Dorval's Macro Corner

November 2019

François-Xavier **CHAUCHAT**

Dorval's Macro Corner - The Four Pillars

THE MACRO	VALUATION	MARKET DYNAMICS	THE MICRO
The big picture Economic policies Political risks Cyclical momentum	Equity multiples Bonds' term premia Bonds' quality premia Relative value	Investors' positioning Correlations and decorrelations Technical analysis	Microeconomic themes Sector economics Granular analysis

Dorval Asset Management

The extension of the economic cycle favors a broadening of the equity rally

The great growth scare of the month of August, which had seen the word recession spread like wildfire, gave way to clear relief. The excessive pessimism we were talking about this summer has been corrected. The loss of anxiety on the fronts of Brexit and the trade war obviously counted a lot. But the relief came also from economic indicators and company earnings, all showing slowdown but without the dreaded collapse.

The process of downward revision to global growth has not been stopped yet, but green shoots are emerging. Global sales of semiconductor rebounded after the collapse of the fourth quarter of 2018. And after a prolonged recession in the car sector, signs of life have appeared in Germany, a possible harbinger of export stabilization and better adaptation to new environmental standards. In total, the global manufacturing PMI seems to have bottomed out in July, and has risen slightly since then. This is good news, since it is the industrial cycle that led the dance of downward revisions to global growth. If aggregate demand remains supported by monetary and fiscal policies, there is little reason for the industrial recession to continue.

The Federal Reserve has taken due note of these improvements, and has announced its willingness to pause after three rate cuts since July. Are we then now threatened by a reversal of risks, which would see long-term rates rise sharply? This scenario cannot be completely ruled out, but for the moment, it faces the foreseeable softness of growth and inflation. In China, the United States and Japan, which has just raised its VAT rate, growth in the fourth quarter should be rather weak. In addition, deleveraging remains a priority in China, and in the America some indicators such as labor market tensions and lower corporate margins lead to caution. Added to this is the inversion of the yield curve during summer, but this argument is less relevant today because, unlike previous episodes, it is not associated with financial stress. All in all, the most likely scenario remains that of a global cycle that plays extra time, rather than a strong re-acceleration.

This close-to-potential growth is favorable for equity markets. If investors are increasingly convinced that the worst of the industrial cycle has passed but that long-term rates are only going up slightly, then they can buy more stocks in the next few months. We would then observe a broadening of the investment universe to previously unloved market segments, such as small caps, banks, UK stocks and the Japanese market. We also note that the regime of negative interest rates in Europe is starting to provoke cracks in the "Solvency II" rules of insurers, rules that are currently unfavorable for equities but which are evolving, and which will be reviewed in 2020.

In our funds we have raised our exposure to equities since mid-October, and at the same time increased diversification towards financials and certain yield stocks. In our international funds we have continued to reduce our exposure to bonds, and have taken a position on domestic UK stocks. The latter could benefit both from the lower probabilities of a no-deal Brexit, and from a post-election fiscal stimulus package.

Dorval's Macro Corner - The Four Pillars

THE MACRO	VALUATION	MARKET DYNAMICS	THE MICRO
Global industrial stabilization may no longer be wishful thinking. Confirmation would allow end-cycle anxieties to subside, to give way, if not to a strong recovery, at least to a soft but not weak growth scenario.	**If bond yields remain low, we can argue that the P/E of growth stocks, the highest in more than 15 years, is probably sustainable. But what about the rest of the stock market, the "value" universe, whose P/E is almost 40% lower?**	**The origin of the recent equity rally is to be found in the correction of an excessive economic pessimism. We now monitor the relationship between cyclical stocks and bond yields in order to assess the health of the bull market.**	**A return to the average historical P/E of two emblematic European cyclical sectors—the car and banking industries-would allow a rise of around 20% in stock prices, provided that EPS do not disappoint too much.**

Dorval Asset Management

The global manufacturing PMI has been a good leading indicator of this cycle of downward revision to growth. Destocking after a probable excess of optimism in early 2018, the US/China trade war and specific sectoral problems all led to the downturn. However, the PMI index appears to have bottomed in July 2019.

