Letter n°18

Capitalist changes and Stock Markets: between risks and opportunities

« A rose, she has lived as long as roses live, the span of a morning. » Malherbe

Four introductory remarks :

The precarious :
More and more, the stock market fortunes of companies are like the roses evoked by Malherbe in his unforgettable poem of 1607. In 2007, Exxon was the largest American company on the stock market, a paragon of American multinationals. This year, it was removed from the Dow Jones Index and replaced by Salesforce. One of many examples of the paradigm shifts in capitalism. **Camdessus**, former IMF governor, wrote in his book "**Vers le monde de 2050**", "**the world changes hands**"; that G7 countries will lose their influence, 30% of world GDP today as compared to 60% in 1960, the same applies to the flagship stocks of the stock market. The rotation is rapid and the investor must integrate it because the real or opportunity losses can quickly be high.

The volatile :
Polarized on the daily variations of the equities, many forget the bottom waves. So we thought it would be appropriate to study the price variations since the highs of 2007, because this includes the crash of 2008, this year's crash and the market's recovery since then, at least in the United States. The deviations from the average of the indices are enormous, and everyone will be able to understand the usefulness of the analysis over 13 or even 20 years.

The temporary :
In 2000, the American top 5 included an industrial, General Electric, an oil company, Exxon, a pharmaceutical, Pfizer, a bank, Citi and a Tech, Cisco, ahead of Walmart, a distribution company and ahead of Microsoft. A reflection of the diversity of American strengths. Today, there are only technological stocks. In 2000, the top 5 capitalized $1.63 trillion, in 2007, $1.71 trillion, today $6.9 trillion. An unprecedented concentration.

The patent :
Unsurprisingly, the structural slowdown in world economic growth - 5.2%/year between 1960 and 1974 and 2.8%/year between 2008 and 2015 - corresponds to a lower growth in turnover. Since 2009, the average growth in turnover of S&P500 companies has not exceeded 4%, it was 7% on average over the previous forty years. The few companies able to post turnover growth close to 20%/year benefit from a higher premium as they are leaders in their sector. "Growth stocks", as opposed to "value stocks", are thus favoured by investors and are treated at PEs or turnover multiples significantly higher than the average.

We will successively analyse the disgrace of banking stocks, the disaffection of oil companies, the bankruptcy of the airline sector, the disfavour of telecommunication stocks, the misfortune of industrial stocks struggling with Chinese competition, the avatars of industrial stocks struggling with changes in technology, the impact of sociological changes on a whole series of sectors, from luxury goods to cosmetics, the fall of distribution and the good performance of consumer stocks and finally, technology and the stocks of the 4th industrial revolution.

The disgrace of banking stocks :

First there was the financial crisis, the subprime crisis, the collapse of Lehman Brothers, a weakening of the banking sector, the implementation of stricter regulations, increased capital requirements, the standards imposed by Basel III. In addition to these consequences of the 2008 crisis, there are now fears of an increase in bad debts and a multiplication of bankruptcies.

Unsurprisingly, the performance of banking sector stocks is the worst. Unicredit in Italy, Commerzbank and Deutsche Bank in Germany, Crédit Suisse and UBS in Switzerland, Société Générale or Natixis in France, Barclays in the UK, have recorded performances between -85% and -98% for the worst, in other words, these banks are currently only trading at a tenth of what they were previously worth.

This market pessimism is clearly excessive because the ECB is providing assistance with refinancing at -1%, European banks have twice as much capital now as compared to that in 2008 and are often valued below their book value. Société Générale, for example, holds Euros 68 billion of capital but has a stock market capitalisation of Euros 9.3 billion.

In the United States, regulation has not only been less relentless but it has also eased. In addition, the number of players is lower, the banks have not had to bear negative interest rates as in the Eurozone or Switzerland and the recovery from the 2008 crisis has been faster. Also, performances are different. Citigroup fell by 92%, but Morgan Stanley's decline did not exceed 34%, JP Morgan did well with +78% and the big winners were the credit card companies, Mastercard in particular up by 2072%.
Among financial stocks, insurers held up better. Admittedly Axa fell by 50% but Allianz's stock price remain unchanged while Swiss Life and Bâloise are up 7%.

The disaffection of oil companies :

In 2007, the price per barrel reached $150 and Goldman Sachs specialists were anticipating $300, which had an impact on the valuation of the future profits of oil companies and their stock prices. Today, the price of a barrel of Brent is $42 after having been negative for a few hours in the spring and having remained at $15 for a few weeks.

At current prices, the shale oil industry in the United States is no longer competitive. U.S. crude oil production has already declined this year from 13 million bpd to 11 million bpd and will decline further next year.

Many of the world's deep offshore oil fields, for example, are no longer profitable, exploration and production spending has declined by more than 50% in recent years and could fall by a further 25% this year, from $530 billion to $410 billion. As **Walter Benjamin** would have said, "**Let things take their course, this is the catastrophe**", as the prospects for renewing reserves, the key to oil companies' valuation, are dwindling.

