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Letter n°91

How have stock markets evolved since the pre-COVID period?

"Never make plans, especially concerning the future." Alphonse Allais.

- Alphonse Allais' prudent advice would have been very useful for many investors in early 2020, before a series of unprecedented events since World War II.

- To cushion these shocks and finance the energy transition and increased defence budgets, governments massively resorted to fiscal measures, distributing aid and subsidies to both businesses and households.

- Subsequently, central banks, faced with a resurgence of inflation, had to abruptly raise their interest rates, risking a recession.

- What has been the performance of different stock markets in this interval? What are the winning stocks, themes, and sectors of this period? Who are the losers at the same time? These are the various points discussed in this Letter 91.

- Several observations emerge as follows:

1st observation, the outperformance of the US market:

As often happens in challenging periods, we observe an outperformance of the American markets, surpassed only by that of Japan. Based on an index of 100 before the emergence of COVID, the EuroStoxx is at 119, the S&P 500 at 140, and the Nikkei at 156. The driver of the appreciation of the American market is the Nasdaq, which has risen by 75%.

- However, the increase is concentrated around the "Magnificent 7". Other American indices, such as the Dow Jones or the Russell 2000, show modest appreciations. This point has been frequently mentioned, but it is essential for analysing the evolution of portfolios.

2nd observation, European markets are still less valued and the UK lagging behind:

- The EuroStoxx has appreciated by 19% in nearly four years. There is nothing exceptional about this. It is a figure below the long-term average.

- Italian and French markets (25% and 24%) have slightly outperformed the EuroStoxx index, while the FTSE 100 index in the UK, with only +1.8%, has delivered a disappointing performance.

- In Germany, some major companies have suffered due to their dependence on Russian energy or the Chinese market: the share price of Volkswagen has contracted by 36%, Continental by -29%, Bayer by -42%, and BASF by -26%.

- In the UK, among the various reasons for the market underperformance, there are the consequences of Brexit, Boris Johnson's mishandling of the COVID crisis with inflation much higher than major European countries, more significant interest rate hikes, and a stock index lacking in technology and luxury stocks.

3rd observation, the underperformance of large Swiss stocks:

- The Swiss market, known for its defensive nature, has shown disappointing performance since February 2020, with an increase of less than 10%, approximately 2.5% each year.

- Swiss investors, traditionally focused on a few major companies, are experiencing poor results because, over this period, Novartis has decreased by 0.5%, Lonza by 11%, and notably, Roche by 27%. Givaudan, another prominent Swiss company, has appreciated by less than 8%.

- This underperformance is exacerbated by the appreciation of the CHF against all currencies, 10.2% against the dollar, more than 11% against the Euro, and thus, performances translated into CHF are penalised.

4th observation, China's poor performance:

- The Sino-American rivalry is fully in favour of the United States. Despite the size of the Chinese market and its protection of foreign competitors, major Chinese corporations have performed poorly.

- Factors include the mismanagement of COVID, Xi's ideological tightening, the real estate debt crisis, and the structural decline in growth.

- The 14% decline in the Chinese CSI index and the 36% drop in the Hong Kong index starkly contrast with the 40% appreciation of the S&P500.

- Technological independence is a priority for Xi Jinping. There is a list of favoured sectors, and everyone is familiar with the "China 2025" plan. However, the emphasis on state-owned enterprises, control over private companies, and pressure on major entrepreneurs are worrisome and may discourage innovation, ultimately handicapping Chinese growth.

- A justified testimony to these concerns is the decline in technology stocks, even though they are currently sought after worldwide. Over the examined period, the technology index is down by 24%, while the Nasdaq has risen by 75%.

- Let's delve deeper and focus on two segments of the tech industry: online sales and video games. In the first, Chinese groups have the advantage of the size of the Chinese market and its protection compared to their American counterparts. Alibaba and JD.COM control 75% of the market, and Alibaba commands 20% of retail sales in China, while Amazon only achieves 5% in the United States. Yet, the underperformance of Chinese stocks is evident.

- The video sector is interesting to observe because it has been affected by Xi's decision to restrict children's access to video games. In video sharing, the three major Chinese players—ByteDance (unlisted) with its subsidiary Douyin in China and its subsidiary TikTok internationally, Bilibili (market capitalization $5.5 billion), and Kuaishou (market capitalization $31 billion)—have suffered from this policy.

- In summary, let's consider the BATX, the Chinese equivalent of the GAFAM: Baidu, the Chinese Google, declined by 8% while Alphabet, the parent company of Google, appreciated by 86%. Alibaba dropped by 64% while Amazon increased by 46%. Tencent, the Chinese Facebook and the second-largest mobile payment provider with WeChat after Alipay, hindered in the launch of video games, decreased by 9% while Meta (formerly Facebook) increased by 67%. Xiaomi, somewhat equivalent to Apple, only appreciated by 17%, a distant performance from Apple's 147%.

