CHAHINE CAPITAL
Performance Engineering
30/3/2019
STRATEGY OVERVIEW

Long-term interest rates on the slide

Summary

The Federal Reserve has pulled off a monetary policy U-turn since the severe stock market correction late last year. Investors have moved from pricing in two or three rate hikes this year to no change, and there is now even talk of a rate cut. The Fed has also promised to halt its balance sheet reduction programme, which had been on autopilot. There are more and more signs of slowing activity, with the consensus forecast for world GDP growth dropping 0.2 point to 3% with the possibility of more revisions to come. The US economy still appears to be robust, but the Fed has had to revise its own forecasts down. A Chinese slowdown is not reflected in these forecasts, but its annual car sales have just dipped from 30 million to 23 million. Europe is subject to heavy revisions of its own, especially given the threat of Brexit. The German yield curve has become even more inverted, stoking fears of recession. The ECB has been more vigorous and the German 30-year yield is down to an historically low 0.67%. This raises the question: what ammunition is left to the authorities if recession materialises?

One of the consequences of this environment is investors' renewed interest in real estate. Yields in the sector have dropped to 3% for prime office space in Paris and by more in growth markets such as the USA, and Eastern and Southern Europe. Returns on residential property are running at around 2-2.5%, to which inflation should be added. The easy money of the post-crisis years ended up with the already solvent rich and worsened inequalities. It also enabled American firms to buy up their own shares, at an annual rate that hit a new high of 4.2% in Q4 2018. This has optimised earnings per share and bolstered share prices.

The deal of the moment is the euro/dollar carry trade, which is currently banking 3% over a year if the parity between the two currencies stays put and more than that if the dollar appreciates. It is worth an additional 1.8% if euro cash is invested through the trade in investment-grade corporate bonds. This is certainly a speculative investment if abused, but perfectly sound if it is used to obtain a desired level of dollar exposure in a large private portfolio.

The third type of investment is in equities, which can never be left out, with adjustments to marginal exposure as a function of risk. The S&P 500's earnings yield is 5.8%; Europe's is 7.3%. Equity markets are historically more profitable than bonds, but of course they are exposed to the economic cycle. Many investors stayed away from equities after the financial crisis, which halved share prices. Our risk premium valuations give us an end-2019 objective for the S&P 500 of 2,833 points compared with last Friday's close at 2,834 points. This suggests that Wall Street is fair value, and we believe the background risk to be high, given that profits are at a cycle high. We are therefore slightly underweight our benchmark. For HNWI portfolios worth more than €10 million, our asset allocation is 48% in real estate, 34% in equities, 8% in 2-4 year Treasuries, 5% in other bonds and 5% in cash. The larger the portfolio, the more diversification there is within each segment, for example through office premises, hotels, mezzanine loans, private equity and carry trades.

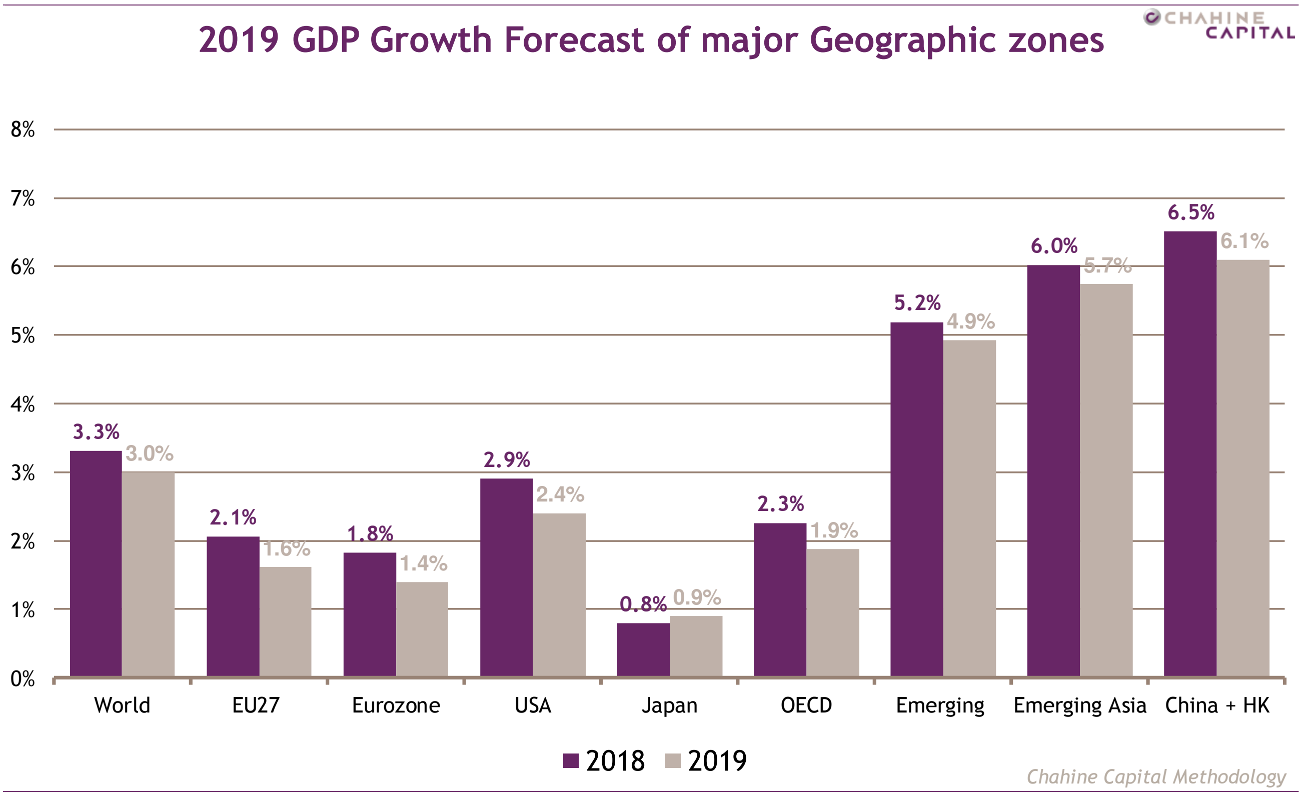
Despite the economic slowdown visible across much of the globe, equities have been one of the best performing investments so far this year. The MSCI World is up 12.8%, which largely makes up for losses last year. Lower interest rates are the prime reason for this move, and our asset allocation has benefited from it. But readers should remain aware of the risks, including Brexit. We have left that one alone in this edition, except to remark that the markets stopped reacting to it a long time ago. Could they be right about that?

