Letter 41

The markets. Between fears and expectations. What to think?

"We are now entering a world of imponderables, and at every stage occasions for self-questioning arise."

Churchill on his return from Yalta

Since the low of 23 March 2020, the S&P 500 has appreciated by 101% and since its pre-crisis high on 19 February 2020, the increase is 33%.

Admittedly, earnings have recovered, several major economies are returning to their pre-crisis GDP levels, the economic impact of the spread of the virus variants is assumed to be under control within a year, and liquidity injections and budgetary support have not been on the same scale as the aid provided after the crises of 2001 and 2008. But it is clear that within a year, these fiscal and monetary interventions will have disappeared and this must be anticipated in our investment strategies.

Without being alarmed, it is essential to question the sustainability of this stock market movement, to diagnose the risk factors and to identify the confidence factors. And, Churchill's words are useful advice for approaching the markets today.

Excessive fears :

- ***Fears related to Covid :***

Covid is not yet under control but a halt in savings and a new recession no longer seem to be feared.

To date, the official figure for Covid-related deaths is 4.5 million. A figure that is difficult to establish and probably underestimated, but it represents 0.06% of the world population. This is nothing like the Spanish flu outbreak at the end of the First World War, with fifty million deaths for a world population then of 1.5 billion.

5 billion doses of vaccines distributed worldwide is a remarkable achievement in some 9 months but it is still insufficient to ensure herd immunity. 76% of Spaniards were vaccinated at the beginning of September, 70% of the French, 69% of the British and Italians, which is encouraging and, for the moment, better than in Israel, 68%, and the United States, 60%, two countries that have been quick to roll out vaccination. But the virus will not be controlled as long as emerging countries do not benefit from a wide vaccination coverage. And, we are far from it. In the meantime, variants will sustain fears.

- ***Fears related to inflation and long-term interest rates :***

In August, the inflation rate in the Eurozone reached 3% and in the United States 5.4% (3.6% in July, according to the PCE indicator used by the FED) thus, were higher than the 2% target posted by central banks.

Both the ECB and the Fed have already shown tolerance for inflation temporarily above 2%, but some are concerned about a lasting change. What exactly is the situation? What about the different sources of inflation?

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Fear linked to the rise in commodity prices : since the beginning of the year, the price of a barrel of Brent crude oil has increased by 41%, a ton of aluminum by 39%, a ton of copper by 20%, and nickel by 17%. And in agricultural products, durum wheat is up 65% as a result of poor harvest. Apart from agriculture, which is subject to climatic hazards, raw materials are expected to stabilize, especially if the growth rate of the major countries stabilizes or slows down.

Fear linked to disruptions in supply chains : everyone has heard about shortages in certain sectors such as semiconductors, hindrance for the automobile industry, wood and materials, hindrance for construction... but ***the WTO*** (World Trade Organization) is maintaining its forecasts of an 8% increase in the volume of international trade in 2021 after -5.3% in 2020.

In summary, supply shortages and production bottlenecks are perceived as temporary, and as the result of a momentary distortion of supply chains after the sudden shutdowns in 2020.

Fear born of inflation in house prices : low interest rates encourage property purchases. Over one-year, median prices in the US have increased by 17.8% and, more worryingly, as in 2008, there has been an increase in mortgage-backed bond issues.

Fear of emerging wage inflation : at the root of this risk is labor shortages in many countries and in several sectors such as digital, cybercrime, delivery, personal services, cleaning, the cloud. Unfulfilled job vacancies in the United States that was 10.1 million at the beginning of July, a figure higher than the number of job seekers, rose by a further 13% in August. Elsewhere in the world, particularly in Europe, the trend is similar.

As a logical consequence, wages have risen by 4.3% over the past year in the United States, a higher annual rate than before the crisis. In the service sector, companies like McDonald's have had to increase staff salaries by 10% and people are recruited at $17/hour compared to $11/hour before. More and more companies are paying $15/hour on hiring.

