GADD
WEALTH MANAGEMENT

Market Insight

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A V-shaped recovery of the world economy

The depth of the recession is prompting the IMF to revise its global growth forecast downward for 2020. However, it maintains its choice of the letter that will characterize the recovery in 2021. It will be V-shaped. But the method used to calculate global growth probably has something to do with it... In any case, the markets have already taken note and their valuations are rich.

The International Monetary Fund is expecting a 4.9% drop in world GDP this year, which breaks down into an 8% fall in activity in developed countries and a 3% downturn in emerging countries. The figure of 4.9% being much closer to the decline in emerging countries than in developed countries brings us to a key question: what is the size of emerging countries compared to developed countries?

1. After recession comes recovery

	2020			2021	
	Avril 20	Sep 20		Avril 20	Sep 20
Monde	-3,0	-4,9		5,8	5,4
Pays développés	-6,1	-8,0		4,5	4,8
Pays émergents	-1,0	-3,0		6,6	5,9

The weight of the Big Mac

It is with the "Purchasing Power Parity" method that the IMF calculates the weight of each country in the world economy. The PPP makes it possible to determine what the exchange rate should be in each country of the world to give, everywhere, an identical purchasing power to consumers.

The well-known example is the Big Mac parity calculated by "The Economist" magazine. It consists of comparing the price of the double hamburger in the world and calculating the exchange rate that would equalize its price. Example: the Big Mac costs today 5.71 dollars in the United States, 6.50 francs in Switzerland, 21.7 yuan in China and 190 rupees in India.

The ratio between the price of the Big Mac in each country and that prevailing in the United States corresponds to the equilibrium PPP exchange rate: it is thus 1.14 for the franc, 3.80 yuan and 33.3 rupees respectively, for one US dollar.

China's Gross Domestic Product is 95'480 billion yuan, or 14'000 billion dollars, at the current rate of 6.82 yuan per dollar. If you follow the example of the IMF and use instead the Big Mac parity of 3.80 yuan per dollar, China's estimated GDP rises to 25'126 billion dollars, which increases the size of the Chinese economy by 80%!

In reality, of course, the IMF uses a wider basket than the simple Big Mac to be representative of consumer habits. On the basis of consumer price indices, the undervaluation of all currencies - except the Swiss franc - against the dollar is even more pronounced than with the Big Mac. The undervaluation of the Yuan increases from 44.3% to 47.3% and that of the Indian rupee from 54.9% to 72%. The size of the Chinese economy increases by 90% when measured by PPP, while that of India increases from $2,940 billion to $10,510 billion, more than triple! Overall, the weight of the BRIC countries increases from 23.8% of the world economy to 33.5% when measured by PPP rates.

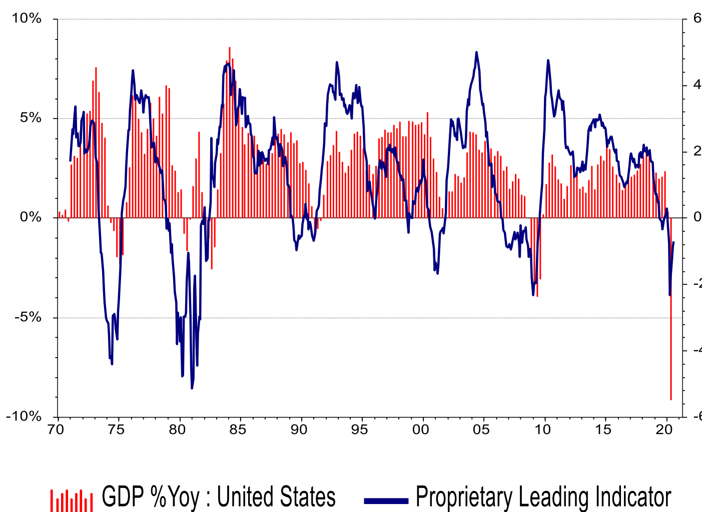
We must therefore be aware that the weight of emerging countries is overestimated when using PPP rates and that the decline in world growth this year is much closer to the 8% that developed countries will record than the expected fall in emerging countries. Similarly, the rebound of nearly 6% in activity expected in the emerging countries next year is probably not unrelated to the anticipated 5.4% increase in world GDP for the same year.

