CHAHINE CAPITAL
Performance Engineering

01/06/2021

STRATEGY OVERVIEW

Equity markets: expensive, yes, but not overheating

Despite positive macro and micro momentum, investors are starting to worry about the strength of the current rally, now a year old. There are more and more stories in the media on the 'dangerously high markets' theme, with accompanying parallels drawn between now and the early 2000s or 2007-08. Over and above the magnitude of the rally, which is clearly disconnected from economic reality, market sentiment is particularly striking. The FLIPO (Free Lunch at Initial Public Offer) of the late 1990s has given way to FOMO (Fear Of Missing Out)… does this mean that the situation is about to deteriorate in the same way as it did after 2000 or 2007? We are not at all convinced that it will.

Government bond yields appear to have bottomed out at the end of 2020, when 10-year rates were negative in many countries and at an all-time low of 0.5% in the USA. Rising prices for government debt naturally affected the rest of the bond market, from investment grade to the high-yield segment: spreads in the latter are at record lows in the USA and Europe. But we should not rush to conclusions. Nominal yields may never have been as low, but this is not true of real yields, and certainly not at the long end. We believe that nominal yields on government and corporate debt will remain at or around where they are now for some considerable while yet.

Although a number of signals for equity markets seem to suggest overheating, especially when compared with previous episodes, we are not convinced on that count either. For one thing, microeconomic momentum is extremely positive, which is bringing the price to earnings growth ratio back to pre-Covid, more reasonable levels. For another, and in contrast with the past, the world's biggest financiers are now clearly keen to support equity as well as bond markets. And as the relationship between the size of the Federal Reserve's balance sheet and the S&P 500 demonstrates, this matters. So while the upside for equity markets may now look limited, given how far they have already rallied – especially on Wall Street – risky asset prices have every chance of stabilising at around current levels worldwide.

The US corporate results season is ending on an impressive note. Almost all S&P 500 firms have announced their figures (98%, to be exact, or 495 of them), and 87% have posted earnings per share higher than analysts expected. This is the highest percentage recorded in the FactSet database, which for this variable goes back to 2008! Over the past five years, on average, the percentage of positive surprises has averaged about 74%. Moreover, aggregate earnings for the S&P 500 in Q1 are expected up 52%, compared with a 23.8% increase expected at end-March and 15.5% expected at the end of December. If realised, this would be the sharpest gain since the 55.4% reported in Q1 2010.

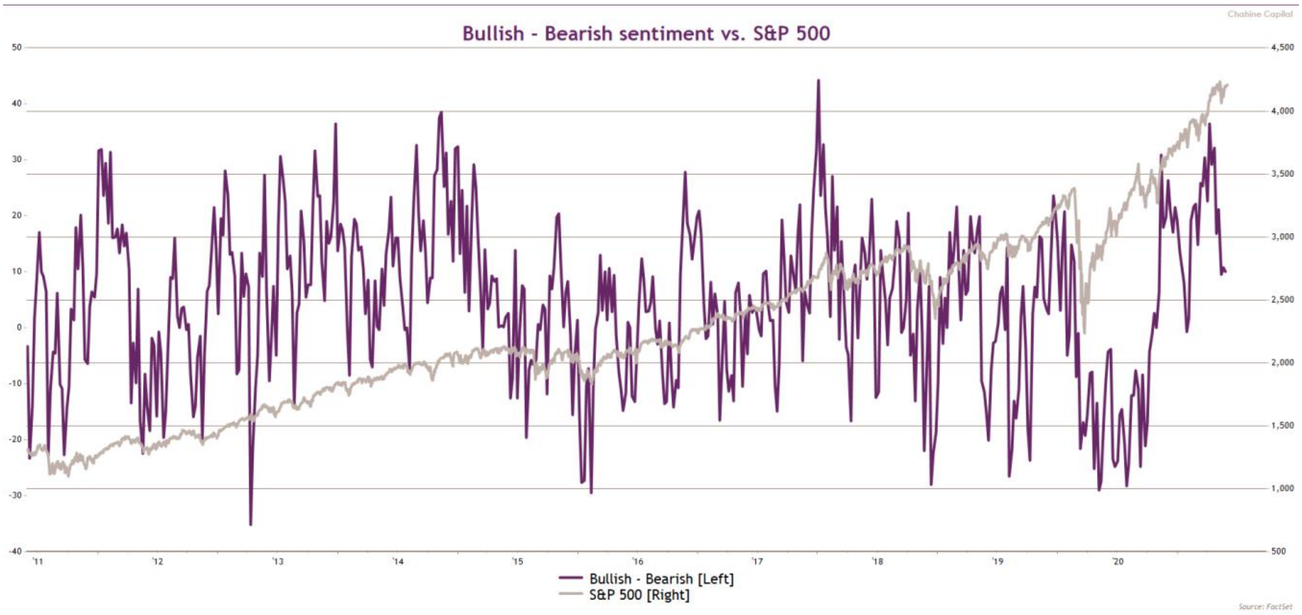
Our valuation model indicates that US markets need to consolidate in the short term, however. If interest rates stay where they are now, the correction would have to be in the 9-10% area. Our scenario that takes account of the fact that tax hikes will dent future profits among US firms from 2023 onwards (a scenario that does not appear to be priced in yet) suggests that the correction should be around 14%, again with unchanged interest rates. The consolidation would have to be only 8% in the event that long rates eased to 2%. We therefore continue to urge caution on US equities. The euro zone is on a very different trajectory. Our model suggests that European equities are fair value at the moment, irrespective of the scenario. It follows that we would overweight European equities against their American counterparts, just as we recommended last month.

Michaël Sellam

Investors turn jittery

Despite the positive macro and micro momentum we described in our May edition, investors are starting to worry about the strength of the current rally, now a year old. This is reflected in the bullish-bearish sentiment ratio, which has been sinking since February and an historically high start to the year.

Early-year certainty has evaporated

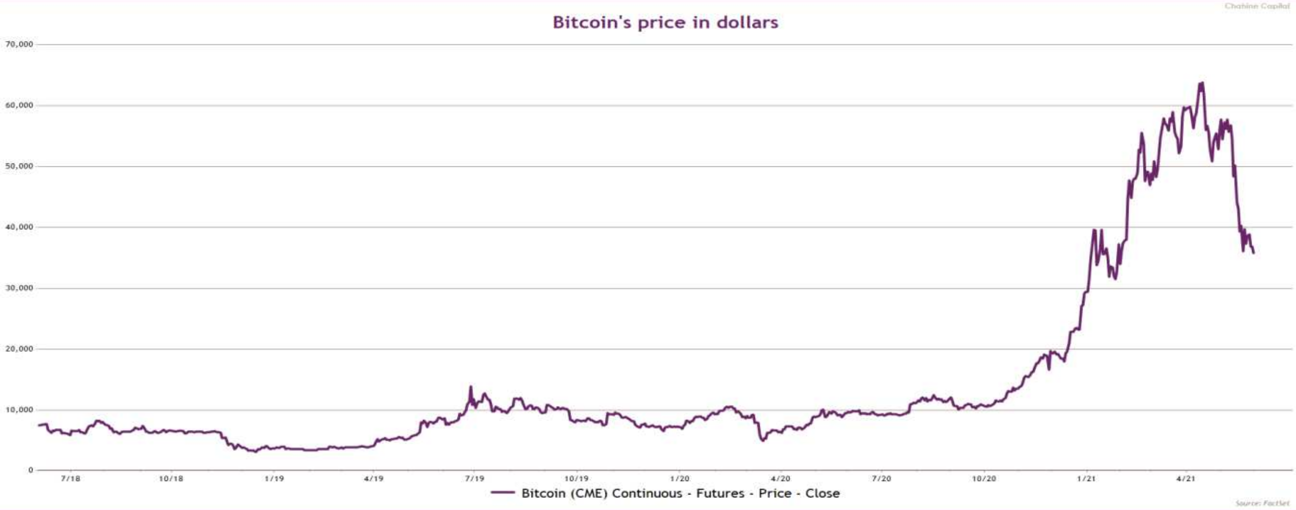


There are more and more stories in the media on the 'dangerously high markets' theme, with accompanying parallels drawn between now and the early 2000s or 2007-08. The idea that financial assets and real estate are overheating stems from admittedly dramatic price increases over the past year and valuations that in some cases were higher only during the period leading up to the financial crisis.

Over and above the magnitude of the rally, which is clearly disconnected from economic reality, market sentiment is particularly striking. The FLIPO (Free Lunch at Initial Public Offer) of the late 1990s has given way to FOMO (Fear Of Missing Out)…

Surging prices for alternative assets such as commodities and cryptocurrencies are also making investors nervous. This phenomenon is being taken as proof of excessive liquidity, the implication being that the monetary authorities will tighten policy sooner than had been expected or that social unrest will increase worldwide, just as it did in the early 2010s.

