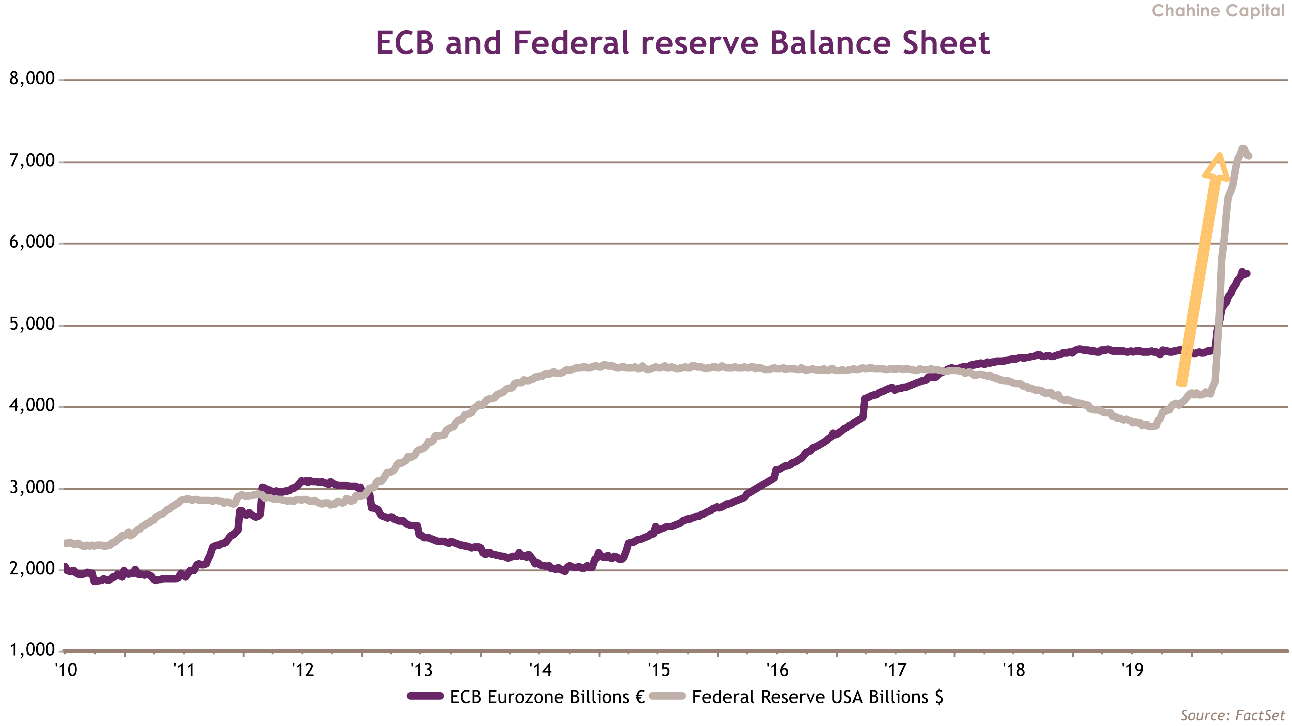
Investors want to believe in a swift recovery



After the 2008 financial crisis, the Fed expanded its balance sheet from $1 trillion to $4.5 trillion over six years. This time around, its balance sheet has jumped from $4 trillion to $7.5 trillion in a matter of weeks, and more is on the way. The same phenomenon is true of Europe and Japan, although on a slightly less spectacular scale. Nobody has raised any objections to this policy, nor will they so long as confidence persists. In more normal times, printing money is a good recipe for inflation, as seen recently in Venezuela and Argentina, as devalued paper is of no use in importing goods and services. The UK already imports more than it imports and Brexit-related disorder will hurt the pound. But there is as yet no sign of inflation in developed countries; quite the opposite, in fact.

The crisis has sharply reduced consumer demand, and households with unchanged incomes have looked to bolster their savings rather than increase spending beyond the strict minimum during lockdowns. The US savings rate rose from 7% to 32% in April, although it has fallen back since. There is no sign of inflation in the short term, which could undermine confidence in currencies. We are left with this mountain of cash looking at what remain very limited investment opportunities in a high-risk environment without many viable projects to buy into.

