10 July 2020

US corporate earnings could fall by -44% in Q2

GDP is expected to fall by -32% in Q2, will not return to 2019 levels before 2022. The Fed systematises yield curve control. End of interest rate volatility. Complacency on equities.

Key points

- Annualised GDP contraction of -32% in Q2?
- GDP contraction of -5.5% in 2020 followed by a +3.9% recovery in 2021
- Sharp rise in budget deficits, debt and the Fed's balance sheet
- Towards an institutionalisation of yield curve control by the Federal Reserve?
- Disappearance of volatility in US interest rates
- The dollar remains the preferred currency
- -44% collapse in corporate profits in Q2
- Negative impact of a Democratic victory
- Excessive optimism in equity markets

Annualised GDP contraction of -32% in Q2?

A few weeks ago, we mentioned how difficult it was to assess the extent of the economic contraction in Q2 before the summer.

The nature of the shock was so exceptional that an assessment of the impact in Q2 also seemed less essential to us for managing investment risks and opportunities than determining the likelihood of recovery of the world's largest economy in H2.

At this time, the latest GDP contraction estimates for the quarter that ended on 30 June point to a likely -32.6% collapse in economic activity in the US according to a panel of 71 economists.

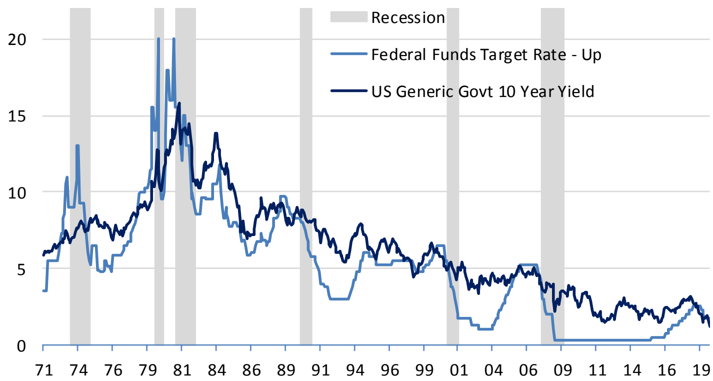
Given the broad easing of lockdown measures since the end of June, GDP is expected to be up by +18% in Q3.

The recovery is then likely to continue in Q4 at a reduced rate of +6 absence of a second wave of Covid-19.

Over 2020 as a whole, US GDP is expected to contract by -5.5%. The US recession thus already seems over, as we enter the second half of 2020 with rather solid GDP growth prospects.

However, we must remain cautious given that the recovery taking place will still not allow us to return to a level of GDP similar to that of 2019 before 2022.

US recessions, long-term rates and Fed funds



Sources: BearBull Global Investments Group Limited

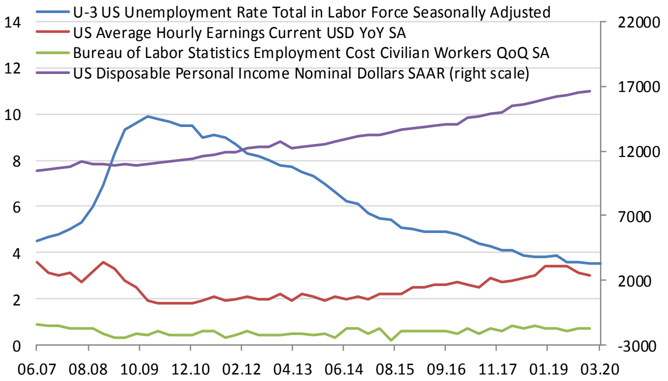
US consumption, which still accounts for nearly 70% of GDP, is key to shoring up economic recovery prospects.

The return to the job market of around 5 million people in June following 2.7 million in May is a positive factor in this respect, supporting the sense of optimism in financial markets.

It remains to be seen whether this trend will be sustainable and whether it will quickly put the 20 million new job seekers recorded in May back to work.

In this context, we are currently witnessing one of the greatest historical divergences between the direction of the real economy, expected to slow down significantly over the 2020/2021 period, and the euphoric stock market, which is undoubtedly largely driven by the substantial increase in central bank liquidity and the hopes of a rapid rebound in corporate profits.

Unemployment, earnings, labour cost, income



Sources: BearBull Global Investments Group Limited

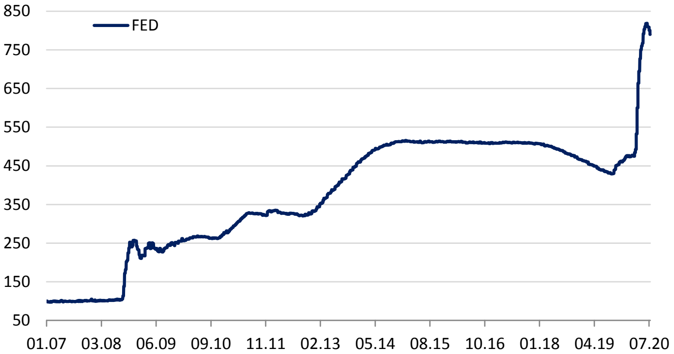
Towards an institutionalisation of yield curve control by the Federal Reserve?