Should we be alarmed? Should we fear a spiral that could spread to all sectors? Of the four causes of inflation identified above, the first two, which are currently prevalent, seem to be temporary. The third and fourth still have little impact, but it is from these that structural inflation could possibly come. The Fed, like other central banks, is not worried and anticipates inflation of 2.5% in 2022 after 4.8% for the 4th quarter.

In the medium term, the key variable will be the productivity trend. Productivity has been declining in recent years despite technological innovations, but it seems to be on the rise again with the development of e-commerce, teleworking, robotization and in the future, the development of artificial intelligence. In fact, as has often been written, inflation could be fuelled by a return to protectionism, but we do not believe in this drift.

The situation is more problematic outside the OECD. In Russia, inflation is 6% and it erodes purchasing power. The same is true in Brazil, where inflation is close to 9%, in Turkey it is 17.5%, in India it is over 6.2%...

- ***Fears related to a shift in central bank policy*** :

In view of the high level of debt in all major economies, central banks share the same concern and desire to keep long-term rates as low as possible, preferably below the rate of GDP growth.

In 2020, according to ***the IIF*** (Institute of International Finance), public debt issued by the United States

and Canada accounted for 20% of GDP and half was acquired by the Fed and the Bank of Canada. In Japan, issuance reached 15% of GDP and the Bank of Japan bought almost two-thirds. In Britain, issuance accounted for 15% of GDP and the central bank bought 90% of this debt. In France, issuance was equivalent to 11% of GDP and the Central Bank acquired the equivalent of nearly 8% of GDP. In Italy, issuance reached 10% of GDP and 90% absorbed by the Central Bank. In Germany, issuance accounted for 9% of GDP with almost 7% acquired. The balance sheets of the major central banks will reach $28 trillion by the end of the year, approximately 1/3 of the world's GDP! Such an increase cannot be maintained in the context of recovery. South Korea was the first economy in Asia to raise interest rates. Others will follow. New Zealand? Norway?...

The ***Fed***, anxious not to repeat the faux pas of 2013 when the rate hike tripped the markets, is considering a reduction in liquidity injections, currently at $120 billion each month. But recent employment figures will encourage it not to rush into tightening its monetary policy.

The ***ECB*** will carry out its PEPP program until March 2022, monthly purchases of €60 to 70 billion instead of €80 to 90 billion, added to its usual purchases (Asset Purchase Program) of €20 billion/month.

Rates are low and negative in many European countries as central bank purchases exceed net issuance, and this should continue as government budget deficits are expected to shrink over the months. In 2021, they are still very high with 11% expected in Italy, 9.3% in France, 8.6% in Spain, 7.2% in Germany and 7.9% on average for the Eurozone.

The Bank of Japan : its balance sheet represents 130% of GDP, double that of the ECB, as a percentage of GDP, and almost four times that of the Fed. The BOJ thus holds approximately half of Japan's public debt and the banks also have 13%.

There is no sign of a downturn because inflation is not threatening and activity remains moderate.

- ***Fears related to the geopolitical situation*** :

There are many comments on the impact of the Taliban's return to power in Afghanistan, the American failure, the weakening of the West. Obviously, the impact on the stock markets is zero, the impact on the world economy is non-existent because the GDP of Afghanistan represents nothing, and the purchase of defense assets, advocated by some, makes little sense because the problem is not budgetary. The United States spends $750 billion/year on its defense budget, more than the next nine countries, and in twenty years it has spent some $1 trillion. Without success.

From this withdrawal negotiated by Trump and carried out by Biden, we cannot deduce that the US is less involved in Asia than it is with China. On the contrary, the economic and political stakes are high. In the short term, the Chinese are increasing their incursions into Taiwanese airspace but they should be wary of intervening because they know the Americans are wounded by the failure in Afghanistan and are therefore incapable of accepting humiliation without reacting.

Moderate expectations :

Without being blissfully optimistic, a return to pre-crisis GDP levels can be diagnosed in several major countries much faster than after all previous crises, and supportive factors for the markets can be pointed out.