Jacques Chahine

A Fed U-turn in response to faltering activity

The Federal Reserve has pulled off a monetary policy U-turn since the severe stock market correction late last year. Investors have moved from pricing in two or three rate hikes this year to an indefinite period of no change, and following recent economic data there is now even talk of a rate cut. The markets and the White House would certainly want it. The Fed has also called a halt to its balance sheet reduction programme, which was on autopilot. This all reflects fears of slowing growth, with forecasts still being shaded lower. Our in-house world growth database is now showing a 2019 forecast down 0.2 point to 3% since the start of the year, compared with 3.3% last year. All regions are contributing to this slide. We had hoped for some stabilisation of forecasts last month but the revisions continue, especially in Europe. The consensus forecast for Germany is down from a high at 1.9% to 1.3%, France's figures are identical and Italian GDP is expected to barely move. The USA has caught the virus, and the Fed is blaming the international environment for revising its own 2019 forecast from 2.3% to 2.1%. The consensus view from Q1 2019 has dropped from 2.1% to 1.7%. In China, and although the Party's official forecasts are unchanged, a deceleration in activity is hard to deny. Chinese car sales are now running at an annualised 23.6 million, for example, compared with 30 million a few months ago. Growth numbers for other high-growth Asian countries and for Japan are also down.

Less growth worldwide this year

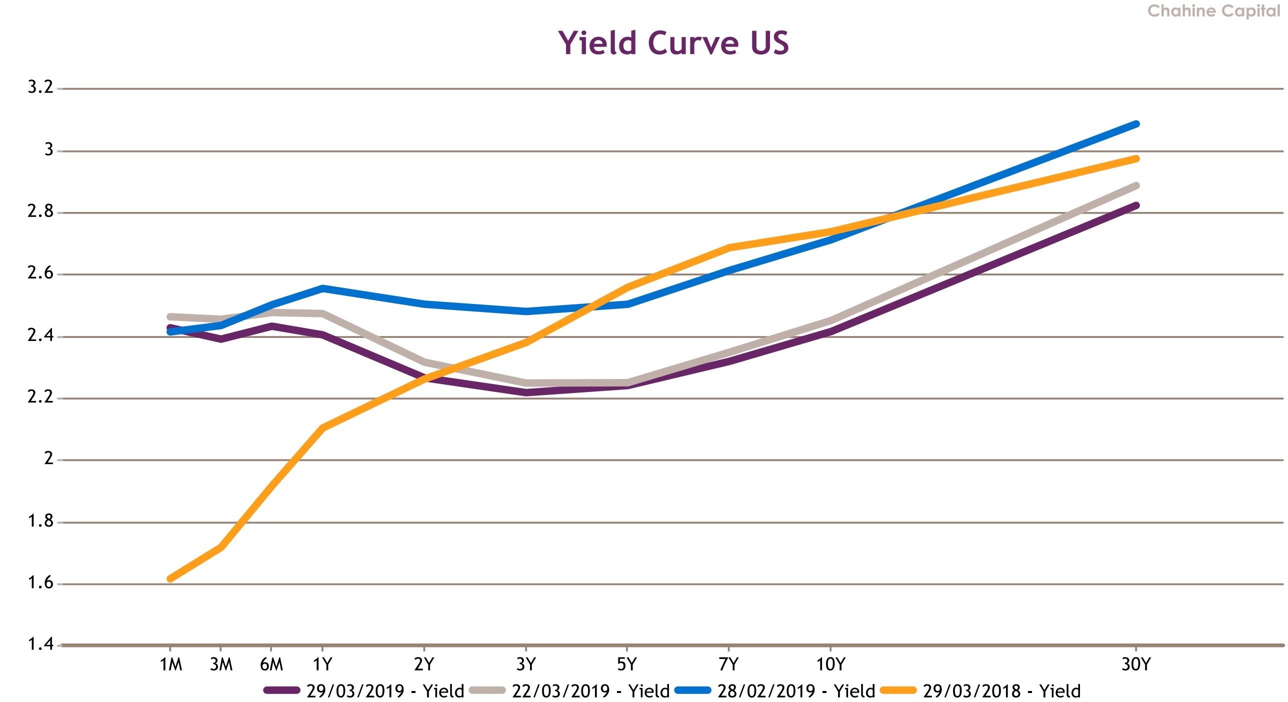


Chahine Capital Methodology

Inversion at the front end of the US curve

Central bankers have decided to calm the markets' nerves, leaving a shallow U-shaped US curve. US interest rates are steadily lower out to 3 years or so before picking up again. A year ago, the US curve had a healthy upward slope, matching the strength of the economy at that time. The inverted section of the curve shown below, with yields dropping from 2.4% to 2.2%, imply that the markets expect a Fed rate cut, albeit a modest one. The monetary authorities will be obliged to take steps to boost the economy, in other words, and that is the scenario unnerving investors.

