Are investors demanding less of a risk premium for equities?

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| SummaryApart from a continuing rally on the back of unchanged fundamentals, there is little new to report on equity markets. The S&P 500 is up another 100 points to 3,110 points, the interest-rate environment is much the same as last month and the end of the Q3 results season proved uninspiring. Our year-end objective is now at 2,846 points, pretty much in line with where it was a month ago (2,834 points) and implying a 9% overvaluation that we would struggle to justify with reference to interest rates or profits. There is just one of our valuation model’s parameters that we have not tweaked: the risk premium, which we have kept at 3% above the yield on government debt. But given that the yield on the Treasury long bond has fallen in stages from over 10% 40 years ago to 2.26% today, investors may well have eased up on the risk premium they require from equities. If we cut it to 2%, our year-end objective rises to 3,654 points. Our own preference is to avoid tinkering with the model in this way, however, and we are maintaining an equity market allocation at 35% (although it has climbed to 37% because of the rally) compared with a benchmark allocation of 40%.The market is assuming that an agreement between the USA and China over trade is a done deal, but the negotiations are dragging on. At the end of the day, high-tech America will send the Chinese a few million pigs and shedloads of soybeans amid hopes that they will obtain better protection of intellectual property in return. The Chinese want tariffs to be removed, but US negotiators need leverage to ensure a deal is respected. Traders are taking it for granted that the yuan will stay firm and lobbyists back in America are pushing Donald Trump towards an agreement on the grounds that he will not want to disappoint investors in an election year. It could all add up to a poor agreement. US GDP growth has slowed on trend from around 5% per year in the 1960s to 2% in the present decade, which is now accepted as its normalised rate. Forecasters expect 1.8% in 2020. Following acceleration in the 1990s and up until 2006, and particularly after the financial crisis, the world growth rate has eased from 3.5% to 2.7% in local currency terms. Increases in corporate profits over the period are all the more remarkable for the fact that margins are at historical highs, thanks to IT. US profits have been growing 1.3% faster on trend than GDP, although recent tax reform has had a part to play in that too. Repeating that adjustment would be difficult. The US economy is currently enjoying its longest-ever period of uninterrupted annual growth, but it is hard to see recession being held off forever and that will affect the earnings CAGR in our valuation model. We are currently using a CAGR of 2.1%, rather than the 3.3% that would justify equity prices. Note that earnings estimates for 2019 are now falling, and projections for 2020 are being revised lower. Q3 results announcements included significant revisions for Q4 and onwards from the corporate side, especially among Russell 2000 small caps dependent on domestic demand. Recent declines in investment and the uncertainty inherent in an election year will both weigh on profits.Low interest rates are still the only good reason why world equity markets are up 24% - and Wall Street up 26% - this year. Liquidity injections by the Federal Reserve have only fuelled the rally. The most recent PMIs are positive and offer some hope of a rebound in growth. A survey of market strategists gives us an average expectation of 3,272 points for the S&P 500 next year, with Morgan Stanley and UBS at 3,000 points. Our own assessment is 2,950 points. Our European market valuation is close to current trading levels. Jacques Chahine |

## A declining price for risk?

Apart from a continuing rally on the back of unchanged fundamentals, there is little new to report on equity markets. The S&P 500 is up another 100 points to 3,110 points, the interest-rate environment is much the same as last month and the end of the Q3 results season proved uninspiring. US corporate earnings were down 1.8% from the year before and Q4 earnings are expected to be down 1.7%. The 30-year Treasury yield is virtually stagnant at a very low 2.23%. Our theoretical objective for the index at year-end has barely moved since last month, at 2,846 points compared with 2,834 points. We are finding it hard to justify the implied 9% overvaluation with reference to the usual hypotheses.

Some of these hypotheses are on the generous side, such as an 8% rise in EPS next year rather than the consensus (and not very credible) estimate of 9.2%, plus 6.3% in 2021. The current index level could certainly be justified with a 30-year at 1.85%, and 30-year Germany at just 0.19% should prevent any of us ruling that out! One could also argue that US growth will rebound once an agreement on outstanding trade issues is reached with China. But then, as all strategists would point out, there is always some scenario that could justify any given market level.

