# The remarkable resilience of US profits


## Summary

While the media are focused on an apparently endless cycle of Covid news, Wall Street has been setting one imagination-defying record after another. The Nasdaq, IT and biotech have soared to new highs: the index has outstripped the S&P 500 by 62% over the past 15 years, with an acceleration in that trend since the pandemic broke out. Annual average performance over the past 30 years has been 12%, highlighting the extent to which society is being transformed. IT has penetrated deeply into every sector of the economy; its weight in the S&P 500 has risen from 13.6% at the beginning of 1997 to 28.2%, and of course it has been critical to the creation of giants in other sectors, such as Amazon and Tesla in cyclical goods and Google, Facebook and Netflix in communications. A great many other firms are based on digital technology. Back in 1997, the biggest company in terms of capitalisation was General Electric; it now a relative pygmy among industrial stocks, neglected by firms opting to subcontract blue-collar jobs abroad. Even Boeing has demonstrated an inability to make things properly. The next battleground will be automotives, where Tesla is attempting to become the sector's iPhone and could well succeed. Volkswagen's boss says that the future is in software and direct sales… Tesla is capitalised at over $375 billion and has stolen a somewhat provocative march on its German competitors by setting up shop in Berlin and offering to share its technology. Our economies are changing dramatically, and the pandemic has hastened it all through e-commerce, home working, transport and healthcare, for example. American monopolies have been the big winners, leaving Europe to import almost all its high-tech requirements and live off low-margin automotive and industrial products.

Growth opportunities are particularly attractive when interest rates are zero or negative, which is why GAFAM, hi-tech stocks and firms like Tesla are doing so well in stock market terms. Share prices for some niche healthcare companies have risen exponentially. In contrast, the pandemic has badly damaged the financial sector, energy and most cyclicals. The structural make-up of the US economy has made it more resilient than most: the drop in US profits is likely to be limited to 19% this year, compared with drops of 36% in Europe and even 40% for eurozone firms (and that latter figure is being revised lower). The MSCI World index has risen overall this year, but European markets are lagging. Our Digital funds are up, however.

US Q2 earnings held up incredibly well, posting a genuine surprise at 20% over expectations. The overall drop in earnings for the year has been revised from 24% to 20%. The decline in profits is concentrated in low PER sectors such as energy, finance and air transport. Some IT, healthcare and consumer staples companies are reporting higher profits. The consensus expectation is for a 28% rebound in 2021, but we are pencilling in 21%. And even with a PER of 20.8x 2021, the market's earnings yield is 4.8%, compared with a 30-year yield of 1.38%... But these projections could collapse if the pandemic persists or if investors react badly to a Biden victory in the presidential election.

World GDP is expected to contract 4.4% in 2020. That number is revised from 3.85% in June, confirming that the post-lockdown rebound is not as vigorous as it had been assumed. The world economy is then expected to grow by 5.4% next year, albeit subject to a great deal of uncertainty related to the pandemic. Europe has been among the most badly damaged regions and we can only hope that the stimulus package agreed by EU member states will do its intended job. Some US macroeconomic indicators are looking better, notably a massive return to work and good PMIs. But America's trade deficit has worsened, and together with massive Fed injections this has undermined the value of the dollar. We are planning to reduce our exposure to the greenback and are maintaining our buy recommendation on gold that we issued at the end of June.

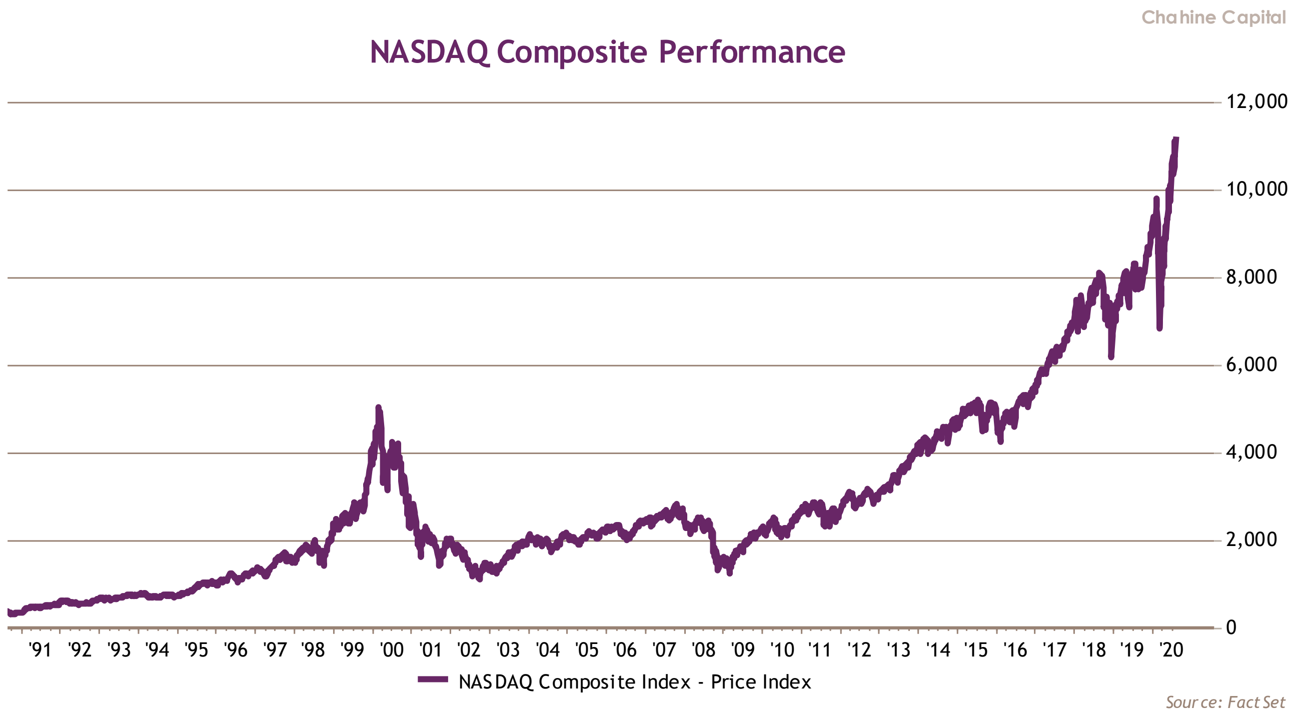
Our S&P 500 valuation is up to 3,452 points on the back of better corporate results and we are sticking with our overweight recommendation. In Europe, our valuation suggests a market priced at fair value.


*Jacques Chahine*

## Lift-off for the Nasdaq and hi-tech stocks

While the media remain fixated on bad news around Covid-19, Wall Street is posting record after record in a way that would have defied imagination. The S&P 500 index closed on 21 August at 3,397 points, above its 19 February high of 3,386 points. The Nasdaq index of IT and biotech stocks closed at its own record 11,312 points, emphasising an even more impressive rebound from its Covid lows. The Nasdaq was already responsible for one of the biggest bubbles in market history and lost 78% of its value when the dotcom craze collapsed in 2000. It took 12 years to recover from that one and renew with 5,000 points, and has clearly more than doubled since. The investors that were in raptures over the internet back in 2000 turned out to be right, but somewhat ahead of time! It took several types of technology to mature before the benefits of the internet really became evident. Amazon existed during the dotcom bubble, but it was basically a bookshop back then. Google was in its early days, and had not yet started eliminating its competitors, Apple was there but its iPhone appeared only in 2007. Facebook dates back to 2004. Microsoft is the only one of these companies to have maintained a leadership position throughout and is now battling Apple for the title of world's largest market capitalisation. At the beginning of 1997 that crown was held by General Electric, which is now struggling to survive.

### Annualised performance of 12% over 30 years

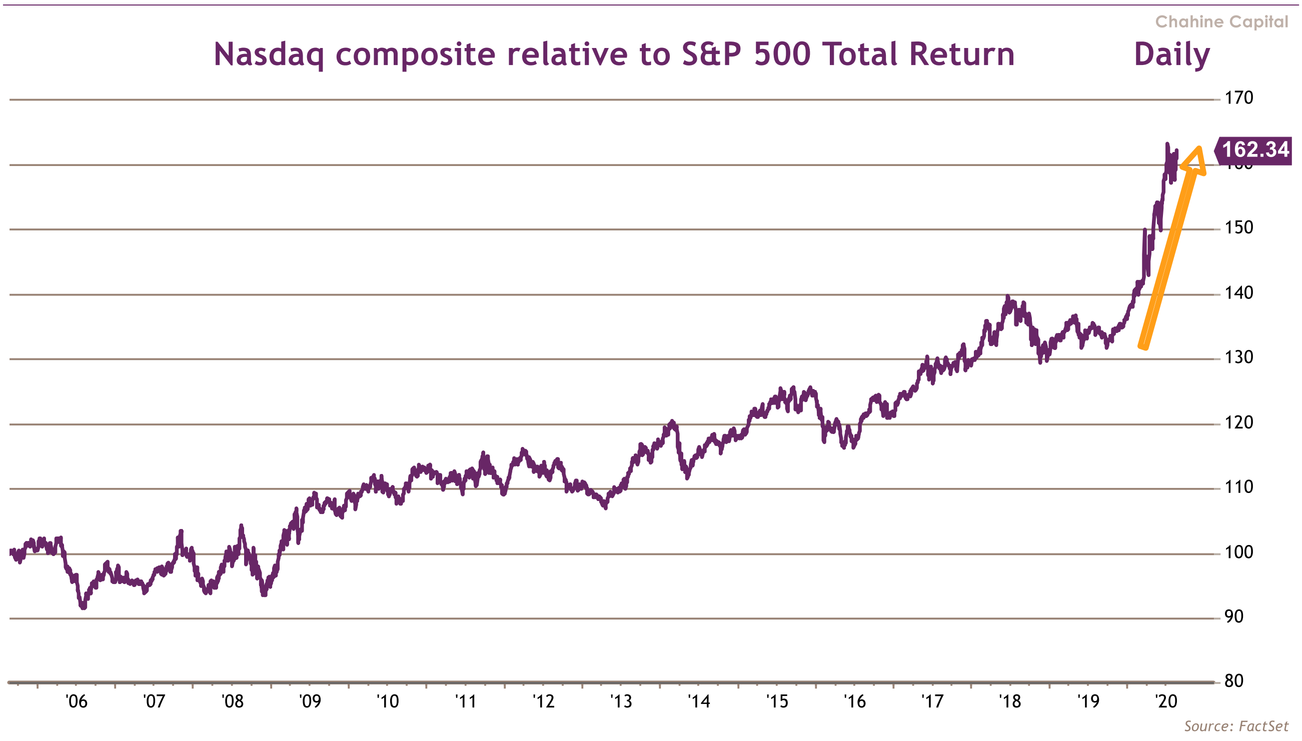



## Automotives, the next high-tech target?

One of the stars surging out of nowhere is Tesla, which is not even included in the good old S&P 500 yet. It is now capitalised at $384 billion, making it the ninth largest listed company. Assuming that the market is not actually insane, this valuation points to the imminent transformation of the car industry into four-wheeled computers. From just under 500,000 Tesla vehicles sold in 2020, analysts expect 930,000 in 2022. The market does not believe that traditional manufactures will catch up, either;  Tesla has had the impudence to open a factory in Berlin. Volkswagen is doing its best to make the attempt on the hi-tech side and is hiring aggressively. According to its boss, “The big differentiator in the future will be software, direct customer contact, the car becoming an internet device”.