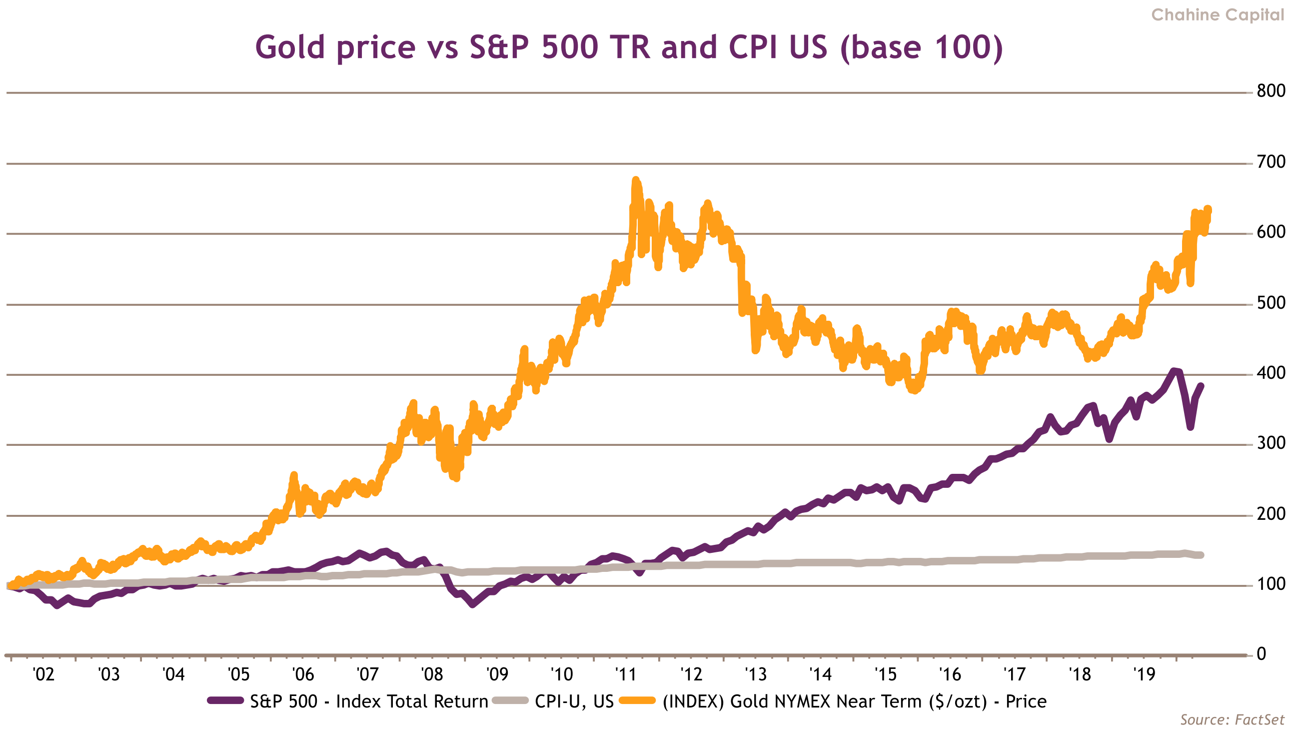
Cash injections to continue



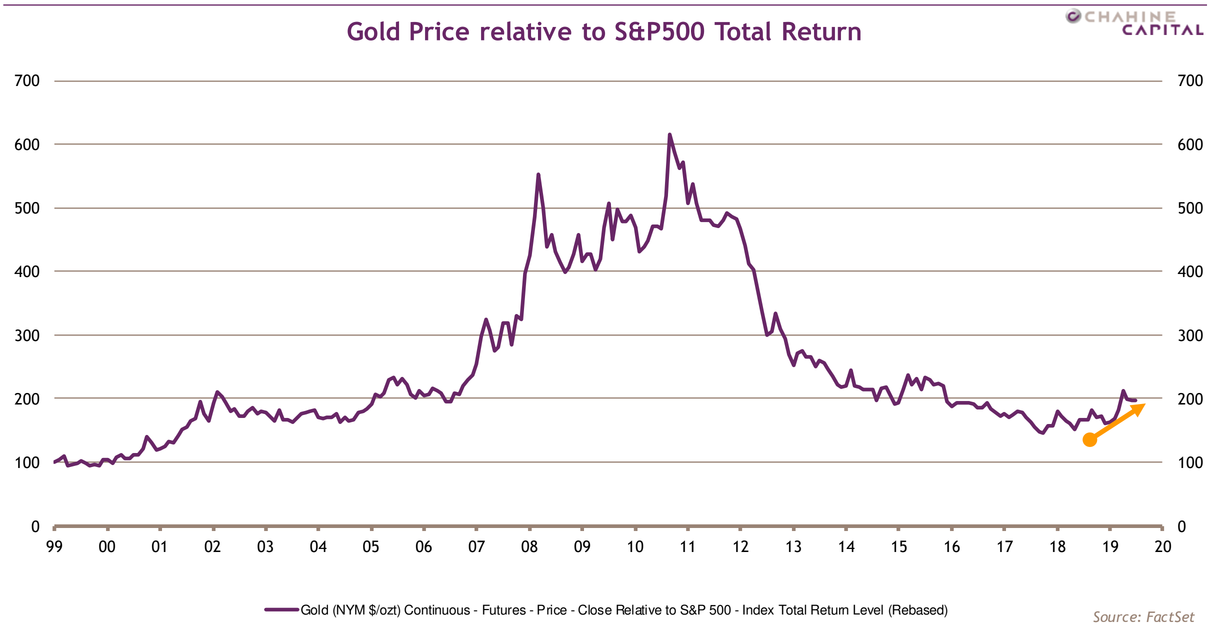
What central banks can't print: gold

Government bond yields are close to zero or negative, and triple-A corporate bonds offer little more. The equity market is clearly very deep, and the mega-wealthy are typically invested in their own companies or equities. If any of our readers was suddenly called upon to advise on the allocation of a $100 million portfolio, they would clearly be unwise to go for 100% equities or 100% cash. We would be looking at something like 40% equities, 40% real estate and the rest in various forms of cash… and gold. In a situation where abundant liquidity has reduced the cost of carry or of futures contracts, real assets with timeless appeal like gold are attractive options. Currencies all depend on confidence, and further liquidity injections cannot raise the value of existing assets. It would not take much for a few leading voices to suggest insurance policies denominated in gold. We are not such a voice, but believe that a 4-8% allocation in gold would be a shrewd move. This should not be seen as a day trade! Wiser heads than ours have already benefited, as gold prices have been rising steadily since equities corrected in the autumn of 2018. Over the past 20 years, gold has outperformed the S&P and of course beaten inflation, but that stemmed mainly from a rally that started in 2000 and accelerated when the 2008 crisis struck. Investors turned away from 2011, however, and gold was a miserable investment between then and 2018. It has outperformed the S&P 500 by 36% since then, confirming its tendency to exaggerate both ways. We are clearly in an outperformance phase, which given current events seems destined to continue.