Soaring Bitcoin prices echo the frenzied speculation of the period leading up to the financial crisis

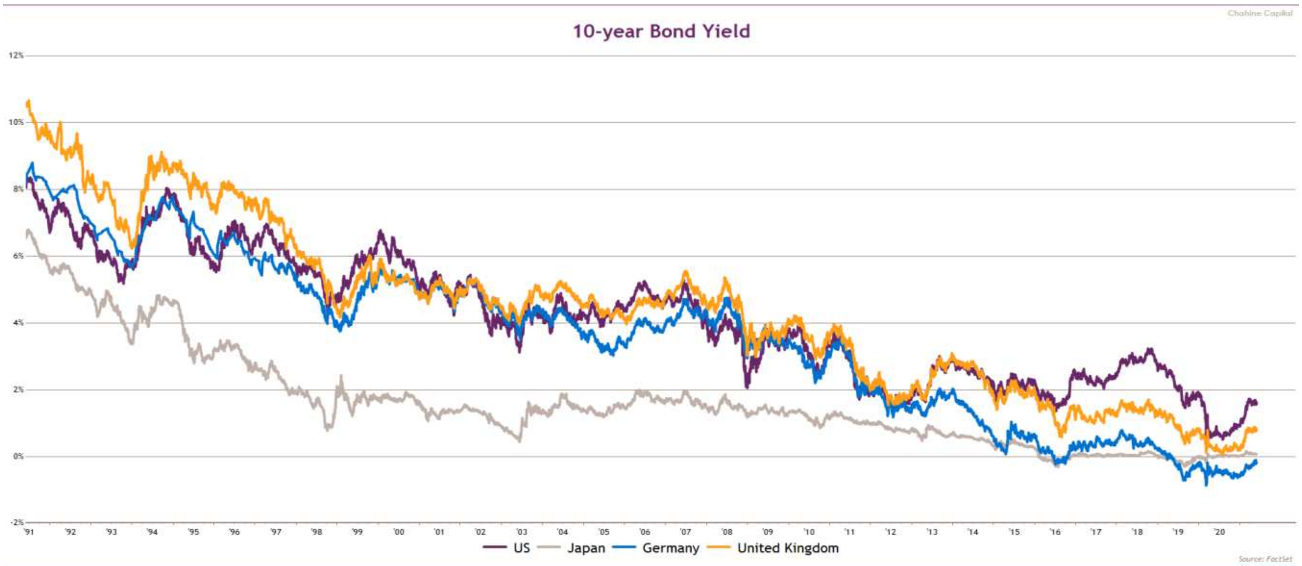


Could the situation degenerate in the months ahead, in a re-run of 2000 or 2007? We are not at all convinced about that.

A bond market crash is virtually impossible

Government bond yields appear to have bottomed out at the end of 2020, when 10-year rates were negative in many countries and at an all-time low of 0.5% in the USA. Evidently, bond prices have very little upside left, including at the very long end. 30-year US Treasury yields have never been as low, not even in the 1930s and 1940s. But that does not mean that they are about to rise significantly, especially given cyclical factors such as the fragility of the world economy and excess capacity in all but a few sectors and structural considerations such as ageing populations and the digital revolution. In our view, they all point to very low bond yields for the foreseeable future.

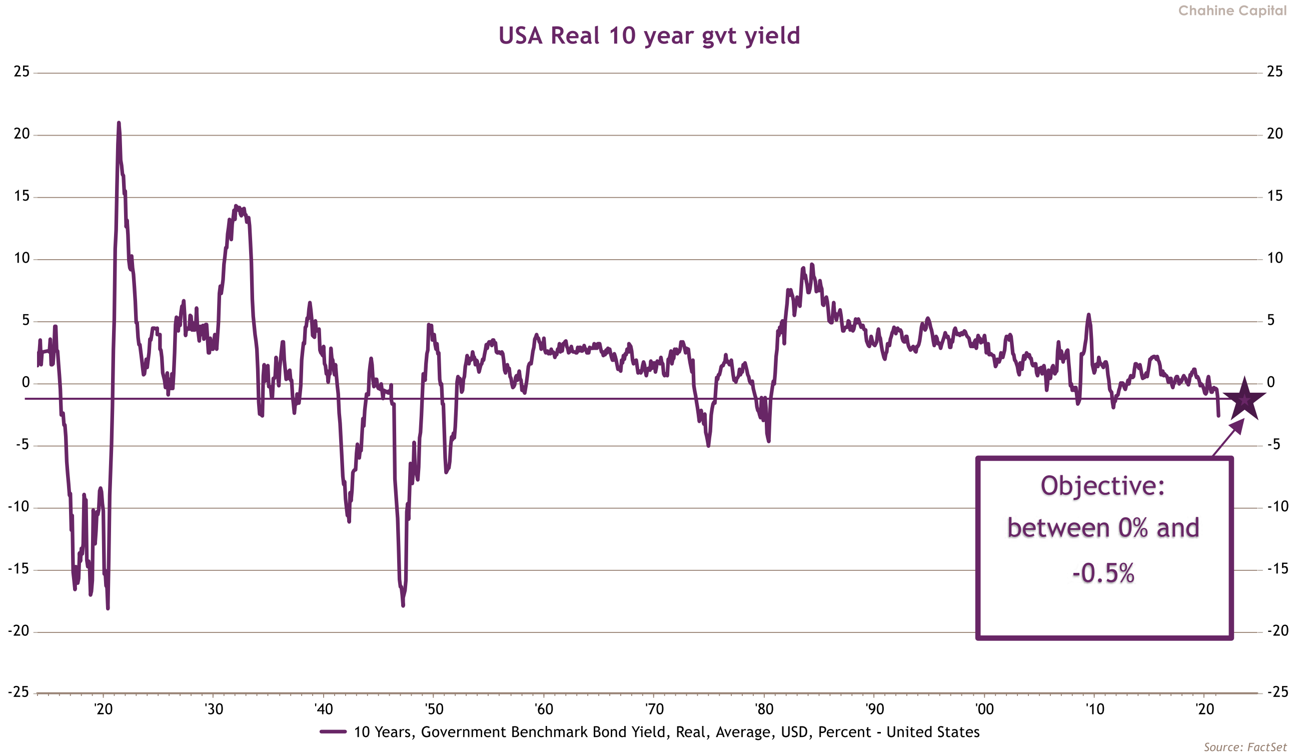
Following their dive, government bond yields have levelled off worldwide



Rising prices for government debt have naturally affected the rest of the bond market, which is historically expensive all the way from investment grade to the high-yield segment. Spreads in the latter are at record lows in the USA and Europe.

While any examination of long time series would highlight the levels to which bond markets have climbed, it would be unwise to jump to conclusions. Nominal yields may well be at record lows, but this is not the case for real long-term yields. Considering that inflation is likely to subside in the months ahead, real 10-year yields could well stabilise between zero and -0.5%, a level that is by no means unusual (see chart below).

Real yield levels are not unprecedented, and could stay close to zero for some time yet



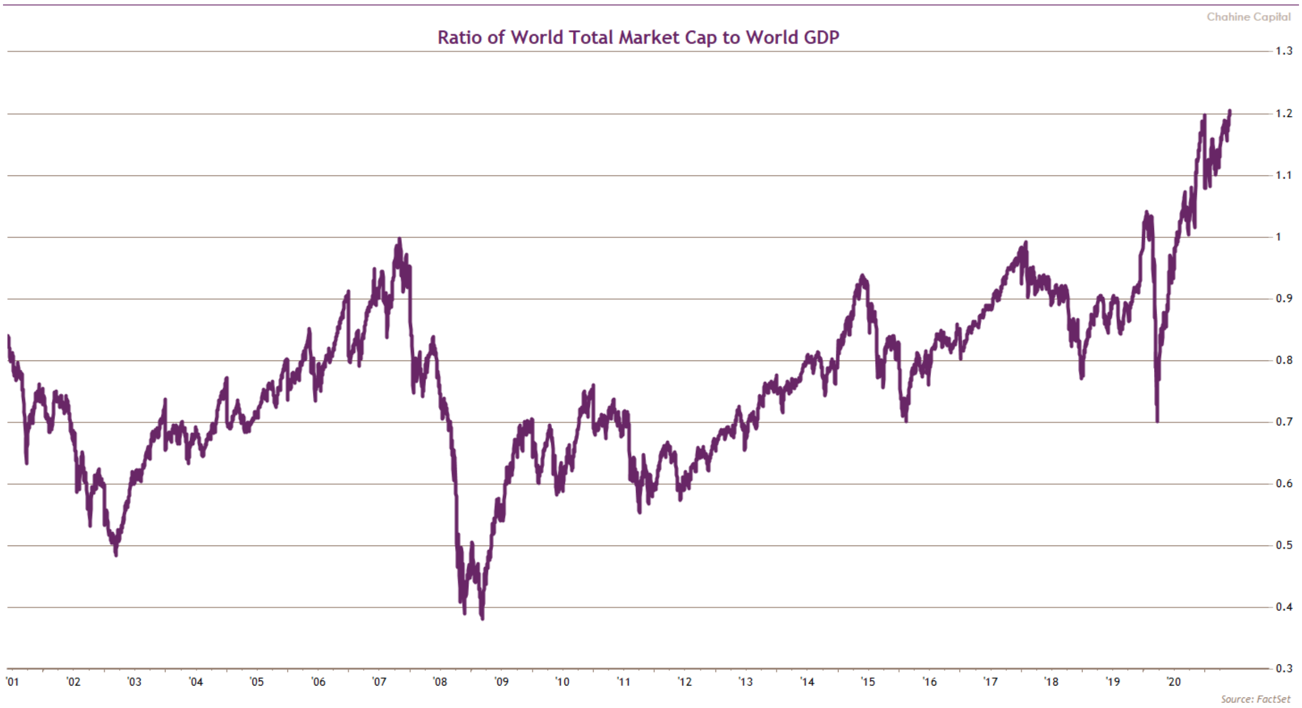
A bond market crash in the near or medium term is all the more unlikely for the fact of repeated central bank confirmation that they want to keep long rates down. It is not even a matter of choice: government stimulus is desperately needed worldwide, and that can only happen if central banks finance the deficits this creates. Moreover, by destroying wealth, a sudden rise in interest rates would mean social unrest on a scale that all governments would prefer to avoid.

