



Dorval's Macro Corner

May 2020

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

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Some legitimate worries, but priority goes to the recovery theme

As the severe confinement ends, questions arise about the political, fiscal, social, economic and financial consequences of the coronavirus crisis. Tensions are already rising again between the United States and China, and the German Constitutional Court has just issued a destabilizing ultimatum to the ECB, giving it three months to justify some aspects of its public debt purchase program. In the short term, however, **governments, businesses and investors will remain focused on the dynamics of reopening economies**, and on deepening the already massive fiscal and monetary support measures. In this regard, we note that the German government is seeking to minimize the impact of the Karlsruhe Court's judgment, leaving the ECB to continue its action.

The risks are the least controllable on the virus side, but here too the recent news is quite encouraging. At this stage, none of the countries that have already reopened their economies (China, Austria, Korea, etc.) have faced a second major wave of new cases. This is obviously the crucial point because **the faster and more complete the reopening of the economy will be, the less the damage caused by the crisis will last**. As in China, the slump in the tourism, recreation and transportation sectors, as well as the precautionary measures still in place, weigh heavily - but this is likely to change as well. Several treatment protocols could also be validated in the coming weeks. In addition, the release of fiscal arsenals militates for a constructive vision, with more recovery plans to come. Finally, despite the explosion in technical unemployment, **most of the incomes have been preserved thanks to governments intervention**, which allows for a rapid recovery in demand. **In developed countries, a return to the level of 2019 GDP is therefore possible in the second half of 2021**. This is not a particularly optimistic scenario, since this level would still remain more than 3% lower than forecast before the crisis. The recovery should therefore have to continue in 2022 and 2023.

After the strong stock market rebound in April, many voices are raised to worry about supposed complacency by investors. This is not our analysis. We do not see a disturbing disconnect between stock prices and the foreseeable trajectory of global GDP. Above all, **the collapse of banking, cyclical and commodities stocks does not fit well with fears of market complacency**. Nor are we seeing optimism in risk appetite measures, but rather a partial easing of the solvency and liquidity risk premiums that piled up in March.

Unlike 2007/08, which had seen a complete reversal of market leadership, **the shock of the coronavirus has above all accelerated trends already in place**. Nearly zero interest rates on public debt have spread to almost everywhere in the developed world, the theme of the digital economy is triumphing, and investors favor companies with solid balance sheets. As a result, **the valuation of the Nasdaq and growth stocks has soared**, and the sectors that were already the cheapest before the shock are even cheaper. For us, these divergences call for **a rebalancing of the portfolios towards the assets most likely to benefit from the reopening of the economies**, including the cyclical sectors and the small stocks. Dorval AM's portfolios are well positioned to benefit from this recovery, although we will remain reactive in the face of the many unknowns of this health crisis.





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THE MACRO

The economic flash crash in advanced economies is over. A return to 2019 GDP in H2 2021 seems plausible. Along with the unknown about the virus, a politicization of the crisis is one of the risks to watch out.

VALUATION

Despite the strong rebound in April, we do not see any market complacency with regard to foreseeable economic developments. Rather, the relative discount in the value sectors has reached a new historic low.

MARKET DYNAMICS

Global measures of risk appetite have not yet normalized on financial markets. The most cyclical sectors retain significant upside potential in our central scenario.

THE MICRO

The coronavirus crisis has produced a highly asymmetrical shock to EPS forecasts for 2021. Divergences should now decrease with the reopening of the economy, to the benefit of cyclicals.