A new gold rush



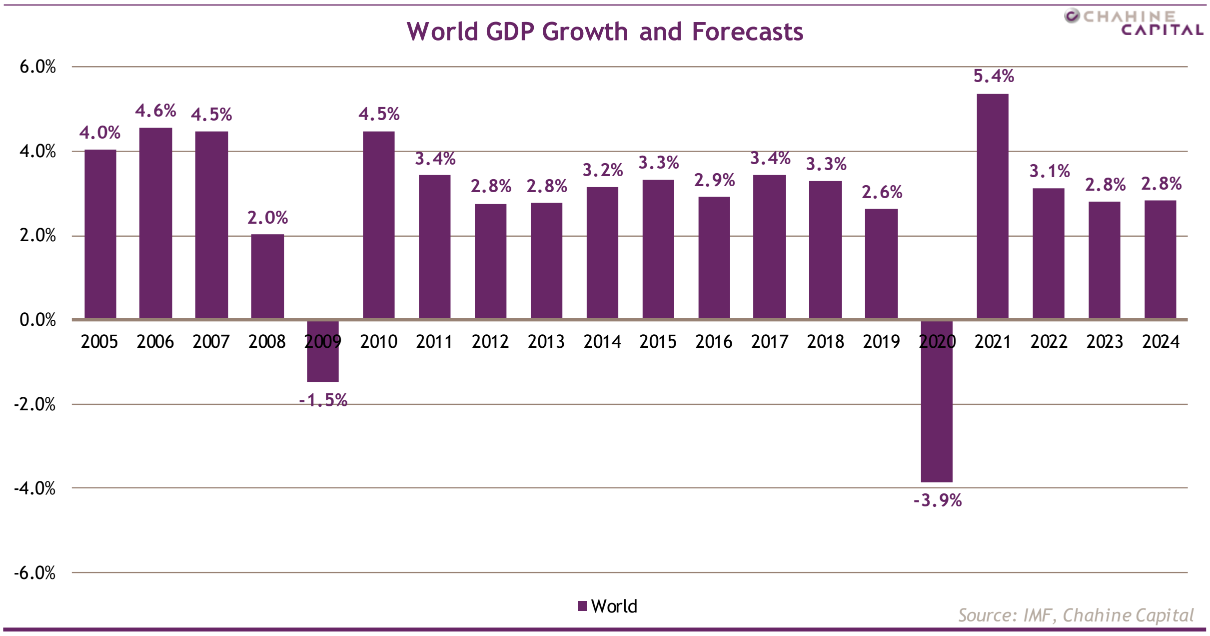
Gold prices still way down on the highs of the early 2000s



World GDP growth: -3.9% and still being revised

World GDP growth estimates for 2020 are starting to crystallise, and currently work out at -3.9% in local currency terms (not purchasing power parity). That figure compares with -3.2% last month. Projections for 2021 incorporate sharp rebounds and are up from 4.7% last month to 5.4%. We are wary of 2021 numbers, especially as most of us tend towards optimism on the long-term future. Note that 2019 was the worst year for world GDP growth for a decade.

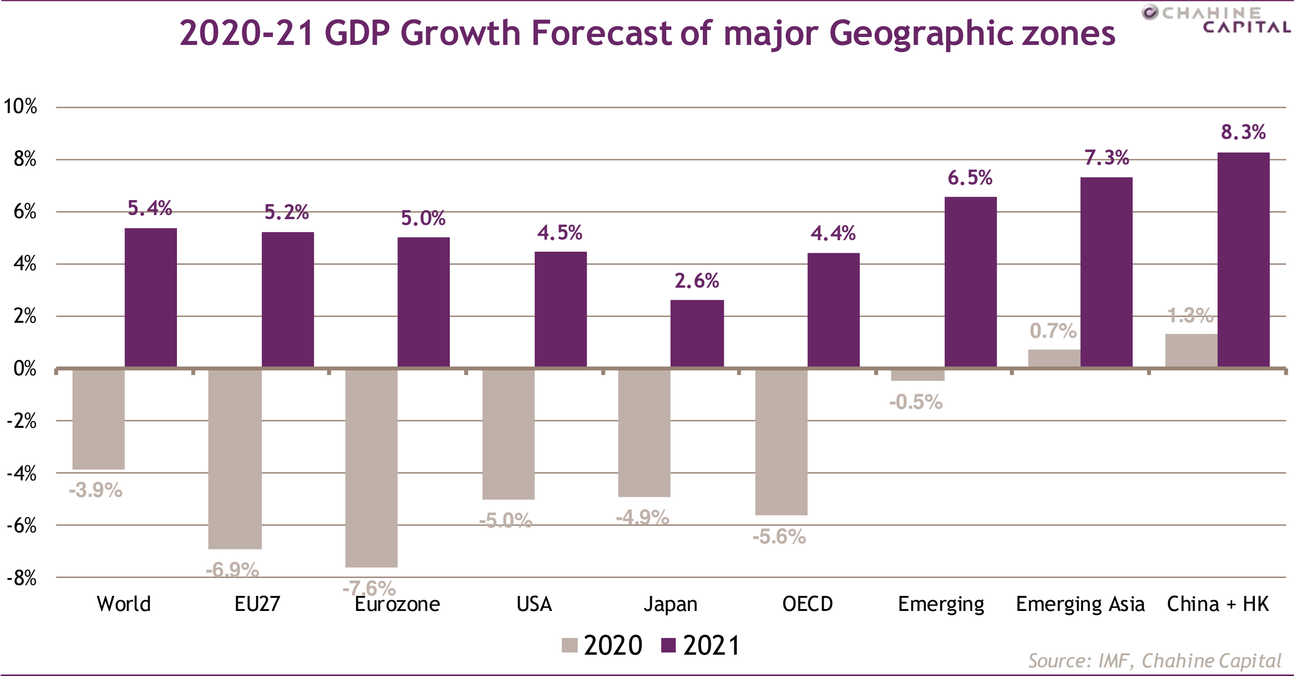
Forecasts for 2020 likely to be revised down



