



Dorval's Macro Corner

July 2019

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Dorval's Macro Corner - The Four Pillars

THE MACRO	VALUATION	MARKET DYNAMICS	THE MICRO
<p>The big picture Economic policies Political risks Cyclical momentum</p>	<p>Equity multiples Bonds' term premia Bond's quality premia Relative value</p>	<p>Investor's positioning Correlations and decorrelations Technicals</p>	<p>Microeconomic themes Sectors' economics Granular analysis</p>

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The battle against slowing growth takes shape

The debate rages about the implications of the recent sharp decline in global long-term interest rates for financial markets. **The bearish view is that the collapse of bond yields reflects a high level of anxiety about the economy**, and that this is incompatible with rising equity prices. Another risk is that bond yields have gone too low too fast, and that a destabilizing bond market correction might soon take place, like those of May 2013 and May 2015. By contrast, **the bullish argument is that equity valuation has not yet adapted to the extraordinary low level of bond yields**, as many measures of the equity risk premium suggest. Contrary to a urban legend, very low interest rates have indeed failed to inflate equity P/Es. However, they have contributed to **a two-tier equity market**, pushing investors to pay higher prices for quality growth stocks, to the detriment of value stocks.

As usual, financial market developments will be shaped by the balance between economic conditions and monetary policy. With global manufacturing slowing down further, still significant trade tensions, and the US economy showing signs of weakness, the case for slower growth looks compelling for now. **In other times, monetary policy makers were happy to see the economy slowing at this mature stage of the cycle**, because they feared overheating. This attitude often contributed to end the expansion cycle. Today, by contrast, **any lasting growth slowdown is seen by central banks as a major threat because inflation remains too low for comfort**. The ECB has thus announced a new round of monetary easing, and the Fed is expected to cut interest rates at the end of July. Some observers think that this policy is risky for future financial stability, but central banks think differently: their biggest fear is the return of deflation risks if the economy slows further. What they target is a soft landing of the economy.

The return of a combative ECB comes at a moment when **the general direction of policy making is moving more clearly pro-growth and pro-federalism in Europe**, as shown by the nomination of Christine Lagarde (ECB) and Ursula Von Der Leyen (EU Commission). More fiscal spending and the issuance of "project bonds" (for example on green energy) are now in the cards. Even German policy makers increasingly admit that investing when interest rates are negative might not be a bad idea after all. One should avoid getting too excited, but it is fair to say that **almost everything happening these days is taking the opposite way of the view of the Euro doomsayers**.

Should investors already anticipate the success of policy makers in stabilizing the slowing global economy? After already 18 months of industrial downturn, it is indeed tempting to call the bottom. In this case, returning gradually to cyclical stocks, and reducing the bias towards defensive and growth stocks may make sense. Meanwhile, continued political and cyclical uncertainties, and substantial corporate profit warnings in the global cyclical universe, argue for caution, at least for now. In our international flexible portfolios, we have a close to normal equity weighting, with no strong bias towards growth or value. We are reducing the duration of our bond holdings, but remain well invested in Italian bonds.





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Global stocks have underperformed bonds since early 2018. Can monetary easing change this, or do we need a cyclical recovery? — Lower bond yields have probably contributed to favor growth over value investing. What is the next step?

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In Europe, the two-tier economy is producing sharp EPS divergences between cyclical sectors, with construction and industrial services doing well—With a debt burden at a new record low, will European corporations raise capex?