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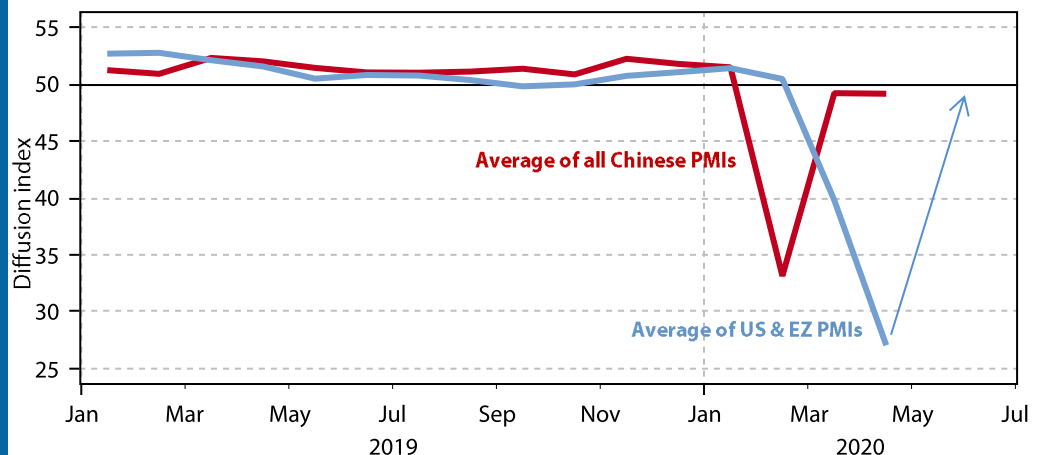
According to PMI indicators, the economic flash crash lasted one month in China and two months in developed countries. Unless there is a significant resurgence of new Covid-19 cases, a rise in American and European PMIs to levels close to 50 seems guaranteed by the summer.

With most of the income preserved, and bankruptcies most often avoided, a return to the GDP level of 2019 during the second half of next year is possible. We can imagine either better or worse depending on the different epidemiological scenarios first. Politics will also matter.



An economic flash crash rather than a downturn...

The actual and expected trajectories of PMI surveys



Sources: Markit, Macrobond

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...to be followed by a prolonged catch-up

Goldman Sachs scenario for advanced economies (real GDP)



Sources: Goldman Sachs, Macrobond

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Following the sharp recovery in prices from the March 23 low, some observers are concerned about possible market complacency. A simple comparison between share prices and global GDP suggests that this concern is probably misplaced.

Rather than the relationship between stocks and the economy, the tough question is the record valuation gap between winners and losers in the structural developments at work since 2007. The acceleration of digitization and the collapse of bond yields favor InfoTech and non-cyclical sectors, but isn't this fully priced in ?



Aggregate stock prices look in line with the economy...

MSCI world equally-weighted vs global nominal GDP in US\$

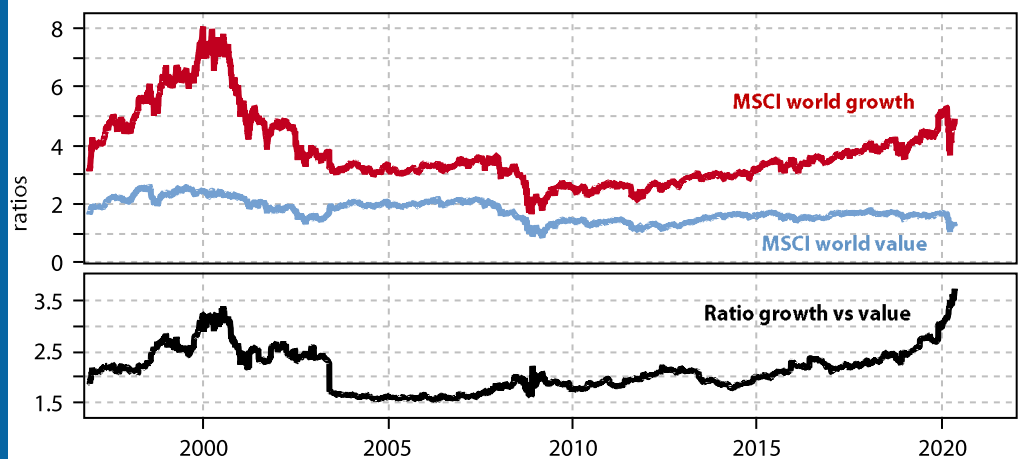


Sources: MSCI, Macrobond

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...but the winners-losers spread has reached new highs