Among the key sectors, we note the ongoing recovery of semiconductor sales since Q2, and glimmers of hope in the German car industry, according to the recent readings of the IFO survey.

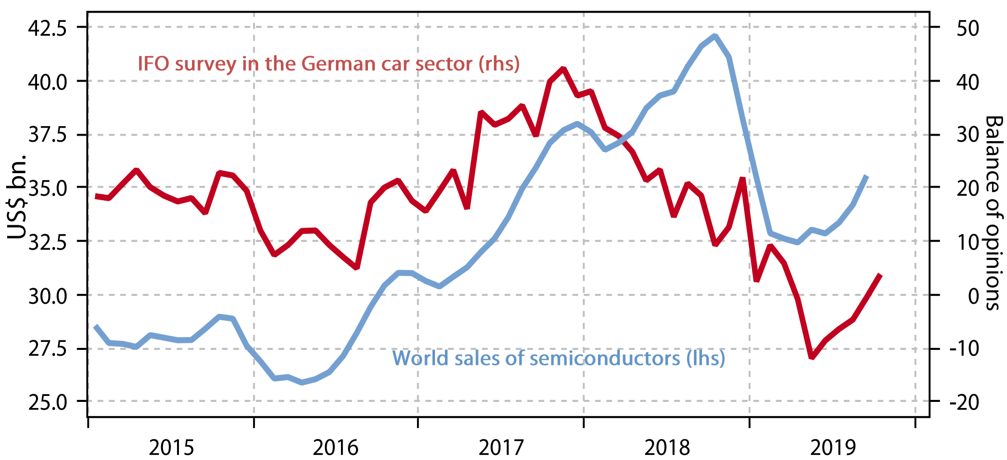
The industrial cycle has led global growth revisions

Global growth expectations vs. manufacturing PMI

Sources: Bloomberg, Markit, Macrobond Dorval Asset Management

Ongoing stabilization in the semiconductor and car industries

Global semiconductor sales & business climate in the German car sector



Source: Macrobond Dorval Asset Management

NEITHER BEAR NOR BULL
BUT CAMELEON

Dorval's Macro Corner - The Four Pillars

THE MACRO	VALUATION	MARKET DYNAMICS	THE MICRO
Global industrial stabilization may no longer be wishful thinking. Confirmation would allow end-cycle anxieties to subside, to give way, if not to a strong recovery, at least to a soft but not weak growth scenario.	**If bond yields remain low, we can argue that the P/E of growth stocks, the highest in more than 15 years, is probably sustainable. But what about the rest of the stock market, the "value" universe, whose P/E is almost 40% lower?**	**The origin of the recent equity rally is to be found in the correction of an excessive economic pessimism. We now monitor the relationship between cyclical stocks and bond yields in order to assess the health of the bull market.**	**A return to the average historical P/E of two emblematic European cyclical sectors—the car and banking industries-would allow a rise of around 20% in stock prices, provided that EPS do not disappoint too much.**