The Federal Reserve acted vigorously in response to the seriousness of the risks that the health crisis posed to the US economy by lowering its key rates to zero and announcing a new bond purchase programme of around 700 billion.

Since then, the Chair's statements have provided reassurance regarding the Fed's willingness and ability to act to implement appropriate monetary policies without limits. During Q2, the increase in the size of the Fed's balance sheet from USD 4.15 trillion to USD 7.169 trillion effectively attested to this very active strategy aimed at supporting government spending and ensuring low rates across the entire US Treasury yield curve.

Will the Fed's new monetary policy standard soon officially involve the introduction of a systematic policy of controlling interest rates across the entire yield curve?

Federal Reserve balance sheet



Sources: BearBull Global Investments Group Limited

The asset purchase programmes set up by the Federal Reserve several years ago were already aimed at controlling long rates in addition to the traditional policy of steering short rates using key rates. This strategy was nevertheless limited in time and scope by the stated objectives and limits of the asset purchase programmes. However, with the current expansion in the US budget's financing needs, the Fed has been forced to react very vigorously in recent weeks by massively increasing its capacity for action and by expanding its debt purchase plans, which in just a few months has led to extraordinary growth in its balance sheet (+72%). From now on, it may have to maintain this policy over the long term by institutionalising its long-term interest rate management in its strategy. The explosion of US debt to cope with the Covid-19 crisis clearly appears to be a major new long-term risk in the event of a rise in interest rates. It could indeed have very damaging consequences for the dollar in particular. Consequently, the US central bank will no doubt have to integrate the steering of long rates and, more broadly, of the entire yield curve into its monetary policy. This would logically imply the continuation of the current upward trend in its balance sheet. Among the expected effects of systematising interest rate control across the yield curve as a whole, we should mention the possible disappearance of any reaction to any form of resumption of inflation or deterioration in public finances.

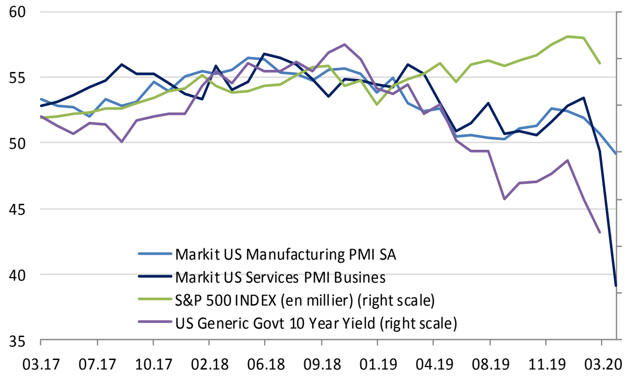
Disappearance of volatility in US interest rates

The fall in ten-year Treasury yields from 2% in December 2019 to 0.31% at their lowest point on 9 March was historic and came just before the Fed's decision on 15 March to lower its key rates to their lowest level in history to counter the devastating economic effects of the lockdown imposed by the Covid-19 crisis.

Since the end of March, dollar interest rates have been completely under the Federal Reserve's control, which has been particularly effective in steering its action to keep US Treasury yields at the desired levels. Ten-year Treasury yields have remained virtually unchanged for the past three months at 0.65%, and the ten-day volatility of the Treasury yield has fallen sharply since the peak reached on 16 March.

US rates will no longer react to the growing budget deficit, as the Fed seems determined to act to keep yields under its control. They may also no longer react to improving economic conditions and a resumption of growth in the coming months.

<u>Long-term rates, PMIs and S&P500</u>



Sources: BearBull Global Investments Group Limited

Although dollar rates are very low, they remain higher than rates in euros, yen and Swiss francs across the yield curve. This positive yield differential is likely to ensure an inflow of capital in favour of the dollar and the US bond market. International investors looking for diversification and yield should therefore still favour the US. The current situation in the capital markets has become a little more complex since the central banks have taken drastic measures to support governments' financing needs.

For several weeks now, we have been seeing an institutionalisation of what can be considered a monetisation of government debt. The consequence of this policy could be the maintenance of low rates on all yield curves and thus indirectly a global environment characterised by the absence of yield, or even negative yields in a growing number of interest rate markets.