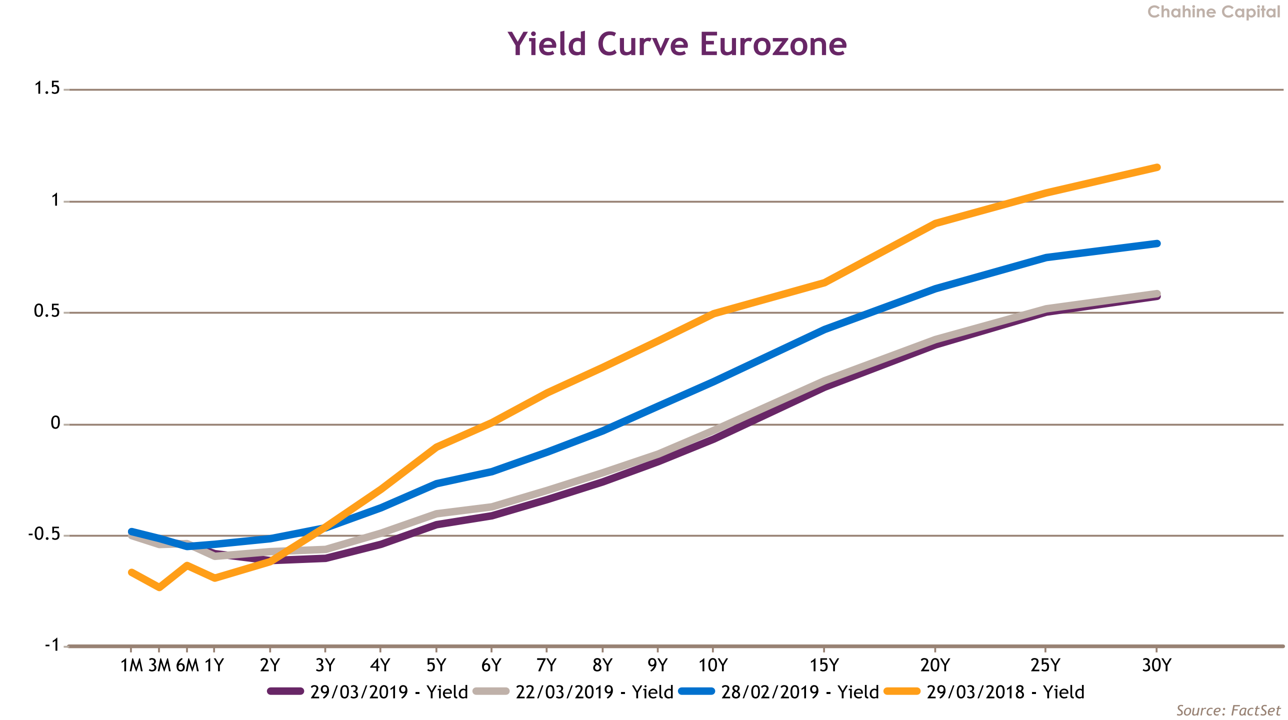
A more inverted US curve



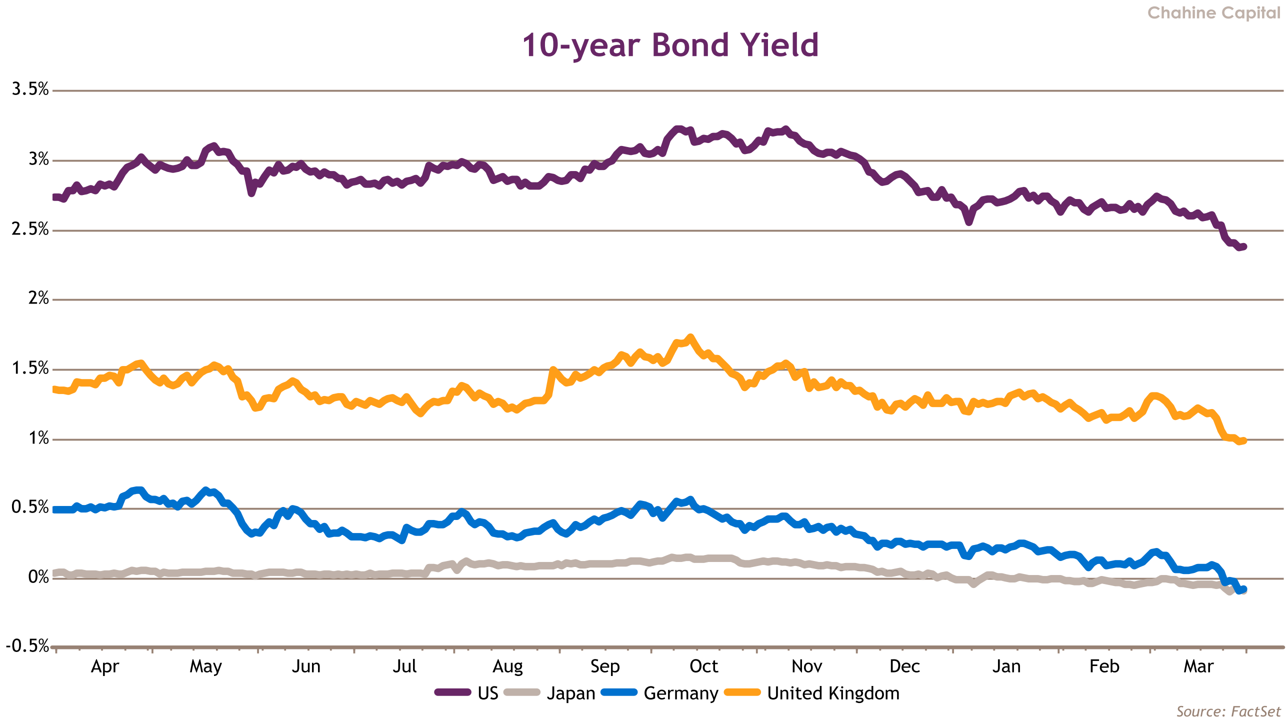
Source: FactSet

Given the euro zone's weaker starting point, Mario Draghi has needed to intervene more energetically. He has hinted at a longer period of accommodating monetary conditions to reflate the economy and offset faltering external demand. Negative interest rates are a worry for eurozone banks, however, as deposits at the ECB are already costing them €7 billion per year. The ECB is looking at ways of mitigating this effect and underpinning the health of the financial system, but in the meantime its policy has pushed bond yields even lower and the resulting yield curve looks surreal. The German 30-year yield is now 0.57% and the whole curve is negative out to 10 years. The euro curve also features the shallow U out to 3 years, which implies more rate cuts and/or more liquidity injections. The problem is identifying any ammunition the ECB could use in the event of recession. The Fed has far more room for manoeuvre and could cut its key interest rate range from 2.25-2.5% to zero if it had to. Could the ECB really cut its own rates to -1 or -2%? Or would it be simpler to hand out cash to consumers to get them buying again?

A barely believable euro curve



Long rates down across the board



What does 10-year Germany at 0.57% really mean? And what kind of investor would sign up for virtually no return for 30 years, with all sorts of unknowns and crises to come, and in ignorance of future inflation and variations in interest rates? Does the market really believe that the eurozone economy will stagnate for decades, having deflated ever since the 2008 crisis? Current interest rate levels suggest that investors are struggling to find profitable alternatives, even with extremely low borrowing costs.

Which investments make sense at the moment?

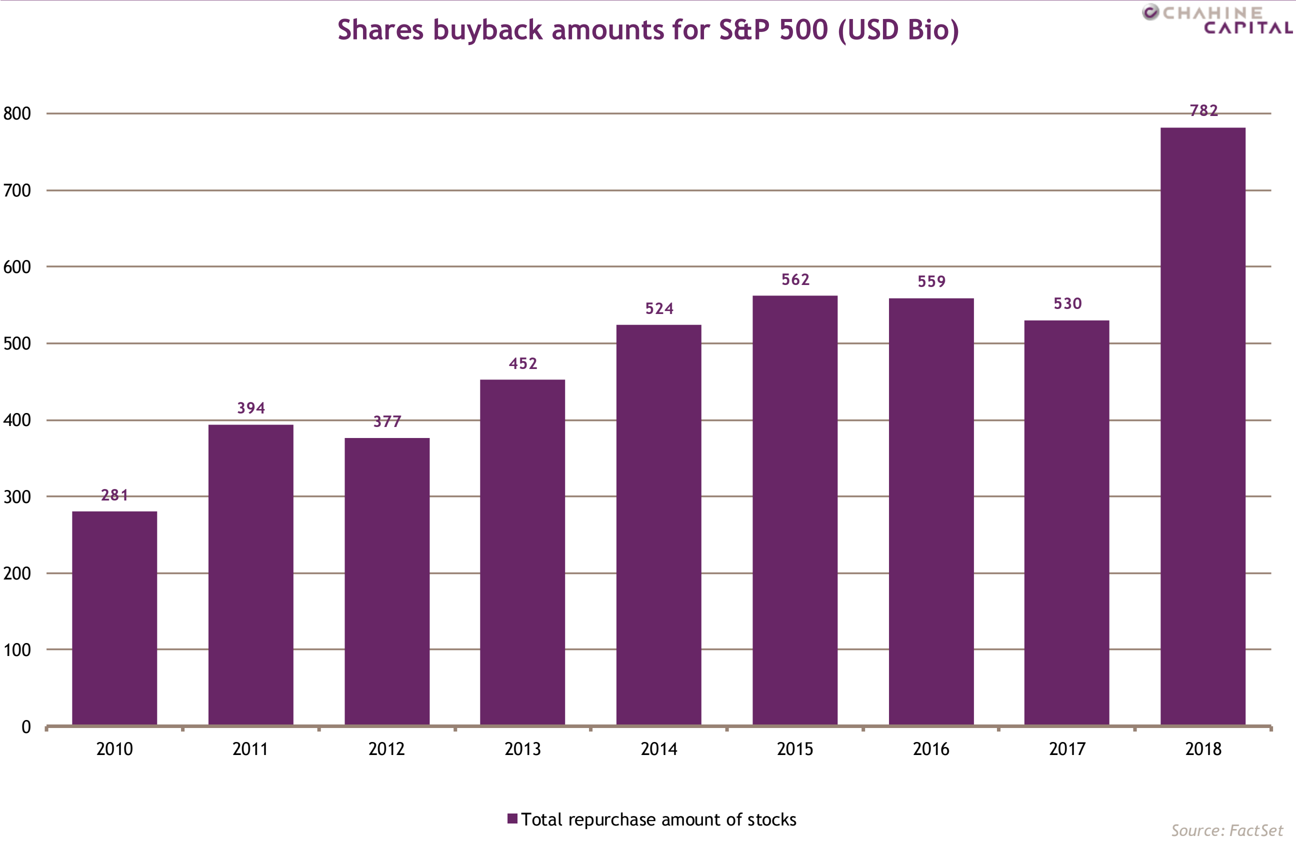
Very low interest rates are only available to the most solvent borrowers, of course, and Europe's weakened banks are in no mood to take on risk. Many are still running huge portfolios of non-performing assets from the crisis. One result is that the real estate sector now offering the best risk/return profile around. In Paris, prime offices in the best locations can return an annual 3%, and with inflation indexation. By comparison, returns on prime residential property are around 2-2.5%. A reliably solvent borrower could access finance at Euribor+0.75%, and Euribor is zero. Within the real estate sector, diversification could lead investors to consider more profitable propositions than those on offer in France, such as in the USA or higher-growth EU countries like Spain, Portugal and in Eastern Europe.