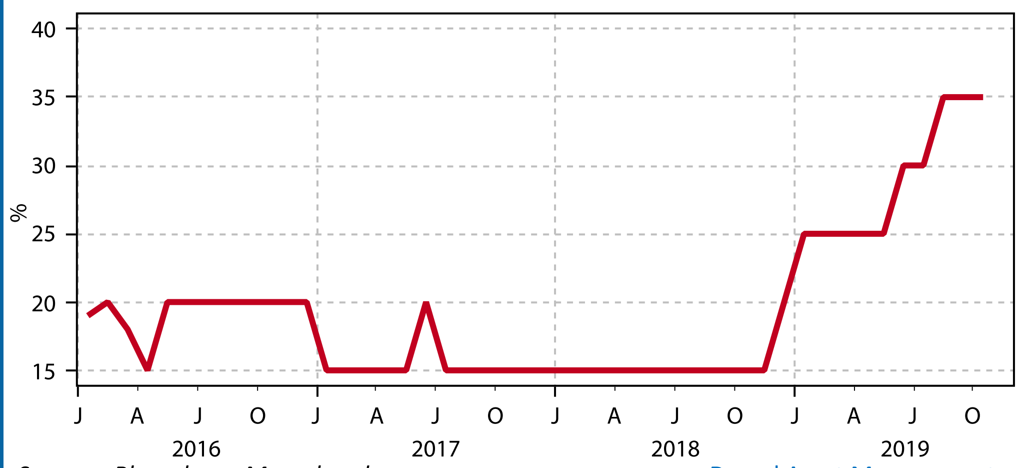
Dorval Asset Management

The maturity of the US cycle is leading economists to become increasingly cautious. The recession risk in the 12 months is estimated at 35% by the Bloomberg consensus, well above the last cyclical bottom of early 2016.

The slight inversion of the yield curve this summer has increased nervousness, since this inversion preceded all modern recessions in the United States. The popularity of this indicator can also make one fear a self-fulfilling prediction. Yet the financial stress of businesses and especially households is much lower than in previous episodes.

End-cycle anxieties in America

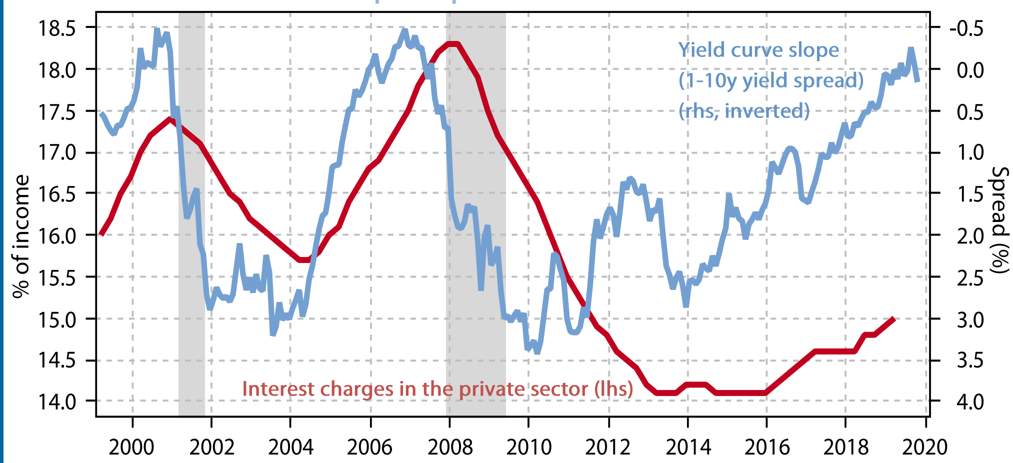
1-year ahead recession probability (Bloomberg consensus)



Sources: Bloomberg, Macrobond Dorval Asset Management

Yield curve inversion this summer, but financial stress is low

Yield curve slope vs. private debt burden in the US



Sources: Bloomberg, Macrobond Dorval Asset Management

NEITHER BEAR NOR BULL
BUT CAMELEON

Dorval's Macro Corner - The Four Pillars

THE MACRO	VALUATION	MARKET DYNAMICS	THE MICRO
Global industrial stabilization may no longer be wishful thinking. Confirmation would allow end-cycle anxieties to subside, to give way, if not to a strong recovery, at least to a soft but not weak growth scenario.	**If bond yields remain low, we can argue that the P/E of growth stocks, the highest in more than 15 years, is probably sustainable. But what about the rest of the stock market, the "value" universe, whose P/E is almost 40% lower?**	**The origin of the recent equity rally is to be found in the correction of an excessive economic pessimism. We now monitor the relationship between cyclical stocks and bond yields in order to assess the health of the bull market.**	**A return to the average historical P/E of two emblematic European cyclical sectors—the car and banking industries-would allow a rise of around 20% in stock prices, provided that EPS do not disappoint too much.**