5th observation, the awakening of the Japanese market:

- Historically weak since the early 1990s, the Japanese market has experienced some rebounds, often disappointing. However, since February 2020, there has been a substantial increase of +56%, even surpassing the performance of the American market.

- There are two main reasons for this rise, one conjunctural and the other structural. The first is the substantial depreciation of the Yen. This is easily explained by the divergence between Japanese monetary policy and the policies pursued by other central banks. In the context of rising inflation, all central banks have massively raised interest rates, while the Bank of Japan chose to maintain the cap on 10-year rates between 1% and 1.5%. The Yen depreciated, benefiting export-oriented companies.

- Another, more structural factor is the Japanese authorities' desire to encourage companies to reduce their traditionally abundant liquidity, repurchase their shares, and externalize their value. Even today, despite the market's rise, 40% of Topix 500 companies trade below their book value, whereas, for comparison, only 5% of American companies are in this situation.

- In a perspective of declining interest rates worldwide, the Yen could strengthen somewhat, and the Japanese market might correct in the short term. However, fundamentally, the market remains attractive.

6th observation, the four promising themes since February 2020:

- Four themes have driven the markets since the start of the conflict in Ukraine: energy, with a 54% increase in the United States and 24% in Europe; defence; luxury, boosted by the use of savings accumulated during COVID and the rise of the middle class in emerging countries; and artificial intelligence, a crucial factor in the appreciation of the tech sector.

- The weight of some of these stocks in the indices often explains the majority of index appreciation.

- Technology stocks, after a challenging 2022, reduced costs, laid off employees, and shone throughout 2023. Since February 2020, tech stocks have risen by +75% in the United States and +28% in Europe. A standout performer is Nvidia, up +700% since February 2020. In Europe, ASML, known for its expertise in semiconductor engineering, has risen by 132%, and STMicroelectronics by +50%. American tech giants have even more dazzling performances, with Apple up +140% and Microsoft up +135%.

- In the ***defence sector***, Rheinmetall, the top German defence company, has surged by 278% because revenue is expected to double by 2026 to €14 billion, and the operating margin, currently at 12%, is projected to grow to 15% by 2026. Saab, BAE, and Leonardo have also risen by around 170%, and to a lesser extent, Thales and Dassault Aviation have seen gains. This contrast is evident when compared to companies more dependent on civilian aerospace, such as Airbus, Rolls-Royce, or Safran. The difference is also striking compared to the period before the conflict in Ukraine, as the sector was neglected, and many funds refrained from investing in it.

- In the ***luxury sector***, standout performers during this period include Hermès, up by 176%, Ferrari up by 104%, LVMH up by 80%, ahead of L'Oréal at 64%. However, the rise has not been universal, as evidenced by declines in Kering (-26%) due to Gucci's underperformance, Moncler, Swatch, and the modest appreciation of Burberry. Selectivity in choice is, therefore, essential.

- Other sectors showing outperformance during this period include **automotive stocks**, up by 133% in the United States thanks to Tesla's +350%, although GM declined by 16%. In Europe, the sector appreciated by 27% thanks to a +27% increase for Mercedes-Benz and a 61% rise for Stellantis.

  We could add, in the industry of leading companies benefiting either from the transition or from technology, Schneider +77%, Saint-Gobain +59%, and ABB (the world leader in electrification and automation techniques).

  Additionally, there are companies benefiting conjuncturally from rising interest rates, such as banks. Among them, Unicredit +96%, Commerzbank +101%, BBVA +70%, and UBS benefiting from the Credit Suisse operation. However, other banks, including BNP, Santander, HSBC, and even worse, Société Générale, are disappointing.

- Considering the rise in energy prices, the performance of European oil stocks like TotalEnergies, Shell, BP, and Repsol is disappointing due to their negative image. More interesting are American oil stocks, less encumbered by the transition and still seeking production growth. Examples include Marathon +186%, ConocoPhillips +94%, Exxon +71%, and oilfield service companies like Schlumberger or Baker Hughes, up by +56%.

7th observation, certain themes have been abruptly reversed:

- In the stock market, it is well known that one must be agile as themes can quickly reverse.

- Take the example of ***maritime transport***: freight rates soared during the COVID period, and companies' results in 2022 reached historic records. However, rates have since dropped, sometimes by 95%, and the sector is facing the influx of new ships, an expected increase of a quarter in container capacities in the next two years, leading to an addition of overcapacity. In our monthly reports, we have repeatedly warned against a reversal, but it is more severe than feared: A.P Moller Maersk, with a fleet of 700 ships, saw its quarterly results fall to $520 million, far from the $8.9 billion earned in the third quarter of 2022, and the group anticipates two to three years of weakness. Hapag Lloyd, the fifth player in the sector, is on the same line. Next year, the sector is expected to lose $15 billion, and restructuring and consolidations can be anticipated.