In the circumstances, we believe that nominal government – and therefore corporate – bond yields will stay close to where they are for some considerable time yet.

Equity markets: expensive, but not unsustainable

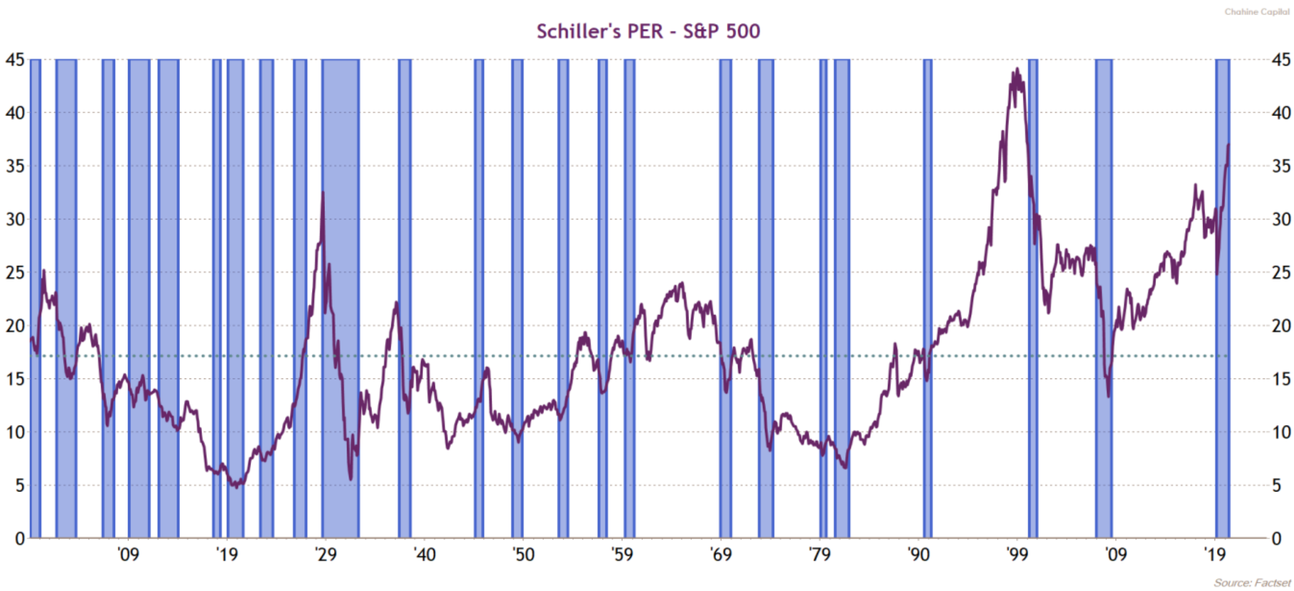
There are plenty of signals that would normally point to overheating equity markets, especially with reference to past episodes. World market capitalisation is at a record 120% of expected world GDP in 2021, well above the previous peak at 100% in 2007. Wall Street is the main driver of this phenomenon, with capitalisation now at almost 190% of GDP, up from 150% in the late 1990s.

Companies have never been so highly priced, especially in America



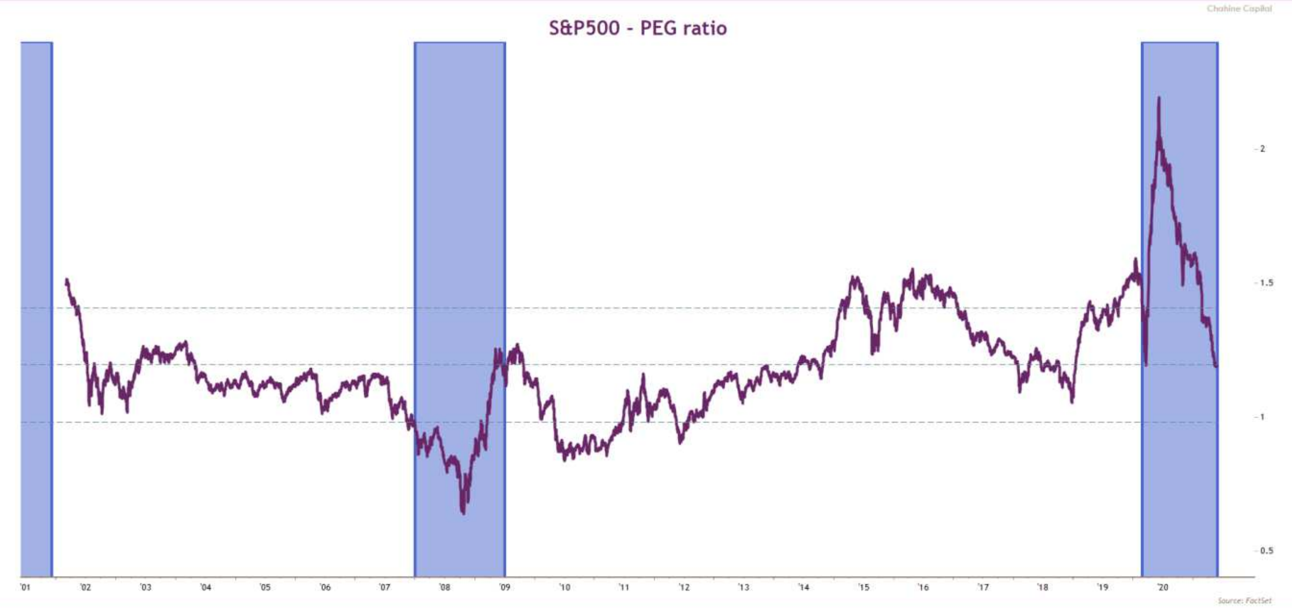
If that was not enough for investors to worry about, the Shiller PER – which aims to eliminate the cyclical element of earnings among S&P 500 firms – is now well above its 2018 and even 1929 peaks, and is now rapidly approaching its extremes of the early 2000s (see chart). As far as 'standard' PERs using expected earnings over the coming 12 months are concerned, and even though estimates of those profits are aggressive, levels are similar to those seen in the late 1990s. We can fully appreciate why observers declare equities to be historically expensive right now.

Market multiples at their highs, despite optimistic earnings forecasts



All that said, we do not think that historical comparisons are relevant. Microeconomic momentum is extremely positive, which is bringing the price to earnings growth ratio back to more reasonable, pre-Covid levels.