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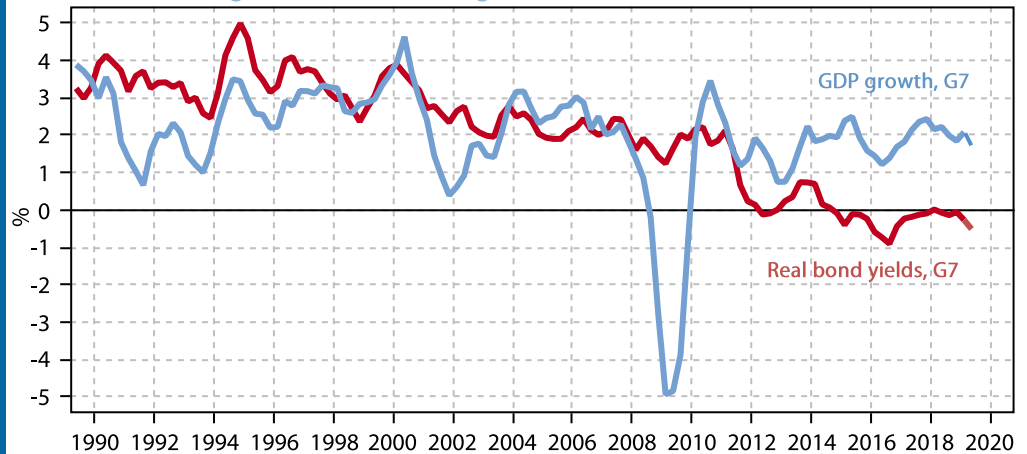
The ill-named secular stagnation theory suggests that the post-financial crisis economy needs prolonged and active supports in order to grow. An indeed, abnormally low real interest rates seem to be a necessary condition for getting normal economic growth...

... but even that has not fully ensured price stability. Despite low unemployment, inflation has remained below normal in most G7 countries. If economic growth continues to slow, deflation risk could quickly reemerge, which is why central banks are ready to act preemptively.



Super-low real rates are required to get decent growth...

GDP growth and real long-term interest rates in the G7

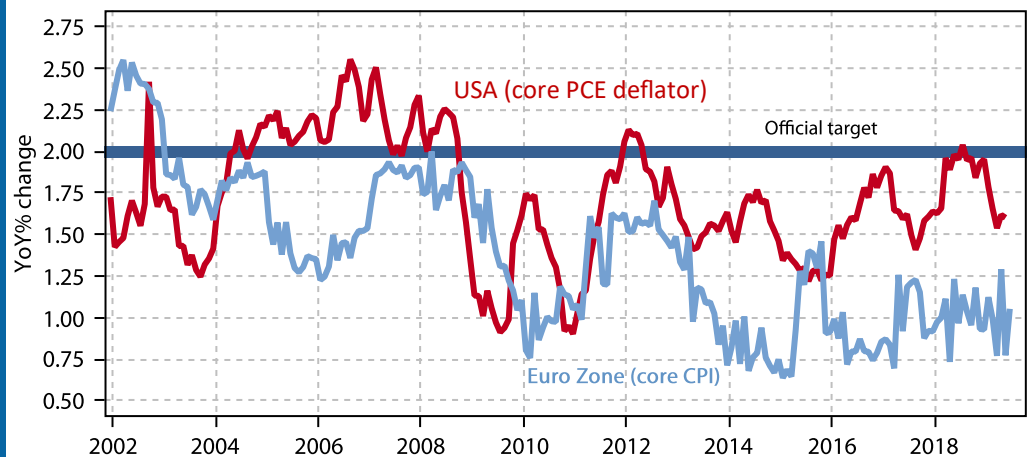


Sources: OECD, Macrobond

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...and to avoid the return of deflation risks