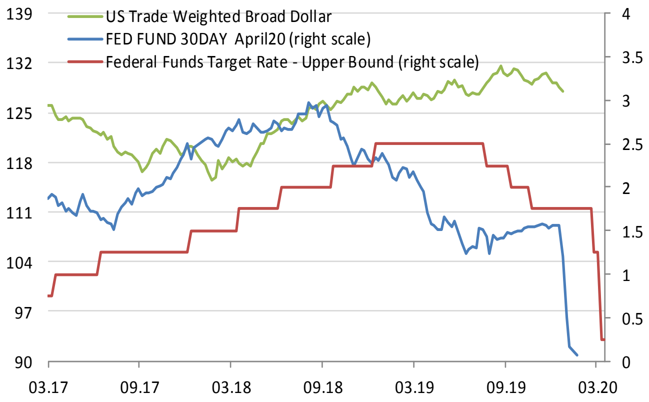
The risk of a rise in interest rates is now low in the medium term, but investment opportunities are reduced and mainly involve less secure debtors. Within the group of countries with an investment grade rating, the US offers a low but positive return and is likely to continue attracting capital from the Eurozone and Japan. Opportunities have also been reduced in the corporate segments since the publication of our strategy in April, when we mentioned investor interest in this segment due to the attractive positive risk premiums. This is no longer the case.

The improvement in the investment climate in recent months has also been favourable for the high-yield segment and emerging market bonds. In this context, opportunities are reduced, and the contraction in risk premiums does not mean that we are willing to implement yield pick-up policies that are risky from our point of view.

The dollar remains the preferred currency

The dollar is no longer supported by a short-term interest rate differential in its favour since the two monetary policy changes implemented by the Federal Reserve in March. On the long end of the yield curve, however, somewhat of a spread in its favour remains, particularly on ten-year Treasury yields (0.7%), which remain significantly higher than the yields observed on government bonds in euros, francs or yen, for example.

<u>Fed funds, key rates & trade-weighted dollar</u>



Sources: BearBull Global Investments Group Limited

However, the dollar retains its role as a safe haven in times of uncertainty, particularly when published economic statistics turn out to be poor or uncertain. In recent weeks, the start of the deconfinement process in the US, the improvement in leading indicators and the rebound in employment have been factors supporting risk taking.

Improved sentiment and better economic figures have therefore tended to penalise the dollar, while the risks of a new lockdown and a second wave of contagion have tended to favour the greenback.

The economic and health environment in the US remains uncertain and, in this context, caution could still benefit the dollar.

The dollar's weighted exchange rate is likely to rebound and approach 99-100 again, while the US currency should depreciate against the euro and appreciate slightly against the franc.

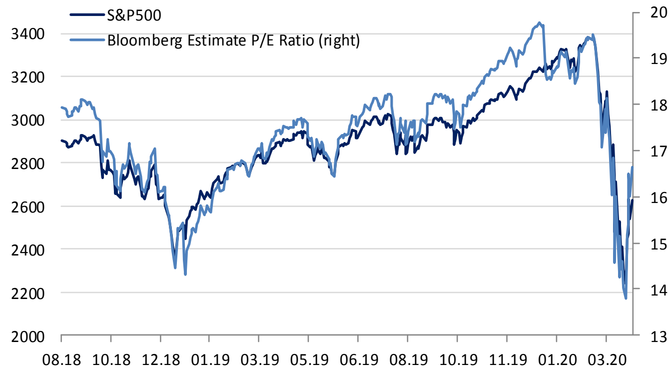
Excessive optimism in equity markets

Perhaps even more so in the US than in other countries, liquidity seems to be the determining factor in equity markets' advance in recent weeks. More recently, employment statistics showing the number of jobseekers dropped by around 5 million have also supported the enthusiasm of investors, who are once again prepared not to look too closely at actual economic and business conditions.

Deconfinement logically raises hopes for a return to normal economic activity, but we believe that we will have to be patient before we can expect to return to a level of employment similar to that of January before the health crisis.

PMI indices logically point to a recovery, but it seems to us quite premature to anticipate a return of consumption to previous levels. The prospect of sustained low interest rates is certainly very favourable for the economy, but the shock experienced by the various economic agents over the last few months cannot be absorbed so quickly.

S&P500 (index & PE 2021)



Sources: BearBull Global Investments Group Limited

In the US, GDP is expected to grow by -5.5% in 2020 and +3.9 in 2021. Compared with two-year forward expectations at the beginning of the year, the growth deficit remains extremely large, provided that 2021 keeps its promises.

US equities are once again trading at PEs well above their historical average, which may be justified by the particularly low level of interest rates.

However,at current levels we see little room for disappointment in corporate earnings. The current consensus for Q2 earnings is -44% (Y/Y), but equity markets remain invariably focused on the future. Sales are expected to be down -12% and will be accompanied by a margin contraction of 400 basis points to just 6.8%. A few months before the 2020 elections, Democrats seem to have more than a 60% chance of winning the presidency and the Senate, as well as an 85% chance of winning the House of Representatives. Jo Biden's policies if elected could reduce expected corporate profits by 10% in 2021. We believe that the current complacency, especially regarding certain tech stocks, cannot last. The risk/return ratio does not seem attractive to us, and we suggest reducing exposure to US stocks in the expectation of better opportunities.

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