



# Dorval's Macro Corner

February 2020

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## 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

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### No excess economic optimism, but questions about equity valuation

As with previous epidemics (SARS, H1N1, etc.), **the coronavirus will have a temporary and reversible negative impact on the Chinese and global economy**. This epidemic is emerging at a time when indicators confirm that **the recessionary forces at work since spring 2018 in the global industrial sector are dissipating**. The manufacturing PMI of developed countries has been recovering slowly since last October. Car registrations have clearly rebounded in Europe in recent months, which proves that the previous decline was mainly due to supply disruptions linked to regulatory developments. Finally, worries about world trade have subsided following the signing of an agreement between the United States and China. The economic stabilization scenario therefore seems to be well in place.

The sharp rise in global stock markets since last summer has raised concerns that investors have even become too optimistic about the economic cycle. This is not our analysis. Sentiment surveys show that investors and financial analysts were actually far too pessimistic in 2018 and 2019, especially in Europe. This sentiment has now simply normalized. **Long-term interest rates have also fallen, which shows some caution about the growth outlook**. Finally, the rebound in cyclical stocks that started in October 2019 has fizzled, and leadership has quickly returned to defensive sectors and growth stocks.

**Far from signaling an excessive enthusiasm on the global economic cycle, the recent stock market dynamics raises above all the question of equity valuation**. Are we dealing with an emerging bubble, encouraged for example by the rise of ESG investing, or with a logical rerating of the equity asset class, motivated by the collapse of yields of other asset classes (bonds, real estate in big cities, etc.)? Probably a bit of both.

However, **the suspicion of excess valuation concerns only a part of the market, that of growth stocks**. The P/E ratio of the MSCI world growth index has reached 23, the highest since early 2002, against a historic median of 19.3 since 1994. Steller profit growth in the new economy oligopolies, the rise in profit payout rates, and the flight to quality in a world where growth is both rarer and more disruptive have undoubtedly favored this development. Compared to real yields on US Treasury bonds, **the equity risk premium for growth stocks remains comfortable**, which is very different from the situation that prevailed in 1999/2000. **However, compared to the value compartment, whose average P/E is only 13, growth stocks have never been so expensive** since the 1999/2000 bubble. This huge gap will be increasingly difficult to justify.

In our asset allocation, we have maintained a fairly high exposure to equities because we believe that **the very favorable balance between economic growth and interest rates will continue to support global stock markets**. But we believe that the confirmation of the cyclical recovery—once the coronavirus effect has passed—should allow a better balance of performance between growth stocks and some value segments, including small caps in Europe, cyclical stocks, and Japanese and British companies.





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### THE MACRO

The economic impact of the coronavirus could blur cyclical signals for a few weeks, but the ongoing industrial stabilization should remain in place. The manufacturing sector of the export champion countries is finally recovering.

### VALUATION

The valuation of growth stocks is on an upward trajectory that raise fears of a bubble, especially in relation to the cheap value universe. Relative to bond yields, however, even high P/E stocks remain attractive.

### MARKET DYNAMICS

Neither investor surveys nor the recent poor performance of cyclical stocks indicate any euphoria about the economic cycle. On the contrary, defensive stocks have recently outperformed. There is no excess economic optimism.

### THE MICRO

The two emblematic value sectors of the euro zone, the automobile and the banks, have recently given back a part of their market performance of Q4 2019. Activity in these two sectors is however on a clear recovery path.

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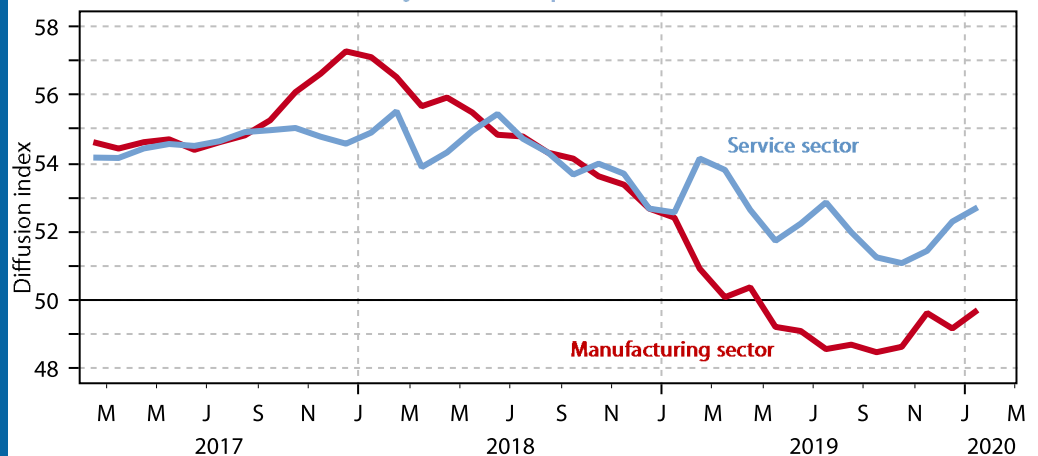
Recent indicators have confirmed both the dynamism of the service sectors, and the stabilization of the global industrial cycle, even if it is a little early to speak of a real recovery. The coronavirus effect may make the cycle less readable in the coming weeks, but the principle of stabilization looks solid.