Core inflation in the US and in the Euro Zone



Source: Macrobond

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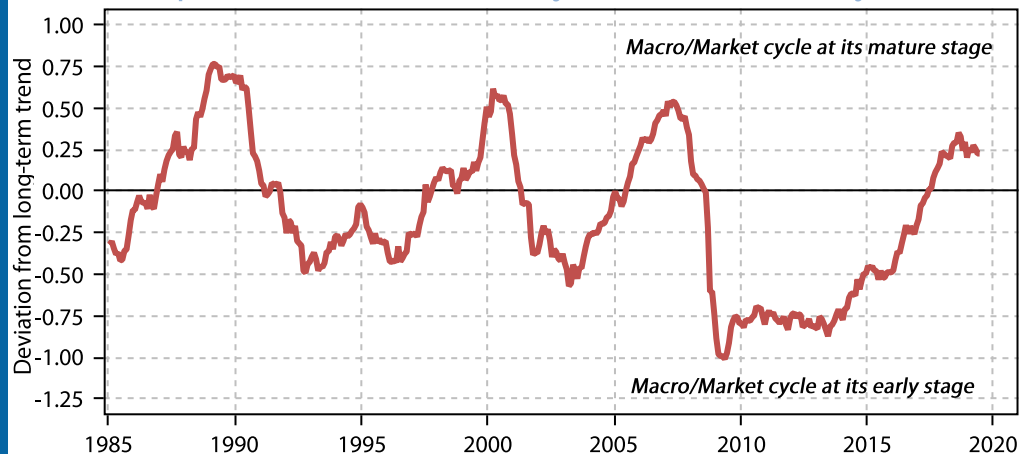
A combination of macroeconomic and financial market indicators in the G7 suggests that the macro/market cycle has been in its mature stage since 2017. With unemployment at a record low in most OECD countries, and with the US and now German yield curves almost inverted, investors have become nervous about recession risks....

...but inflation and credit growth have remained well below traditional peak levels. This provides central banks with the incentive to prolong the cycle further.



A mature macro/market cycle...

Composite indicator of the maturity of the macro/market cycle

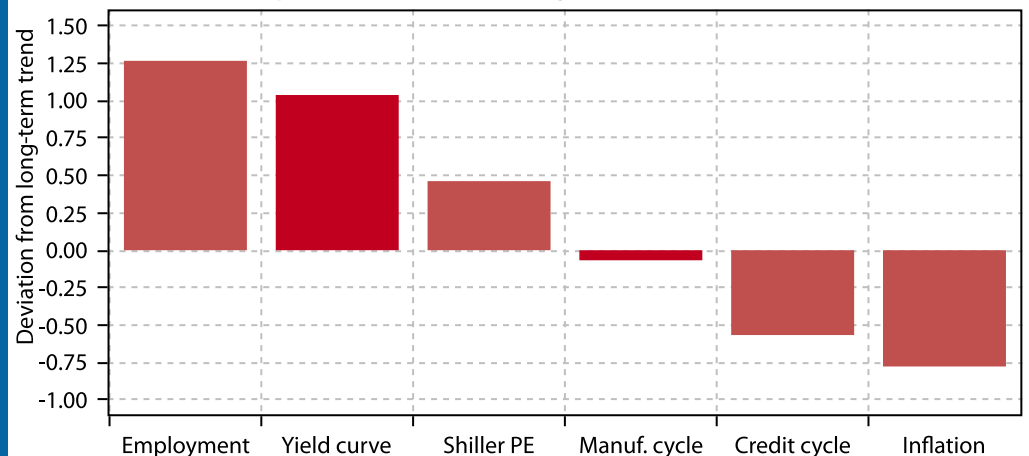


Sources: Dorval AM, Macrobond

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...but with still sub-par inflation and credit growth

Level of sub-components of the maturity indicator, as of end-June 2019



Sources: Dorval AM, Macrobond

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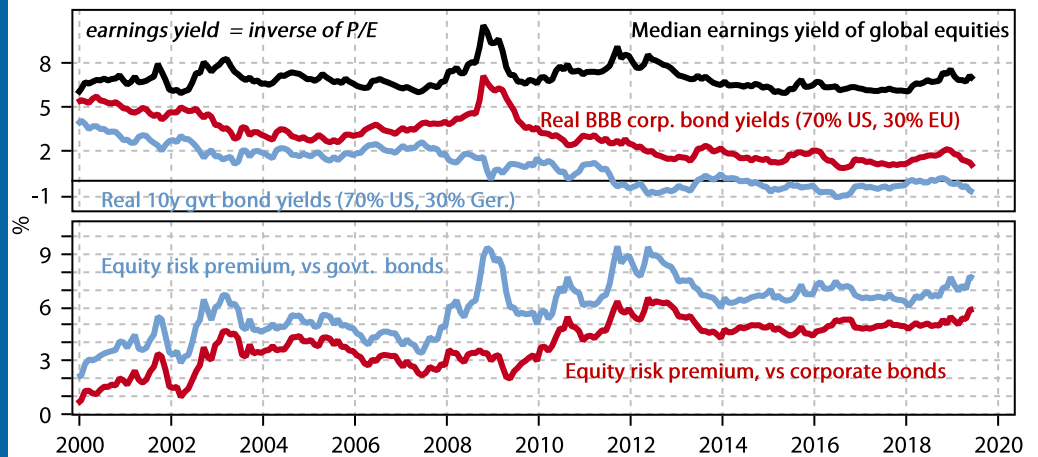
A popular view is that lower and lower interest rates have artificially inflated equity valuation. This is not what we have observed. The decline in real bond yields has failed to produce any increase in equity P/Es. As a result, the equity risk premium, whether measured against government bonds or corporate bonds, has reached its highest level since 2012.