Covid has merely accelerated an already substantial transformation in the economic environment, and this is what we see in Nasdaq outperformance relative to the S&P 500.

### A pandemic effect on hi-tech stocks




There are very many examples of Covid-related lift-offs. The obvious place to start is healthcare, where firms involved with vaccines, diagnostics or other pandemic-related research have seen their share prices multiplied by 20 times over in some cases. Elsewhere, we could cite an e-commerce company whose share price has jumped 16-fold since the start of the year, Zoom (up three times over to capitalise at $81 billion), Tesla (up four times over) together with other stocks related to electric cars, a new cloud company (up three times over), artificial intelligence specialists and DocuSign in electronic signatures. These sorts of niche enterprise are clearly characteristic of the times we live in. But the internet giants have benefited greatly as well: Amazon, needless to say, Microsoft via home working and its cloud division, social media companies busy entertaining people with time on their hands, Apple – again, thanks to home working – plus Walmart, Netflix and many others. Google has gained only 18%; its business model relies on what are now slumping advertising revenues, but its investors are in a forgiving mood.

## The Covid effect on the tech revolution

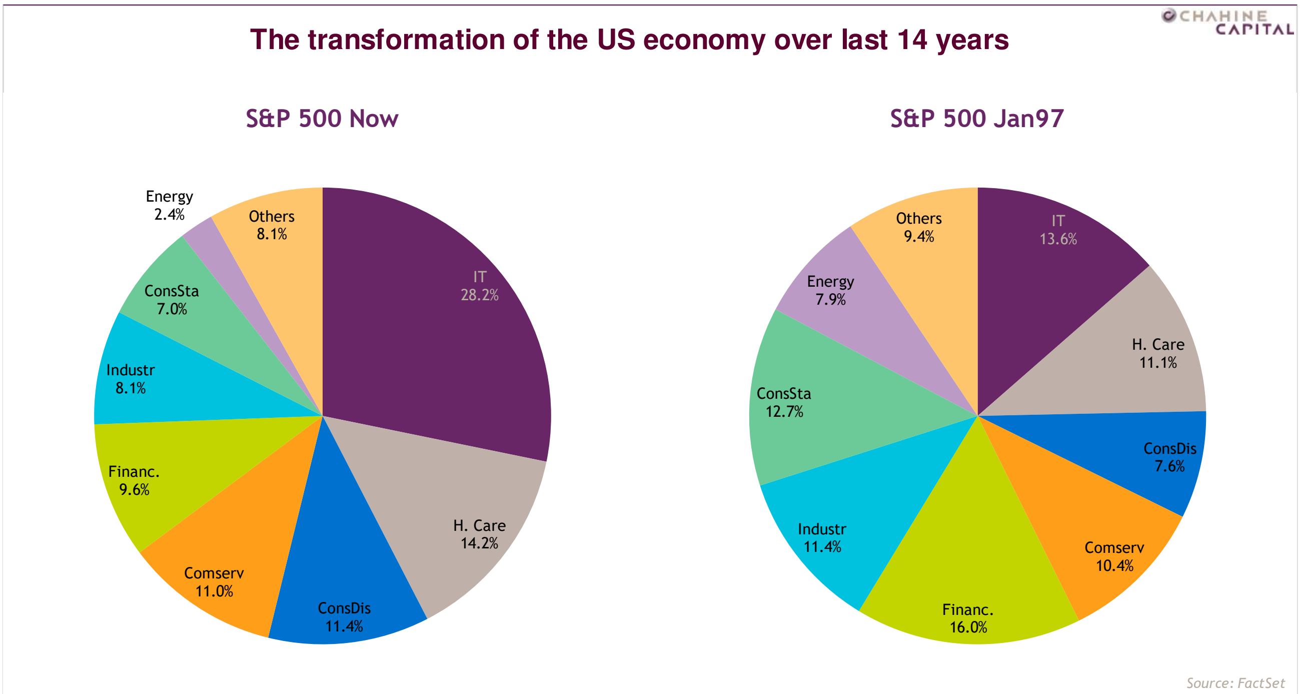
In a context of zero or negative interest rates, growth stocks are particularly attractive. As we have seen, the share prices for GAFAM and hi-tech names such as Tesla have soared. Some of the habits formed during lockdown will persist, starting with remote working. The switch from office to technology proved incredibly smooth. We have all discovered that we really don’t need to travel all the time, and teleconferences are perfectly adequate most of the time. Shareholder meetings can be virtual, and decisions confirmed by electronic signature. Legal agreements have been signed virtually in the same way. We have realised that just about anything can be purchased via the internet, including groceries. Food used to be considered the exception to online buying. Many of these practices will continue long after the pandemic, which has vastly accelerated a process that was already under way. Changes in sector weights over the past 14 years of US stock market history reflect precisely that.

The most obvious change has been the jump in the capitalisation share of IT within the S&P 500 from 13.6% to 28.2% over the period, especially as today's figure is an underestimate. Note that many firms reliant on digital technology are classed in other sectors. Classified as a discretionary consumer stock, Amazon is a prime example. Similarly, a whole new sector has been created – communication services – that hosts names like Google, Facebook and Netflix alongside a moribund telecoms segment that would have accounted for 6.3 points of its 10.4% capitalisation in January 1997. Apart from Amazon, discretionary consumers include Booking.com; the sector will also include Tesla once it is added to the index. The big losers over the period are all more traditional sectors: financials were the biggest sector in 1997 at 16% but are now down to 9.6%, consumer staples are down to 7% and energy has slumped from 7.9% to 2.4%. The transformation of the discretionary consumer goods sector is all the more remarkable for the fact that its weight has increased overall. Amid so many well-publicised bankruptcies in traditional retailing, Amazon has gone from strength to strength. It represents fully 4.9 points of the 11.4% sector weight. Automotives do not amount to much of a sector these days but will bounce back once Tesla joins the index, weighing $380 billion compared with $62 billion for Ford and GM combined. The Tesla story has much in common with iPhone, which dethroned Nokia in telecoms and Sony in terms of 'infotainment' and photography. Investors are ready to believe that Tesla will destroy a traditional car industry that took 120 years to get to where it is now.

Unsurprisingly, the pandemic has boosted the profile of the healthcare sector, which now ranks second to IT in the S&P 500. Although mega-mergers have turned the pharmaceutical majors into inefficient monsters, new biotech players have emerged on the back of new breakthroughs. The majors are only too happy to gobble them up when they do so. Not all investors will remember Bristol-Myers, Wyeth, Schering-Plough or Warner-Lambert, for example, who have disappeared alongside so many European firms in the same business. Covid has seen the majors leaning heavily on innovators in their search for a vaccine, although they are well-placed to produce millions of doses once they are identified.

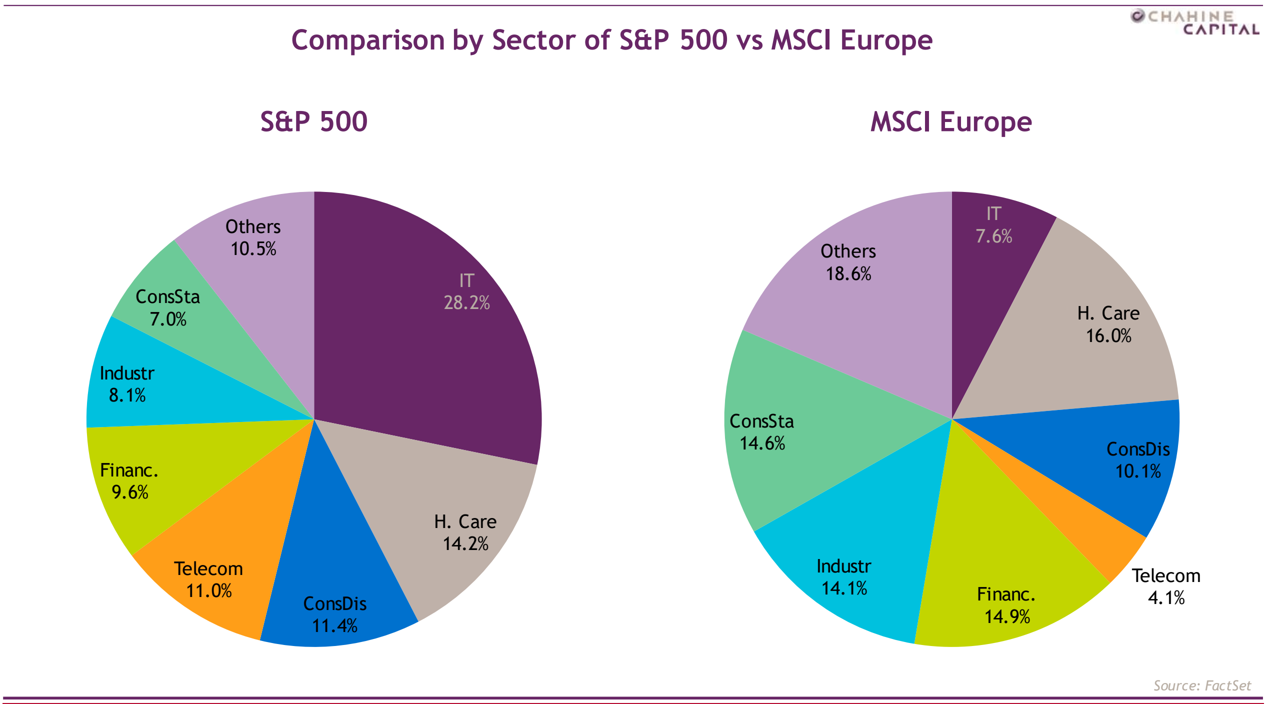
The industrial sector has lost just under 2 points of its capitalisation share since 1997. GE accounted for 3.1% of market capitalisation all on its own back then, and is down to 0.2% today. Boeing used to be the sector's big star but is now in disgrace. Industry is no longer attracting American entrepreneurs; its environmental footprint and tight margins have destined it for subcontracting, often in Asia. Apple assembles in China and Tesla sources battery components from joint ventures in South Korea, China and Japan, presumably well protected with its patents. One of its latest patents covers a battery that can last for a million miles… The inability of Americans to produce these components implies opportunities for Asia and Europe to create hi-tech industrial goods along German, Swiss or Nordic lines.