The eurozone has been particularly hard hit, and its GDP is expected to drop 7.6% this year. That figure masks contrasting North-South forecasts within the bloc, however. Across Europe, we are looking at Germany -6.3%, Austria -4.85%, Belgium -6.8%, Denmark -4.85%, Finland -4.45%, Ireland -3.75%, Luxembourg -4.3%, Netherlands -3.6%, Norway -4.9%, Sweden -4.05%, Switzerland -5.5%, France -8.5%, Italy -9.5%, Spain -9.5% and Portugal -6.5%. The USA and Japan are at -5%. Asia's numbers are still positive, including 1.9% for China (4 points down on the pre-crisis forecast, but far better than the OECD!).

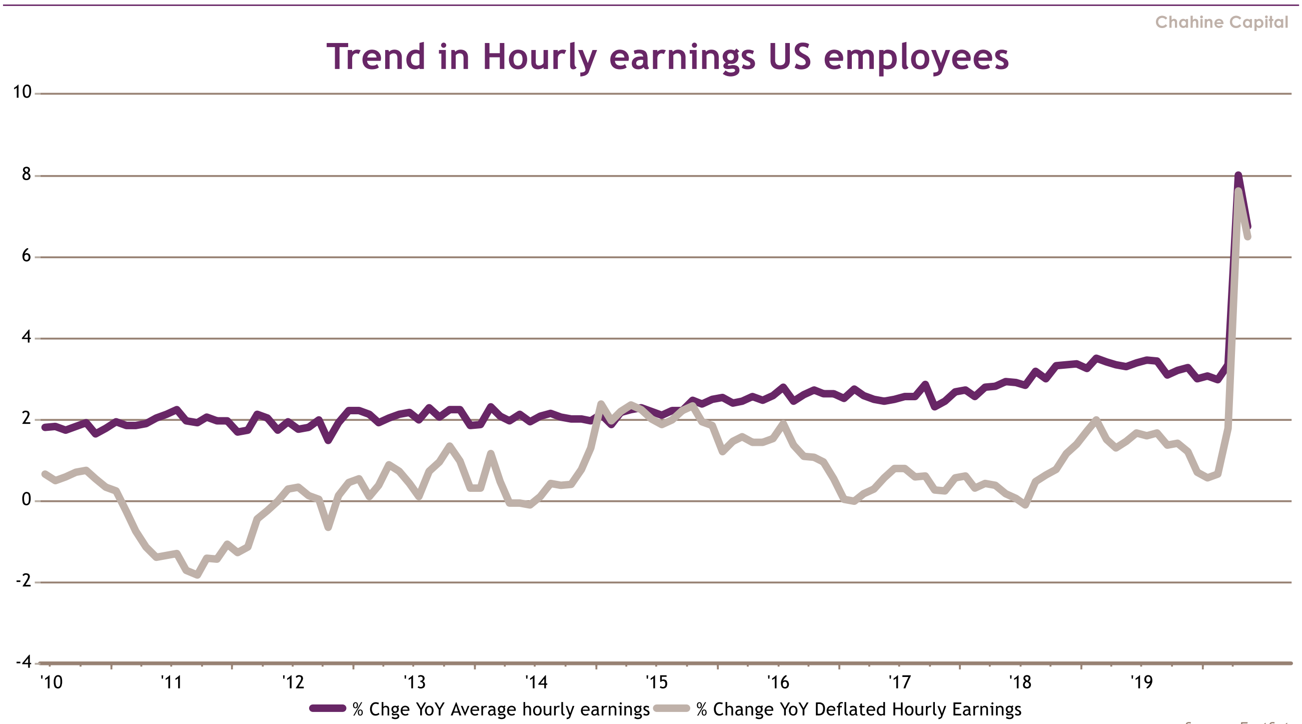
Macroeconomic data make for very poor reading, notably those relating to consumer confidence and construction. But PMIs picked up in May in the USA and (from a lower base) in the euro zone. Thanks to helicopter money delivered to American households, wages and bonuses have been banked and one only hopes that they will be used reasonably soon. The crisis appears to have resulted in a significant increase in the hourly wages of workers not subjected to lockdown.