In this respect, the Japanese case is fascinating. The equity risk premium of the Japanese stock market has reached new highs while the Bank of Japan has bought massive amounts of stocks. Japanese stocks are now the cheapest in the developed world.



Lower real yields have increased the "equity risk premium"

Median earnings yield (E/P) of MSCI world A/C vs. real bond yields

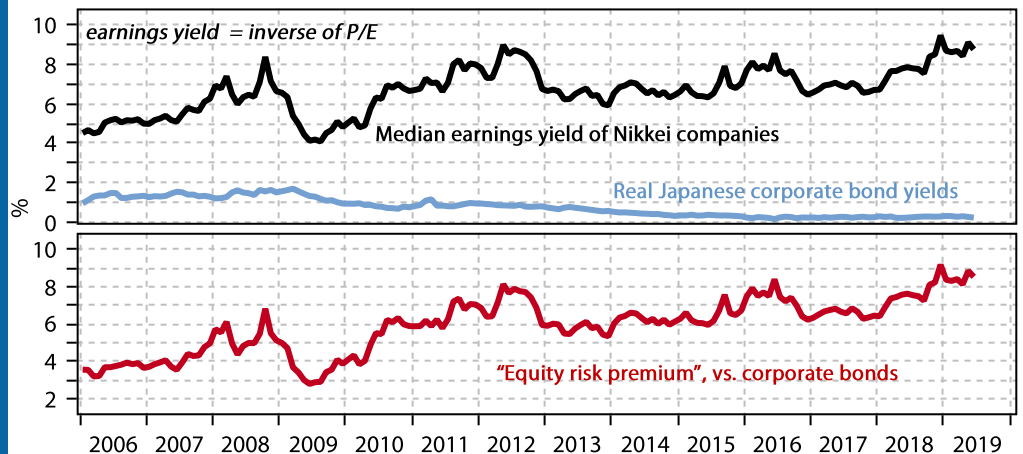


Sources: Citi, Macrobond

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For now, the Bank of Japan has failed to boost equity valuation

Median earnings yield (E/P) of the Nikkei, vs. real corp. bond yields



Sources: Bloomberg, Macrobond

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Since the beginning of the global industrial slowdown (2018Q1) global equities have underperformed the US long bond, which looks logical. Will this consistency be maintained now that central banks are expected to cut interest rates? The 2007 precedent, for example, suggests that stocks can outperform bonds even in a slowing economy.

In recent months, the sharp decline in long-term interest rates in a context of slowing economic growth has contributed to the strong outperformance of "growth" investing.