## An accelerated economic transformation




All in all, the structure of the US economy has enabled it to cope with the pandemic better than anywhere else. Profits are expected to decline 19% in the USA this year, compared with 36% in Europe and as much as 40% in the euro zone. And the latter estimate is still being revised downwards.

## European companies are more exposed to the crisis



The structural differences between the European and American economies explain this gap in earnings performance. Firstly, Europe has a much smaller IT sector. Its two leaders are SAP, which is highly specialised in a compatibility niche and ASML, a leader in semiconductors that makes the machines that in turn make the world's most advanced microprocessors. It has recently suspended the sale of an a machine to China in response to American pressure. Dassault Systèmes is iconic but capitalises at $46 billion, nowhere near the trillions that its big US competitors weigh. Europe has a relatively large healthcare sector but it is made up mainly of majors rather than biotech stars. It has no equivalent of Amazon in cyclical stocks, although fortunately it does have all of the world's top luxury goods names. Thanks to the top end of German production, the European automotive sector still matters, but it hold off Tesla? In communications, the big telecoms operators do not have the same sort of comfortable future that their American equivalents have. There is nothing to compare with social media names like Facebook, nor Netflix. The financial sector is a mainstay of the European index but has sagged with the crisis and remains vulnerable. Yes, Europe has an impressive industrial sector, but it operates on tight margins and is sensitive to the state of the economy. Airbus has pulled well ahead of Boeing but is capitalised at just $63 billion and struggles to make money even in good years. Europe is certainly ahead in consumer staples, thanks largely to Nestlé and l'Oréal. Energy is buried in 'Others', but over-represented in Europe and is of course taking a massive hit from the pandemic.

All in all, these comparisons show that most European firms - particularly finance, energy and automotives – are pulling index earnings down, and apart from healthcare there are not many that are showing much resilience.

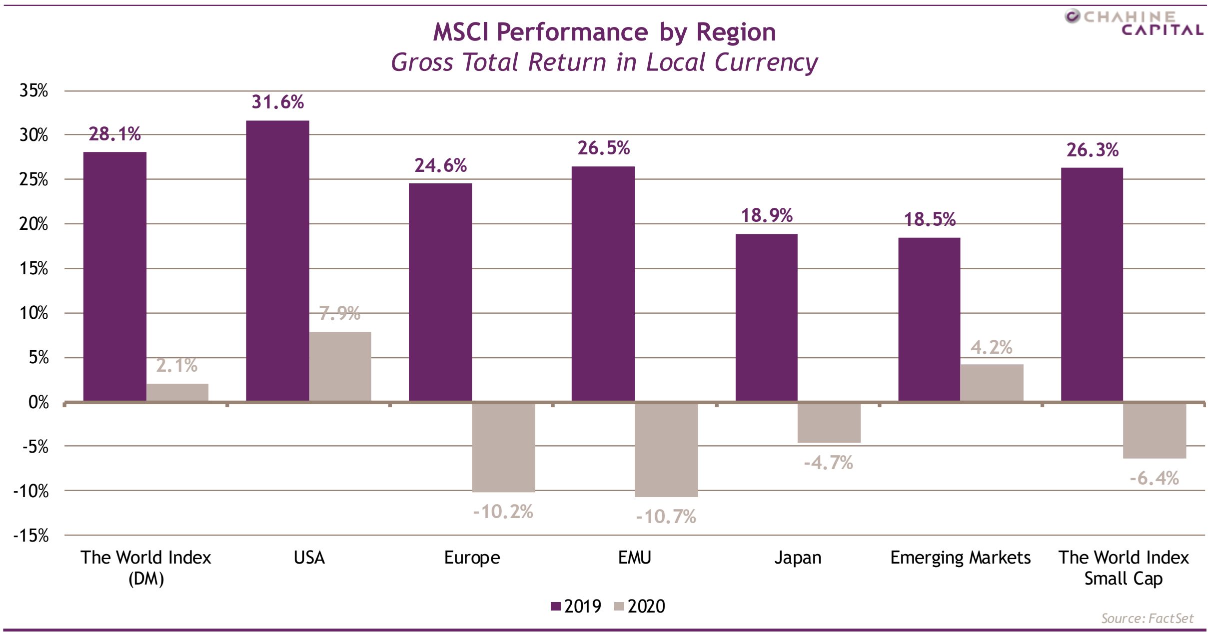
## The MSCI World index back in positive territory for 2020

Thanks to Wall Street's overall gains this year – in total return terms, the MSCI USA index is up 7.9% and the S&P 500 6.5% - the MSCI World is now 2% higher than where it was at the start of the year. For the reasons just mentioned, Europe is still down more than 10%, although our Digital funds are up between 1% and 5%. Emerging markets have helped close the gap, especially in Asia, while the Japanese market has limited its losses to 5%.

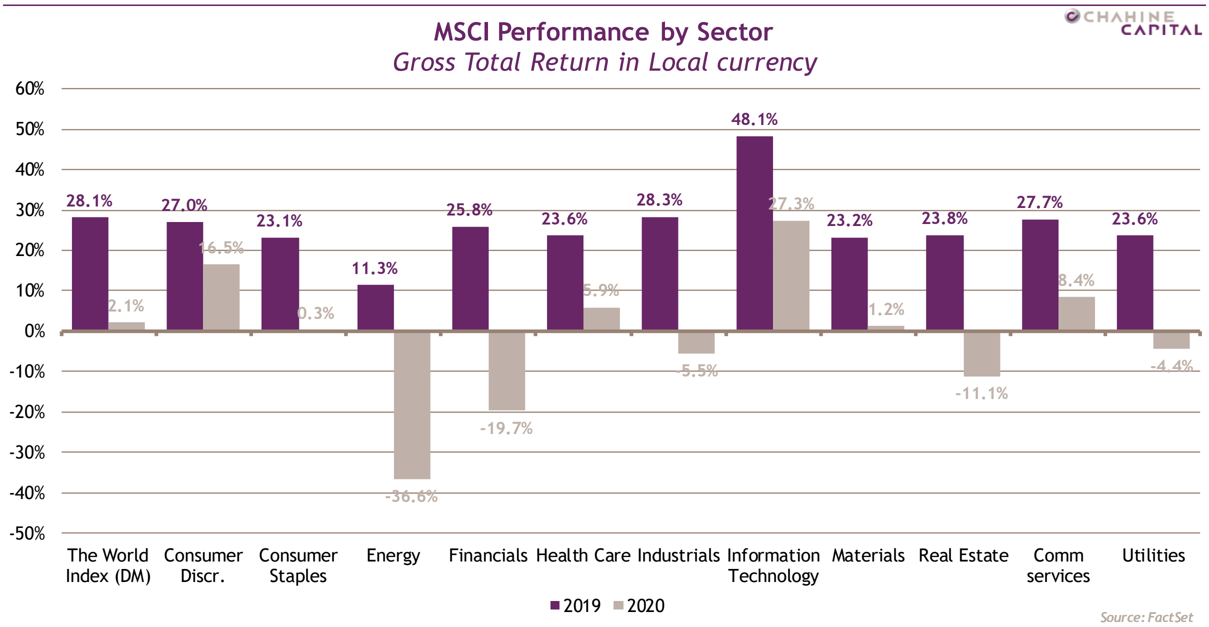
By sector, IT is at the top of the leader board with an average 27% gain spread across a large number of stocks but including 78% for Apple; next is the discretionary consumer sector, explained entirely by Amazon and Tesla. Facebook, Google and Netflix account for the communication services result. As we have seen, the crisis has hugely benefited some companies and severely damaged others, such as energy (via lower oil prices) and finance (via heightened risks and provisioning against them). The real estate sector has limited its losses to 11% overall but we note corrections of over 50% for shopping mall groups such as Simon Properties and (the segment's leader) and Unibail Rodamco.

It is hard to see how IT and other hi-tech stocks can maintain their uptrends, especially as the economic downturn will stifle purchasing power. There has to be a point at which we all have enough smartphones and innovation starts to dry up. It is no longer Apple that is developing new apps but a whole new segment that is increasingly reluctant to pay Apple its 30% cut. As far as technology in general is concerned, China is retaliating against the West's efforts to block tech transfer by banning specific companies once it has the autonomy it seeks. It has threatened Windows and a ban on iPhones on the Chinese market could be next. That market is bigger than Europe and the Americas put together and the government has made technological independence a priority.

## US firms less exposed to the crisis



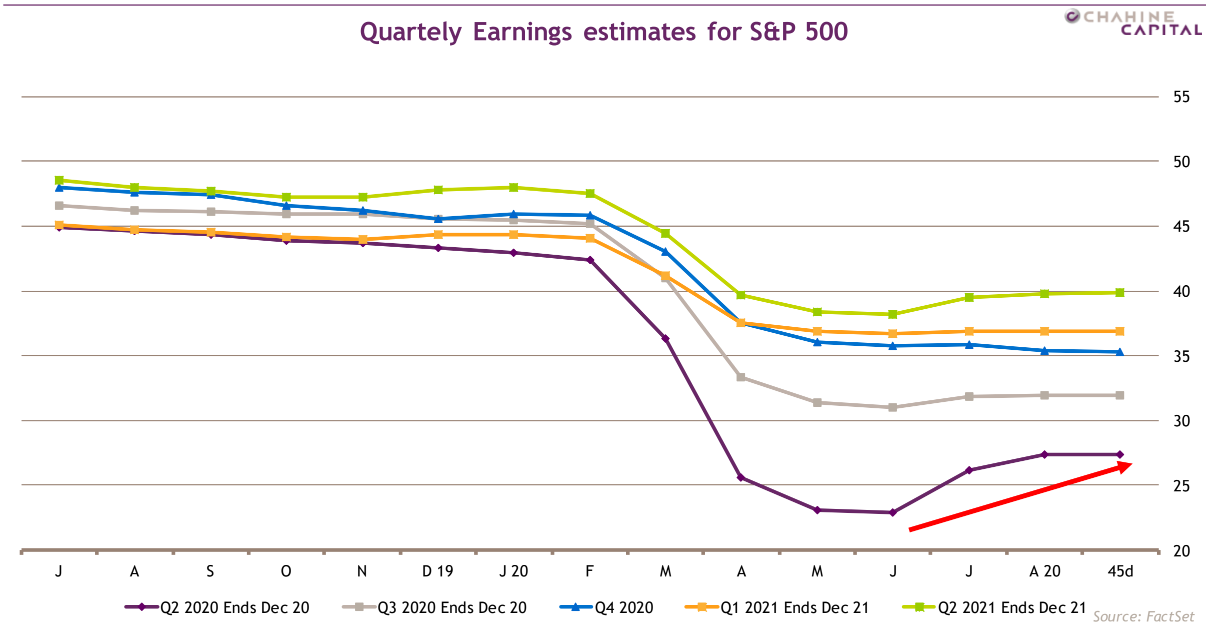

## A dizzying rise in IT share prices




# US Q2 results better than expected

Q2 results were far more resilient than expected, and amount to a real surprise compared with expectations at end-June and given the economic situation. The consensus estimate for S&P 500 companies was 22.91 points per share, a number we retained in our model, but the final figure was some 20% better at 27.39. Although we assumed that analysts were being as over-optimistic as usual, the Q2 numbers have prompted a rise in estimates for Q3 and the maintenance of those for Q4. All in al, 2021 EPS for the index has been revised from 123 to 127 points, and our model was at 120.2. We believe that these results justify a good part of the market's rally over the summer. The decline in profits this year could be limited to 21.8%, compared with the previous consensus forecast of 24.2%, which is what we use in our model.