Asian growth figures revised by less than OECD estimates



Source: IMF, Chahine Capital

A spike in wages for employees not locked down

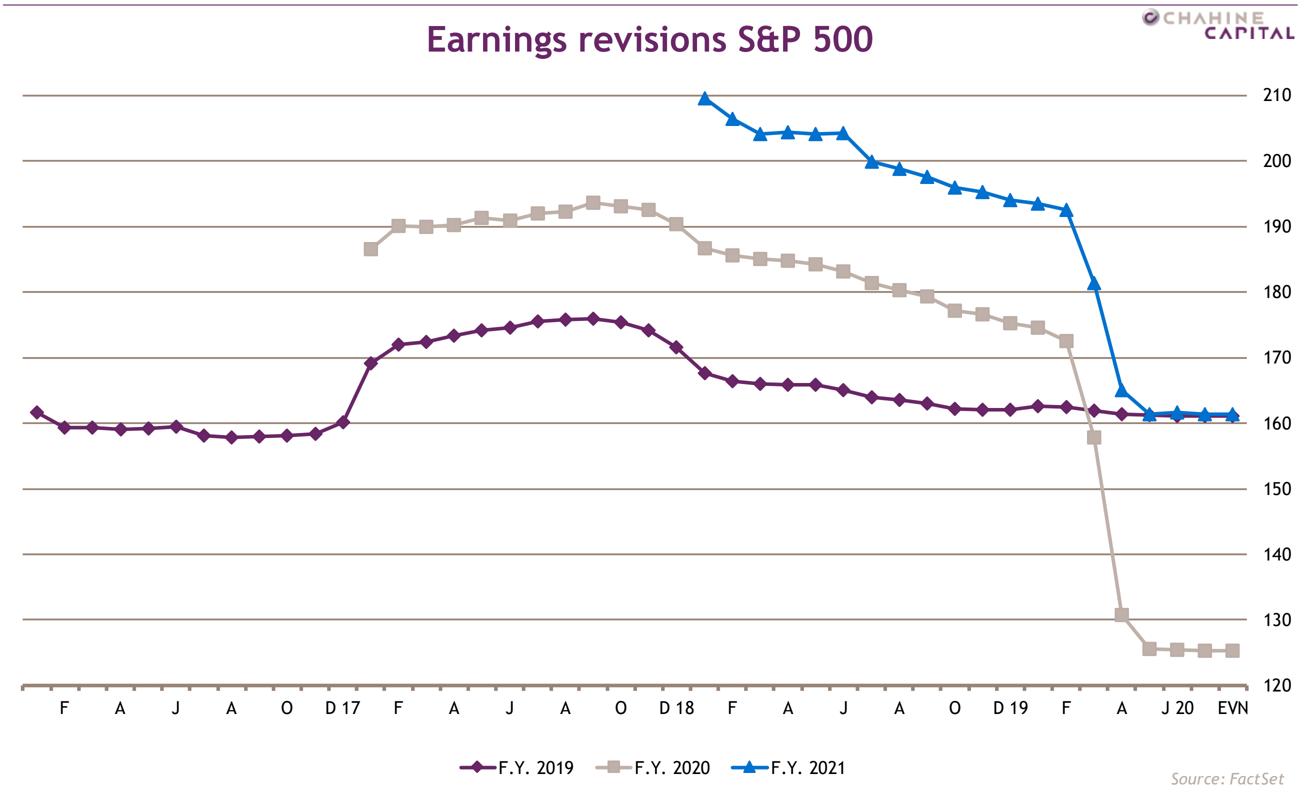


Source: FactSet

Unchanged earnings estimates

Analysts had already honed their 2020 US earnings estimates by the end of May and opted to leave them unchanged in June. That does not mean indefinite stabilisation; in our view, the market rally has clouded judgements. The consensus view is a 24.2% drop in EPS, and we are retaining -26.3%. For 2021, analysts assume a rebound to virtually 2019 levels, which looks excessively upbeat. Our top-down estimate is a 14.4% gain next year, compared with 31% consensus figure. The sectors holding up the best are much the same as those performing in market terms: IT (earnings up slightly), healthcare and consumer staples (both down slightly). Utilities profits will be down marginally but sector stocks have corrected sharply despite solid dividends. The biggest declines in profits are in energy, cyclical goods and industrials. While cyclicals include Amazon and a few imitators, it also includes autos and the whole leisure segment. Financials' earnings are down 37% and continue to suffer major revisions; we could yet see some very bad surprises from the sector.

Profits down 24% in 2020



Q2 numbers announced from now onwards will be the worst of all, as they will cover the maximum lockdown period. Consensus analysts expect a 44% drop on Q2 2019; while their figures are usually shaped by companies' own guidance but for obvious reasons they are unusually subject to surprises. But then the market has already priced in the bad news and is more interested in the spread of the pandemic and its potential future impact. A proven vaccine would have a dramatic impact on the whole market, for example, and interest rates are so low that any disappointments would be swiftly forgiven. Wall Street is trading at 18.6x 2021; the IT sector is at 22.4x but could post 15% EPS growth in 2021 after flatlining profits this year. Healthcare is cheaper at 14.6x and could also post 15% growth next year; the reason for the difference is that healthcare is benefiting from a one-off event rather than anything recurrent.