The lull in the trade war, the emergence of the 5G cycle and the decline in recessionary forces in the auto sector have contributed to an industrial rebound in the countries that are the most sensitive to world trade.



### The cyclical trough was reached last autumn

PMI surveys in developed economies

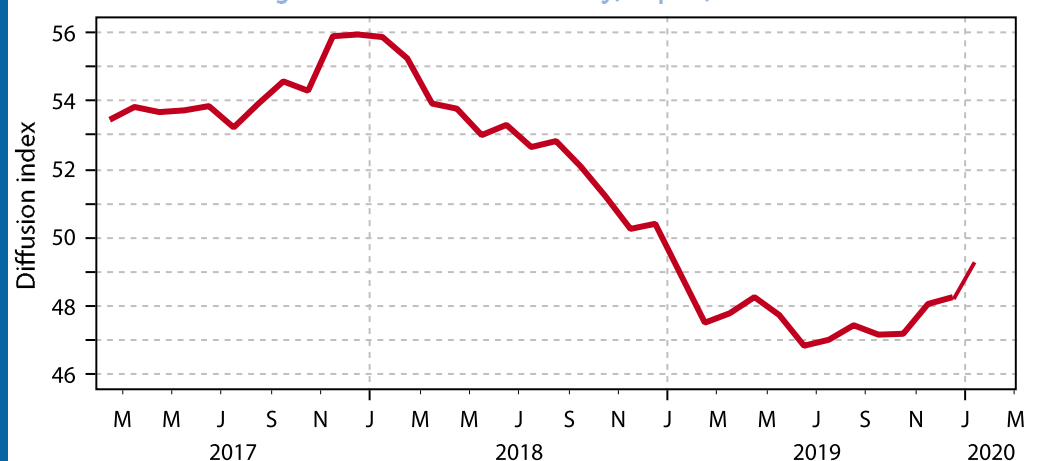


Sources: Markit, Macrobond

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### The rebound of the export champions

Manufacturing PMI—median of Germany, Japan, Korea & Taiwan



Sources: Markit, Macrobond

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NEITHER BEAR NOR BULL  
BUT CAMELEON



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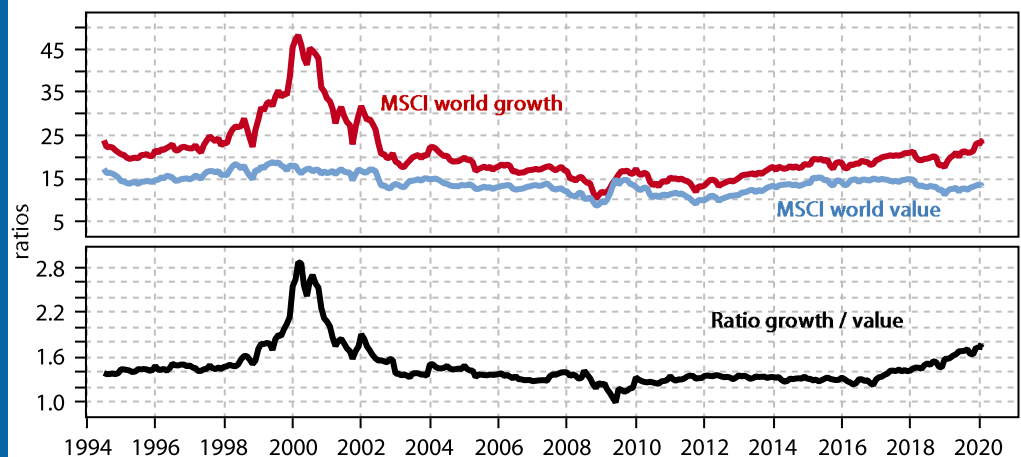
Measured by MSCI, the P/E of growth stocks has returned to its levels in 1994/1997. This is 80% more than the P/E of the value universe, vs. 50% on average since 1994. The "over-profits" of the oligopolies of the new economy, the upward trend in profit distribution, and the relative feeling of security compared to a very often disrupted value universe (like financials) may explain this phenomenon.

Are we seeing a bubble, or is it only the result of lower interest rates? Compared to bonds, even growth stocks remain attractive ... So what about value stocks!