Unlike the PER, PEG is coming back into line



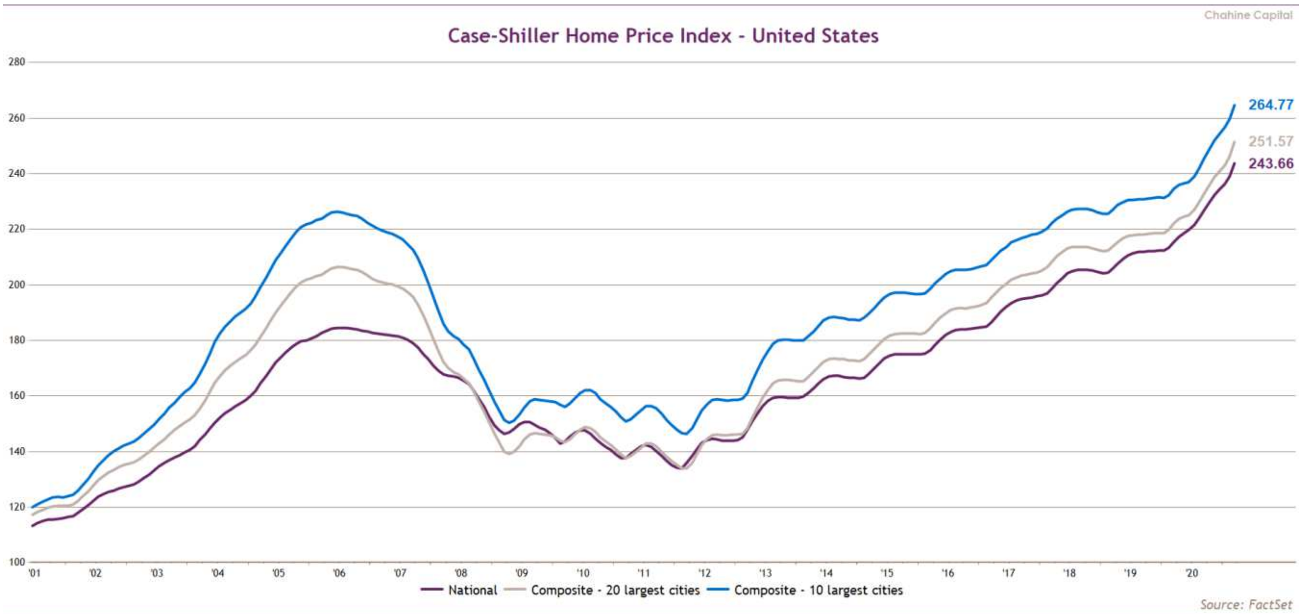
Moreover, and in contrast with the past, the world's biggest financiers are now clearly keen to support equity as well as bond markets. And as the relationship between the size of the Federal Reserve's balance sheet and the S&P 500 demonstrates, this matters. In a situation where private agents continue to save, and where low interest rates can sustain high multiples, Fed liquidity injections will push savings into equities in the months ahead.

So while the upside for equity markets may now look limited, given how far they have already rallied – especially on Wall Street – risky asset prices have every chance of stabilising at around current levels worldwide. This assumes that the macro and micro newsflow remains positive (good short-term dynamics) and that interest rates stay close to where they are now (long-term dynamics).

The US house price rally is not a sign of major disequilibria

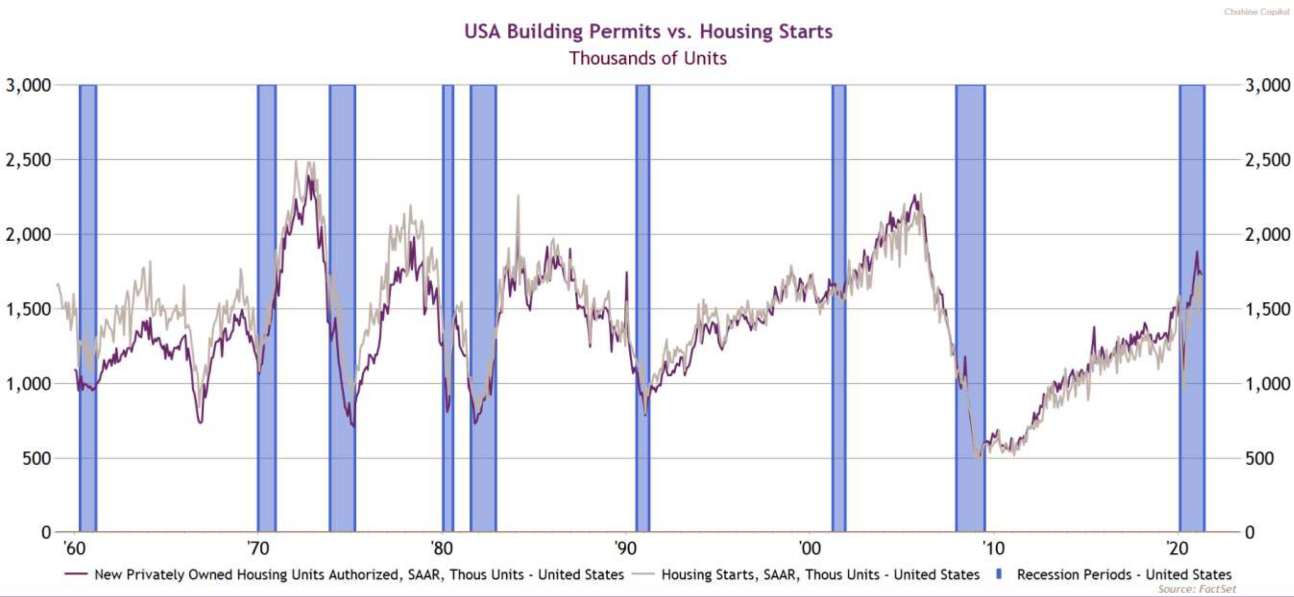
While the situation on equity markets is typically compared with the conditions that prevailed in the late 1990s and the internet bubble, many commentators compare the state of the US real estate market with 2006-07, just before the subprime crisis. It is true that nominal house prices are well above their previous peak in 2006 and that annual house price inflation is in double digits for both new and existing homes (see chart), but here too we believe talk of overheating would be premature.

US real estate prices are above their peak of 15 years ago, when the market was overcooked

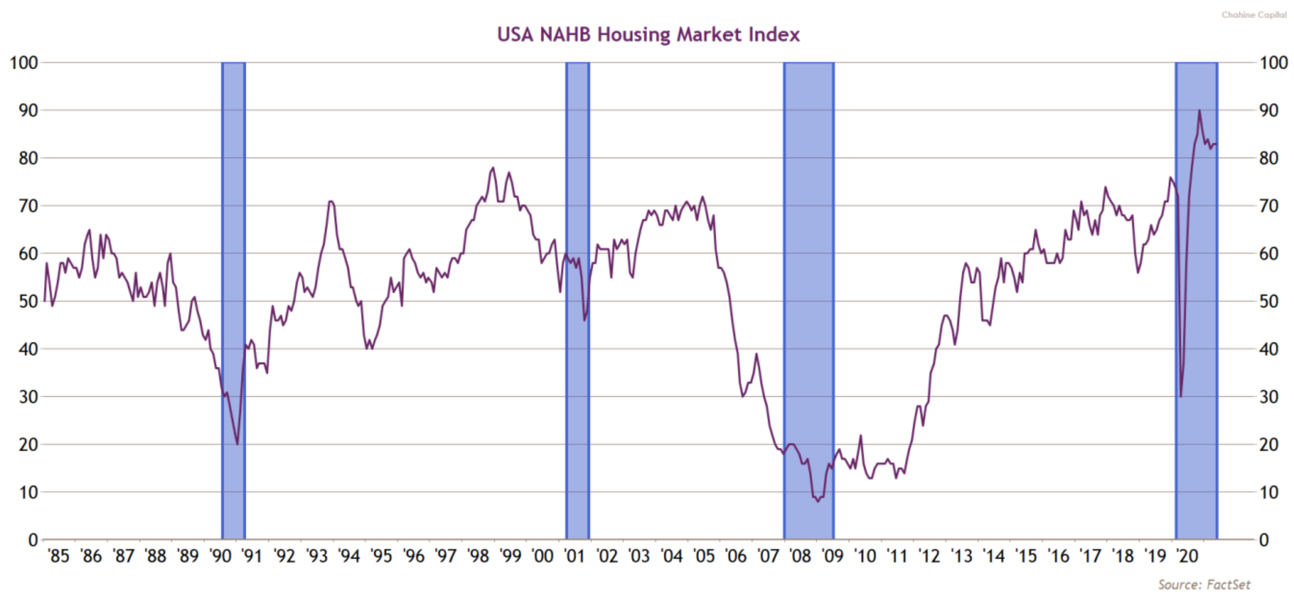


Recent price trends clearly reflect an appetite for bricks and mortar in the USA. Building permits are up sharply to levels not seen for almost 15 years; sentiment among builders is even more positive than it was in 2004-06.