- ***A rapid return to the pre-crisis economic situation*** :

In the United States, China and several Asian countries, pre-crisis level have been restored or even

exceeded, but some observers are concerned.

The fall in household confidence to a 10-year low (see the University of Michigan index) and the disappointing U.S. employment figures in August are interpreted as a fear that the pandemic will again penalize growth. We do not think so.

While 1.5 million people in the United States refuse to work due to the spread of the virus, certainly, the number of people employed is still 5.3 million lower than in February 2020. And while the forecasts for GDP this year have been revised from 7.5% to 6% or even 5.7%, the figure remains flattering and we are not worried about it. Such a figure remains well above the annual average of 2.3% recorded between 2010 and 2019 and the decline in unemployment has never been so rapid, coming from 10.2% a year ago.

Admittedly, punished in the polls by his exit from Afghanistan, Biden will face difficulty getting his $3.5 trillion social plan passed and an additional growth stimulus seems to be fading. However, with the end of the exceptional employment aid, at the beginning of September ($300/week), the incentive to find a job has increased for the 7.5 million people receiving this benefit. The participation rate, at 61.7% in August, far from the 63.3% before the crisis, could recover and the unemployment rate, 5.2%, will be less than 5% at the end the year.

In ***Europe***, during the summer, growth remained strong despite the resurgence of the virus as economic actors learned to work with it. The GDP of the Eurozone remains 2.5% lower than at the end of 2019 but the gap should be closed in the coming months as the activity indicators, in industry as in services, are very good.

The unemployment rate has fallen to 7.6% and the number of people employed, 159 million, is still 2 million lower than in February 2020. Growth forecasts are revised upwards in many countries, in France to 6.25% this year, in Spain to 6.50%, in Italy...

In ***Japan and Asia***, this new wave of the virus has slowed growth, as vaccination rates were then low but a catch-up is underway. This is even happening in less developed economies like Vietnam.

In ***China***, by the end of 2020, the country returned to its pre-crisis GDP level but with the resurgence of Covid and the lockdown of some cities, the activity index in services fell to 46.7 and stimulus measures are possible by the end of the year. In the meantime, the Chinese slowdown could be detrimental to some cyclical stocks.

In ***Russia***, GDP did not fall by more than 3.1% in 2020. This year, the country is benefiting from the recovery in commodity prices and posted a 6.8% year-on-year growth in industrial production in July and a 10 points year-on-year GDP expansion in the 2nd quarter.

There is no need to worry about the growth of the major economies in 2022 because the surplus savings accumulated since the beginning of the crisis are substantial : $ 1.7 trillion in the United States, nearly $300 billion in Japan, £170 billion in the United Kingdom, nearly €160 billion in France... There is a potential consumption windfall.

That leaves the ***emerging countries***. Covid is an undeniable brake on growth. According to ***the ILO***, while on average, social protection expenditure accounts for 16.5% of GDP in developed countries, it is only 1.1% in the poorest countries. Thus, 4 billion people in the world have no social protection and have suffered income damage during the recession. Countries without social protection have not benefited from crisis buffers and the recovery of GDP/capita is slower. In addition to Covid, in a context of a rapidly increasing public debt, 52% of GDP before the crisis, 60% today according to the ***IIF***, the

concern is a tightening of US monetary policy, leading to capital outflows, and therefore pressure on interest rates that will weaken indebted actors.

- ***Various factors supporting the markets*** :

Rates : everything encourages investors to be cautious, to abandon the bond market and to invest even more in the equity markets. Not only are the real long-term rates on junk bonds in Europe (rate at 2.3%, inflation at 3% according to the Bank of America index) and the United States negative (rate at 4%, inflation at 5.4%), but recently, most of the European public debt was at negative rates (all German public debt, French debt up to 10 years, Italian and Greek public debt up to nine years ago, just a week ago).