## America's resilient profits




We are still looking at a serious drop in profits, but it is concentrated in traditionally low-PER sectors such as energy (reporting losses) and finance (down 35%). Three sectors – consumer staples, healthcare and IT – are reporting higher profits. Some of the biggest losses concern airlines, which expect to be an aggregate $23 billion in the red this year, and that does not include companies outside the index. Cruise ship operators are in a similar situation.

Consensus estimates for the first two quarters of 2021 are buoyant and the full-year projection is 28%. That would put US profits back at their 2019 cycle high. Our own estimate is a more cautious 21.6%. The 2021 PER with such a rebound would be 20.8, which is extremely high in a context of historically low interest rates. The earnings yield is 4.8%, compared with a 30-year yield of just 1.38%...

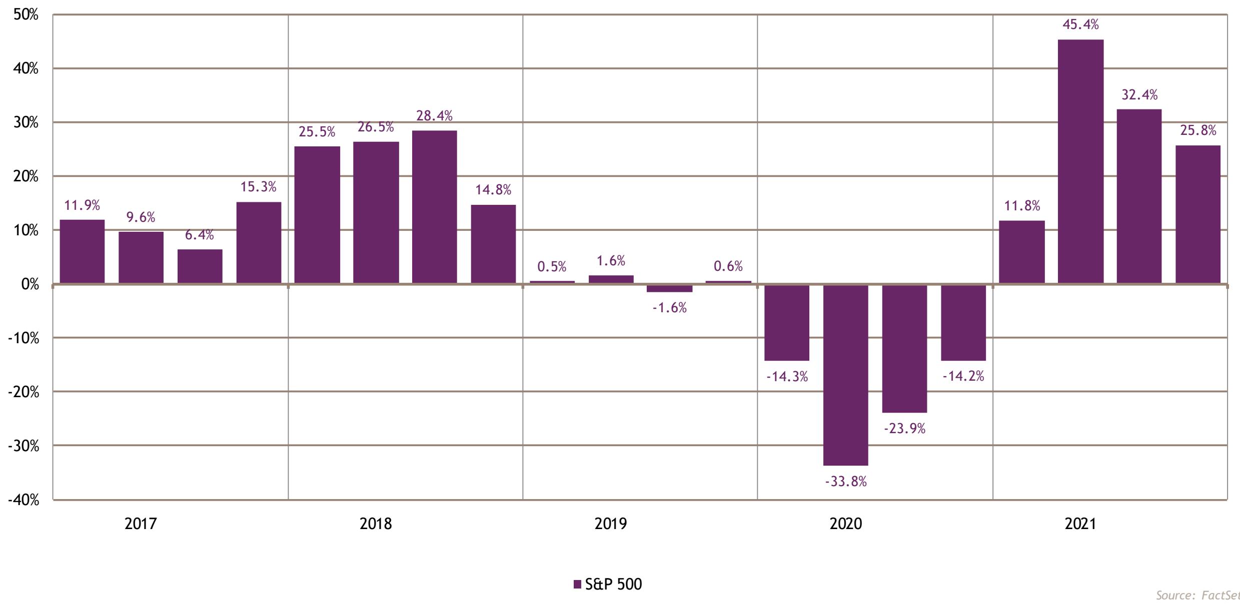
Confidence in next year's earnings is not unshakeable, and assumes that the pandemic comes under some sort of control. That is of course far from certain and it is unclear how we are going to get through the rest of 2020, let alone beyond that. Hopes rest with a miracle vaccine; some 200 are being developed and around a dozen are at an advanced stage, with news on their effectiveness likely by the end of the year. Other unknowns are the US presidential election, where the financial markets would prefer Donald Trump's re-election and the Democrats his total defeat. While there is certainty in the continuation of massive liquidity injections, there has to be a risk of indigestion given the staggering quantity of dollars already in circulation and the extent to which they have already boosted Wall Street.

## High capitalisation multiples amid very low interest rates

| *Data as of* | Weight vs | Perf | | Weighted P/E | | % Wted EPS Chge | | | Div Yield | Revision vs M-2% | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *21/08/20* | S&P 500 | 2020 | 2019 | 2021 | 2020 | 2021 | 2020 | 2019 | 2021 | 2021 | 2020 |
| S&P 500 | 100.0% | 5.1% | 28.8% | 20.8 x | 26.1 x | 25.6% | -19.4% | 0.1% | 1.77% | 1.7% | 4.0% |
| S&P 500 ex Energy | 97.7% | 7.2% | 30.0% | 20.7 x | 25.5 x | 23.0% | -15.9% | 1.9% | 1.67% | 1.4% | 3.9% |
| | | | | | | | | | | | |
| Consumer Discr. | 12.1% | 23.1% | 26.2% | 31.7 x | 53.8 x | 69.6% | -42.3% | -1.2% | 0.90% | 6.3% | 29.7% |
| Consumer Staples | 7.6% | 1.7% | 24.0% | 20.3 x | 21.8 x | 7.6% | 0.6% | 0.9% | 2.85% | 1.2% | 1.5% |
| Energy | 2.3% | -41.0% | 7.6% | 26.1 x | | Recov | Loss | -30.5% | 6.02% | 20.7% | 44.6% |
| Financials | 9.2% | -21.2% | 29.1% | 12.7 x | 16.6 x | 31.1% | -34.6% | 7.0% | 2.52% | -0.6% | 4.2% |
| Health Care | 13.9% | 4.6% | 18.4% | 15.9 x | 17.7 x | 11.6% | 3.3% | 7.5% | 1.82% | 2.3% | 4.8% |
| Industrials | 8.1% | -6.6% | 26.6% | 20.0 x | 36.7 x | 83.7% | -50.4% | -3.7% | 1.86% | 0.1% | -5.0% |
| IT | 27.8% | 28.4% | 48.1% | 25.6 x | 29.1 x | 13.8% | 3.4% | 1.1% | 1.09% | 1.8% | 2.9% |
| Materials | 2.5% | 0.8% | 22.5% | 19.7 x | 25.4 x | 28.6% | -17.8% | -18.7% | 2.21% | 4.8% | 4.9% |
| Real Estate | 2.6% | -7.8% | 24.8% | 50.0 x | 51.2 x | 2.3% | -28.5% | -2.3% | 3.11% | -4.8% | -0.5% |
| Comm Services | 11.1% | 10.3% | 30.4% | 21.6 x | 25.7 x | 19.3% | -10.1% | 2.4% | 1.15% | 0.9% | 2.9% |
| Utilities | 2.8% | -8.5% | 22.9% | 17.8 x | 18.8 x | 5.5% | -0.7% | 2.2% | 3.53% | -1.8% | -1.3% |

## Expected 2021 profits at 2019 levels

### Quarterly Earnings per Share growth S&P 500



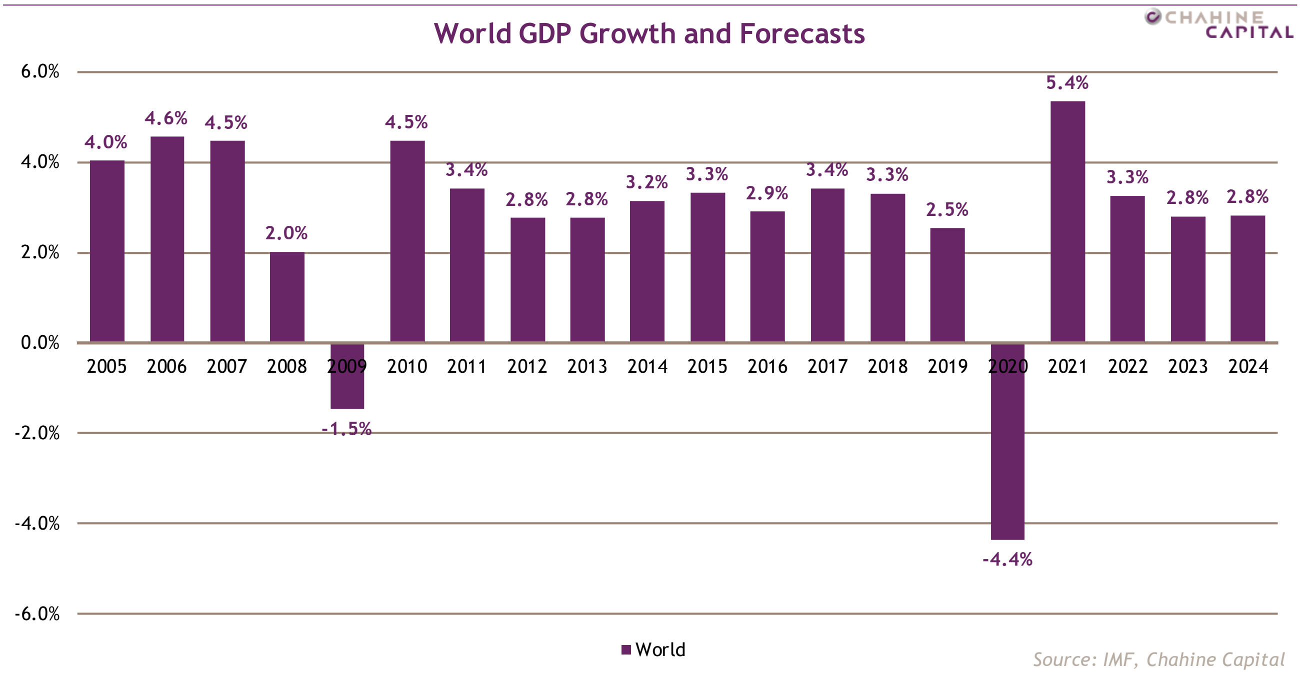

*Source: FactSet*

## World GDP set to contract 4.4%

The latest estimate of the drop in world GDP compares with forecasts of 3.85% in June and confirms the sluggish nature of the post-lockdown recovery. By way of comparison, during the financial crisis the world economy contracted by around 2% in 2008 and a further 1.5% the following year. The overall drop was worth around 6% over the whole crisis; GDP rebounded 4.5% in 2010 and growth was maintained at around 3% in subsequent years.