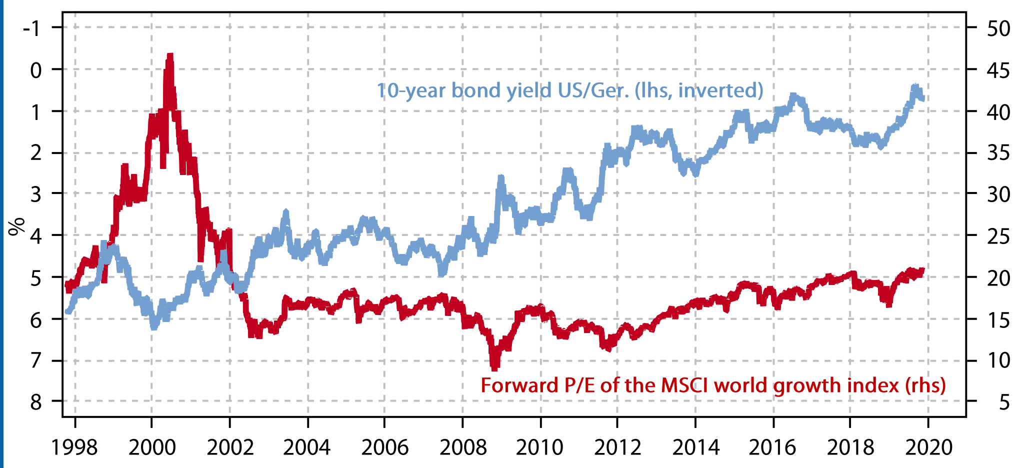
Dorval Asset Management

With a P/E slightly higher than 20, growth stocks have never been so expensive since the beginning of 2002. However, we are far from the 1999/2000 bubble levels. Moreover, the collapse of interest rates can probably justify P/Es of 20 or more. Provided that long rates do not rise violently.

The value universe has not yet been able to benefit from the "lower for longer" interest rate effect, and its relative valuation has fallen sharply. Will this strong discount associated with global macroeconomic stabilization allow for catch-up?

Ultra-low bond yields may warrant high P/Es for growth stocks

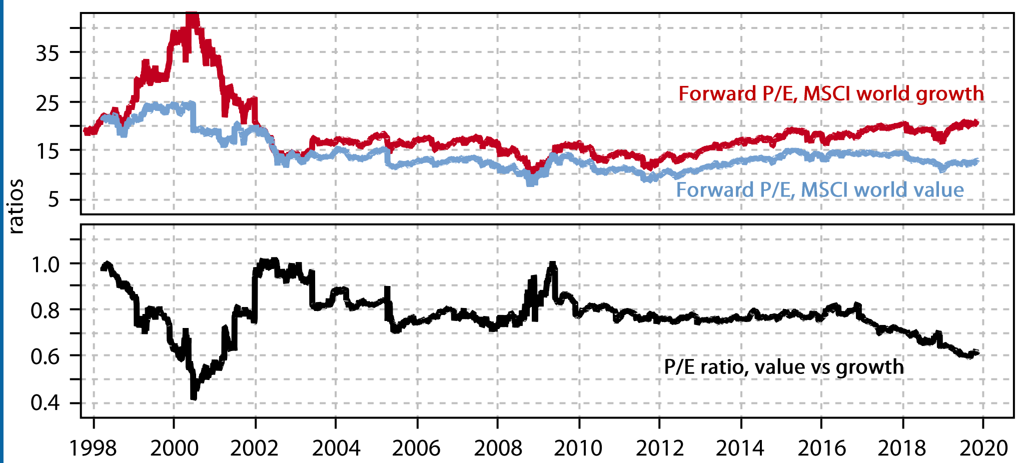
Safe-haven bond yields and forward P/E for growth stocks



Sources: MSCI, Bloomberg, Macrobond Dorval Asset Management

Can this effect spread to value stocks?