Add to the low prices, the opprobrium thrown at the industry by renewable energy advocates, the pressure on banks or fund managers to stop lending or investing in companies in the sector.

All these factors explain the fall in stock prices. In oil services, stock market icons such as Schlumberger have dropped 78% of their valuation, just like a Halliburton -65% or in Europe a Saipem, -94%. The "Majors", yesterday's portfolio core stocks, often with little debt, Royal Dutch and British Petroleum lost 59% and 56% respectively, and even Total, despite investments in renewable energies, fell by 48%.

With the coming economic recovery, the supply-demand balance will be restored, and we therefore expect an appreciation in company prices over the next twelve months. To corroborate this view, companies like Total, rich in cash flow, have the capacity and the will to invest massively in other energies, solar, liquid gas..., to ensure their future.

Contrary to oil stocks, Air Liquide, an unbreakable stock, positioned on industrial gases and hydrogen, has appreciated by 168% since 2007 and "clean energy" stocks have for some time been profiting from the current fad and would continue to benefit from the election of Joe Biden.

The bankruptcy of the airline sector :

The sector has always been fragile because margins are low. Also, the recent drop in traffic, 50% worldwide since the beginning of the year, forces the States to bail out the sector and, very early in April, we recommended not to invest in this sector.

At the beginning of the year, IATA anticipated $29 billion in profits for the sector, today it fears $100 billion in losses in 2020. According to the specialist firm Oliver Wyman, of the 27,500 aircraft in the world fleet, 20,000 were at a standstill at the beginning of May and 10,000 should still be grounded by the end of 2020. To take just one example among the major companies, Air France has lost 91% of its stock market value since 2007. Over the period, the "low cost" companies have fared better and gained market share, hence the slightest decline of Easy Jet, -16%, and the appreciation of Ryanair +112%. Here again, the American market, which is more concentrated, is doing better and the decline of United Airlines is limited to 15% over the period.
It is still early to invest in this sector because a second wave of aid and recapitalisation plans should be necessary.

Behind the crisis in the air sector are the difficulties of the aeronautics industry and the recent fall of aircraft and engine producers. If Airbus, since 2007 has posted an enviable increase of 178%, its fall since the beginning of the year is approaching 50%. Specialist firm Oliver Wyman predicts that 20% of orders would be cancelled, 40% postponed and the fleet in 2030 would no longer be at 39,000 but 34,000.

The disfavour of telecommunication stocks :

The stocks of this sector had their hour of glory in 2000 and were then among the first victims of the crash. Between 27 March 2000 and June 2007, Orange had given up 86% of its market value, Deutsche Telekom 84% and Swisscom 33%.

Since 2007, the decline has continued. The pressure on margins, the multiplicity of operators, the cost of licences, such as the recent example of the 5G for Euros more than 5 billion in Germany and 2.8 billion in France, and network investments help to understand the decline of more than 80% for Telecom Italia and Telefonica, that of Orange, 60% and we can only congratulate the performance of Iliad, the latest entrant, +120%.

The misfortune of industrial stocks struggling with Chinese competition :

In many segments of the industry, competition from emerging countries, sometimes subsidised Chinese public companies, has shaken the European leaders. Arcelor and Thyssen Krupp have given up nearly 90% of their valuation. Lafarge, once the world's leading cement company, merged with Holcim but lost 64% of its market value. To a lesser degree, Alstom lost 26%. But in these different sectors, the big players are now Chinese because China produces more than 50% of world's steel and cement.

A few European jewels stand out, such as Siemens +20% and, above all, Thales +41%, Schneider +90%, Legrand +148% and Seb +204%, all companies well adapted to the changes in the international competitive environment.

The most brilliant were the technology companies able to capitalise on their strengths, with Atos and Cap Gemini up by just over 100% and, above all, the "stars", Ingenico +582% and Dassault Systèmes, +604%, one of Europe's top performers.

The avatars of industrial stocks struggling with changes in technology :

Worldwide automobile sales were 90 million in 2019, and will be 15 to 20% lower in 2020. A little over a century ago, the automobile supplanted horse-drawn cars and today the automobile itself is facing challenges, the electric car, the driverless car which attracts rich new players from the tech sector, market saturation in Western countries, the lesser attraction of young people for car ownership, the potential of large emerging markets provided they overcome competition from local producers (see the difficulties of Renault or Peugeot in China)... Thus, since 2007, the market value of Renault has lost 81%, PSA 63% and Porsche 55%. The German constructors are doing better, like VW +89% and even BMW +21%, even Volvo, +14%, which has a Chinese shareholder in its capital.

The equipment manufacturers and/or the suppliers of spare parts are also resisting. One thinks of Michelin -2%, Faurecia -18% but above all Valeo, +97% and Autozone in the United States, with strong growth.

The impact of sociological changes: ageing, rising inequalities and the development of the middle classes in emerging countries :

Ageing and rising standards of living benefit the health sector and everywhere there is an increase in spending in this sector as a percentage of GDP. And the recent Covid crisis will not reverse this trend. In the United States, health spending reaches 18% of GDP and in Europe, 11% of GDP.
At most, we can fear recurring initiatives, the latest being Trump, on a cap or a drop in the price of medicines or decisions on a reduction in the life span of patents.