Life insurers that ensure guaranteed minimums to their policyholders will be interested in this niche to bolster their returns. But given risk aversion, credit is scarce for companies seeking to expand. This is why all the accommodating monetary policies introduced since the 2008 crisis have benefited the rich and worsened inequalities.

Share buybacks

Buying back your own shares is another use of cheap money. S&P 500 companies did so in record proportions last year, amounting to an overall buyback rate of 3.5%. Tax reforms encouraging the repatriation of stockpiled US corporate profits abroad only heightened this trend. Buybacks send two important messages: companies are not identifying any better investment options, and they are keen to optimise their own earnings per share. The surge in buybacks recorded in Q4 (4.2% of shares) helped to buoy share prices after their correction.

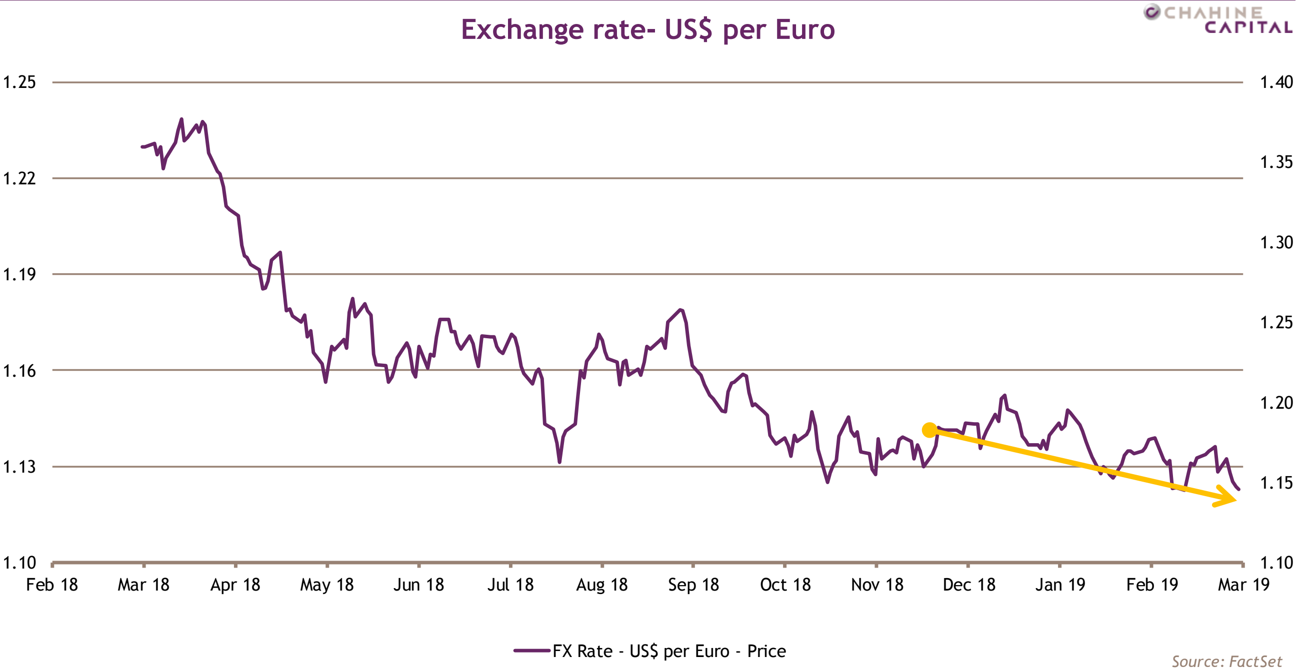
Corpoate buybacks surge again



The euro/dollar carry trade

The current interest-rate differential between the USA and euro zone creates a carry trade: borrow euros at negative interest rates, for example for 12 months (1-year German government debt is yielding -0.6%) and invest them in US Treasuries at 2.40%. Assuming that the dollar-euro parity is unchanged in a year's time, the return on the trade is a comfortable 2.4%+0.6%=3%. The trade is frictionless if executed through a swap or via dollar futures. In the context of a 'non-speculative' portfolio that is required to have some assets invested in dollars, the trade is more profitable than a straight purchase of Treasuries, assuming that the investor's bank does not charge negative interest on euro cash. Euro cash can also be invested in mid-quality bonds at an average 1.8%. Given that the ECB is proving even more accommodating than the Fed, the euro has depreciated against the dollar, making the carry trade even more attractive. The ECB's desire for a weaker euro as means of boosting competitiveness in international markets is not much of a secret.