MSCI growth vs value, price-to-book ratios



Sources: Bloomberg, MSCI, Macrobond

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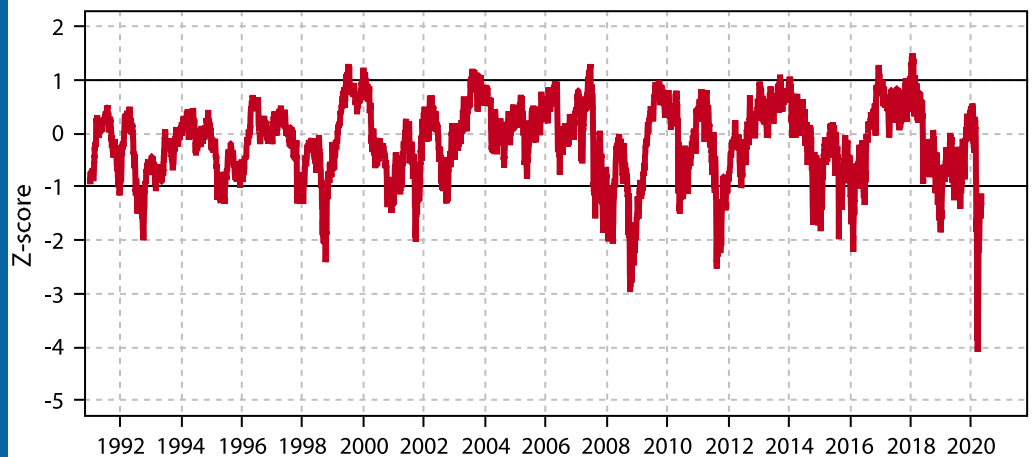
After a historic collapse in March, worse than in 2008, global risk appetite on financial markets rebounded sharply in April. However, we are far from normalization, and even further from over-optimism.

The still very depressed level of performance in the sectors most affected by the coronavirus shock also illustrates the lack of complacency ... and the potential for recovery.



A less extreme fear, but no optimism yet...

Goldman Sachs index of risk appetite on global markets

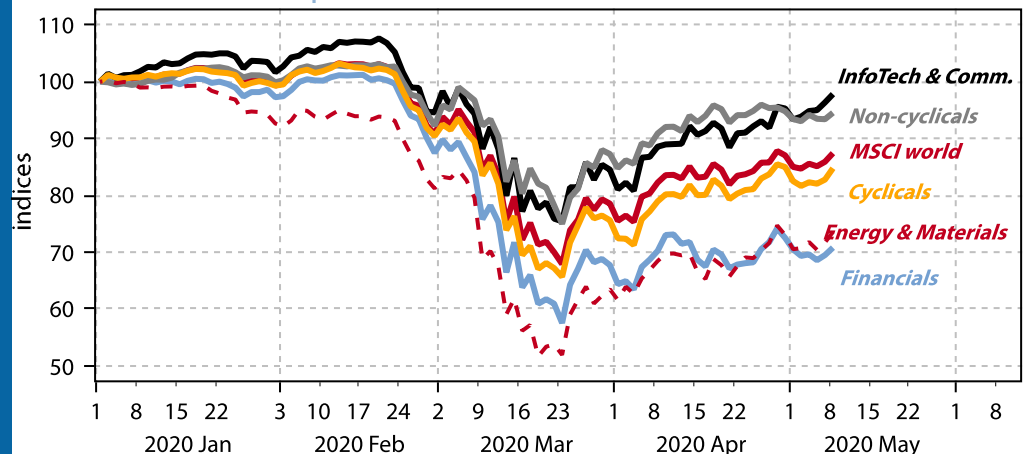


Sources: Goldman Sachs, Macrobond

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...and cyclicals have heavily underperformed

Groups of sectors for the MSCI world (in US\$)