The consensus macroeconomic world growth forecast for 2021 is 5.4%, which would represent a rebound to more or less the GDP of 2019. If that is what actually materialises, the contraction in activity will be smaller and shorter than that associated with the financial crisis. But we repeat that it implies a *modus vivendi* with Covid-19 and therefore a return to something nearer normality and renewed international trade. The leisure sector matters a great deal to many countries and was one of the few areas in which households tended to spend freely; for that reason, there is serious money seeking out struggling hotel chains.

### A 2021 rebound plagued by uncertainty

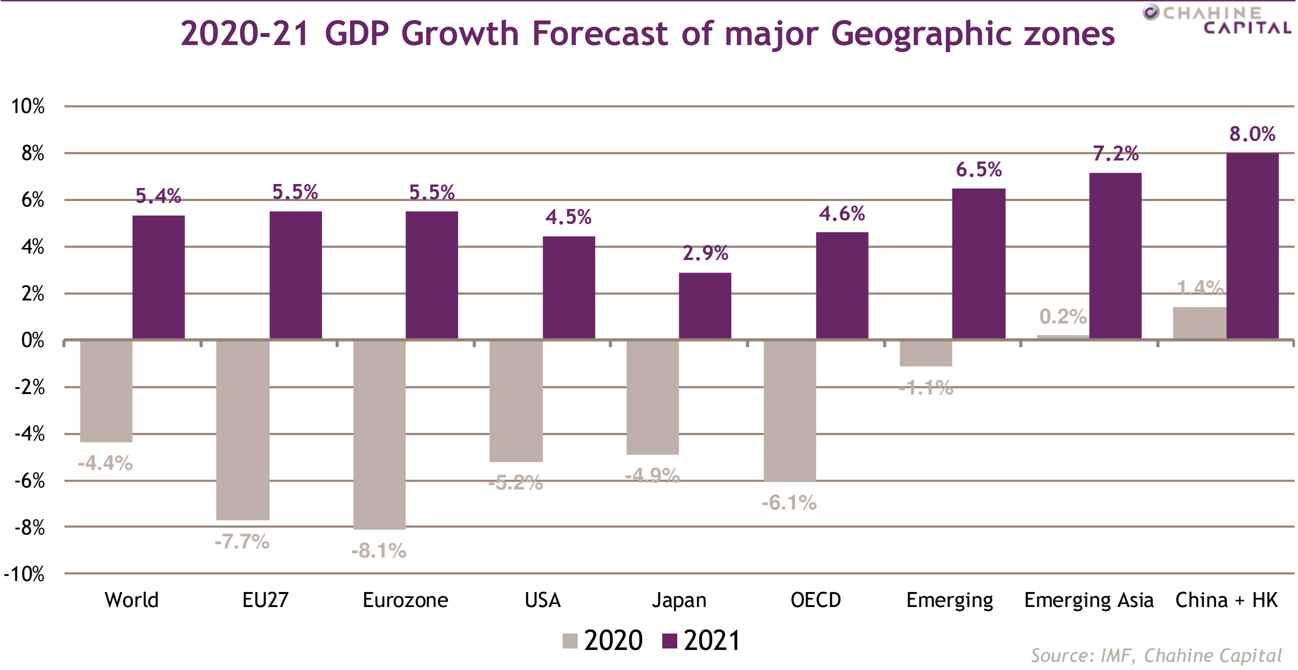


Source: IMF, Chahine Capital

The euro zone economy will be the hardest hit this year with an estimated 8.1% contraction; its southern member States are looking at 10% or more, including France. The UK economy is expected to contract 9.4%, and Brexit will make matters worse. The Nordic economies are holding up better, with declines in GDP likely to be limited to 5%. Despite its coronavirus infection rate, the USA is on course for a 5.2% drop (estimated at 4.9% two months ago). Chinese GDP is projected to rise 1.5%, although Hong Kong is looking at -5%.

The expected 5.4% rebound in world GDP next year includes growth worth 8% in China. The euro zone is hoping for a dramatic rebound, which apart from the pandemic will depend on the success of its stimulus package. US growth is pencilled in at 4.5%. In our view, all these forecasts assume a return to a semblance of normality.

## A sharp rebound in activity next year, assuming Covid is under control




# Better US macroeconomic data

As the chart below shows, Covid-19 is far from tamed in the USA. The country has suffered more deaths from the disease than any other, and the total continues to worsen. Brazil, Mexico and India are also reporting exceptionally high death tolls. Worldwide, efforts are focusing on preventing a so-called second wave. Mr Trump's denial of the crisis could well cost him re-election, and despite his inflated claims to the contrary it seems that the most powerful nation on the planet is unable to test enough people to prevent further contamination. The president is presumably working on the theory that a vaccine will materialise before the election date.

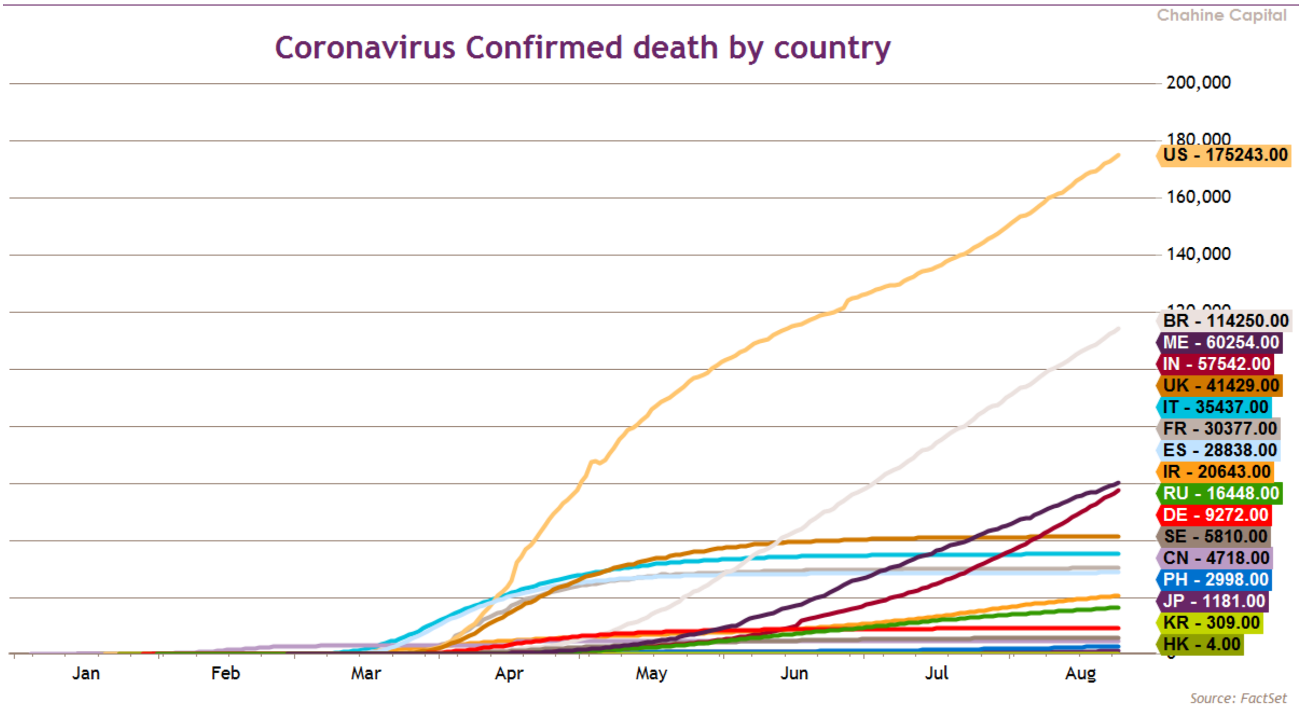
The US economy shed 21 million jobs in April but has renewed with hiring and some 9 million unemployed are back at work. For once, the welfare system went for generosity, and an extra $600 per week on top of unemployment benefit worked out as a substantial increase in income for some of those that lost their jobs. Unfortunately, that scheme ended in July and Congress cannot agree on an extension. People that kept their jobs benefited from an 8% increase in hourly wages, although that gain is now down to 4%. Even in the leisure and hospitality sector, where the number of employed slumped from 16 million to 8 million, employment is back up to 12 million. We do not have equivalent statistics for France, but we suspect that government support for wage bills will have avoided a similar labour market profile.

US consumer confidence dipped sharply – although not to the lows seen during the 2008 crisis – and has picked up slightly since. Consumers remain cautious, and their spending in June was still 5% lower than it had been the year before.

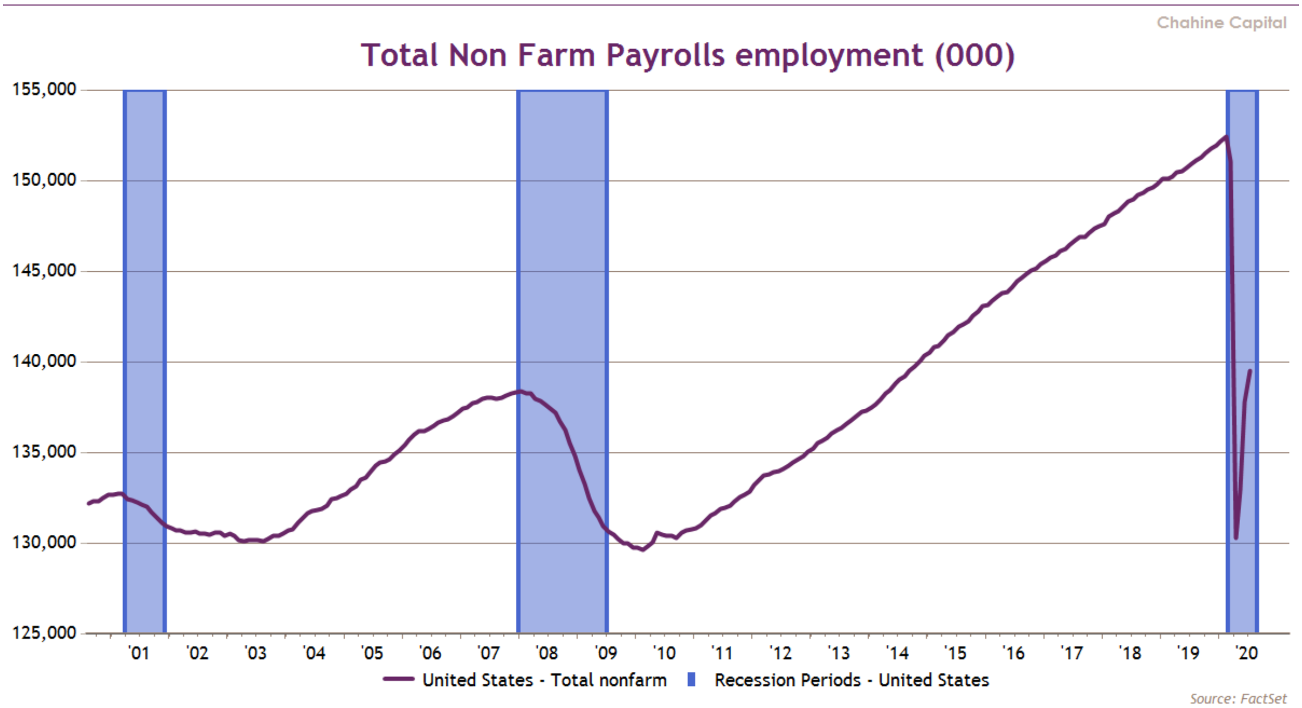
The US trade deficit has worsened from $35 billion to over $50 billion during the pandemic, which has moved more dollars into third countries. Together with Fed liquidity injections, this has prompted dollar depreciation against the euro and other currencies.