One hypothesis that we have not explored to date is that investors may have altered their attitude to risk. Specifically, and in view of low volatility, they may have reduced the risk premium they require to hold equities to below historical levels. Conventional financial theory typically uses a constant 3% risk premium, meaning a return requirement of 3% over 30-year government bonds, i.e. or 5.26% at present.

Long rates at historical lows



As the chart shows, 30-year Treasury yields have declined from over 10% 42 year ago to just 2.2% today. But our model is still calibrated with that 3% risk premium. If we had used 2% for the entire period it would have no impact on the market’s valuation, just as changing the EPS projection period from 8 years would have no impact. But of course it has an impact if we change the risk premium during the period, and were we to reduce it from 3% to 2% on the assumption of a change in what investors feel they require in return for holding equities our S&P 500 objective would jump from 2,846 points to 3,654 points.

The market’s 2020 PER is 17.6, i.e. an earnings yield of 5.7%. But the dividend yield is only 2%, and (necessarily unpredictable) dividend growth is where expected returns will have to come from. As the payout rate is a very stable 35% of profits, dividend growth will depend directly on profits growth. Our model incorporates a 2.1% CAGR for earnings over the coming 8 years, which would appear to take account of a recession in profits at some point during the period.

The model also shows that the return on US equities that investors are looking for, as implied in market prices, is 4.83%, composed of the 30-year Treasury yield of 2.23% plus a 2.6% risk premium. Clearly, any increase in the bond yield would reduce the risk premium by the same amount. We can therefore explain the market’s valuation by the willingness of investors to accept more risk as they search desperately for yield, often amid negative interest rates. We leave it to our readers to judge whether a shift in the risk premium justifies what looks like greater appetite for risk. For our part, we remain underweight equities. This is a position we have held since September 2018, when the S&P 500 was at 2,914 points; we reduced our allocation from a benchmark of 40% to 35%. The market’s rally since that time has automatically lifted our exposure to 37%. Our opinion has not changed, as the market is currently pricing in a great deal of good news. And that includes a good trade agreement with China.

## After all the shouting, not much of an agreement

Negotiations between the USA and China do not seem to be going anywhere quickly, and certainly not smoothly. Mr Trump has offered a doubling of American agriculture exports to $50 billion per year, but the Chinese would struggle to absorb that much because swine fever has drastically reduced their demand for soybeans. A flood of US imports would destabilise the domestic market – and violate the free-market principles that Americans keep preaching. Mr Trump is unlikely to reverse all his tariff measures, as he needs something to ensure Chinese compliance with any agreement, but the Chinese are still holding out on that point. In any case, Chinese concessions on protecting intellectual property are proving elusive. As usual, they are happy to make vague promises but not to commit to specifics. While they have offered up a goodwill gesture on the currency by ensuring its appreciation, the current exchange rate of around 7 yuan to the dollar is still weaker than in 2018-19. And now the US Congress’s intervention on Hong Kong has touched a very raw nerve.

Mr Trump is unlikely to emerge victorious from this trade war, especially as major multinationals such as Apple are lobbying hard to protect their supply chains. The only tangible outcome of two years’ debate is a contraction in world trade that has particularly affected exporter countries such as Germany and South Korea. The US president is effectively a prisoner of Wall Street and his re-election, and he will probably have to settle for no more than a face-saving agreement with China.

A modest goodwill gesture on the yuan



## Sluggish economic growth is here to stay

This month we have taken a close look at long-term US and world growth trends. Based on a rolling 8-year cycle, we have calculated average growth rates. Recessions have regularly interrupted these cycles, notably in 1956, 1968 and during the oil price hikes of 1973. We found that in the 1950s, the US economy averaged over 4% annual growth over 8-year cycles; in the 1960s, that rose to 5%. The oil shock of 1973 sharply reduced the cycle average to 3%, but after the 1980 and 1981 oil price hikes the average rose to 3.5%. That was true even of cycles encompassing the 2000 dotcom collapse in 2000, and right up to the financial crisis in 2008. The latter cut average growth to 1.2%, and although it has rebounded it has been only to 2.3-2.4%, and that is without the 2007-08 recession. Moreover, economists agree that we are now at the highs of the growth cycle. In short, the US economy has moved from normalised growth rates of 4% to 3.5%, 3% and now 2.3% (the expected growth rate for 2019) over the past four decades. 2020 is expected to produce growth of just 1.8%, and the Federal Reserve is assuming a normalised growth rate of no more than 2%. A recession could cut the cycle average to 1.5%.