The fact remains that what matters for the financial markets is that a global recovery will follow the worldwide recession. And that the latter is not as severe as one might think, at least when one considers that the United States remains the leader of the world economy.

Recession not as severe in the United States

Unsurprisingly, the United States is being hit hard by the coronavirus. But the announcements that have been made in several media recently that the drop in economic activity in the United States exceeds 33% in the 2nd quarter are erroneous. Compared to the 1st quarter of this year, the drop in GDP is actually only 8.25% but the figure is multiplied by 4 to be annualized. For this calculation to make sense, the next 3 quarters would have to show declines comparable to those of the 2nd quarter. However, the widely followed forecast of GDPNow published by the Atlanta Fed for the 3rd quarter shows a meteoric rebound ... of more than 30%.

2. In the United States, recovery is announced



It is preferable to measure growth by comparing a quarter of GDP not with the previous quarter but with the same quarter of the previous year. On this basis, the decline in US GDP in the 2nd quarter is "only" 9%. This is an all-time record, but not of the magnitude loudly proclaimed by some media. By way of comparison, Germany experienced a 10% drop in its GDP during the same quarter. What's more, the recovery is in full swing, as shown by our leading economic indicator.

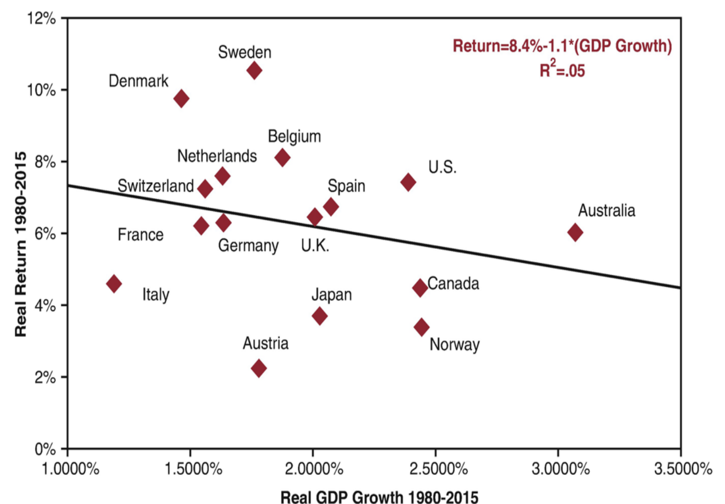
Does performance rhyme with advance?

The fact remains that the US economy is still depressed. As a result, criticism is raining down on financiers who speculate on the stock market, propelling it to new heights. A few clarifications are in order.

Explaining the stock market's good performance in a deplorable economic environment is justified first of all by the fact that investors in the financial markets are looking to the future, rather than to the present and the past. Moreover, this predictive capacity of the Stock Exchange for economic growth is illustrated by the fact that the stock market is one of the 10 components of the leading indicator used by economists to predict the growth of the American economy.

Given that cyclical recoveries generate increases in corporate profits, it is a widely held belief that equity markets perform better during periods of economic growth. And that in times of crisis - or recessions - it is bonds that should be favored. What is attractive in theory is not necessarily validated in practice. Academic studies show that the correlation between stock market performance and economic growth is ... negative. This is shown in the third graph:

3. Performance does not necessarily rhyme with growth



Source : Paul Marsh, Mike Staunton, Elroy Dimson, "Triumph of the Optimists"