The end of lockdown has boosted existing and new home sales. Many households are now looking to buy houses and move out of apartments in case of renewed lockdowns and to ease home working. Residential property prices continue to rise.

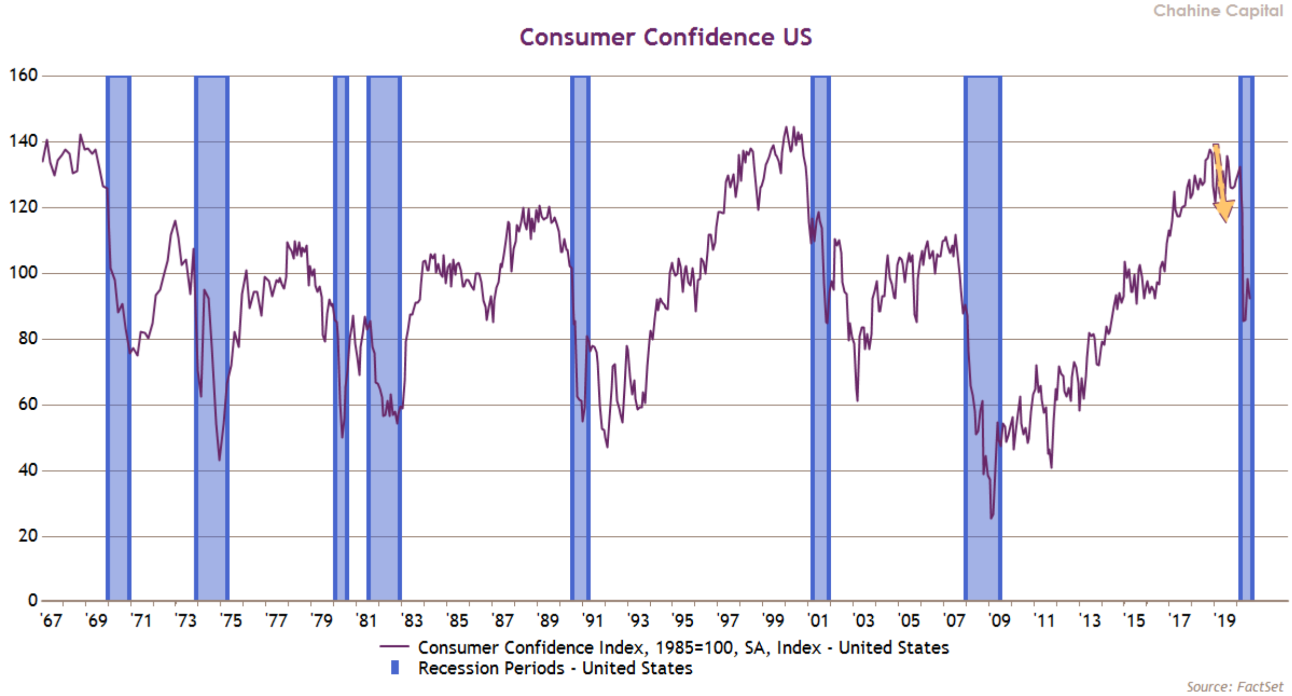
## Rampant coronavirus could cost Mr Trump his re-election




## A swift but partial rebound in employment



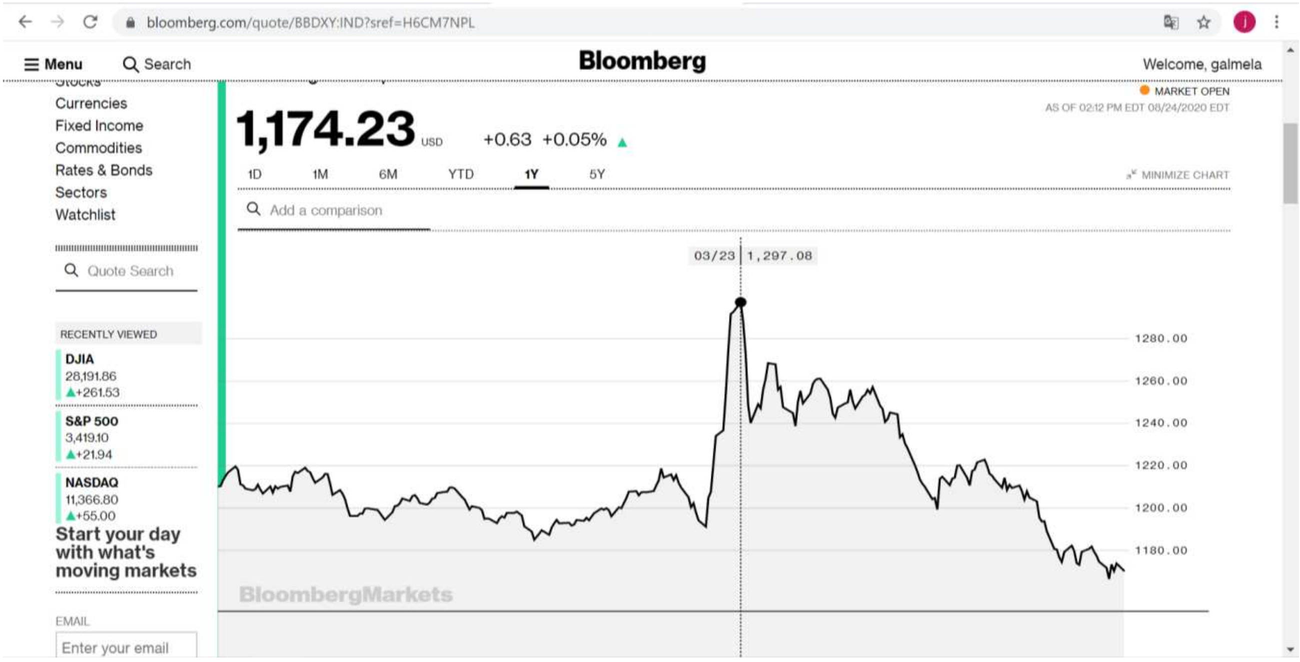
## An uptick in consumer confidence



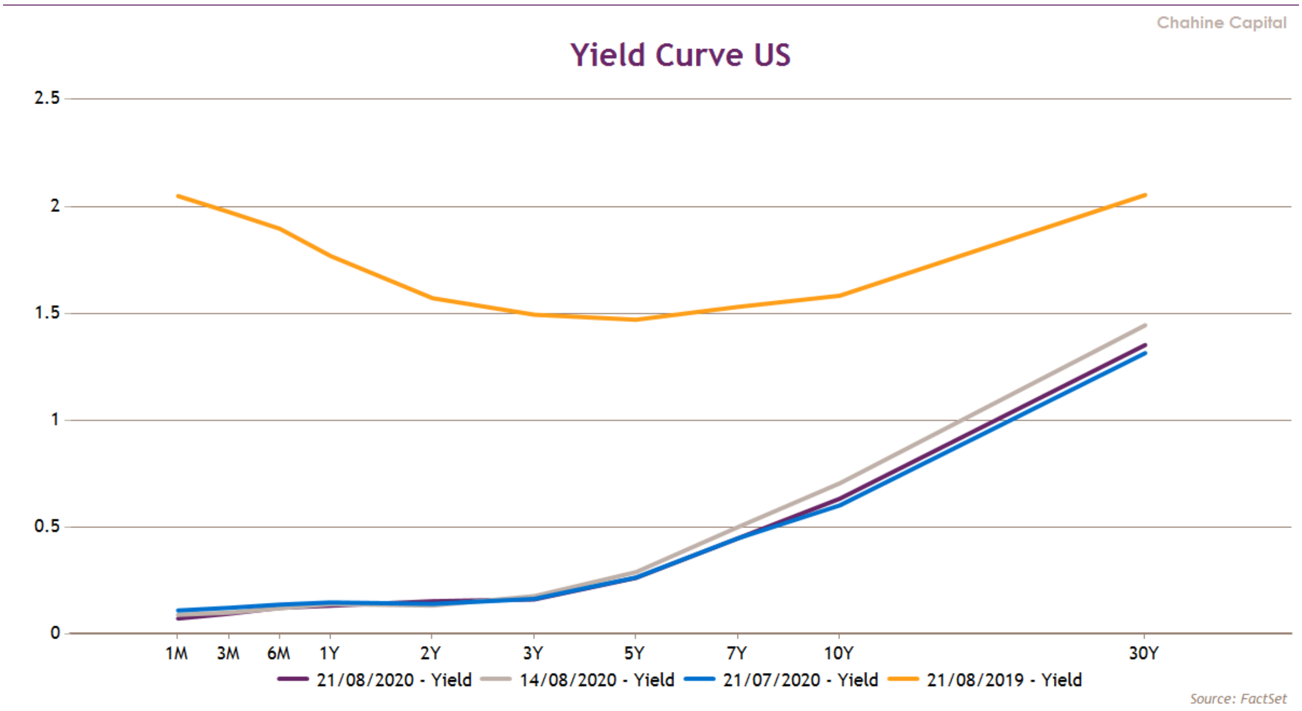

# A flood of dollars

The most recent indicators, and notably PMIs and ISM indices, point to a marked upturn in manufacturing in both the USA and euro zone. This suggests a degree of normalisation. But the markets' biggest support factor remains persistently low (and in Europe, negative) interest rates. The US yield curve has a positive slope, but the 30-year has eased to just 1.31%. The market clearly does not expect the Fed to raise its rates anytime soon! At the same time, the Fed continues to print money to finance government largesse: its balance sheet has swollen by some $3 trillion to a record $7 trillion in the past few months, and we recall that it took years for it to reach $4 trillion in the first place. Central banks in the euro zone, japan and the UK have been doing the same thing. US federal government debt has mounted to $26.5 trillion, compared with a 2020 GDP of around $20 trillion, and goodness knows where it will be this time next year. Modern economic theory suggests that economies can sustain a great deal of government debt; in Japan, the debt to GDP ratio is above 200%, although commentators forget that unlike the USA, Japan is running a trade surplus. Surplus dollars washing around international trade circuits will help devalue the dollar, and an uncontrolled correction could trigger a serious crisis of confidence. The dollar has already depreciated significantly against its index made up of a basket of other currencies; after a period early in the pandemic during which it served as a safe haven, the index has tumbled from a high at 1,297 points to 1,174 points. At these levels, we recommend that investors reduce slightly their portfolios' dollar exposures. By buying S&P futures rather than trackers, for example, investors are exposed only to margin variations.