  Let's note that the winners of this weakness in freight rates are companies like Amazon or Target, contrasting with the losers from a year or two ago.

- Other well-known victims of a reversal are stocks associated with remote work and companies in the ***health sector*** that recently benefited from vaccination campaigns.

- Additionally, consider some stocks related to the ***energy transition*** which, after impressive runs, have corrected. Siemens Energy, down by 54%, is a pertinent example, but we will revisit this in the upcoming Letter.

8th observation, the disappointment represented by sectors reputed to be defensive:

- Several sectors have shown negative performance during the period, including many well-established traditional companies.

- Healthcare: Except for Eli Lilly, the first pharmaceutical company to surpass a $500 billion market capitalization, and Novo Nordisk, the first in Europe with a market cap exceeding $400 billion, many players in the sector, despite the COVID crisis, have displayed mediocre performance in recent years.

  Examples include Roche, Novartis, Pfizer, Sanofi, BioMérieux, Lonza, typically defensive stocks with market caps below $200 billion. Eli Lilly and Novo Nordisk, the exceptions, are both driven by their new obesity treatment and diabetes medications. Others suffer from patent expirations and generic competition.

- The worst-performing sector is ***real estate***, down by 45%, and unsurprisingly, the rise in interest rates is the primary cause. Unibail-Rodamco, down by 56%, is an example among others..

- ***Telecommunications stocks***, such as Orange in France, Telecom Italia in Italy, and Telefonica in Spain, all show negative performances over the period, ranging from -50% to -10% .

- Similarly, ***not all technology stocks outperformed***. Far from it. Atos has lost more than 90%, Philips 35%, Ericsson nearly 30%, and SAP has appreciated only slightly. Recently, the worst performance was recorded by Worldline, the French payment services provider, down by 76%, a victim of several outages and a profit warning.

- ***Consumer discretionary stocks*** like Carrefour, Inditex, or H&M have been stagnant over the period. Worse, Zalando is at -49%, and Adidas is down by 38%.

- ***Other consumer stocks*** like Nestlé, Carlsberg, Unilever are in decline. Danone, for example, is down by 21%, while Colgate is stagnant at +3%.

- ***Materials stocks***, not benefiting from the energy transition, like Holcim or Solvay, have not performed well.

- The ***insurance sector***, including Allianz, Swiss Life, Axa, has been stagnant over the period.

- Poor performance is also seen in the communication and utilities sectors, for example, the electric utility Enel is down by 22%.

- As we can see, the list of affected quality stocks and sectors is extensive.

9th observation, the challenges of the Private Equity market:

- The global market is valued at $12 trillion, but the interest rate environment is no longer as favourable as it was in 2010 after the financial crisis. While nearly 30,000 companies were delisted from the stock market between 2005 and 2020, today, the Private Equity market is facing difficult times.

- For a long time, the strategy of market players was not dictated by expected profitability but by the cost of debt. However, after experiencing exceptional years between 2008 and 2021, players are now grappling with rising interest rates. The leverage on debt, once a profitability driver, has become, with each refinancing, a burden challenging the profitability of investments.

- Additionally, it has become difficult to sell holdings. During the first 9 months of 2023, asset sales or market listings only amounted to $584 billion, a figure much lower than the $1.4 trillion generated in 2021. These numbers haven't been this poor since 2013. Unable to liquidate certain assets, Private Equity firms are transferring them to new funds.

  Fortunately, the sector is said to have $3 trillion in liquidity, with over $600 billion raised just after the COVID crisis that has yet to be reinvested. Major Private Equity players, such as Blackstone, are taking advantage of this situation to expand into corporate lending and the private debt market, competing with traditional banks.

  To improve their situation, some Private Equity firms are buying out minority stakeholders in companies they had taken public in recent years that are now underperforming.

Conclusion: "Strategy without tactics is the slowest route to victory" Sun Tzu.

- ***What conclusion can we draw***? As Sun Tzu noted, tactical movement and pragmatism are essential in these markets filled with obstacles and unforeseen events. Some of the outperformances since the eve of COVID come from trends that were neither anticipated nor predictable in February 2020: sectors that were then neglected, such as defence, or less known, like artificial intelligence. Part of the luxury sector's fortune comes from the use of the surplus savings accumulated during COVID. The outperformance of some banking stocks results from the end of negative interest rates and the rise in rates.

  Conversely, the underperformance of real estate results from the rise in rates, not foreseen at the time, as inflation seemed to have disappeared.

  In summary, given the budgetary stimuli and improved corporate margins, the performances of a majority of sectors and stocks are actually average.

- ***What does the future hold?*** The markets are not overpriced, the beginning of disinflation in recent months, and the prospect of the first rate cuts in mid-2024 should provide a new impetus and allow for a rotation of themes. Emerging markets should benefit from the new context. Bonds, very poor in the last three years, are already making a comeback. The $ should underperform in favour of other major currencies. There are many topics we can discuss.

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