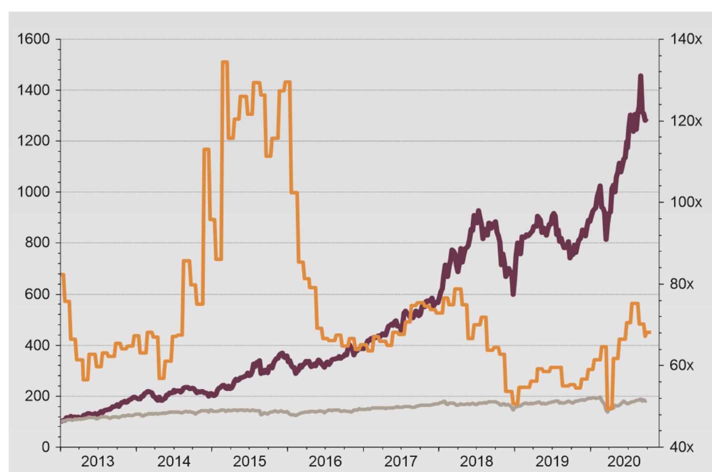
On the horizontal axis, GDP growth in the main developed countries is measured, while on the vertical axis, it is the performance of the stock markets of the corresponding countries between 1980 and 2015. The link between the variables is negative, as shown by the downward slope of the regression line between performance and growth.

The reasons for this can be multiple: a country may, on the one hand, adopt a policy of unbridled growth stimulation through excessive government spending or investments by companies in low value-adding projects. Or by consumer spending largely financed by credit. The increase in debt - public and/or private - that results from these policies is not to please investors in the financial markets.

On the other hand, if growth is too strong, it may lead to inflationary pressures, which are not to the liking of central banks. The resulting tightening of monetary policies is not appreciated by stock market regulars.

Last but not least, yet another argument to explain the apparent disconnection between stock market performance and economic growth is the way stock market indices are constructed. The vast majority of these are based on the system of capitalization, which consists of giving more weight to large companies and the best performers. In the United States, the identification of the latter is child's play: they are Facebook, Amazon, Apple, Netflix, Google (Alphabet) and Microsoft, grouped under the acronym FAANGM.

4. Without FAANGM, the US stock market is not as high!

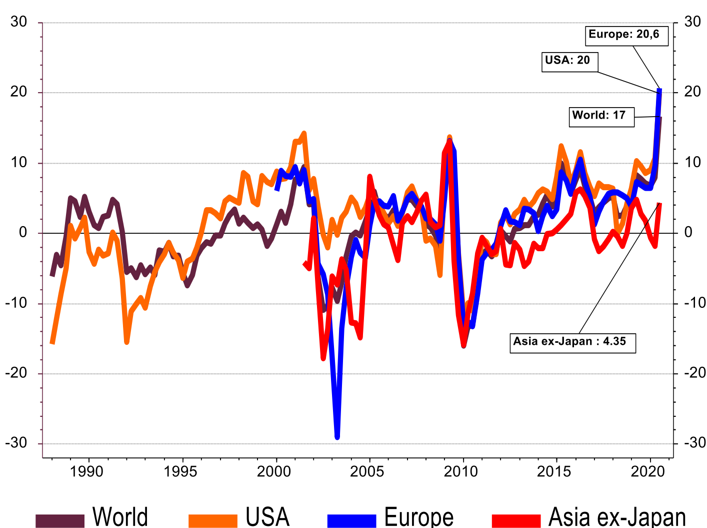


The verdict is indisputable: since January 1, 2013, the cumulative performance of FAANGM has been 1200%, whereas the US stock market index without these flagship technology stocks is only 95%. And we can hardly claim that the FAANGM are very representative of the American economy. There are many other companies in the United States that are more representative, and their stock market performance is in line with the prevailing economic sluggishness.

The valuation of FAANGM's shares is also very rich, with a multiple of the expected profits for these 6 companies of more than 60 times the expected results for the next 12 months.