### The valuation of growth stocks becomes a cause for concern...

Forward P/E of MSCI indices

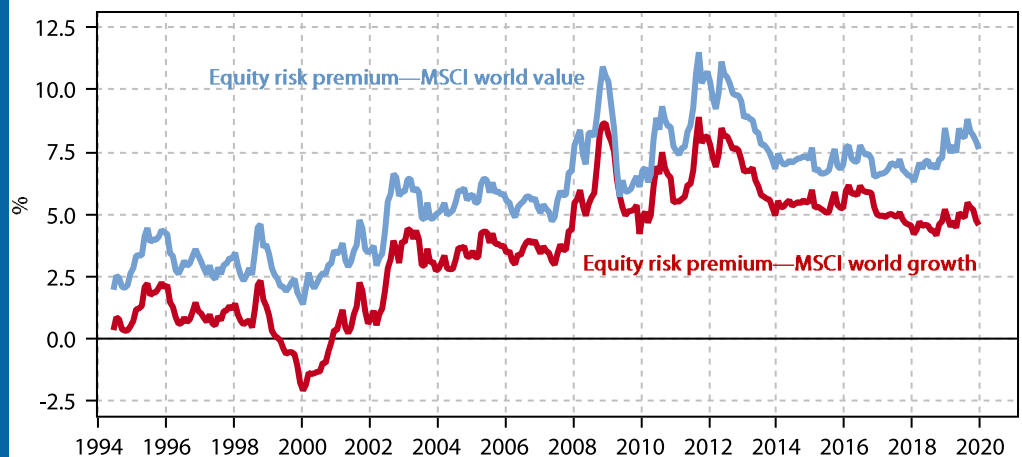


Sources: MSCI, Macrobond

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### ...except when compared to bond yields

Equity risk premium = inverse of P/E minus real US bond yields



Sources: Dorval AM, MSCI, Macrobond

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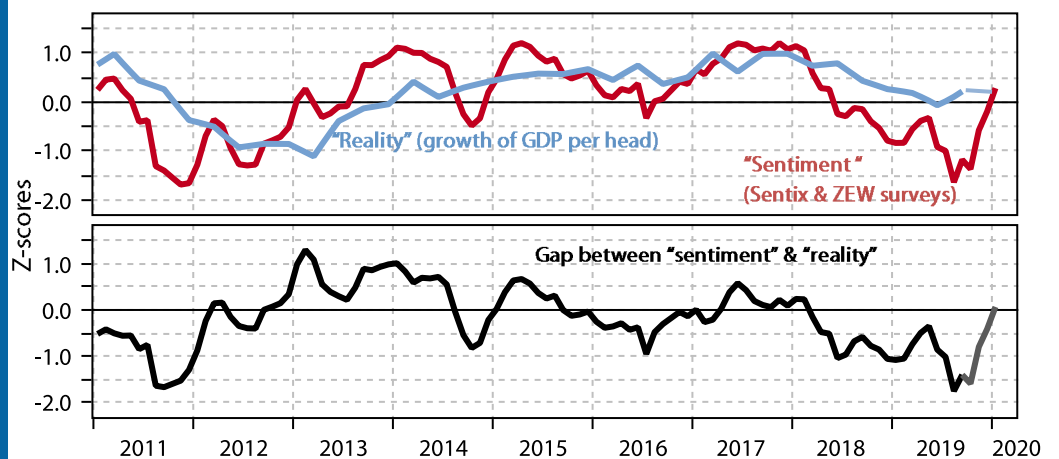
Economic growth per capita in the euro zone is running at rates close to 1.2%. Surveys show that investor perception was much more negative than that in 2018 and 2019. The gap between "sentiment" and "reality" has recently normalized. We see no excess optimism.

After outperforming defensive stocks in Q4 2019, cyclical stocks were less in vogue in January 2020. Neither the dynamics nor the relative level of cyclical stocks indicate the least excess enthusiasm for a cyclical recovery. Rather the opposite.