The €/$ carry trade is strengthening the dollar



Source: FactSet

Investing in equities, eyes wide open

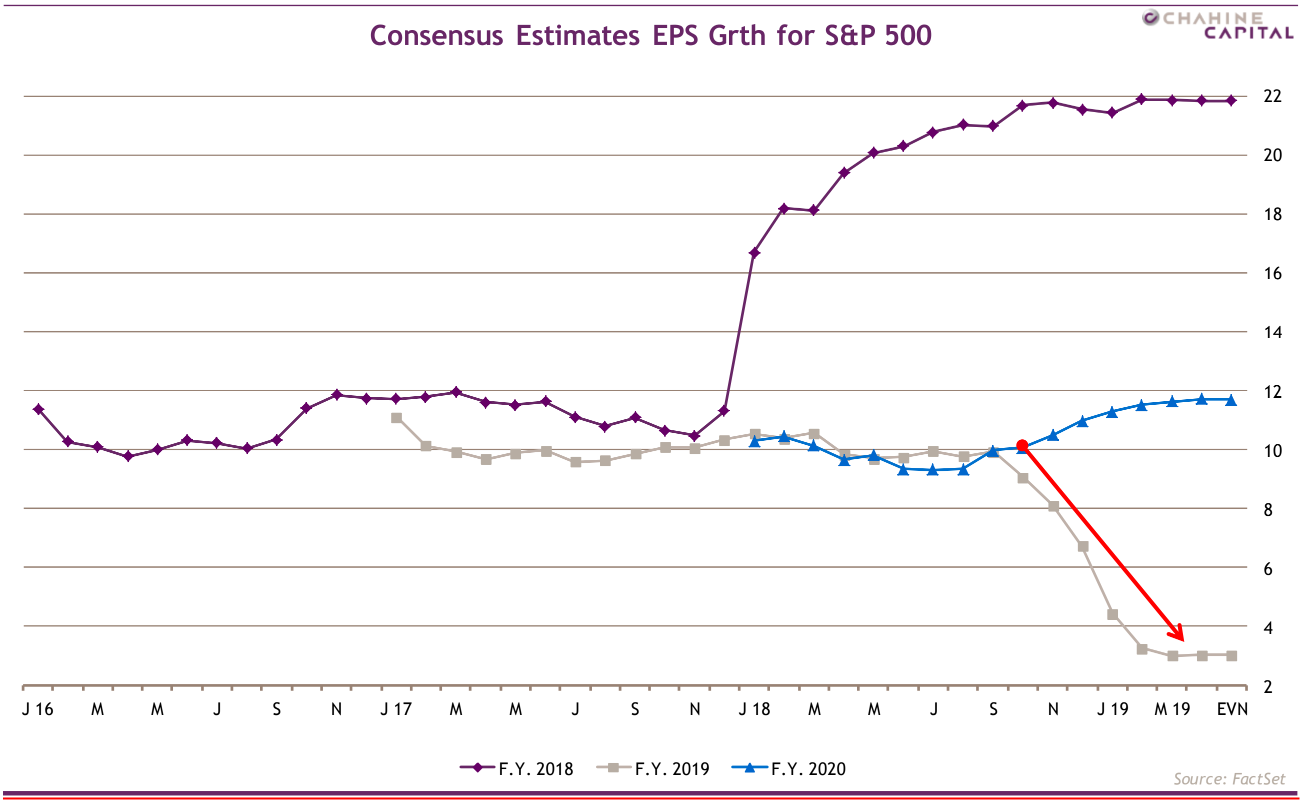
Compared with the two investment ideas just discussed – real estate and a non-speculative carry trade – the equity market is clearly riskier. But it is also the most profitable investment over a long period of time. Right now, for example, the earnings yield (the inverse of the price to earnings ratio) is 5.8% in the USA, 7.3% in Europe and 8.1% on emerging markets. Equities have historically outperformed bonds, especially with appropriate diversification worldwide and within the dominant US market. The problem is that returns on equities are subject to cycles, and hence the need for a significant risk premium. The halving of equity prices during the financial crisis has dissuaded more than a few investors from entering or re-entering this market to stay clear. Our portfolio management strategy is to maintain a fairly stable asset allocation and to play investment themes appropriate to the moment (such as those discussed above) only at the margins of that allocation.

A reversal in the 2019 profits curve

Calculating the balance between risk and return is fairly straightforward for bonds or real estate, but this is not true of equities. Equity values depend on the level of long-term interest rates and profits, which in turn depend on the economic environment and outlook.

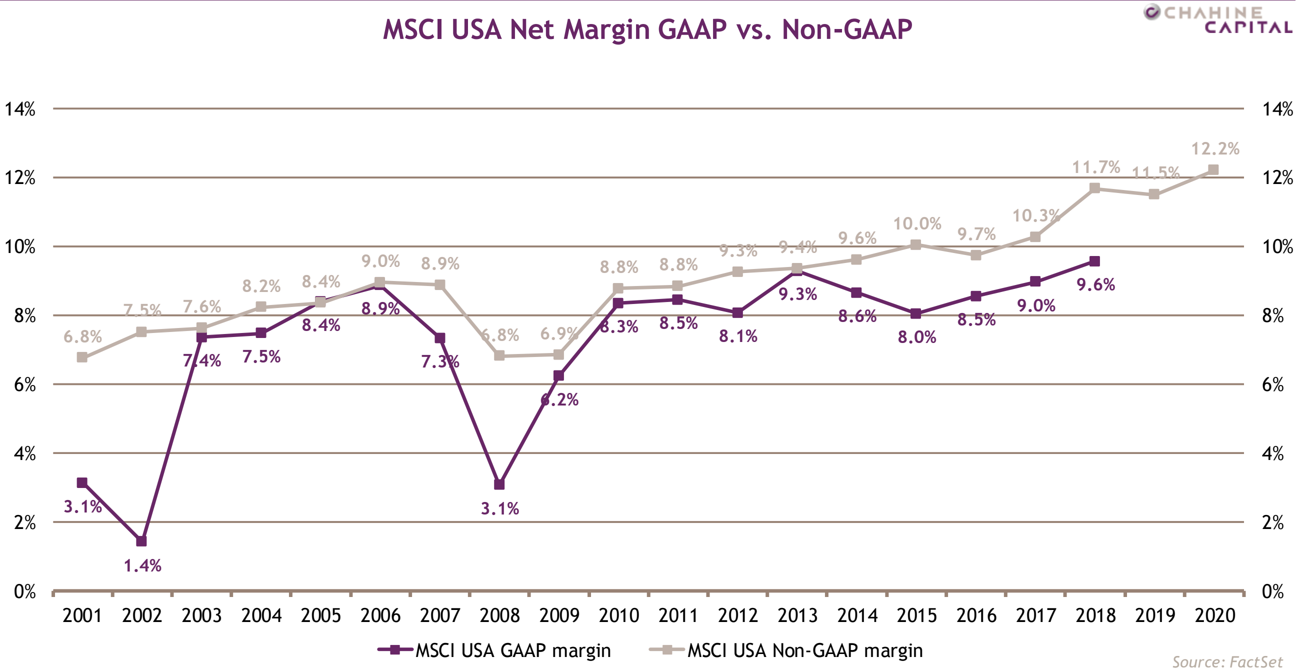
The S&P 500 corrected by around 20% in the final months of 2018; readers will recall that we suggested in September that it was excessively overvalued. Share prices have recovered most of their losses since the Fed's U-turn and the consequent fall in long-term interest rates. The yield on the 30-year Treasury has declined from its recent high at 3.5% to 2.81%. With an eye to re-election, President Trump has eased off on China and therefore US exporters, including IT. But he can do nothing about the international slowdown in economic growth, which of course affects the US economy and the S&P 500 as well.