In addition, the phasing out of liquidity injections by mid-2022 could create pressure on long-term rates that are detrimental to bond investments. Finally, official rate hikes in the United States are not expected before the 1st half of 2023 and in Europe, -0.5% today, this hike will occur even later. So, there is time to reinvest in these markets.

Good corporate results, driven by productivity gains and accompanied by share buybacks back to pre-crisis levels, are an important support because, despite the appreciation of the markets, there has been little year-on-year revaluation of P/Es.

Mergers and acquisitions : this is a driving force in the markets and there have never been so many of them. According to ***Refinitiv***, the global value of transactions, $3.9 trillion this year, is nearly 50% higher than the average for 2015-2019 ($2.6 trillion in 2019). There are four reasons for this, the liquidity of companies, low interest rates, capital raised by private equity funds, and competition from SPACs, stock market vehicles with no assets other than cash to invest in two years, which, despite a $75 billion drop in their stock market value since February, are still worth $250 billion.

Renewed caution on private equity : of the 3 sources of capital gains generated by these funds, value creation is often the least important, debt leverage the most important, and higher transaction is a significant factor. According to Pitchbook, the debt/EBITDA ratio for private equity transactions would be 6x. A danger in the event of a market downturn. We therefore prefer to invest in equities without hesitation.

The only concerning factor is real estate in China, which accounts for a quarter of GDP, with a lot of overcapacity and large debts accumulated by private operators. Evergrande, the number one operator, was recently downgraded by rating agencies to the worst rating before default because its debt reached $300 billion. It is the emblematic example of these excesses and risks. Another example is Huarong, a state-owned financial conglomerate with $240 billion in debt. But the Chinese authorities, like the US government in 2008, during the real estate crisis and the difficulties of Fannie Mae and Freddie Mac, cannot afford a financial crisis and have the capacity to manage the situation.

In the United States, the key question is whether margins have peaked, after a 90% increase in earnings/shares over 1 year and 42% expected during 2021. This will depend on the "pricing power" of the companies but we are maintaining the neutral opinion adopted two months ago after having been Buy more than a year.

In Europe, our overweight position has been justified because, not since 2013, has the European market recorded such a strong appreciation with 7 consecutive months of gains. Better-than-expected earnings and ECB injections explain this increase.

In China, the stock market accounts for more than a third of the MSCI emerging index but only 4% of

the world index for 18% of global GDP. Stock market performance, excellent in 2020, is bad this year. Sanctions, pressures, regulatory changes against certain sectors, technology and education in particular, explain this. There will be an upsurge.

Conclusion: "The world has become infinite again, in the sense that we cannot deny it an infinite number of interpretations" Nietzsche *in The Gay Science.*

If everything is only interpretation, there is no truth, says Nietzsche. Resurgence of the crisis and sharp slowdown or resilience of growth? We are inclined to be optimistic, notwithstanding a downward revision of growth prospects in the United States and China at the end of the year, an upward modification of inflation expectations by certain analysts, a rise in Covid variants, and warnings about private debt in China that is 2.2x GDP and mainly made up of the debt of real estate companies. These are all reasons for the markets to be skeptical. We consider these concerns to be temporary, but they are likely to dampen market appreciation.

A few investment themes stand out : maintaining a minimum bond allocation, giving priority to large countries over emerging countries, benefiting from advances in technology, artificial intelligence, 3D and robotization for many OECD countries and companies, avoiding service companies for the time being. The avoidance of service companies, which are rich in low-skilled labor likely to obtain wage increases that are detrimental to margins, and the sidelining of private equity, which is often at risk in terms of future returns because of the leverage and premiums paid on purchase. Let us reaffirm our caution on the UK market penalized by supply disruptions following Brexit (+10% this year against +19% for the EuroStoxx50).

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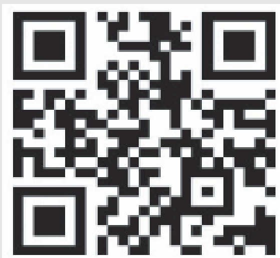

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