The stock-to-bond ratio & the manufacturing cycle

MSCI World A/C vs. US long bond (total returns) & the global manuf. PMI

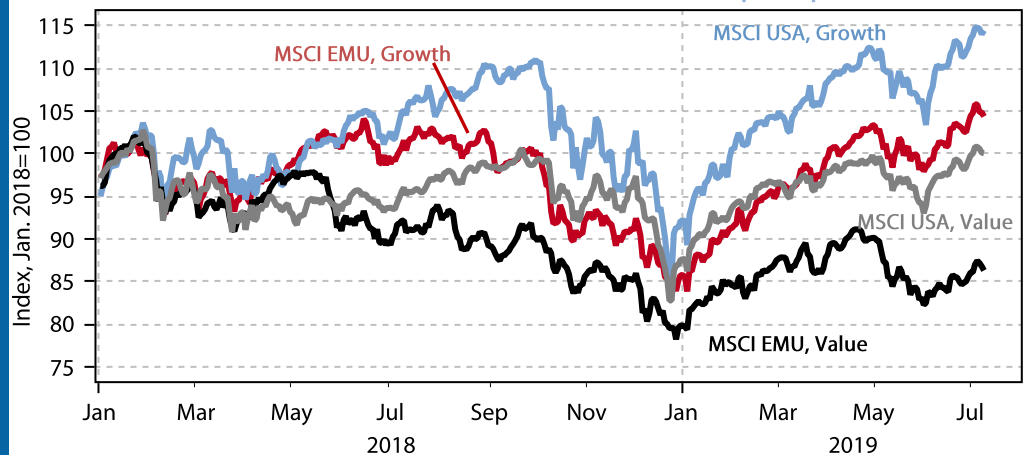


Sources: Bloomberg, MSCI, Macrobond

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A two-tier equity market

MSCI Growth vs Value, in the USA and in the Euro Zone (price performance)



Sources: MSCI, Macrobond

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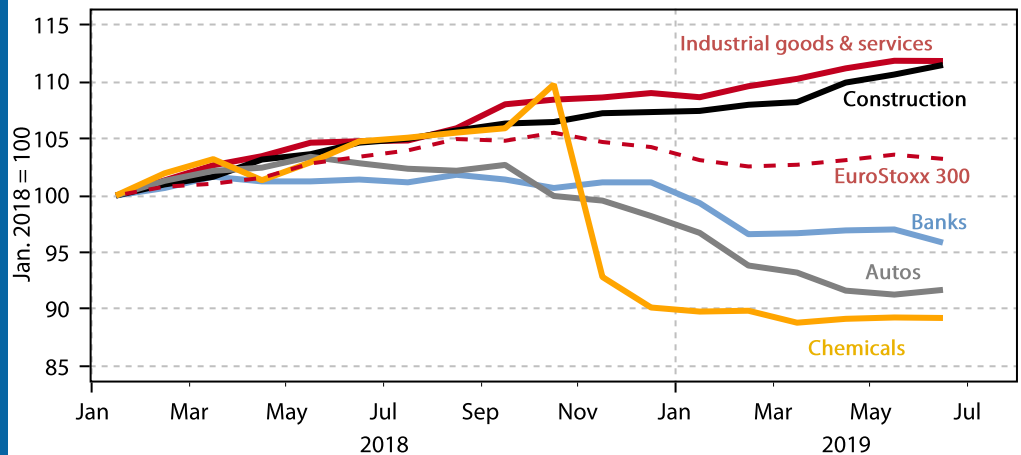
Although cyclicals are not in favor in these days of slowing growth, a number of cyclical sectors are doing well in Europe. This reflects a two-tier economy, with a near recession in the manufacturing sector, but still good growth in the construction sector and in most services.

The additional decline in interest rates will ensure that the spectacular decline in interest charges continues. This will be good for net profits in Europe, but could also trigger a rise in capex at some point, as firms take benefit from super-low rates to invest more.



A large dispersion of profit growth in Europe's cyclical sectors

Forward EPS, sectors of the EuroStoxx 300 (SXXE)



Sources: Bloomberg, Macrobond

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The collapse of corporate interest burden in Europe

Interest paid by non-financial corporations, as % of value added (Euro Zone)



Sources: Eurostat, Macrobond

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ABOUT DORVAL ASSET MANAGEMENT

DORVAL ASSET MANAGEMENT, is a public limited company with share capital of €303,025.00, having its registered office at 1 rue de Gramont, 75002 PARIS.

Dorval Asset Management, recorded under no. 391 392 768 on the Paris Trade and Companies Register, is approved as an asset management company by A.M.F. (French financial markets authority) under the number GP 93-08. www.dorval-am.com

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