### The end of excess pessimism about growth in Europe

Investors and financial analysts have become more realistic about growth

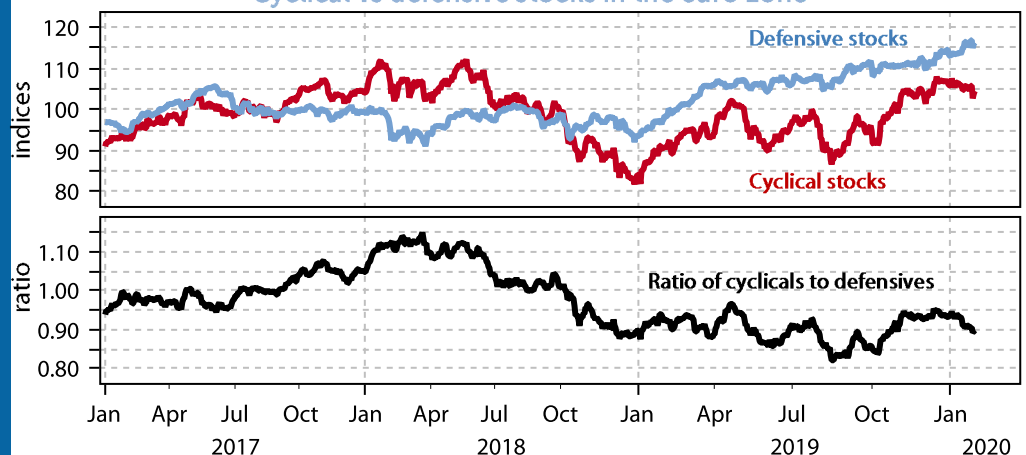


Sources: Dorval AM, Macrobond

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### Investors are far from being over-enthusiastic about the cycle

Cyclical vs defensive stocks in the euro zone



Sources: Goldman Sachs, Macrobond

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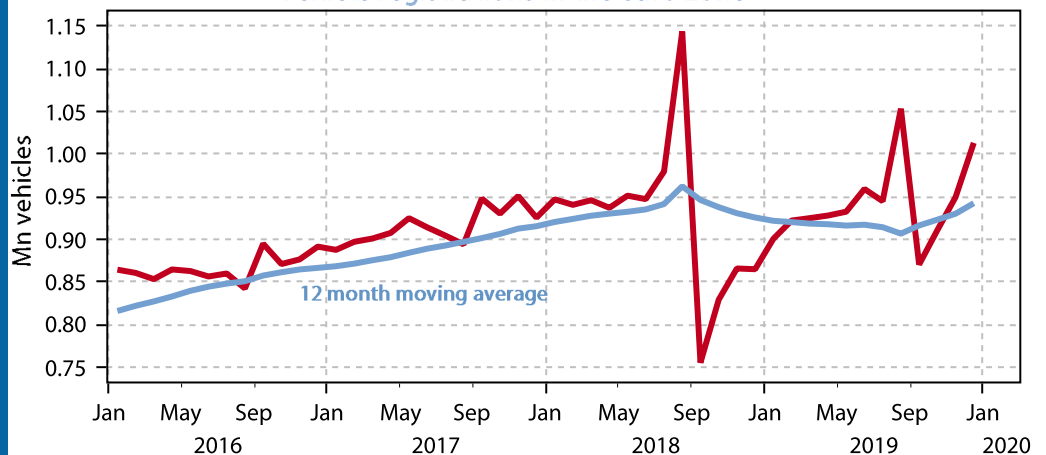
Car registrations in the eurozone have started to rise again, which proves that the setbacks of 2018/2019 were indeed due to supply effects (WLTP). Demand remains buoyed by rising employment and real wages, and attractive credit conditions. The profitability of car manufacturers is, however, in question in the context of new regulations, and the transition to electric cars.

The banking sector has been undergoing a violent transition shock since 2008. Its profitability has been cut, but the level of activity has been picking up significantly over the past year, thanks to better financial markets and resilient credit demand.



### A clear rebound of car sales in Europe

Vehicle registrations in the euro zone

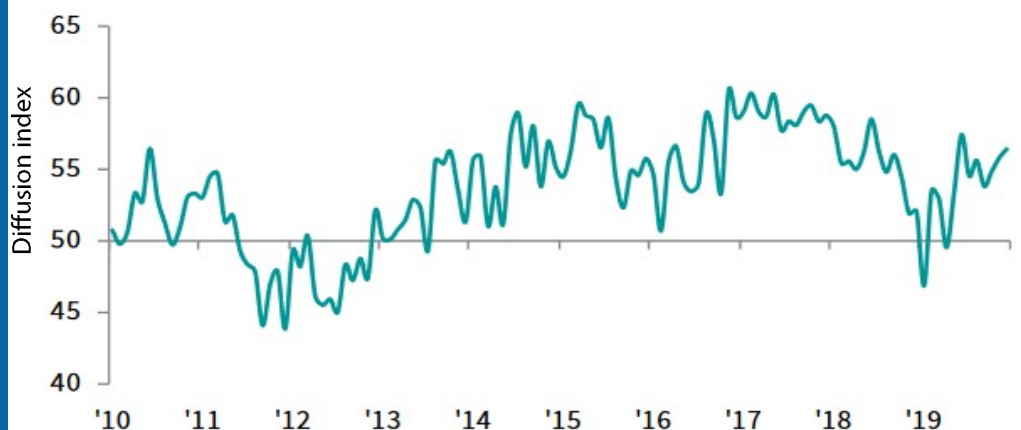


Source: Macrobond

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### European banks report stronger business activity

PMI index in the European banking sector



Source: Markit

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