The picture is much the same at world level. The 1990s and 2000s featured higher growth rates as a result of globalisation, with cycles averaging 2.5% then to a peak of 3.5% just ahead of the 2008 crash (local currency terms, not the PPP measure used by the IMF). The world economy has not been as buoyant since, and cycles averages have lost 0.7 point to around 2.8%.

The US economy’s normalised growth rate may fall below 2%



The 2008 crisis cut 0.7 point from average world growth rates



## More sluggish GDP growth will affect profits

The CAGR for profits – their average growth rate – over 8 years is an important variable in our valuation models. A review of its history for S&P 500 companies shows that it varies enormously over the growth cycle. In 2001, for instance, it slumped to 3.3% as a result of the dotcom collapse but had rebounded to 8.4% on the eve of the 2008 financial crisis. It dropped to an all-time low of 1.2% (covering 2000-08) before rallying again as the economy recovered. Once the 2008-09 cycle low had dropped out of the calculation, it climbed to 6.3%. Tax reform boosted US corporate earnings by no less than 12% all on its own, adding 1.4 point to the CAGR.

The average growth rate in profits over the past 25 years is 6%, although financial engineering (share buybacks, for instance) has boosted the result. GDP growth averaged 2.45% over the same period, which given an average inflation rate of 2.24% gives us 4.7% in nominal terms. It follows that profits have increased by more than the economy as a whole; this reflects the emergence of digital technology with margins often hitting 40%. The chart below highlights the rise in average profit margin to a peak at 11.6% amid tax reform in 2018, compared with 8.8% at the previous cycle high. GAAP and non-GAAP series show the same pattern. The CAGR we calculate for our risk premium model is 2.1% for the coming 8 years, and although that might look pessimistic it does provide for a virtually certain recession in profits at some point during that time. We are already in the longest recorded period of recession-free US growth, but it will end sometime. Profits growth is set to be negative in 2019, and the stabilisation in margins already evident suggests that profits will rise by no more than GDP in the future, i.e. by 1.8% GDP growth plus 2% inflation (or 1.4% if we use the PCE deflator). Our assumption of recession in the coming 8 years all but implausible, and it would take a complete transformation in the economy to avoid it. It would take an 8-year CAGR of 3.1% to justify the current market level, i.e. 1.8% GDP growth plus the 1.4% PCE deflator.

Recessions make a big difference to the profits cycle



US margins have stabilised at a high level



## Negative EPS growth in 2019 and overoptimism on 2020

Q3 results are almost all out and have proved disappointing. If we look at the Russell 3000 index, which includes small as well as large caps, earnings estimates have been revised up 1.4% relative to companies’ own guidance, but guidance for Q4 has been reduced by 4.8%. For small caps, downward adjustments have been severe at 7% for Q3 and 11% for Q4. Small cap profits are expected down 11% over 2019 as a whole. Given that most of these firms are focused on the domestic market, the slowdown in demand is real enough.

All in all, Q3 profits were 1.8% down on the year before. Q4 looks likely to produce a 1.7% drop, unless ‘surprises’ intervene. EPS for the year will be down 0.6%. This all indicates that the strong earnings figures projected for 2020, with growth pencilled in quarter after quarter, are unrealistic. We have already cited the case of Boeing, for which analysts are predicting profits next year some 31% above their record level of 2018 and despite a flat 2019, in this regard. Massive provisions may even be announced before the end of this year. Analysts are also predicting massive increase in Gafam profits in 2020, especially at Facebook. But how far can these companies’ profits really rise, especially when they are under investigation for abusing competition rules? The consensus forecast for EPS growth is 9.2%; we are going with 8%.

Downward revisions after profits announcements



Questionable EPS estimates for 2020



The chart below reflects changes in companies’ own guidance – which analysts then use for their own projections – following Q3 announcements. We have rarely seen such a wide spread of downward adjustments across the various sectors. IT and healthcare appear to be the only sectors holding up at the moment; discretionary consumers (GM, Amazon) have been revised sharply lower, as has the energy sector. Boeing is not the only company affecting the industrial sector: FedEx (contracting world trade), GE and Caterpillar are other examples. Within basic materials, chemicals are particularly affected. US national accounts show reduced investment as a result of uncertainty over trade, and the fact of an election year is unlikely to help on that front.