The good performance of the stock market indices in recent months, combined with downward revisions in earnings growth, has resulted in high discrepancies between earnings multiples and expected earnings growth for the next 12 months. For example, the Eurostoxx index in the Euro zone has an earnings multiple of 17.6 times the expected earnings for the next 12 months. If we compare this valuation multiple with the expected decline in earnings of 3%, we obtain a gap of 20.6, the most unfavorable since 2000.

5. Compared to the expected earnings growth, the earnings multiples are high!



In a nutshell, we expect a rather favorable scenario on the macroeconomic level, reassured that the recovery will follow the recession. Our indicators are consistent with the IMF's message of a V-shaped recovery. We opt for caution and content ourselves with a U-shaped recovery scenario, given that many sectors in the transportation and leisure industries are still lagging behind.

We also reflect this prudence in our asset allocation, with a search for more favorable buying signals to increase the share of risky assets.

Michel Girardin, *Senior Economic Advisor*

Money-market and fixed-income

The disastrous global activity of the first half of the year gave way to a much more favorable trend during the summer with the rebound in international trade, manufacturing production and consumption. Epidemic dynamics remain poor overall, but should not lead to total reconfinement, only increased health restrictions in some areas. Overall, growth forecasts are more optimistic for 2020 with a global decline of only 4.9%, while remaining cautious for 2021 with an estimated rebound of 5.4%. The absence of inflationary pressures allows central banks to pursue accommodating and flexible monetary policies with prospects of low interest rates for a long period. As a result, sovereign yields remain at historically low levels of around 0.6% for the US 10-year and -0.5% for the German 10-year, while credit spreads are gradually returning to pre-crisis levels. We have increased the dynamically managed euro sovereign share and reduced the convertible share. In the balanced portfolio, the bond allocation is largely composed of Corporate Investment Grade and High Yield as well as emerging debt, to the detriment of sovereign debt. We maintain a short duration of approximately 3 years on this allocation by means of hedges.

Equities

Global growth rebounded sharply in the third quarter and is now returning to a more normalized trend while remaining penalized by an unstable health situation. Continued low interest rates and fiscal stimulation measures have increased the attraction of equities, particularly in growth sectors such as technology, the digital economy, renewable energies and certain healthcare segments. These sectors have high valuation multiples in markets that are themselves well valued. The stock market recovery is not homogeneous across the different geographic regions: the US market, which is heavily weighted in these sectors, has now returned to positive territory since the beginning of the year; similarly, the Chinese market, whose economy recovered more quickly from the second quarter; conversely, Japan is in slight decline and Europe, weakened by the financial sector, is down by more than 13%. The equity allocation remains stable in our balanced portfolio, equally divided between the USA and Europe, Asia Pacific including Japan and the other emerging zones, Latin America and Eastern Europe. The main sectors represented are technology, healthcare, financial services and industry. Growth stocks outperformed value stocks by 25% over the total equity share. We continue to reduce the level of tactical coverage during market downturns.

Currencies

The weakening of the U.S. currency continues and prompts us to reduce the tactical U.S. dollar allocation in the balanced portfolio. This change in trend is accompanied by a decline in so-called emerging currencies ; we decided to reduce the portion invested in Chinese currency. Conversely, we increased our positions in precious metals by introducing silver, which is more linked to the economic cycle than gold.

Alternative

The alternative share is slightly reduced in the balanced portfolio. We continue to reduce systematic management. Equity Market Neutral accounts for about half of the allocation ; the other strategies, Global Macro, Multi Strategy, Event Driven and Miscellaneous share the rest equally.

Outlook

The activity rate has returned above 85% in the major economies and signals a return to normalization of the global economy. Obviously the recovery is uneven across sectors and household confidence, marked by excess savings, is still low. There is therefore a substantial need for public aid to secure the recovery. Central banks are offering unfailing support; it is more confusing for governments, especially in the US, where political hesitation risks delaying the stimulus plan needed for employment and consumption. A slowdown in support policies would give a negative signal to the markets in an election period that promises to be particularly indecisive. We therefore remain cautious in the short term in a context of increased volatility conducive to market entry points.

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