A slump in US earnings growth prospects



This situation has prompted drastic downward revisions to estimates of US corporate profits in 2019. The consensus figure for EPS growth has dropped from 10% to 3%, and we are retaining 2% from our top-down model. Whatever the outcome turns out to be, it follows an exceptional 22% EPS gain last year on the back of tax changes and a buoyant economic environment. If we take account of share buybacks and assume a buyback rate of around 3%, we end up with profits at best unchanged in 2019. A rebound is expected in 2020, but given that we're already in the longest economic expansion since 1956 a recession or sharp slowdown can hardly be ruled out between now and then. Note also that US corporate margins are at historical highs, partly because of the massive rents obtainable on new technology and partly because of the recent tax cut. Non-GAAP margins are expected to fall this year, and the spread between GAAP and non-GAAP profits observed in 2018 highlights significant goodwill depreciation.

A downturn in US profit margins in 2019?



Caution warranted on equities

In line with the drop in the US 30-year yield from 3.09% a month ago to 2.87% (with a low at 2.81% last Friday), our S&P 500 objective for end-2019 has risen from 2,699 to 2,833 points. If there were a stabilisation in the economy's growth path we would lean towards a neutral equities allocation, or at least investment in line with one's benchmark. But given the risks of slower growth, a hard Brexit and a breakdown in talks with China, we intend to remain as we were last month, i.e. slightly underweight relative to our benchmark. Investors that are markedly underweight should consider buying opportunities, however.

The market's 8-year CAGR is a reasonable 3.4%, which is lower than the nominal potential growth rate. It indicates a probable recession in profits during the period.

Tumbling long rates bolster Wall Street valuations

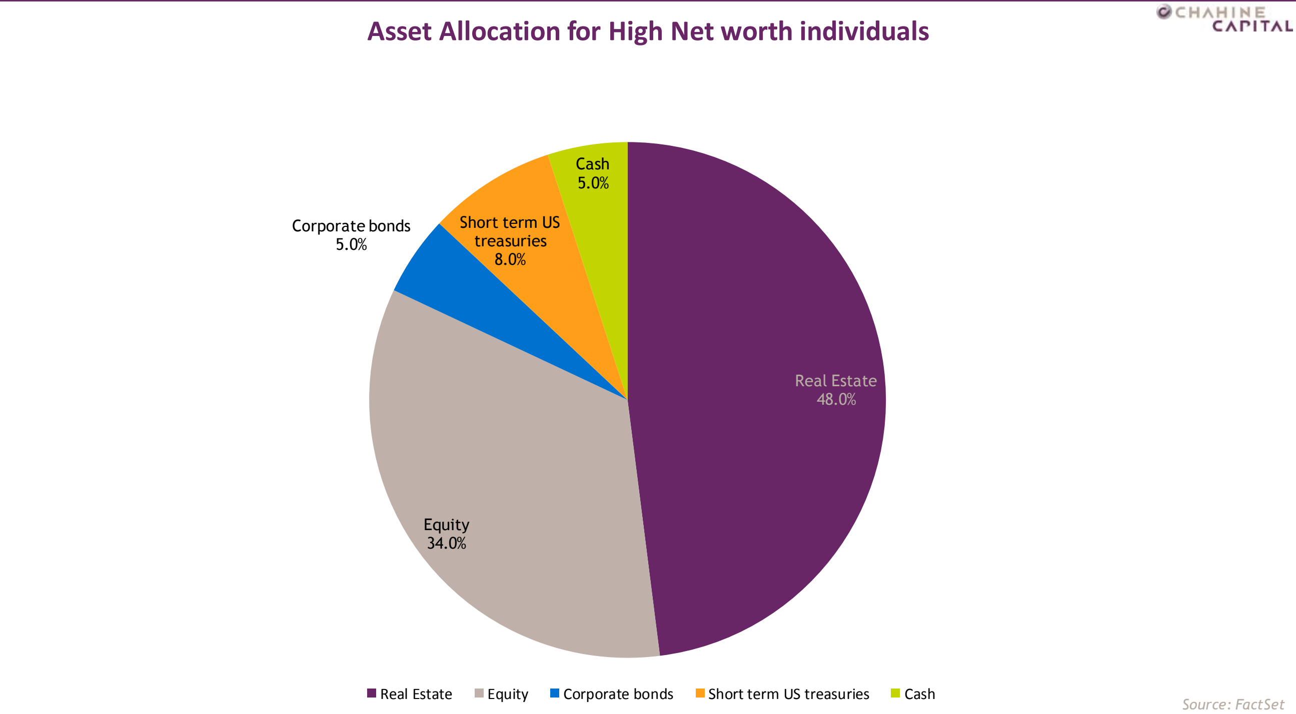
S&P 500 - Valuation end 2019 except implied scenario *CAGR Compounded Annual Growth Rate from 2018*	30 Years Gvt bonds				
	2.50%	2.75%	**2.87%**	3.00%	3.25%
Mild recession: -6.1% in 2019, and 8% in 2020 - CAGR =1.7%	**2 694**	**2 554**	2 492	2 426	2 309
Implied Scenario CAGR 3.9% over 8 years	3 055	2 892	**2 818**	2 743	2 606
Base scenario: 2.1% in 2019 and 9% in 2020 - CAGR = 3.4%	3 065	**2 905**	**2 833**	**2 759**	2 625
Current Index S&P 500			**2 834**		

The mild recession scenario shown in the table would be a simple follow-on from the present slowdown. Profits are assumed to fall 6% in 2019 and recover somewhat in 2020. In that case we could expect the 30-year yield to fall to 2.5%, which gives us a market valuation at 2,694 points. That would still be above its recent low at 2,531 points. A panic factor could of course take the index below that point, but in situations like that investors need to assess the exact situation at the time.

An asset allocation for today's conditions

The pie chart below offers our private wealth managers a suggested asset allocation for HNWI portfolios worth over €10 million that is appropriate to where markets are at the moment. Real estate is the single largest allocation (48%), and includes the client's main residence. Equities are at 34%, although that could be lifted to 40% if trading conditions permit. Liquid assets include short-dated Treasuries and investment-grade corporate bonds. Cash represents 5%.