Forward P/E of the MSCI world "growth" and "value" indices



Sources: MSCI, Bloomberg, Macrobond Dorval Asset Management

NEITHER BEAR NOR BULL
BUT CAMELEON

Dorval's Macro Corner - The Four Pillars

THE MACRO	VALUATION	MARKET DYNAMICS	THE MICRO
Global industrial stabilization may no longer be wishful thinking. Confirmation would allow end-cycle anxieties to subside, to give way, if not to a strong recovery, at least to a soft but not weak growth scenario.	**If bond yields remain low, we can argue that the P/E of growth stocks, the highest in more than 15 years, is probably sustainable. But what about the rest of the stock market, the "value" universe, whose P/E is almost 40% lower?**	**The origin of the recent equity rally is to be found in the correction of an excessive economic pessimism. We now monitor the relationship between cyclical stocks and bond yields in order to assess the health of the bull market.**	**A return to the average historical P/E of two emblematic European cyclical sectors—the car and banking industries-would allow a rise of around 20% in stock prices, provided that EPS do not disappoint too much.**

Dorval Asset Management

The big fright of August was unprecedented in terms of scale and spread. The popularity of the word recession was as strong as in 2008, in a context that was unrivaled. The equity market rally since then has been essentially led by the correction of a really excessive pessimism.

Cyclical stocks have logically benefited from the recent relief, at the same time as long-term interest rates rose a little. It is this elasticity between cyclical stocks and bond yields that is to be monitored. The scenario of a sharp rise in interest rates seems unlikely in the short term.

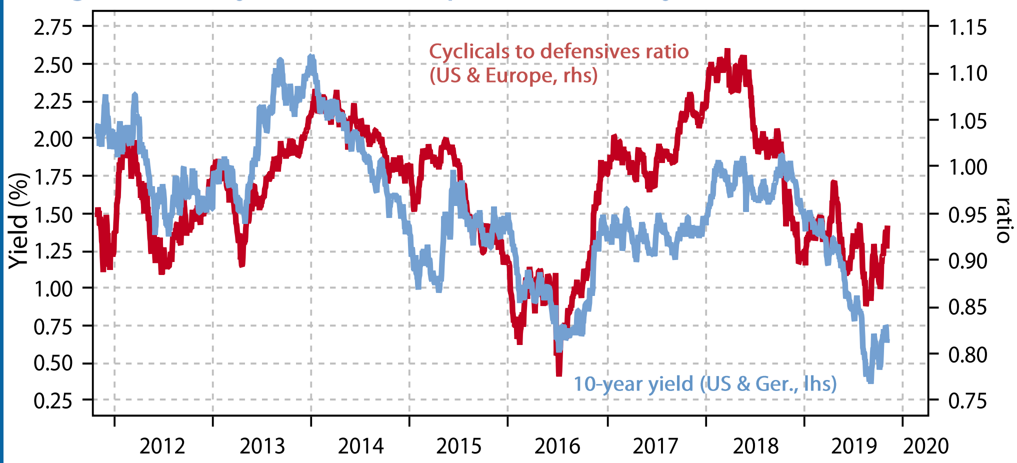
A relief commensurate to the extreme growth scare of August

Frequency of Google searches including the word "recession" in America

Sources: Google Trends, Macrobond Dorval Asset Management

Cyclical/defensive ratio vs. bond yields : unstable elasticity

Long-term bond yields vs relative performance of cyclical vs defensive stocks



Sources: Goldman Sachs, Macrobond Dorval Asset Management

NEITHER BEAR NOR BULL
BUT CAMELEON

Dorval's Macro Corner - The Four Pillars

THE MACRO	VALUATION	MARKET DYNAMICS	THE MICRO
Global industrial stabilization may no longer be wishful thinking. Confirmation would allow end-cycle anxieties to subside, to give way, if not to a strong recovery, at least to a soft but not weak growth scenario.	**If bond yields remain low, we can argue that the P/E of growth stocks, the highest in more than 15 years, is probably sustainable. But what about the rest of the stock market, the "value" universe, whose P/E is almost 40% lower?**	**The origin of the recent equity rally is to be found in the correction of an excessive economic pessimism. We now monitor the relationship between cyclical stocks and bond yields in order to assess the health of the bull market.**	**A return to the average historical P/E of two emblematic European cyclical sectors—the car and banking industries-would allow a rise of around 20% in stock prices, provided that EPS do not disappoint too much.**