Sources: MSCI, Macrobond

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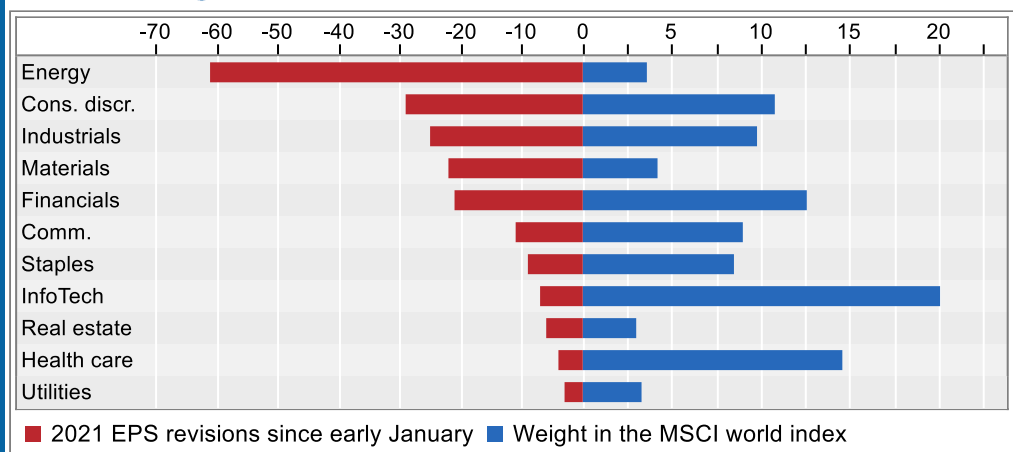
Like economists, financial analysts find it even harder than usual to produce credible forecasts. It is however remarkable to note the impressive asymmetry of the crisis according to the sectors, here on EPS 2021. We see that the MSCI World index was relatively protected by the high weight of the InfoTech and non-cyclical sectors (58% of the total).

With the reopening of the economies, however, the revision gaps should now narrow between cyclical and defensive sectors. It should be taken advantage of.



A very asymmetric shock on EPS estimates...

Bloomberg consensus revisions of 2021 EPS (in %), MSCI world sectors

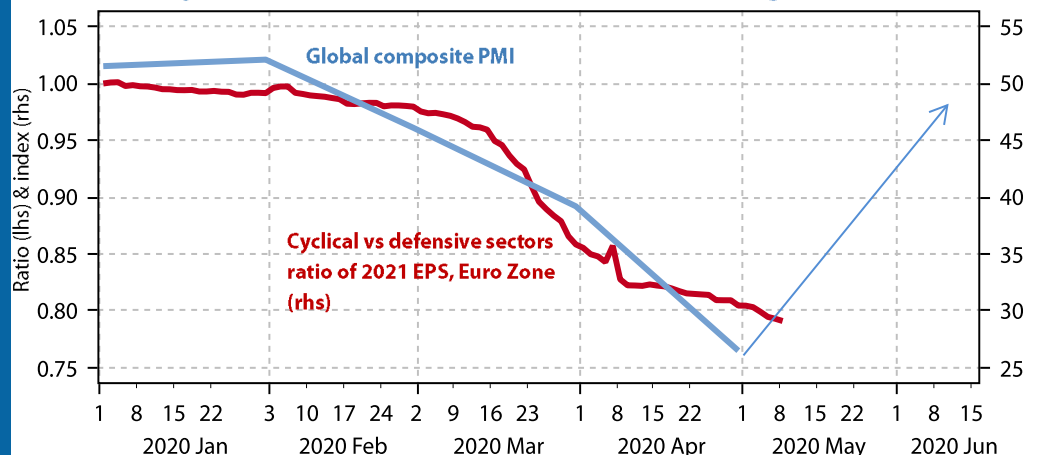


Source: Bloomberg, Macrobond

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...but the expected recovery should support cyclicals

Cyclicals vs defensives, ratio of EPS revisions, vs global PMI



Source: Markit, Bloomberg, Macrobond

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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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