A bias towards equities and real estate



Source: FactSet

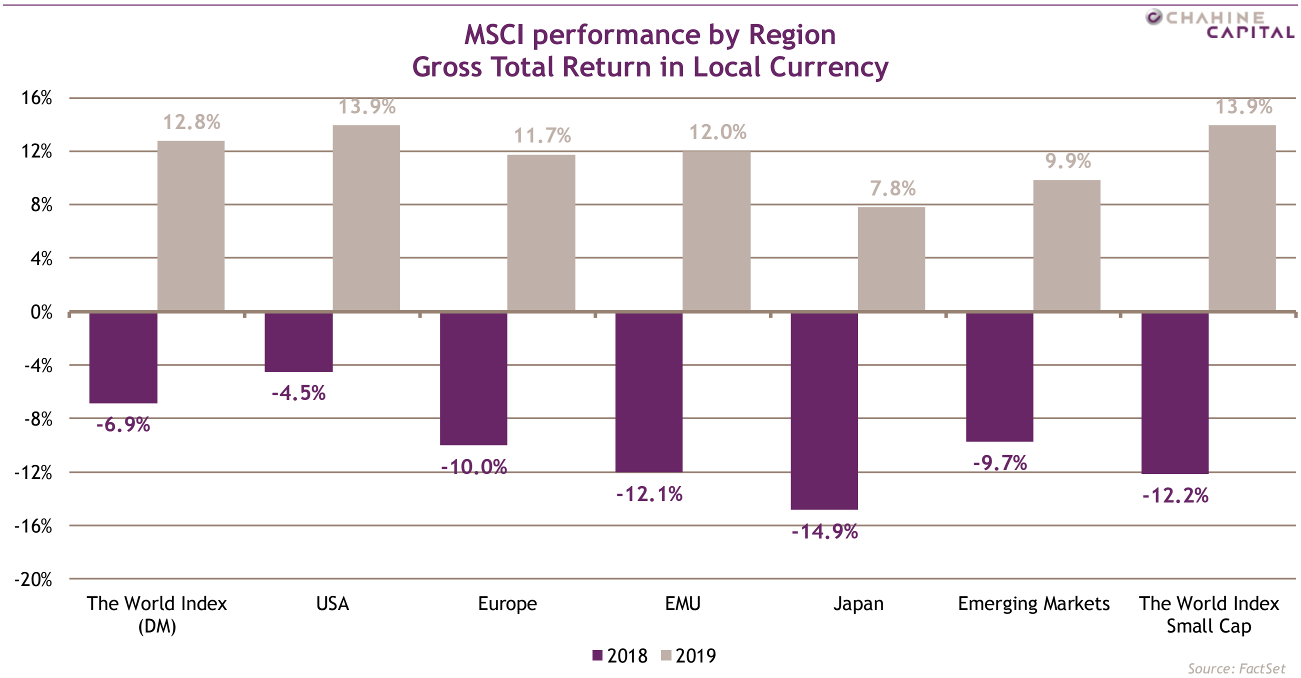
The bigger the portfolio the more diverse it can be, and as Thomas Piketty pointed out, the more profitable it can become as a result. For example, the bond allocation could include mezzanine debt, which is relatively risky but can yield 7% in euros and 10% in dollars. Similarly, real estate could include offices, houses, hotels or warehouses, and equities can be diversified not simply between Americans, Europeans and emerging markets but also through private equity, which can be very profitable if due diligence is carried out. We have already mentioned currency portfolio diversification into dollar futures; large euro portfolios really ought to have 30-40% dollar exposure.

Portfolio managers are all the more effective when they have sight of the client's overall holdings, of course, as the asset allocation may not be optimal otherwise.

A bullish start to the year

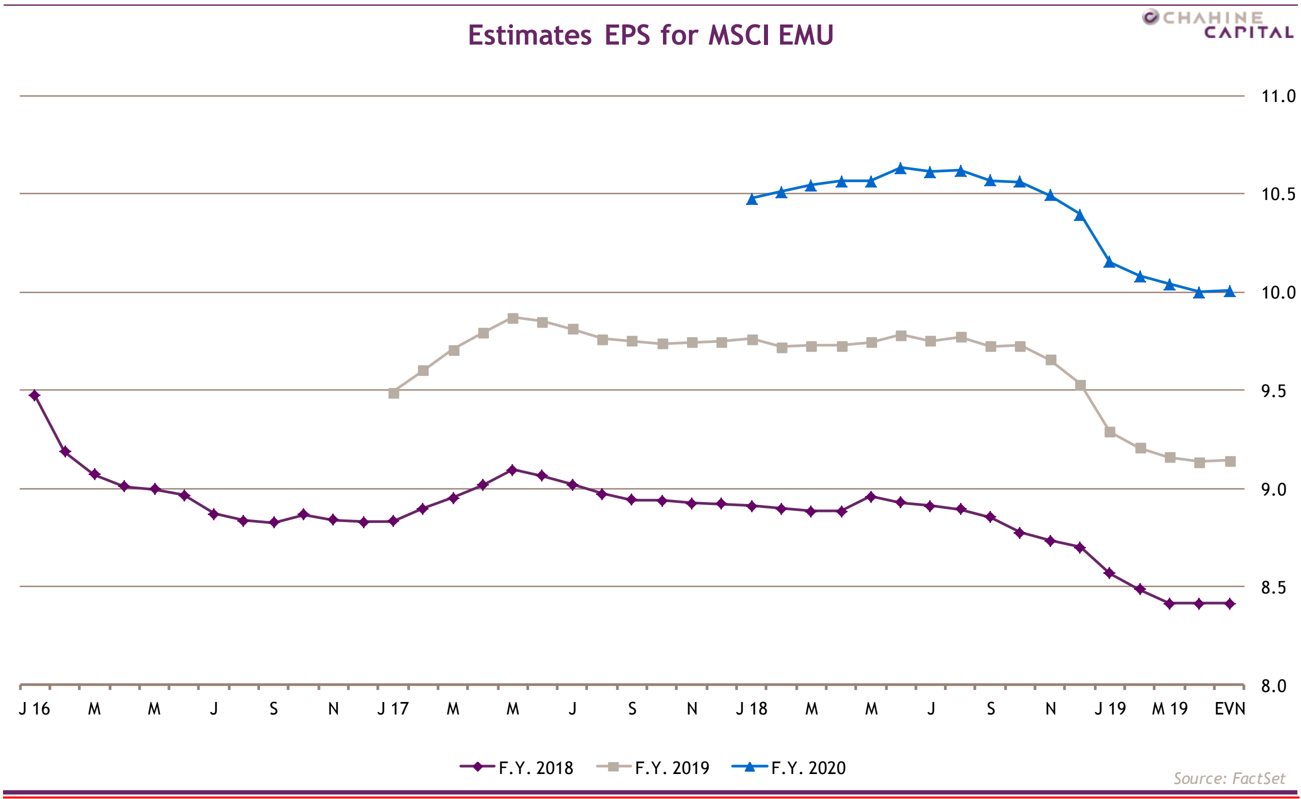
Slower economic growth notwithstanding, equities have been one of the best-performing investments so far this year. The MSCI World index is up 12.8%, mainly because Wall Street has recovered almost all the ground it lost during the correction last year. The US market was down 4.5% over 2018 as a whole but is up 13.9% this year on a total return basis. Lower interest rates are the main reason for this turnaround. The correction has left many investors nervous, however, and as we have seen net share buybacks have been responsible for some of the apparent buoyancy in prices. Small and mid-caps have rebounded after their slump last year. IT stocks are still very much in favour, despite a mediocre outlook for profits. Apple is already expected to post a $2 billion drop in its profits this year but could surprise to the downside. The real estate sector is outperforming, reflecting its own sensitivity to interest rates. In the meantime, the European market has shrugged off Brexit uncertainty to pull back all its 2018 losses.