Not all analysts are optimistic on profits next year. Indeed, some are even predicting zero growth.

Revisions to Q4 profits right across the board



S&P 500 PERs: 19.2x 2019 and 17.6x 2020



## A more normal yield curve

Bond yields have not varied much over the past month and the US curve has a pretty normal shape. That said, stable interest rates right out to the 5-year maturity imply total inaction from the Fed, and the Fed has again injected serious serious liquidity into the financial system. Its balance sheet has swelled from $3.76 trillion to $4 trillion as a result. The Fed’s highly accommodating monetary policy is the main reason for the market rally, but how far can that go? The authorities’ favourite measure of inflation, the PCE deflator, is running well below the crucial 2% mark at 1.4%, but the core CPI inflation rate is well above it.

Little change to a normalising curve



## Positive surprises from the PMIs

US PMI data for November show an upturn relative to previous months. The manufacturing index has risen again, and the services index is now doing the same. Both indices were affected by the Chinese dispute and resulting wobble in growth. ISM indices also measure business confidence but have diverged somewhat, with the manufacturing index sagging below the 50 level and services holding up above it despite a negative trend since August 2018.

In the euro zone, the manufacturing index has ticked higher but is still below 50. In contrast, the services index is above 50 but has dipped slightly.

Improving US PMIs



## Low interest rates continue to drive equity prices

The main market indices are still rising. Over the year to date, Wall Street is leading the way: the S&P 500 has a total return of 26.6%. Dollar appreciation means that a European investor would be up 31.1% in euros. Eurozone equities are up 24.4% in local currency terms, while emerging markets are up only 12.7%. That barely makes up for the losses they suffered last year. Emerging countries may have high economic growth rates but international investors appear uninterested in these fundamentals. Their problem is often that their financial markets are not well regulated and lack transparency; government intervention is also common.

By sector IT is on top with a more than 40% gain since the start of the year despite unchanged profits. Energy continues to suffer from the stagnation of oil prices in the $55-60 range.

Investors would be right to question such performances at a time when equity prices are at their highs. Were they to carry on, they could create a bubble. Our own model suggests a 9% overvaluation in US equity prices, but of course that could increase until some event prompts panic selling. Stock market wealth is not the same as money in all our pockets – for many of us, getting to the end of each month is already a struggle. The US elections are bound to give this theme an airing, and even the mega-wealthy Michael Bloomberg intends to raise it as part of his presidential candidacy.

Record performances in 2019



## Sub-3% world growth

Growth forecasts for 2019 and 2020 are still sliding more or less everywhere.

No hope of a pickup in anaemic world activity



Forecasts for world GDP growth in local currency terms in 2019 have slipped from 2.78% to 2.73% over the past month as a result of revisions in Japan and some emerging countries. The overall projection for 2020 is stable at 2.67%, with some improvements in OECD countries offsetting a dip in emerging economies. The forecast for the USA has climbed from 1.7% to 1.8%. The UK is at just 1%. Longer-term projections are still well below 3%. China’s growth rate is now below 6%.

We have already seen that the 2008 financial crisis notched world growth rates downwards; more recently, Mr Trump’s trade war has not helped the situation. Productivity gains in the digital economy are no longer big enough to fuel growth through the whole economy, and we believe that widening inequalities are a factor slowing activity in their own right. The next crisis could see the introduction of ‘helicopter money’, if hints from the ECB are anything to go by. The scope for growth via the energy revolution is often overlooked, and certainly by short-term leaders such as Mr Trump. Clean and abundant energy could yet cause the deserts to bloom and feed the planet. In the meantime, investment in healthcare is woefully inadequate, and the pharmaceutical majors are still focused more on marketing than research.