Building permits at a 15-year high

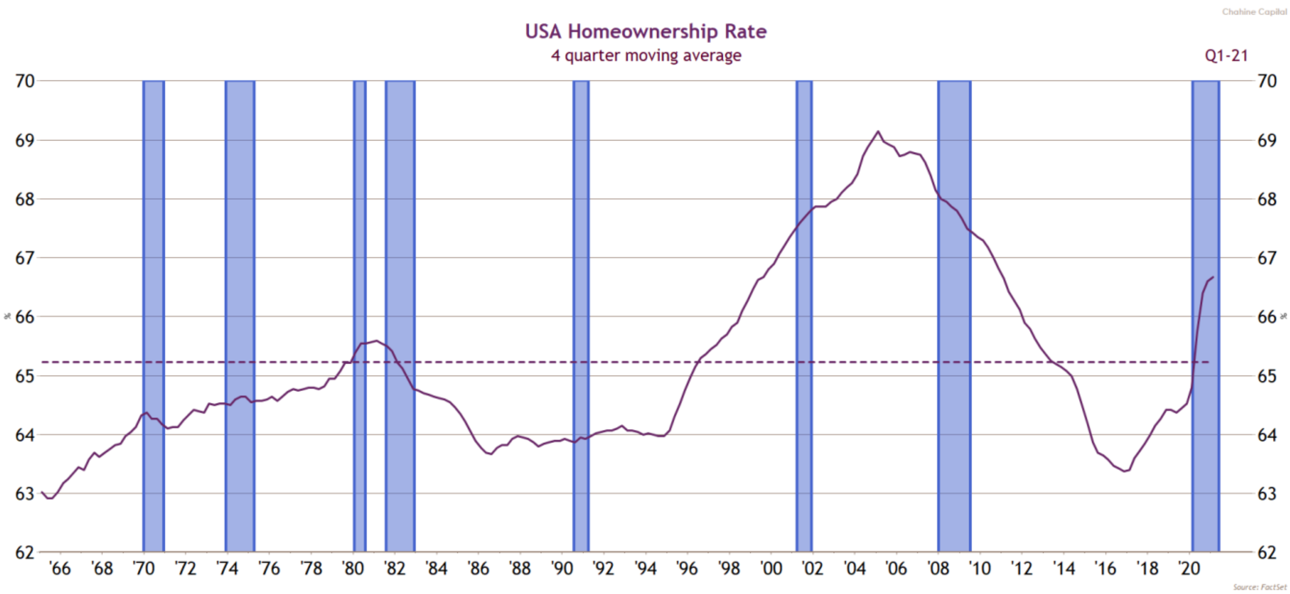


Home builder sentiment at a new peak



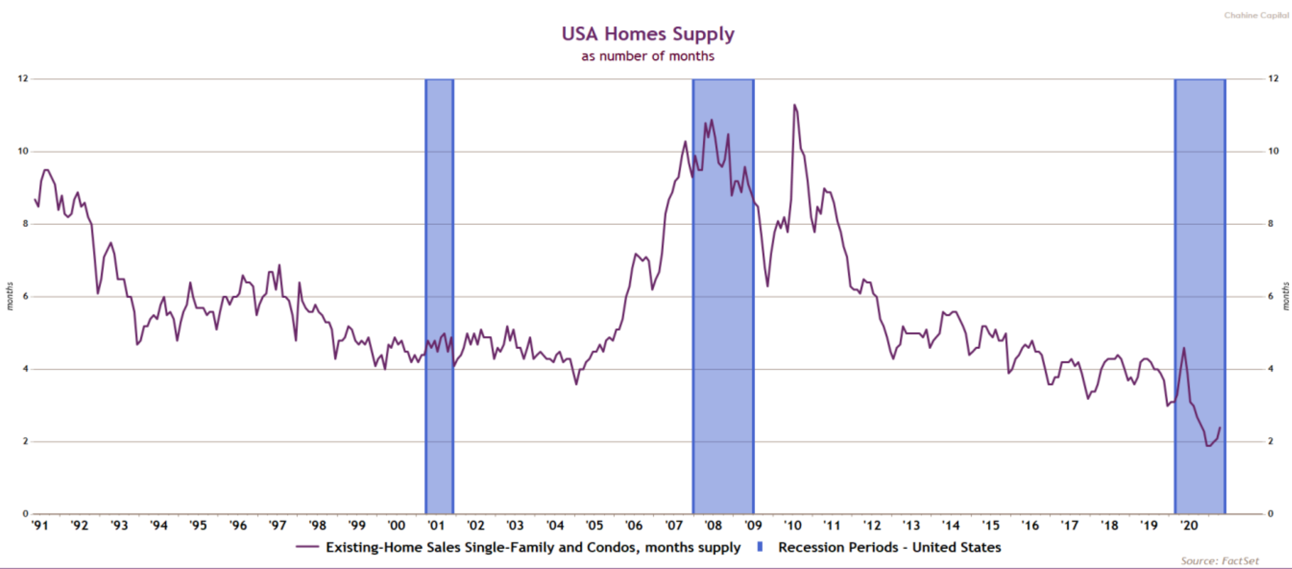
These good figures should be taken in context, however, and particularly with reference to Covid. For one thing, American households are increasingly keen to own their own principal residence – the US home ownership rate has risen from 64% to over 66% in a matter of months. This in turn reflects an historically high savings rate and cheap financing, which makes ownership eminently affordable (see chart).

The pandemic has boosted home ownership



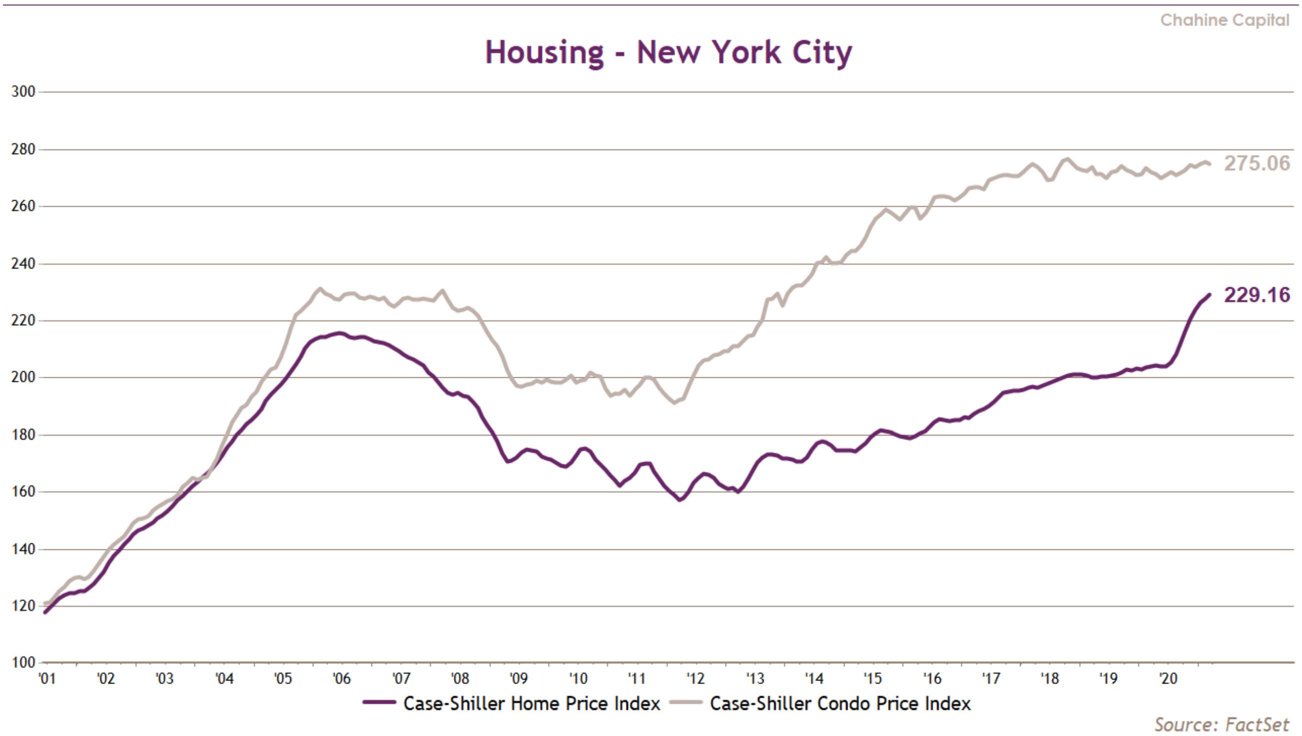
None of this adds up to a serious mismatch between supply and demand on the US real estate market, however, and still less to a situation that could undermine the sector. Quite the opposite, in fact, as our chart showing stocks of unsold homes and the number of months needed to sell a new or existing home shows.

Real estate price trends reflect stronger demand



Recent trends in house prices should not be over-interpreted, as they do not capture the whole story. It is interesting to compare house prices with apartment prices, as the two series are diverging in all the US cities we have observed (cf. New York below). Apartment prices have appreciated very little over the past year.