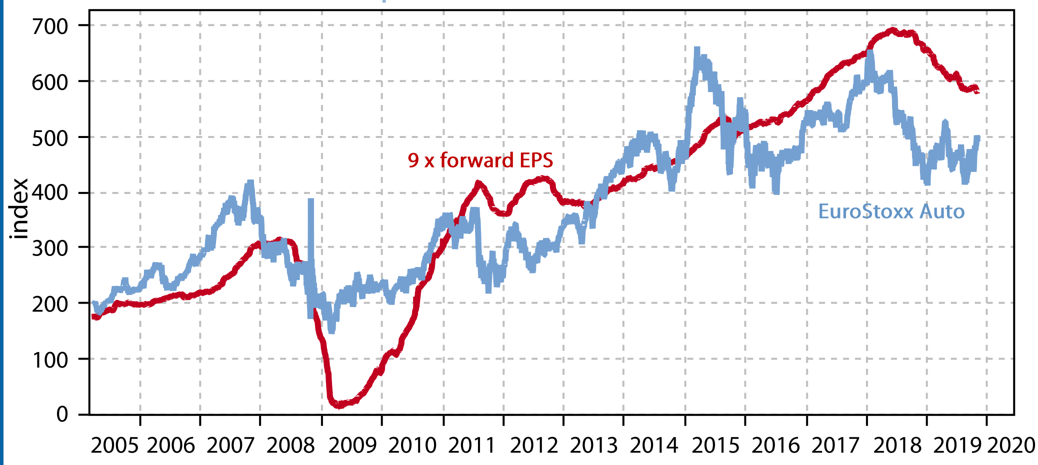
Dorval Asset Management

The automobile and the banks have been the two emblematic sectors of the European discomfort of the last 18 months. They combine both sensitivity to the economic cycle and punitive regulation. What is their potential for appreciation if, as we can think, the process of downgrading revisions to growth is about to stop?

We compared for both sectors the distance to cover for the index to return to a P/E multiple equal to its historical median since 2005. In both cases, and provided that EPS stabilize, a potential of about + 20% appears.

The upside for the European car sector...

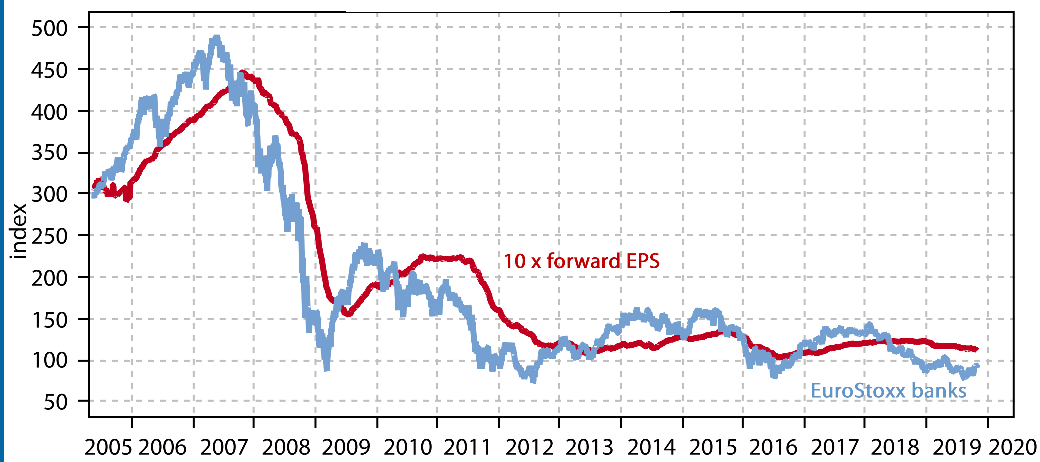
EuroStoxx auto sector price index vs. (EPS x historical median P/E)



Sources: Bloomberg, Macrobond Dorval Asset Management

...and for banks in the euro zone

EuroStoxx banks sector price index vs. (EPS x historical median P/E)



Sources: Bloomberg, Macrobond Dorval Asset Management

NEITHER BEAR NOR BULL
BUT CAMELEON

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

Discover our new website: www.dorval-am.com.

Follow us on :