## Market valuations

Although our model is still signalling a roughly 9% overvaluation for US equities, investors are doing their best to prove us wrong! Most of the fund managers we talk to fear correction and are on the defensive. Strategists are averaging 3,272 points for the S&P 500, with Morgan Stanley and UBS at 3,000 points. Our model is around the 2,950 point mark. What actually happens will depend on the economy. Our simulations include a recession scenario with a 3.9% decline in profits next year and a concomitant fall in long rates to 1.75%-2%. The index would then be valued at between 2,470 and 2,627 points. Note that the market would be at its theoretical fair value with a 30-year rate of 1.80% rather than its current 2.23%, or with a CAGR of 3.3%.

Wall Street trading 9% over fair value



In the meantime, eurozone equities are virtually at fair value, based on a weighted average 30-year yield of 0.7%. Earnings estimates for 2019 are pretty stable but any gain overall will be negligible. Given that the market’s dividend yield is 3.35%, it is hard to imagine any actuarial justification for prices with a 30-year rate as low as it is. It only works with lower profits and dividends in the future. But then European profits have never recovered to their 2006 levels! The banking debacle and the failure of traditional economy companies to reinvent themselves are responsible for that. Europe has no real new economy champion to match anything in the USA, where most of its capitalisation sits. The EU initiative to invest €3.9 billion in new technologies is welcome, as is the record €34 billion invested in start-ups.

No profits growth in 13 years



A slightly overvalued European market



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| ConclusionsApart from a continuing rally on the back of unchanged fundamentals, there is little new to report on equity markets. The S&P 500 is up another 100 points to 3,110 points, the interest-rate environment is much the same as last month and the end of the Q3 results season proved uninspiring. Our year-end objective is now at 2,846 points, pretty much in line with where it was a month ago (2,834 points) and implying a 9% overvaluation that we would struggle to justify with reference to interest rates or profits. There is just one of our valuation model’s parameters that we have not tweaked: the risk premium, which we have kept at 3% above the yield on government debt. But given that the yield on the Treasury long bond has fallen in stages from over 10% 40 years ago to 2.26% today, investors may well have eased up on the risk premium they require from equities. If we cut it to 2%, our year-end objective rises to 3,654 points. Our own preference is to avoid tinkering with the model in this way, however, and we are maintaining an equity market allocation at 35% (although it has climbed to 37% because of the rally) compared with a benchmark allocation of 40%.The market is assuming that an agreement between the USA and China over trade is a done deal, but the negotiations are dragging on. At the end of the day, high-tech America will send the Chinese a few million pigs and shedloads of soybeans amid hopes that they will obtain better protection of intellectual property in return. The Chinese want tariffs to be removed, but US negotiators need leverage to ensure a deal is respected. Traders are taking it for granted that the yuan will stay firm and lobbyists back in America are pushing Donald Trump towards an agreement on the grounds that he will not want to disappoint investors in an election year. It could all add up to a poor agreement. US GDP growth has slowed on trend from around 5% per year in the 1960s to 2% in the present decade, which is now accepted as its normalised rate. Forecasters expect 1.8% in 2020. Following acceleration in the 1990s and up until 2006, and particularly after the financial crisis, the world growth rate has eased from 3.5% to 2.7% in local currency terms. Increases in corporate profits over the period are all the more remarkable for the fact that margins are at historical highs, thanks to IT. US profits have been growing 1.3% faster on trend than GDP, although recent tax reform has had a part to play in that too. Repeating that adjustment would be difficult. The US economy is currently enjoying its longest-ever period of uninterrupted annual growth, but it is hard to see recession being held off forever and that will affect the earnings CAGR in our valuation model. We are currently using a CAGR of 2.1%, rather than the 3.3% that would justify equity prices. Note that earnings estimates for 2019 are now falling, and projections for 2020 are being revised lower. Q3 results announcements included significant revisions for Q4 and onwards from the corporate side, especially among Russell 2000 small caps dependent on domestic demand. Recent declines in investment and the uncertainty inherent in an election year will both weigh on profits.Low interest rates are still the only good reason why world equity markets are up 24% - and Wall Street up 26% - this year. Liquidity injections by the Federal Reserve have only fuelled the rally. The most recent PMIs are positive and offer some hope of a rebound in growth. A survey of market strategists gives us an average expectation of 3,272 points for the S&P 500 next year, with Morgan Stanley and UBS at 3,000 points. Our own assessment is 2,950 points. Our European market valuation is close to current trading levels.  Jacques Chahine |

Main ratios for markets and sectors as of 22/11/2019 (in local currency)



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