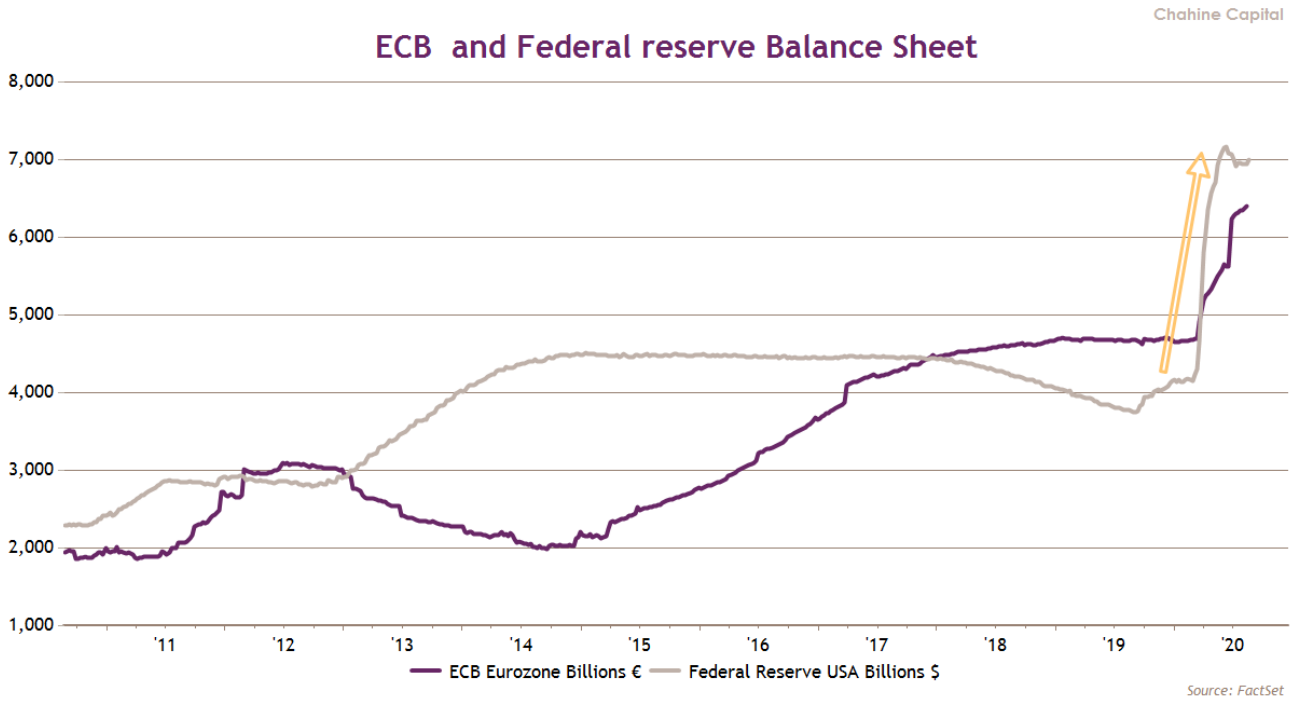
## Abundant dollars have prompted a correction




## A positively-sloped curve, but at very low levels




## The Fed continues to print money




In the event of a presidential election victory for the Democrats, Joe Biden would either be looking to raise taxes to redistribute to his electorate or would let the federal budget deficit increase. Although Mr Biden says that he is against a higher deficit, Nancy Pelosi did not hesitate to approve trillions of dollars worth of new borrowing to deal with the crisis. On the other hand, raising taxes in 2021, when the country is emerging from a serious recession, would be a hazardous operation. In our view, the government deficit will continue to widen and the Fed will continue to finance it.

The likely persistence of abundant cash led us to recommend purchasing gold back in June, when it was trading at $1,774 per ounce. It has since rallied to over $2,000 and is currently at $1,940, which is still worth an investment for those that have not already done so. As we said earlier in the summer, the Fed can print currency, but not gold…. Investors seeking to avoid exposure to the dollar could buy futures on Comex, giving them exposure only to margin variations.

## Market valuations

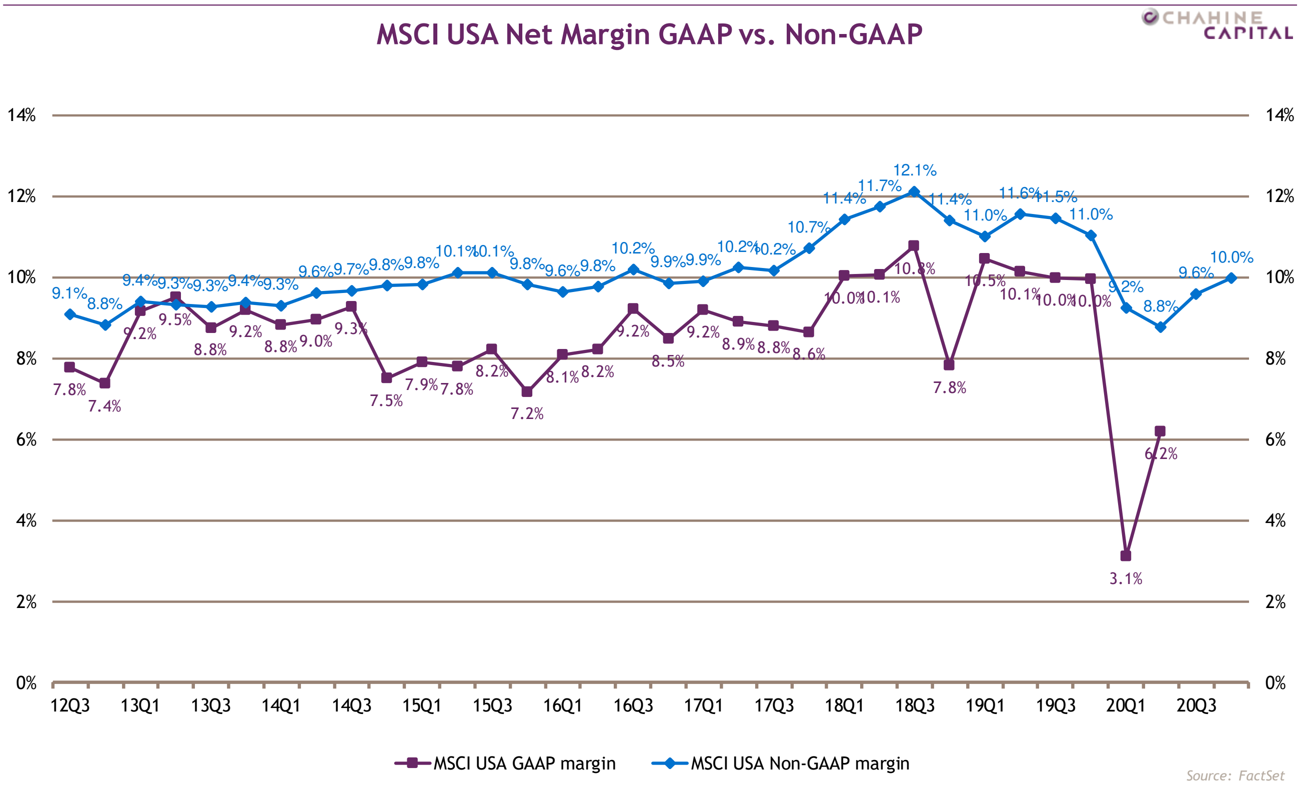
Better than expected US earnings in a low interest-rate environment have made a major difference to our S&P 500 valuation. On top of that, as of July our model has been using 2020 as the base year for its 8-year CAGR projection; as this year will be a low, this will automatically raise the CAGR. We have retained the consensus EPS growth figure of -22% for 2020, then our estimate of 21.6% for 2021 (compared with a consensus growth figure of 28%) and a return to a normalised 8% in 2022. That gives us a CAGR of 5.1% and a theoretical index objective of 3,452 points, compared with a close at 3,397 points at the time of writing and given a virtually unchanged 30-year rate of 1.38%.

### Higher objectives on the back of good Q2 results

| **S&P 500 - Valuation end 2020 except implied scenario** | | | | | |
|---|---|---|---|---|---|
| *CAGR Compounded Annual Growth Rate from 2019* | | | 30 Years Gvt bonds | | |
| | 1.00% | 1.25% | **1.38%** | 1.75% | 2.00% |
| **Deep recession: -23% in 2020, 5% in 2021 - CAGR 1.5%** | **2 875** | **2 678** | 2 584 | 2 347 | 2 208 |
| **Implied Scenario CAGR 4.5% over 8 years** | 3 773 | 3 510 | **3 386** | 3 070 | 2 884 |
| **Return to normal: -22% in 2020,22% in 2021 - CAGR 5.1%** | 3 845 | **3 578** | **3 452** | **3 131** | 2 943 |
| **Current Index S&P 500** | | | **3 397** | | |

The Q2 results also lifted GAAP margins from their Q1 levels. US firms took advantage of depressed share prices at the end of March to clean up their balance sheets, which created a huge gap between GAAP and non-GAAP margins: 3% versus 9%. In Q2 the figures were 6.2% versus 8.8%, which confirms the quality of the results. Higher share prices in Q2 discouraged buybacks, which totalled $91 billion after $217 billion in Q1.

## A significant increase in GAAP margins




We are maintaining our recommendation to overweight this market, but unfortunately we were unable to strengthen our exposure at the limit of 2,900 points that we set at end-June. That train has gone and the correction never came.

In the euro zone, interim results have driven the consensus earnings estimate for 2020 lower, to a 41% contraction. We are using -43%. Energy, cyclicals and finance are all down sharply. Healthcare and consumer staples are the only sectors performing well in this regard. The weighted average 30-year yield for the zone is an absurdly low 0.36% but even that cannot prevent profits evaporating. We expect a 21% rebound in earnings next year, but our CAGR is still negative even with a helpful base effect. This market does still benefit from a dividend yield expected at 3.2% in 2021, however.