The market has already priced in poor earnings this year

Quarterly Earnings per Share growth S&P 500

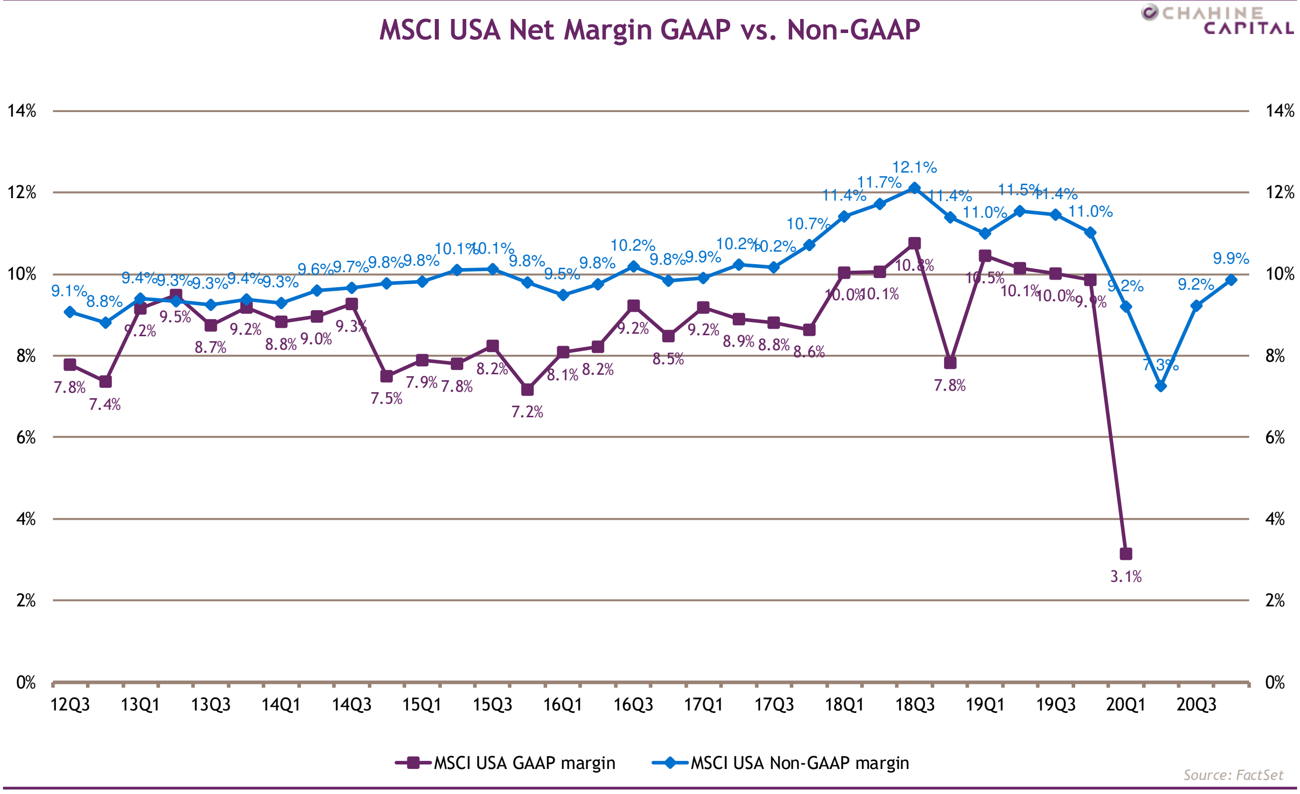
Source: FactSet

Market valuations

Our S&P 500 valuation is much the same as it was last month: 2,935 points compared with last Friday's close at 3,009 points. We have made only minor adjustments to our parameters, shading up our forecasts for 2020 and going the other way for 2021. The CAGR underpinning our valuation is an unchanged -0.1%, implying that the profits cycle peaked in 2019 and will peak again at the same levels next time around. It also assumes that interest rates will be the same; we suspect that they will be higher, but higher EPS growth would offset that effect. Our 30-year rate is more or less the same at 1.42%.

We have access to Q1 accounts for all S&P 500 companies, allowing us to compare GAAP and non-GAAP margins. Unsurprisingly, they have diverged markedly. Berkshire announced $50 billion in losses under GAAP, as it is an investment holding company, but made a profit in non-GAAP terms. Asset depreciation among all those oil companies appears under GAAP but not non-GAAP figures. Some firms will do their best to dress up their books as best they can, which is entirely permissible so long as the two sets of accounts can be reconciled. We pointed out loudly and often before the pandemic that US margins were at all-time highs, but then we also recognise that the digital economy is indeed capable of generating massive margins. Moreover, there is not much that lawmakers can do about Apple- or Google-type margins obtained from monopoly positions.

Massive write-offs in the oil industry collapse GAAP margins



We are maintaining our equities overweight position and will increase it further if the index corrects below 2,900 points. The market remains risky, however, as shown by regular jumps in the VIX, which is why we are avoiding trading. One buying strategy we have considered in the scenario of a sub-2,900 dip is the sale of a call option for 70 points. If the option is exercised, our effective level would be 2,830 points even if the market dropped to 2,500 points (for example!) on the day.

We continue to overweight Wall Street

S&P 500 - Valuation end 2020 except implied scenario

CAGR Compounded Annual Growth Rate from 2019

	30 Years Gvt bonds				
	1.00%	1.25%	**1.42%**	1.75%	2.00%
Deep recession: -28% in 2020, 11% in 2021 - CAGR -1.5%	**2 956**	**2 754**	2 629	2 414	2 271
Implied Scenario CAGR 0.1% over 8 years	3 458	3 226	**3 084**	2 837	2 672
Return to normal: -26% in 2020,14% in 2021 - CAGR -0.1%	3 302	**3 074**	**2 935**	**2 693**	2 532
Current Index S&P 500			**3 009**		

The consensus earnings growth forecast for the euro zone is -36% and falling. We are retaining -40% and a 20% rebound next year. Taken as a whole, the euro zone is a 'value' market, although we acknowledge a few gems in the luxury goods sector. The zone's average 30-year rate is 0.48% and prices imply declining profits in the future. While that is possible if the economy fails to digitalise itself, the market is underpriced and our index objective is 125 points against a close last week at 114 points.

Still upside potential

MSCI EMU - Valuation end 2020 except implied scenario					
CAGR Compounded Annual Growth Rate from 2019	**30 Years Gvt bonds**				
	0.25%	0.35%	**0.48%**	0.75%	1.00%
Deep recession: -50% in 2020, 34% in 2021 - CAGR -9.7%	**109**	**106**	102	94	88
Implied Scenario: CAGR -9.1% over 8 years	122	118	**114**	106	99
Return to normal: -40% in 2020, 20% in 2021 - CAGR -7%	135	131	**125**	**116**	**108**
Current Index MSCI EMU			**114**		

Conclusions

Covid-19 is still making its relentless way around the planet, and even where it was supposed to be done with it is showing a nasty tendency to return whenever restrictions are eased. Financial markets are now paying more attention to its progress than to monetary policies, and equities appear to be caught between a relatively successful normalisation process in Europe and obvious failures to contain the disease in the USA. Donald Trump's relaxed handling of the crisis has damaged his chances of re-election; the virus seems set to dominate the election campaign and Joe Biden is not considered to be a particular friend of equity markets.