This will benefit laboratories capable of launching new molecules and suppliers of health equipment. Thus, since 2007, Glaxo is at +16%, Sanofi +21%, Novartis +33%, Getinge +49% and Vifor +207%. In the United States, Bristol Myers +91%, Medtronic +89% and recently Gilead +200%.

Smaller companies are to be favoured because they are more sensitive to innovation and thus Lonza appreciated by 412%, Biomérieux by 490% and Novo Nordisk, a specialist in insulin for diabetes, by 653%.
Cosmetics stocks are also benefiting from the rise in living standards, for example L'Oréal +210%, Estée Lauder +791% and Essilor +14%.

The luxury sector benefits both from the rise of the middle classes in Asia and the enrichment of the richest 1% in developed countries. Two lasting trends which explain the performances of Richemont +54%, Tiffany +123%, Kering, +370%, LVMH, +412% and above all Hermes, +615% which arouses the covetousness of its competitors.

The fall of distribution and the good performance of consumption stocks :

Since 2007, the concept of hypermarkets, or even supermarkets, has lost a lot to the benefit of proximity and this is reflected in the share prices of the major groups in the sector: Tesco, -50%, Casino and Carrefour -71%.

On the other hand, consumer goods are doing well, with brewers, Carlsberg +55% or Heineken +76%, conglomerates like Nestlé and Unilever, +127% or in the United States, Coca-Cola +84%, Colgate +124% and Procter +115%.
A few niche companies, benefiting from fashion, show exceptional performances, such as
Nike in the United States +780% and Adidas in Europe +519%. Is this sustainable?

Technology and stocks of the 4th industrial revolution :

There is no need to recall the youth of these companies, Amazon created in 1994, Google in 1998, Facebook in 2005 and an average age of 15 years for Nasdaq companies. There is no need to be overly vocal about these sectors because everyone is very well informed about these developments. There is no need to recall the big difference with the 2000 technology bubble, namely the rich cash flows of the current leaders and their absence of debt. There is no need to recall their position, if not as monopolies, at least as monopsonies. According to **Philippe Delmas**, in his book "**Un pouvoir implacable mais doux**", Facebook has 70% of the social networks, Google has 65% of online searches and thus, in 2018, these two companies were collecting half of the online advertising revenues. The net margins of the leading companies exceed 25%, a percentage rarely achieved in the traditional industry. **Peter Thiel**, the man who made his fortune with Paypal, **believes that capitalism is incompatible with competition** because, if there is a price war, there is no capital accumulation.

This year the top 5 has appreciated by nearly 40%, the rest of the S&P, let's not hide it, by less than 5%. We'll just recall a few performances since June 2007: Qualcomm's +162%, Microsoft +564%, Apple 2460%, Amazon 4300% and Netflix 15250%, without forgetting, also in communication, Comcast 234% and Disney 252%. So many American companies because, as we know, technology represents 28% of the market capitalisation of the S&P500 but only 15% of the European EuroStoxx index.

For the near future, the privileged segments will remain e-commerce, life sciences, robotised medical equipment, robotisation and digital payments.

Four conclusions: Schumpeter: "These new products and new methods compete with the the old products and old methods not on equal terms but at a decisive advantage that may mean death to the latter" in Capitalism, Socialism and Democracy.

Changes : in Schumpeter's line, the past does not bode well for the future, today's leaders can disappear, history teaches us that, the producers of propeller planes were not the inventors of jet planes and innovation in a sector often comes from entrants.

Stock market concentration : never before has it been so high. If, in the 1970s, the first 5 capitalisations represented 10% of the American market, in 2000, 18%, today, it is 28% of the S&P500. The rotation of companies among the leaders is rapid. Each year, 5% of the S&P 500 changes. Of the current top 5, only Microsoft ranked 7th in 2000. There is no doubt that the pace of change is accelerating. The next few years promise to be rich in changes. We are thinking of the acceleration of the energy transition, the development of 3D, the multiplication of the number of robots, the interest in smaller series and the spread of digital technology.

Dividends : the percentage drop in prices can be tempered by the importance of dividends, $1.4 trillion in 2019, including $500 billion in the United States, the approximate equivalent of 4% of world capitalisation. This is true in oil but not in others, such as banks or airlines. Thus Total, whose stock price fell by 48% actually increased by 6% after adding dividends. Similarly, in insurance, Zurich decreased by 14% before and increased by 43% after. In pharmaceuticals, dividends have amplified the rise in prices, for example Roche's +39% over the period and +80% if dividends are included. Also in telecoms, for example Swisscom, +13% and +76%.

Growth stocks : they remain an attractive theme in a macroeconomic environment haunted by weak growth. As growth stocks are rare, the unprecedented weighting of the top 5, as well as their performance - exaggerated in the eyes of some - of 360% over the last five years compared to the 45% achieved by the 495 others, can be explained. The valuations of these leaders are lower today than in 2000 and the quality of their positioning and balance sheet is superior.

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Geneva, October 6, 2020

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