Houses are more expensive, but not apartments



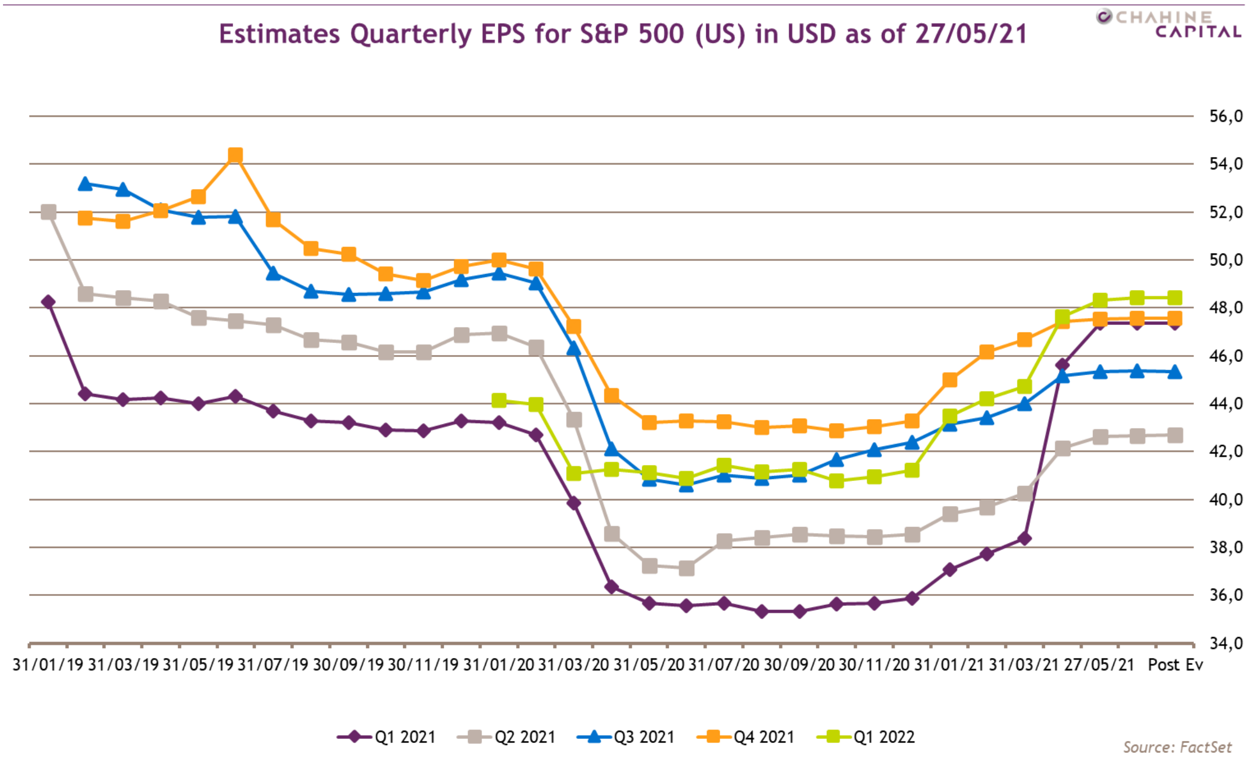
The point is that the rise in US home ownership we have seen over the past year is more of a switch in preferences from apartments to houses, for obvious reasons related to the pandemic. This is in no way comparable with the situation the prevailed before the subprime crisis, when house and apartment prices were rising in step with each other.

The Q1 results season ends as strongly as it started – and on a record note

The US corporate results reporting season is closing in some style. Almost all S&P 500 firms have now announced their results (98%, to be exact, or 495 of them); 87% have posted earnings per share higher than analysts expected. This is the highest percentage recorded in the FactSet database, which for this variable goes back to 2008. Over the past five years, on average, the percentage of positive surprises has averaged about 74%.

Moreover, aggregate earnings for the S&P 500 in Q1 are expected up 52%, compared with a 23.8% increase expected at end-March and 15.5% expected at the end of December. If realised, this would be the sharpest gain since the 55.4% reported in Q1 2010.

Upward revisions for Q1, but no change to estimates as yet for the rest of 2021

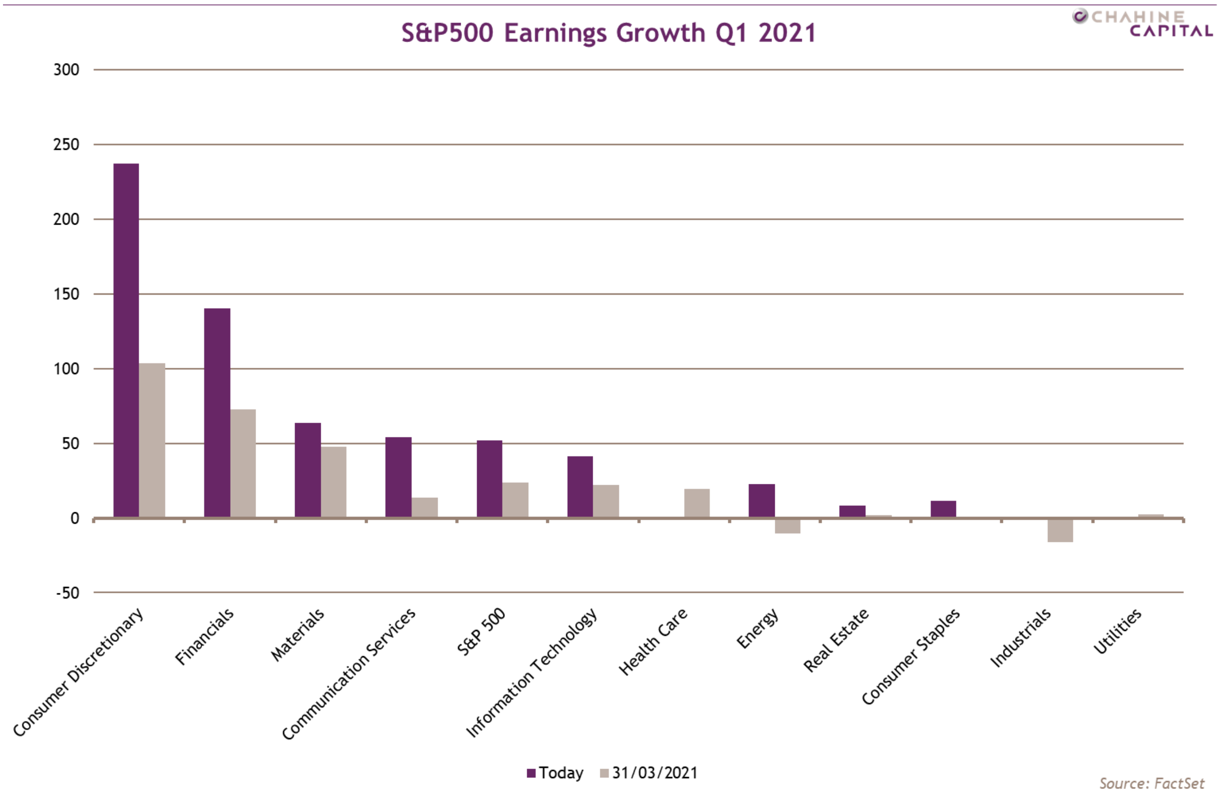


In terms of sector, the observations we made last month still hold. Q1 saw a return to grace for sectors that suffered particularly badly over the final three quarters of 2020: financials, discretionary consumer goods (cars, etc.) and basic materials. Their earnings growth rates in Q1 2021 were 140%, 235% and 64%, respectively.

Readers will recall that strong growth figures for banks largely reflect a base effect related to heavy provisioning in the first half of last year, when the pandemic had its worst economic impact. Provisions reduce earnings, of course, but not turnover. This positive base effect will fade only after the end of this year.

As we did last month, we should mention that earnings prospects for the IT sector are still excellent (Q1 up 42%), confounding the often bearish commentary directed its way over recent weeks.