The crisis has certainly emphasised the digital economy's domination and even acceleration. The IT sector accounts for 27.7% of US market capitalisation, and if we add communications services (where Google and Facebook are classified) we can raise that to 38.4%. IT accounts for only 2.6 million American jobs in a 152 million strong labour force, but has suffered little on that front. The US leisure and hospitality sector has dropped 7 million of its 19 million pre-Covid jobs, and its share of market capitalisation has dropped from 1.9% to 1.5%. Surging bankruptcies in retailing are causing difficulties for shopping malls and the real estate firms that operate them. Smaller oil companies are falling like dominoes, leaving heavy debts behind them. While the more fragile hotel chains have benefited from payment moratoriums, they cannot hold out forever and business failures will mean even more non-performing loans. The financial sector's share of capitalisation has sagged from 22.6% in 2006 to just 10.2%, but Federal Reserve liquidity injections and a $750 billion asset purchase programme that extends even to junk have saved their day. Credit spreads have reverted to normal for prime names but are still high otherwise. In terms of share prices, IT and healthcare have not suffered from the crisis and are trading at their highs. More than 100% gains have been recorded from biotech firms working on vaccines and for DocuSign, an electronic signatures specialist. Tesla is up 129%, reflecting its status as a four-wheeled computer. E-commerce is headed firmly upwards. Thanks to its digital bias, the US market is only 10% off its peak, with a massive performance gap between the real and virtual economies.

After liquidity injections worth as much in a few weeks as in the six years following the 2008 crisis, the Fed will press on with this policy. Nobody has objected to it so far, as it is all about confidence. Stagnant demand has prevented any rise in inflation, and additional liquidity has simply boosted savings. The current risk environment and absence of viable projects are limiting investment opportunities. Yields on government bonds are zero or negative, and triple-A corporates offer little more. The equity market may be deep but it looks increasingly expensive. It is worth remembering at this time that while central banks can continue to drown us in paper money, they cannot print gold! This asset has outperformed all other asset classes over the past 20 years; although it did miserably between 2011 and 2018, it has again outpaced the S&P 500 since the 2018 crisis. It is still some way off its highs associated with the 2008 crisis. We may be getting on this particular train a little late, but we are now recommending exposure to gold, whether in physical or paper form – or in mining, especially given where interest rates are.

World GDP is expected to decline 3.9% this year. Eurozone GDP is set to drop 7.6%, with the worst numbers coming from Southern Europe including France. The USA is at -5%. Asia is still in positive territory, again outperforming the OECD. Earnings estimates are stable; our model is factoring in -26% this year and a 14% rebound in 2021 for the S&P 500. The market is valued at 18.6x 2021. Our S&P 500 valuation is a largely unchanged 2,935 points, compared with a close at 3,009 points, with a CAGR of -0.1%. We are maintaining our equities overweight recommendation and would be looking to increase our allocation in the event that the index corrects below 2,900 points. This is via a short put position that could earn us 70 points.

Jacques Chahine

Main ratios for markets and sectors as of 29/5/2020 (in local currency)