## The eurozone market is close to theoretical fair value

| **MSCI EMU - Valuation end 2020 except implied scenario** | | | | | |
|---|---|---|---|---|---|
| *CAGR Compounded Annual Growth Rate from 2019* | **30 Years Gvt bonds** | | | | |
| | 0.15% | 0.25% | **0.36%** | 0.50% | 0.75% |
| **Deep recession: -45% in 2020, 12.5% in 2021 - CAGR -4.4%** | **97** | **94** | 91 | 87 | 81 |
| **Implied Scenario: CAGR -2.7% over 8 years** | 124 | 120 | **116** | 111 | 103 |
| **Return to normal: -43% in 2020, 19% in 2021 - CAGR -2.1%** | 121 | 117 | **113** | **109** | **101** |
| **Current Index MSCI EMU** | | | **116** | | |

## Conclusions

While the media are focused on an apparently endless cycle of Covid news, Wall Street has been setting one imagination-defying record after another. The Nasdaq, IT and biotech have soared to new highs: the index has outstripped the S&P 500 by 62% over the past 15 years, with an acceleration in that trend since the pandemic broke out. Annual average performance over the past 30 years has been 12%, highlighting the extent to which society is being transformed. IT has penetrated deeply into every sector of the economy; its weight in the S&P 500 has risen from 13.6% at the beginning of 1997 to 28.2%, and of course it has been critical to the creation of giants in other sectors, such as Amazon and Tesla in cyclical goods and Google, Facebook and Netflix in communications. A great many other firms are based on digital technology. Back in 1997, the biggest company in terms of capitalisation was General Electric; it now a relative pygmy among industrial stocks, neglected by firms opting to subcontract blue-collar jobs abroad. Even Boeing has demonstrated an inability to make things properly. The next battleground will be automotives, where Tesla is attempting to become the sector's iPhone and could well succeed. Volkswagen's boss says that the future is in "software and direct sales". Tesla is capitalised at over $375 billion and has stolen a somewhat provocative march on its German competitors by setting up shop in Berlin and offering to share its technology. Our economies are changing dramatically, and the pandemic has hastened it all through e-commerce, home working, transport and healthcare, for example. American monopolies have been the big winners, leaving Europe to import almost all its high-tech requirements and live off low-margin automotive and industrial products.

Growth opportunities are particularly attractive when interest rates are zero or negative, which is why GAFAM, hi-tech stocks and firms like Tesla are doing so well in stock market terms. Share prices for some niche healthcare companies have risen exponentially. In contrast, the pandemic has badly damaged the financial sector, energy and most cyclicals. The structural make-up of the US economy has made it more resilient than most: the drop in US profits is likely to be limited to 19% this year, compared with drops of 36% in Europe and even 40% for eurozone firms (and that latter figure is being revised lower). The MSCI World index has risen overall this year, but European markets are lagging. Our Digital funds are up, however.

US Q2 earnings held up incredibly well, posting a genuine surprise at 20% over expectations. The overall drop in earnings for the year has been revised from 24% to 20%. The decline in profits is concentrated in low PER sectors such as energy, finance and air transport. Some IT, healthcare and consumer staples companies are reporting higher profits. The consensus expectation is for a 28% rebound in 2021, but we are pencilling in 21%. And even with a PER of 20.8x 2021, the market's earnings yield is 4.8%, compared with a 30-year yield of 1.38%... But these projections could collapse if the pandemic persists or if investors react badly to a Biden victory in the presidential election.

World GDP is expected to contract 4.4% in 2020. That number is revised from 3.85% in June, confirming that the post-lockdown rebound is not as vigorous as it had been assumed. The world economy is then expected to grow by 5.4% next year, albeit subject to a great deal of uncertainty related to the pandemic. Europe has been among the most badly damaged regions and we can only hope that the stimulus package agreed by EU member states will do its intended job. Some US macroeconomic indicators are looking better, notably a massive return to work and good PMIs. But America's trade deficit has worsened, and together with massive Fed injections this has undermined the value of the dollar. We are planning to reduce our exposure to the greenback and are maintaining our buy recommendation on gold that we issued at the end of June.

Our S&P 500 valuation is up to 3,452 points on the back of better corporate results and we are sticking with our overweight recommendation. In Europe, our valuation suggests a market priced at fair value.

*Jacques Chahine*

## Main ratios for markets and sectors as of 21/8/2020 (in local currency)

| *Data as of* | Weight vs | Perf | | Weighted P/E | | % Wted EPS Chge | | | Div Yield | Revision vs M-2% | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *21/08/20* | MSCI World | 2020 | 2019 | 2021 | 2020 | 2021 | 2020 | 2019 | 2020 | Fiscal 21 | Fiscal 20 |
| **MSCI The World Index** | **100.0%** | **1.39%** | **25.30%** | **19.1 x** | **24.3 x** | **26.8%** | **-21.8%** | **-1.9%** | **2.06%** | **2.1%** | **3.1%** |
| | | | | | | | | | | | |
| MSCI USA | 65.0% | 6.69% | 29.20% | 21.4 x | 26.4 x | 23.3% | -18.1% | -0.5% | 1.66% | 2.0% | 4.6% |
| MSCI Japan | 8.0% | -6.87% | 15.70% | 16.0 x | 20.9 x | 30.4% | -15.8% | -28.7% | 2.41% | -2.4% | -2.6% |
| MSCI EMU | 12.7% | -12.53% | 21.69% | 15.5 x | 23.0 x | 49.0% | -40.7% | 0.3% | 2.78% | -1.4% | -6.4% |
| MSCI Europe | 22.7% | -13.26% | 22.17% | 15.6 x | 21.4 x | 37.2% | -36.3% | 3.6% | 2.92% | -0.9% | -3.4% |
| MSCI Europe ex Energy | 21.7% | -11.10% | 23.79% | 15.8 x | 20.8 x | 31.7% | -31.8% | 5.5% | 2.78% | -1.3% | -2.7% |
| | | | | | | | | | | | |
| MSCI Austria | 0.1% | -33.35% | 13.38% | 9.8 x | 15.7 x | 59.2% | -50.0% | -25.1% | 3.42% | -2.5% | 0.3% |
| MSCI Belgium | 0.5% | -24.02% | 19.37% | 15.1 x | 18.3 x | 20.5% | -31.9% | 10.9% | 2.90% | -1.6% | 3.5% |
| MSCI Denmark | 0.9% | 15.13% | 28.95% | 24.6 x | 30.5 x | 24.0% | -9.4% | -3.6% | 1.45% | 1.1% | 4.3% |
| MSCI Finland | 0.4% | 3.05% | 8.28% | 17.7 x | 20.9 x | 17.9% | -14.0% | -0.6% | 3.12% | 0.7% | 1.4% |
| MSCI France | 4.5% | -15.90% | 26.10% | 15.8 x | 25.9 x | 64.4% | -46.8% | 4.7% | 2.78% | -1.4% | -14.2% |
| MSCI Germany | 3.5% | -6.26% | 20.10% | 14.8 x | 22.1 x | 48.8% | -33.2% | -4.7% | 2.66% | -0.9% | -2.3% |
| MSCI Great-Britain | 4.3% | -20.92% | 11.37% | 13.6 x | 18.4 x | 35.6% | -38.1% | -5.5% | 3.58% | -1.5% | -5.2% |
| MSCI Ireland | 0.1% | -7.06% | 21.49% | 30.3 x | 66.6 x | 119.8% | -69.4% | -23.6% | 0.64% | -2.0% | -30.2% |
| MSCI Italy | 0.9% | -17.03% | 25.49% | 12.9 x | 20.4 x | 57.8% | -48.7% | -2.0% | 3.61% | 1.9% | 1.8% |
| MSCI Netherlands | 1.7% | -3.18% | 26.85% | 18.9 x | 24.7 x | 30.8% | -28.1% | -4.0% | 2.11% | -2.1% | -4.1% |
| MSCI Norway | 0.3% | -10.97% | 8.26% | 14.2 x | 19.6 x | 38.0% | -26.1% | -11.0% | 3.70% | 2.7% | 14.1% |
| MSCI Spain | 1.0% | -27.34% | 9.85% | 13.7 x | 18.6 x | 35.8% | -51.4% | 7.0% | 3.54% | -5.6% | -6.1% |
| MSCI Sweden | 1.2% | 0.09% | 25.01% | 17.5 x | 19.4 x | 11.1% | -34.8% | 66.8% | 2.67% | 0.9% | 22.1% |
| MSCI Switzerland | 3.2% | -3.81% | 26.97% | 17.7 x | 20.6 x | 16.4% | -10.4% | 9.6% | 2.89% | -0.6% | -1.4% |
| | | | | | | | | | | | |
| MSCI Europe Consumer Discretion | 3.0% | -15.13% | 30.01% | 17.7 x | 65.4 x | 270.3% | -77.4% | -11.7% | 1.11% | -1.0% | -35.6% |
| MSCI Europe Consumer Staples | 3.3% | -7.41% | 22.38% | 18.2 x | 19.9 x | 9.8% | -10.2% | 9.9% | 2.95% | -2.3% | -1.4% |
| MSCI Europe Energy | 1.0% | -43.32% | 3.55% | 12.4 x | 62.6 x | 403.1% | -87.8% | -14.7% | 6.04% | 7.1% | -34.4% |
| MSCI Europe Financials | 3.2% | -27.59% | 17.31% | 9.9 x | 13.6 x | 36.5% | -45.1% | 15.1% | 3.95% | -1.6% | -0.4% |
| MSCI Europe Health Care | 3.3% | -1.27% | 28.40% | 16.5 x | 18.2 x | 10.7% | -1.0% | 9.3% | 2.71% | -2.6% | -2.1% |
| MSCI Europe Industrials | 3.1% | -9.27% | 32.02% | 19.4 x | 28.8 x | 48.7% | -39.8% | 4.9% | 2.09% | -1.1% | -4.0% |
| MSCI Europe Information Technol | 1.6% | 5.81% | 36.00% | 24.8 x | 30.3 x | 22.2% | -11.6% | 5.2% | 0.94% | 1.3% | 2.3% |
| MSCI Europe Materials | 1.6% | -7.01% | 21.39% | 16.8 x | 21.5 x | 28.4% | -22.1% | -13.3% | 3.34% | 1.7% | 3.6% |
| MSCI Europe Real Estate | 0.3% | -20.76% | 18.93% | 15.3 x | 17.0 x | 11.5% | -31.2% | -15.5% | 4.13% | -1.6% | 0.4% |
| MSCI Europe Communication Serv | 1.0% | -20.15% | 0.60% | 13.4 x | 15.3 x | 14.1% | -22.1% | 2.7% | 4.40% | -3.3% | -2.1% |
| MSCI Europe Utilities | 1.3% | -1.10% | 24.29% | 15.7 x | 17.5 x | 11.2% | -10.3% | 23.7% | 4.46% | -0.1% | -1.2% |

*Benchmarks source iShares ETF - Data as of 21/08/2020*

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