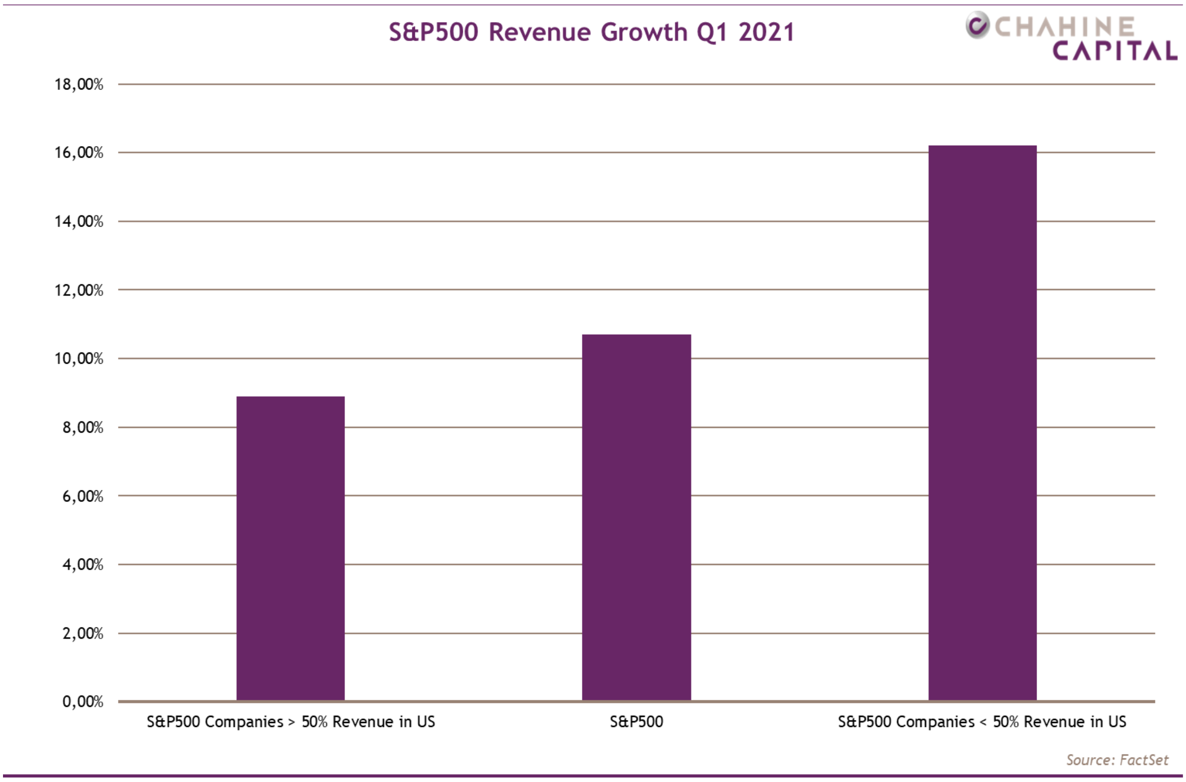
Q1 confirms a rebound among sectors hard hit in 2020



Another interesting development is that US companies that generate the majority of their sales and profits abroad are reporting stronger growth than those that rely more on domestic markets. If we divide the S&P 500 into two categories, one with firms generating more than 50% of their revenue outside the USA and the other for the rest, the first category reported a 16.2% jump in revenue in Q1 compared with an 8.9% increase for the second category.

Moreover, if we break down the first category further, S&P 500 firms that generate the majority of their revenue in Asia (over 25%) reported a 21.6% increase in total revenue in Q1. Those that generated most of their revenue in Europe (more than 25%) reported an 11.8% increase.

Firms generating more than half of their business outside the USA top the revenue growth league table



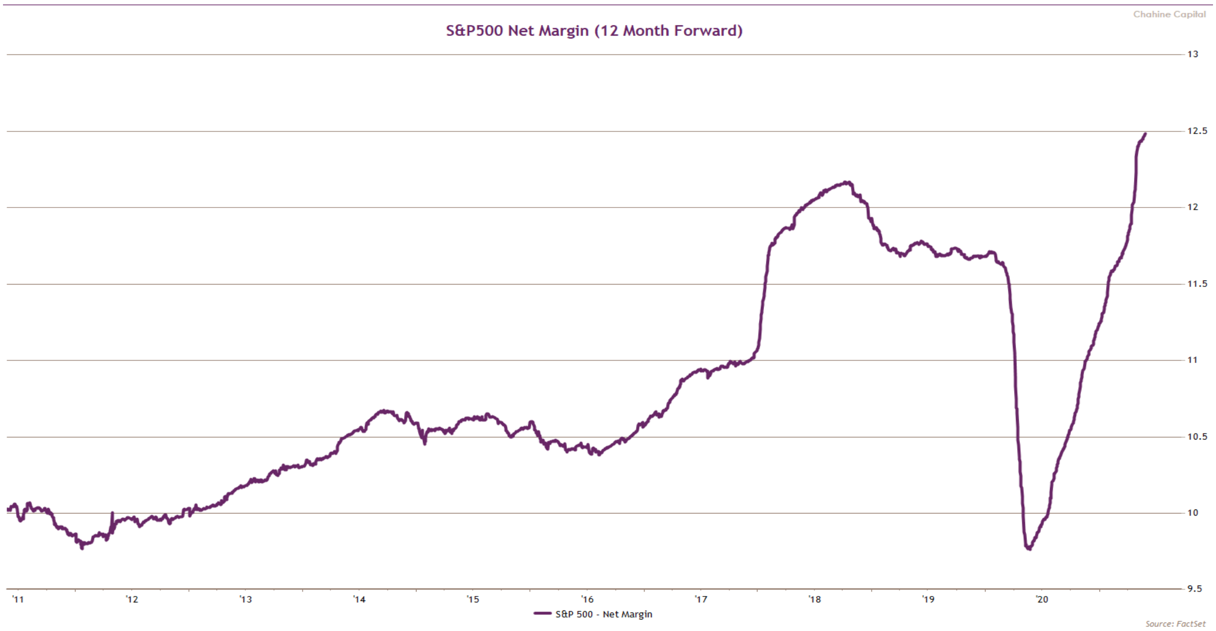
Differences in earnings growth rates between these two categories of S&P 500 companies are far less marked. This is partly a short-term effect related to the financial sector, which is the sector that contributed the most to total earnings growth among firms generating more than half of their revenues outside the USA. If we exclude financials, Q1 earnings growth for firms generating more than half of their sales on US soil drops from 51.2% to 30.3%.

Q2 should pan out as analysts expect, with a Covid base effect helping to maintain momentum on results. The Q2 results season could turn out to be even more spectacular than Q1 in terms of earnings growth, with a consensus forecast of a 60.6% gain for the S&P 500 as a whole. But we are still convinced that expectations for earnings growth in 2022 (11.8%) and 2023 (9.4%) are far too aggressive. We simply cannot see how they can be achieved without Covid base effects and in the context of potential economic growth.

Expected EPS growth rises further, to unachievable levels

Note also that tighter fiscal policies are on the way worldwide, and notably in the USA. The Biden administration (and as suggested by the IMF) is looking to hike corporation tax and double the taxation on multinationals generating profits generated abroad (from 10.5% to 21%). This could be a game-changer for the markets, and either way will automatically reduce post-tax profits by around 5%.

Net margins at new highs



If these intentions are carried through into practice, it would be unrealistic to assume that US margins can stay where they are today. The implication would be serious disappointment on the microeconomic front; the S&P 500 net margin of 12.5% for the coming 12 months is already a record. Net margin for Q1 is expected to come in at 12.8%, its highest level since FactSet started to publish this data in 2008. The previous high came in Q3 2018, in the wake of the Trump tax cuts.

Valuation model: Wall Street is still expensive, Europe is fair value

As US and European equity indices have traded sideways over the past month, and interest rates have barely moved, there is no fundamental change to what our valuation model is telling us. The US 30-year yield is 2.26% at the time of writing, compared with 2.3% a month ago; in Europe, the weighted average 30-year has ticked up from 0.73% to 0.82% over the same period. As we have seen, earnings estimates are still being revised higher, especially for 2021: EPS is expected to increase 32.6% in the USA, compared with a forecast of 28.4% last month and just 22.6% two months ago. Q1 closed with 52% earnings growth, compared with an expected 35% a month ago. In the euro zone, 2021 EPS growth has been revised up from 39.4% last month to 42.1%.

We can well believe that 2021 will be as good for EPS as the analysts are saying, but as we say expectations for 2022 and 2023 are unrealistic, especially in America. To repeat, there will be no more Covid base effect, potential growth rates will not support these expectations and taxes will rise (although not before 2022 or even 2023) for both companies and the wealthiest individuals.

Against this backdrop, our valuation model indicates that US markets need to consolidate in the short term, however. If interest rates stay where they are now, the correction would have to be in the 9-10% area. Our scenario that takes account of the fact that tax hikes will dent future profits among US firms from 2023 onwards (a scenario that does not appear to be priced in yet) suggests that the correction should be around 14%, again with unchanged interest rates. The consolidation would have to be only 8% in the event that long rates eased to 2%. We therefore continue to recommend caution on US equities.