Data as of	Weight vs	Perf		Weighted P/E		% Wted EPS Chge			Div Yield	Revision vs M-2%	
26/06/20	MSCI World	2020	2019	2021	2020	2021	2020	2019	2020	Fiscal 21	Fiscal 20
MSCI The World Index	**100.0%**	**-8.55%**	**25.30%**	**17.4 x**	**22.5 x**	**29.2%**	**-24.0%**	**-1.9%**	**2.29%**	**-3.4%**	**-7.0%**
MSCI USA	63.4%	-5.92%	29.20%	19.0 x	24.3 x	28.0%	-21.4%	-0.7%	1.91%	-2.1%	-4.2%
MSCI Japan	8.5%	-8.36%	15.70%	15.1 x	19.7 x	30.5%	-13.8%	-27.7%	2.50%	-11.1%	-20.5%
MSCI EMU	13.1%	-14.15%	21.70%	14.7 x	20.9 x	41.9%	-35.8%	0.3%	2.94%	-4.9%	-11.4%
MSCI Europe	23.6%	-14.47%	22.17%	15.1 x	20.3 x	34.8%	-33.7%	3.6%	3.08%	-5.8%	-9.8%
MSCI Europe ex Energy	22.5%	-12.78%	23.79%	15.1 x	19.7 x	30.7%	-29.5%	5.5%	2.89%	-5.4%	-9.5%
MSCI Austria	0.1%	-31.73%	13.38%	9.8 x	15.7 x	61.1%	-48.9%	-25.2%	3.73%	-9.1%	-19.5%
MSCI Belgium	0.4%	-25.73%	19.37%	14.4 x	18.4 x	27.7%	-34.1%	10.9%	3.02%	-7.0%	-10.0%
MSCI Denmark	0.9%	8.48%	28.95%	23.0 x	30.0 x	30.4%	-12.7%	-4.2%	1.59%	0.6%	1.8%
MSCI Finland	0.4%	-4.51%	8.28%	16.6 x	19.7 x	19.0%	-15.5%	-0.7%	3.44%	-1.0%	-2.3%
MSCI France	4.8%	-16.31%	26.10%	15.3 x	21.7 x	41.6%	-36.7%	4.7%	2.90%	-4.5%	-10.9%
MSCI Germany	3.5%	-10.73%	20.10%	13.6 x	20.2 x	48.6%	-30.6%	-4.9%	2.85%	-3.6%	-10.2%
MSCI Great-Britain	4.7%	-18.64%	11.37%	13.6 x	18.0 x	32.2%	-34.9%	-5.4%	3.72%	-4.8%	-7.4%
MSCI Ireland	0.1%	-13.11%	21.49%	23.8 x	68.7 x	188.7%	-72.0%	-24.2%	0.67%	-23.8%	-65.5%
MSCI Italy	0.9%	-18.78%	25.49%	12.6 x	20.2 x	60.9%	-49.5%	-1.7%	4.35%	-8.3%	-20.3%
MSCI Netherlands	1.8%	-3.51%	26.85%	18.1 x	23.1 x	27.9%	-23.7%	-3.8%	2.20%	-3.1%	-4.7%
MSCI Norway	0.3%	-16.89%	8.26%	13.7 x	21.3 x	55.2%	-36.4%	-11.1%	4.06%	-6.2%	-3.9%
MSCI Spain	1.1%	-24.63%	9.85%	13.3 x	17.9 x	34.3%	-47.7%	7.0%	3.32%	-8.0%	-15.7%
MSCI Sweden	1.0%	-6.22%	25.01%	16.0 x	21.8 x	35.9%	-45.7%	67.2%	2.79%	-10.9%	-8.0%
MSCI Switzerland	3.4%	-5.78%	26.97%	17.1 x	19.9 x	16.2%	-8.8%	9.6%	3.06%	-1.4%	-3.4%
MSCI Europe Consumer Discretion	3.1%	-18.61%	30.01%	16.5 x	41.6 x	152.8%	-65.9%	-11.7%	1.22%	-10.3%	-37.0%
MSCI Europe Consumer Staples	3.5%	-6.75%	22.38%	17.8 x	19.8 x	11.0%	-8.7%	9.9%	2.94%	-4.0%	-4.4%
MSCI Europe Energy	1.1%	-37.99%	3.55%	14.3 x	46.8 x	226.4%	-82.2%	-14.8%	6.93%	-11.2%	-22.8%
MSCI Europe Financials	3.4%	-28.08%	17.31%	9.7 x	13.4 x	37.3%	-44.6%	15.1%	4.05%	-7.9%	-12.8%
MSCI Europe Health Care	3.6%	2.01%	28.40%	16.4 x	18.3 x	11.3%	2.0%	9.3%	2.68%	-1.7%	-1.8%
MSCI Europe Industrials	3.1%	-15.85%	32.02%	17.6 x	25.6 x	45.2%	-37.0%	4.8%	2.35%	-6.0%	-11.7%
MSCI Europe Information Technol	1.6%	1.20%	36.00%	21.7 x	28.3 x	30.2%	-9.1%	5.0%	1.02%	-1.8%	-3.0%
MSCI Europe Materials	1.6%	-12.58%	21.39%	16.1 x	21.0 x	30.5%	-25.3%	-12.9%	3.57%	-3.3%	-6.8%
MSCI Europe Real Estate	0.3%	-23.57%	18.93%	14.6 x	16.3 x	11.8%	-30.8%	-15.6%	4.30%	-7.4%	-7.8%
MSCI Europe Communication Serv	1.1%	-19.04%	0.60%	12.8 x	15.0 x	17.7%	-19.3%	2.4%	4.43%	-7.0%	-9.9%
MSCI Europe Utilities	1.3%	-2.87%	24.29%	15.2 x	16.9 x	11.0%	-9.2%	24.0%	4.59%	-1.6%	-3.9%

Benchmarks source iShares ETF - Data as of 26/06/2020

Disclaimer

We do not warrant, endorse or guarantee the completeness, accuracy, integrity, or timeliness of the information provided in this publication. You must evaluate, and bear all risks associated with, the use of any information provided here, including any reliance on the accuracy, completeness, safety or usefulness of such information. This information is published solely for information purposes, and is not to be construed as financial or other advice or as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. Any information expressed herein on this date is subject to change without notice. Any opinions or assertions contained in this information do not represent the opinions or beliefs of the publisher. The publisher or one or more of its employees or writers may have a position in any of the securities discussed herein.

THE INFORMATION PROVIDED TO YOU HEREUNDER IS PROVIDED "AS IS," AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, J.CHAHINE CAPITAL AND ITS AFFILIATES, BUSINESS ASSOCIATES AND SUPPLIERS DISCLAIM ALL WARRANTIES WITH RESPECT TO THE SAME, EXPRESS, IMPLIED AND STATUTORY, INCLUDING WITHOUT LIMITATION ANY IMPLIED WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, ACCURANCY, COMPLETENESS, AND NONINFRINGEMENT. TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW,NEITHER DIGITAL ANALYTICS NOR ITS AFFILIATES,NOR THEIR RESPECTIVE OFFICERS, MEMBERS DIRECTORS, PARTNERS, BUSINESS ASSOCIATES OR SUPPLIERS WILL BE LIABLE FOR ANY INDIRECT, INCIDENTAL, SPECIAL, CONSEQUENTIAL OR PUNITIVE DAMAGES, INCLUDING WITHOUT LIMITATION DAMAGES FOR LOST PROFITS OR REVENUES, GOODWILL, WORK STOPPAGE, SECURITY BREACHES, VIRUSES, COMPUTER FAILURE OR MALFUNCTION, USE, DATA OR OTHER INTANGIBLE LOSSES OR COMMERCIAL DAMAGES, EVEN IF ANY OF SUCH PERSON IS ADVISED OF THE POSSIBLILITY OF SUCH LOSSES, ARISING UNDER OR IN CONNECTION WITH THE INFORMATION PROVIDED HEREIN OR ANY OTHER SUBJECT MATTER HEREOF.