Equities rise sharply in the wake of falling interest rates



The European enigma

Our baseline scenario for Europe gives us a higher year-end objective, as our weighted 30-year rate is down to 1.25%. But there is no tangible sign of higher company profits, and the final announcements for 2018 have cut the year's EPS growth to zero. Estimates for 2019 are still being shaded lower and we would now be delighted if our top-down estimate of 3% materialised. We challenge our readers to explain why an asset with a 3.75% dividend yield is regarded as unattractive compared with a 30-year Bund yielding 0.67%. Our model tells us that the market's implied 8-year CAGR is -4.6%. Is that really plausible?



Upside potential if Europe ever stirs

MSCI EMU - Valuation end 2019					
CAGR Compounded Annual Growth Rate from 2018	**30 Years Gvt bonds**				
	0.75%	1.00%	**1.25%**	1.50%	1.75%
Depression scenario: -15% in 2019, and +4% in 2020 - CAGR =-7.6%	**114**	**107**	100	94	89
Implied Scenario: CAGR -5.8% over 8 years	136	127	**119**	113	107
Base scenario: 3% in 2019, and 5% in 2020 - CAGR = -4.6%	146	137	**128**	**121**	**114**
Current Index MSCI EMU			**119**		

Conclusions

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Main ratios for markets and sectors as of 29/3/2019 (in local currency)

	Weight vs	Perf		Weighted P/E		% Wted EPS Chge			Div Yield	Revision vs M-2%	
	MSCI World	2019	2018	2020	2019	2020	2019	2018	2019	Fiscal 20	Fiscal 19
MSCI The World Index	**100.0%**	**12.0%**	**-10.3%**	**14.2 x**	**15.7 x**	**10.2%**	**4.4%**	**12.5%**	**2.61%**	**-0.7%**	**-0.8%**
MSCI USA	60.7%	13.4%	-6.5%	15.4 x	17.2 x	11.9%	3.1%	22.0%	2.02%	-0.2%	-0.3%
MSCI Japan	8.2%	6.7%	-15.8%	11.5 x	12.1 x	5.2%	0.5%	3.4%	2.70%	-1.2%	-1.7%
MSCI EMU	14.0%	11.4%	-14.5%	12.0 x	13.1 x	9.6%	8.8%	0.7%	3.75%	-0.4%	-0.5%
MSCI Europe	25.7%	12.0%	-13.0%	12.5 x	13.6 x	8.9%	9.3%	5.5%	3.96%	-0.5%	-0.5%
MSCI Europe ex Energy	23.7%	12.0%	-13.7%	12.7 x	13.8 x	8.3%	10.1%	2.2%	3.82%	-0.5%	-0.4%
MSCI Austria	0.1%	10.2%	-26.7%	9.0 x	9.6 x	7.5%	-10.8%	9.7%	4.19%	0.6%	-0.2%
MSCI Belgium	0.6%	18.2%	-24.9%	14.7 x	15.9 x	8.0%	13.2%	-0.5%	3.26%	-0.5%	0.1%
MSCI Denmark	0.8%	13.8%	-12.4%	17.8 x	20.3 x	14.0%	1.0%	-1.1%	2.42%	-0.7%	-0.9%
MSCI Finland	0.4%	9.0%	-1.5%	14.3 x	16.2 x	12.6%	8.2%	2.3%	4.70%	-0.4%	-0.3%
MSCI France	5.2%	12.8%	-9.7%	12.8 x	14.1 x	10.5%	8.4%	6.7%	3.49%	0.0%	-0.1%
MSCI Germany	3.6%	8.3%	-20.2%	11.1 x	12.1 x	9.8%	11.3%	-9.7%	3.58%	-0.6%	-1.4%
MSCI Great-Britain	6.0%	7.8%	-12.7%	11.9 x	12.8 x	7.8%	3.4%	9.6%	4.85%	-0.8%	-0.2%
MSCI Ireland	0.2%	11.4%	-23.5%	13.7 x	14.7 x	6.8%	0.0%		2.04%	-0.4%	0.5%
MSCI Italy	1.1%	16.2%	-15.5%	9.8 x	10.6 x	9.0%	6.5%	15.5%	4.74%	-0.4%	0.0%
MSCI Netherlands	1.3%	14.0%	-10.9%	13.7 x	15.0 x	10.1%	3.2%	8.1%	3.34%	-0.5%	-0.2%
MSCI Norway	0.5%	6.0%	-6.0%	12.2 x	14.1 x	16.0%	0.3%	20.0%	4.70%	-0.9%	-0.9%
MSCI Spain	1.4%	8.3%	-15.0%	10.9 x	11.7 x	6.6%	13.1%	-5.5%	4.78%	-0.8%	-0.2%
MSCI Sweden	1.0%	10.9%	-8.1%	14.0 x	14.2 x	1.5%	33.6%	-7.5%	4.28%	0.1%	0.1%
MSCI Switzerland	3.2%	13.5%	-10.1%	15.4 x	16.8 x	9.2%	11.0%	25.4%	3.30%	-0.6%	-1.2%
MSCI Europe Consumer Discretionary	2.9%	13.9%	-17.5%	11.2 x	12.0 x	7.3%	12.9%	-7.9%	3.51%	-0.7%	-1.3%
MSCI Europe Consumer Staples	3.9%	16.8%	-11.3%	17.0 x	18.4 x	8.2%	10.6%	7.4%	3.07%	-0.3%	-0.1%
MSCI Europe Energy	2.0%	11.5%	-5.0%	10.5 x	12.1 x	15.1%	2.4%	49.0%	5.53%	-0.9%	-0.8%
MSCI Europe Financials	4.5%	8.0%	-21.8%	9.0 x	9.7 x	6.8%	12.7%	6.3%	5.55%	-0.5%	-0.4%
MSCI Europe Health Care	3.1%	12.0%	-2.5%	15.1 x	16.5 x	9.5%	5.1%	5.0%	3.09%	0.3%	0.6%
MSCI Europe Industrials	3.4%	13.3%	-15.0%	14.3 x	15.8 x	10.3%	9.2%	3.0%	2.99%	-0.7%	-1.1%
MSCI Europe Information Technology	1.3%	15.7%	-8.2%	16.9 x	20.1 x	18.9%	12.5%	12.4%	1.62%	-0.3%	-0.2%
MSCI Europe Materials	1.8%	14.2%	-16.4%	12.7 x	13.3 x	5.0%	12.3%	0.7%	3.94%	0.1%	0.9%
MSCI Europe Real Estate	0.3%	12.3%	-17.5%	14.5 x	14.3 x	-1.4%	-17.6%	11.7%	4.74%	-1.6%	-2.1%
MSCI Europe Communication Service	1.3%	1.8%	-10.7%	12.7 x	13.9 x	9.1%	5.3%	-3.9%	5.18%	-1.5%	-1.2%
MSCI Europe Utilities	1.2%	10.7%	-1.3%	13.3 x	14.9 x	11.9%	16.4%	-14.2%	5.21%	-1.0%	-1.1%

Benchmarks source iShares ETF - Data as of 29/03/2019

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