S&P 500 - Valuation end 2021 except implied scenario

CAGR Compounded Annual Growth Rate from 2020	30 Years Gvt bonds				
	1,50%	2,00%	**2,26%**	2,50%	2,75%
Tax increase to 25% (approx. -5% impact on EPS) - CAGR 6.7%	**4 382**	**3 869**	3 642	3 452	3 272
Implied Scenario CAGR 9.4% over 8 years	5 091	4 476	**4 204**	3 977	3 761
Return to normal: 32.6% in 2021, 6.9% in 2022 - CAGR 7.4%	4 606	**4 066**	**3 827**	**3 627**	3 438
Current Index S&P 500			**4 204**		

The situation is rather different in the euro zone. The weighted average 30-year yield has risen from 0.66% two months ago to 0.73% last month and 0.82% now, but fears of inflation are exaggerated given the prospects for potential growth. Consensus analysts are still raising their EPS growth estimates for 2021: the forecast is now 42%, up from 39% last month and 33% two months ago. As in the USA, we expect 2021 to be as buoyant as these figures suggest, with the 'deliverance' theme associated with vaccination programmes materialising in macro and micro data from the second half onwards. Our model indicates that European equities are fair value, irrespective of the scenario retained (in the event of a slow recovery, long rates would sink towards zero). Just like last month, we would overweight European equities against their Wall Street counterparts.

MSCI EMU - Valuation end 2021 except implied scenario					
CAGR Compounded Annual Growth Rate from 2020	30 Years Gvt bonds				
	0,00%	0,50%	**0,82%**	1,00%	1,25%
Slow recovery: 35% in 2021, 4% in 2022 - CAGR -1.7%	**163**	**139**	127	121	114
Implied Scenario: CAGR 0.2% over 8 years	187	159	**145**	139	130
Return to normal: 42.1% in 2021, 8% in 2022 - CAGR 0.9%	199	169	**154**	**147**	**138**
Current Index MSCI EMU			**145**		

Conclusions

Despite positive macro and micro momentum, investors are starting to worry about the strength of the current rally, now a year old. There are more and more stories in the media on the 'dangerously high markets' theme, with accompanying parallels drawn between now and the early 2000s or 2007-08. Over and above the magnitude of the rally, which is clearly disconnected from economic reality, market sentiment is particularly striking. The FLIPO (Free Lunch at Initial Public Offer) of the late 1990s has given way to FOMO (Fear Of Missing Out)… does this mean that the situation is about to deteriorate in the same way as it did after 2000 or 2007? We are not at all convinced that it will.

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Michaël Sellam

STRATEGY OVERVIEW

Main ratios for markets and sectors as of 31/05/2021 (in local currency)

CHAHINE CAPITAL

Data as of	Weight vs	Perf		Weighted P/E		% Wted EPS Chge			Div Yield	Revision vs M-2%	
31/05/21	World	2021	2020	2022	2021	2022	2021	2020	2021	Fiscal 22	Fiscal 21
World - Developed	**100,0%**	**10,08%**	**15,04%**	**18,0 x**	**20,5 x**	**13,60%**	**52,06%**	**-19,14%**	**1,87%**	**1,6%**	**2,5%**
United States	53,9%	11,14%	20,22%	21,2 x	24,0 x	13,39%	49,10%	-15,61%	1,37%	1,5%	2,1%
Japan	7,7%	-0,11%	11,46%	15,3 x	17,5 x	14,05%	23,53%	-8,89%	2,07%	1,1%	2,9%
Eurozone	11,2%	13,05%	8,66%	16,4 x	19,3 x	17,73%	69,93%	-38,91%	2,51%	2,8%	3,7%
Europe	20,5%	12,32%	7,19%	16,4 x	18,9 x	15,33%	63,32%	-35,62%	2,65%	2,6%	3,4%
Austria	0,2%	21,41%	-3,26%	11,3 x	12,9 x	14,67%	82,70%	-41,33%	3,17%	2,6%	4,5%
Belgium	0,5%	9,54%	-2,41%	18,5 x	21,1 x	13,69%	24,39%	-25,04%	2,47%	2,9%	5,6%
Denmark	0,7%	6,61%	40,90%	24,5 x	24,8 x	1,32%	34,40%	-7,16%	1,68%	2,9%	5,6%
Finland	0,4%	8,87%	27,09%	19,2 x	21,3 x	11,28%	20,49%	-13,69%	2,80%	2,6%	6,0%
France	3,8%	15,84%	6,34%	18,1 x	21,9 x	21,08%	132,08%	-55,01%	2,34%	2,6%	3,6%
Germany	3,0%	11,05%	13,28%	14,9 x	16,9 x	13,85%	53,63%	-20,02%	2,55%	3,2%	5,0%
United Kingdom	4,1%	13,87%	-8,98%	14,1 x	16,0 x	13,33%	75,64%	-40,01%	3,29%	3,0%	3,5%
Ireland	0,1%	14,43%	11,11%	19,4 x	34,7 x	79,38%	6328,57%	-105,07%	1,06%	3,5%	5,6%
Italy	0,9%	14,15%	1,91%	13,1 x	15,3 x	16,30%	42,23%	-41,57%	3,56%	2,2%	4,2%
Netherlands	1,3%	13,05%	21,86%	20,4 x	22,4 x	9,80%	62,81%	-27,01%	1,56%	2,3%	5,0%
Norway	0,5%	12,73%	5,88%	17,2 x	21,0 x	22,12%	113,96%	-55,05%	3,13%	1,1%	3,5%
Spain	0,9%	11,26%	-4,61%	15,6 x	19,2 x	22,88%	43,61%	-42,67%	3,31%	3,3%	-2,5%
Sweden	1,4%	17,36%	31,77%	19,9 x	21,2 x	6,58%	71,42%	-38,40%	2,29%	2,4%	3,2%
Switzerland	2,5%	5,95%	10,73%	18,4 x	21,1 x	14,63%	18,39%	-7,31%	2,61%	1,4%	1,5%
Europe / Commercial Services	0,5%	10,40%	3,13%	20,1 x	24,4 x	21,64%	54,47%	-29,30%	1,85%	2,5%	2,8%
Europe / Communications	0,6%	9,91%	-3,23%	14,7 x	16,6 x	13,46%	-21,64%	4,86%	4,31%	1,4%	0,8%
Europe / Consumer Durables	1,0%	26,86%	18,46%	10,0 x	11,5 x	15,23%	222,71%	-57,84%	3,11%	4,3%	5,4%
Europe / Consumer Non-Durable	3,3%	13,80%	8,89%	23,5 x	26,6 x	13,41%	22,09%	-21,01%	2,02%	2,1%	2,3%
Europe / Consumer Services	0,5%	18,36%	-1,65%	23,0 x	63,4 x	176,67%	275,12%	-122,57%	1,65%	2,8%	-3,2%
Europe / Distribution Services	0,2%	13,04%	22,70%	20,8 x	24,3 x	17,40%	35,26%	-15,04%	1,75%	4,0%	4,3%
Europe / Electronic Technology	0,8%	13,72%	8,85%	21,2 x	27,1 x	27,69%	139,27%	-51,12%	1,15%	1,3%	1,5%
Europe / Energy Minerals	0,7%	13,40%	-27,63%	10,3 x	11,5 x	11,80%	2873,50%	-92,12%	4,79%	2,6%	5,9%
Europe / Finance	3,8%	15,66%	-5,87%	11,5 x	12,8 x	11,03%	51,42%	-34,63%	3,84%	3,3%	4,5%
Europe / Health Services	0,2%	7,91%	12,06%	20,5 x	23,0 x	11,90%	16,62%	-0,81%	1,60%	2,2%	0,1%
Europe / Health Technology	2,2%	5,09%	8,87%	19,0 x	21,7 x	13,75%	6,37%	-0,97%	2,32%	1,8%	2,0%
Europe / Industrial Services	0,3%	10,99%	-9,31%	14,4 x	18,1 x	25,88%	88,96%	-51,22%	2,86%	1,1%	2,1%
Europe / Miscellaneous	0,0%	18,18%	33,67%	8,0 x	8,3 x	4,49%	118,77%	-81,20%	5,49%	3,5%	26,2%
Europe / Non-Energy Minerals	0,7%	23,34%	17,23%	11,6 x	9,7 x	-16,36%	82,64%	27,70%	4,72%	3,6%	6,1%
Europe / Process Industries	0,8%	7,86%	17,61%	18,9 x	20,7 x	9,02%	34,45%	-13,99%	2,52%	2,3%	3,3%
Europe / Producer Manufacturin	1,8%	14,71%	31,52%	20,9 x	25,3 x	20,86%	84,97%	-32,20%	1,66%	2,3%	2,6%
Europe / Retail Trade	0,5%	6,87%	21,69%	21,4 x	28,3 x	31,02%	73,34%	-24,40%	1,94%	3,5%	2,9%
Europe / Technology Services	1,0%	2,92%	23,86%	26,0 x	31,1 x	19,77%	19,20%	-5,85%	0,81%	2,0%	1,7%
Europe / Transportation	0,6%	26,18%	3,88%	21,5 x	93,3 x	332,96%	116,22%	-255,23%	1,96%	2,2%	0,4%
Europe / Utilities	0,9%	-2,80%	24,35%	16,5 x	17,9 x	8,25%	10,26%	-17,22%	3,90%	1,7%	1,9%

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