HALKIN SERVICES LIMITED

INTERNATIONAL
RISK ANALYSIS AND ASSET ALLOCATION SERVICE

DIRECTORS:
Dr P.J. Warburton
R.J. Griffiths
C.D. Morris
D.A. Osman

Tel: +44 (0)20 8879 6116
Fax: +44 (0)20 8944 6920

email: halkin@halkinservices.co.uk

Company secretary:
Mrs P.A. Ranken
21 Vineyard Hill Road
London
SW19 7JL

Letter no: 828 **20th August 2020**

THE IMPROBABLE VALUATIONS OF GLOBAL PRIVATE MONOPOLIES

This week, the S&P500 finally surmounted its February price peak to stand at a new all-time high. As is well understood, 6 FAAMNG stocks (Facebook, Apple, Amazon, Alphabet (Google), Microsoft and Netflix) have powered the index higher. The 'bottom 490' stocks in the index have, on average, drifted aimlessly since April to remain 15 per cent below their February highs. The percentage of stocks that have lost more than 50 per cent in value in the past year has increased from 1 per cent in 2019 to nearly 6 per cent in 2020, insinuating a broad-based bear market. Vincent Deluard, of INTL-StoneX, considers this a FAAMNG-driven bull market cult that is contingent on the continuation, nay intensification, of financial repression. It is a cult that threatens to destroy most liability-driven investors, e.g. pension and long-term insurance funds, as the compression of yields required to squeeze out further asset price appreciation simultaneously sends the value of their distant liabilities into the stratosphere. There are three disturbing aspects to the equity price action of recent months. First, the extension of the **divergence** in price performance between the FAAMNG stocks and the rest of the S&P500, such that the former is valued at an average of 38.5 times forward earnings. As investors gravitate towards these totemic stocks and index funds weight them ever more generously, inflows are funnelled into FAAMNG and the bull market rolls on. Second, the **disconnection** of FAAMNG from its host economy has increased. More than half of the sales revenue of Alphabet, Apple and Facebook is international, roughly half for Netflix and around a quarter for Amazon and Microsoft. FAAMNG has 25 per cent of the S&P500 by market capitalisation, but only 7 per cent by sales revenues, 5 per cent by employees and 3 per cent by debt issuance. The economic profile of the FAAMNGs is unrepresentative of the US economy. Third, the **dysfunctionality** of FAAMNG valuations on conventional metrics is astounding. Deluard estimates that it would take Microsoft 18 years, with revenue compounding at 8.9 per cent a year, to grow into a 'normal' 2.3 times forward sales. The comparable timespans are 13 years for Apple, 6 for Alphabet and Netflix and 4 for Facebook and Amazon. Alternatively, Amazon would need 31 years of steady growth to achieve a tech market average of 20 times forward earnings, Apple 5 years, Netflix 2.9 years, Microsoft, 2.3 years and Alphabet 1.7 years. The epithet "priced for perfection" hardly

does it justice. More accurately, these stocks are priced for ongoing central bank manipulation. Deluard observes: "the stockmarket no longer leads the economy: price and multiples have rebounded much faster than after any prior market bottoms but many economic indicators have failed to confirm stocks' positive message: five months after a stock market bottom, yields usually rise, curves steepen, gold prices drop, and consumer confidence rebounds – the opposite of what is happening today." There is no future in the FAAMNG price rally: it is on a journey of absurdity and on a crash course with reality.

FROM FAANG TO BAANG: CAN THE MINERS CATCH UP?

In their latest T3 report, "Imminent peak, rollercoaster ahead", Robin Griffiths and Ron William concur that "the super uptrend in FAANG mega-cap stocks is now struggling, after serving as a powerful driving force of the equity market rise." Noting the conjunction of the chart breakdown in the US Dollar and the breakout in the gold price, they argue that this marks the start of the market's loss of confidence in central bank policy and the illusion or debasement of fiat money. They explore the attraction of a rotation out of FAANG stocks into BAANG stocks (Barrick Gold, Anglo Gold, Agnico Eagle Mines, Franco-Nevada and Gold Fields). With reference to the chart below, they observe that a majority of the companies featured display powerful base patterns in their stock prices.

MONITORING INFLATIONARY SURPRISES

On 12th August, it was reported that US CPI rose by 0.6 per cent in July, following a similar increase in June. June's rise was energy-led, but July's was broad-based with a 0.6 per cent monthly gain in the core measure also. Clothing, used cars and trucks (used vehicles experienced their fastest monthly rise since January 2010) and motor vehicle insurance were the source of positive price shocks, lifting annual core inflation to 1.6 per cent. This week, UK CPI inflation increased from 0.6 per cent in June to 1.0 per cent in July and core inflation from 1.4 per cent to 1.8 per cent as price discounting was less prevalent for the time of year and services such as haircuts, dentistry and physiotherapy turned more expensive as providers sought to cover Covid-19 compliance costs. In the EU, the annual core inflation rate rose from 0.8 per cent in June to 1.2 per cent in July, driven by a jump in inflation for clothing and semi-durables, such as cars, furniture, household appliances, personal electrical appliances and pharmaceutical products. In many cases, the rebound in core inflation reflected a degree of normalisation in items whose prices had fallen abruptly in March and April. However, the coincidence of an unexpected jump in core inflation for US, UK and EU should give pause for thought. The PriceStats measure of the US consumer price level continues to plough higher and evidence is accumulating of 'lockdown' and 'social distancing' inflation. Inflation breakevens have recovered well in the US and moderately in Europe. Central banks are still anticipating a deflationary plunge, but this reckons without the impact of substantial government interventions. Watch this space.

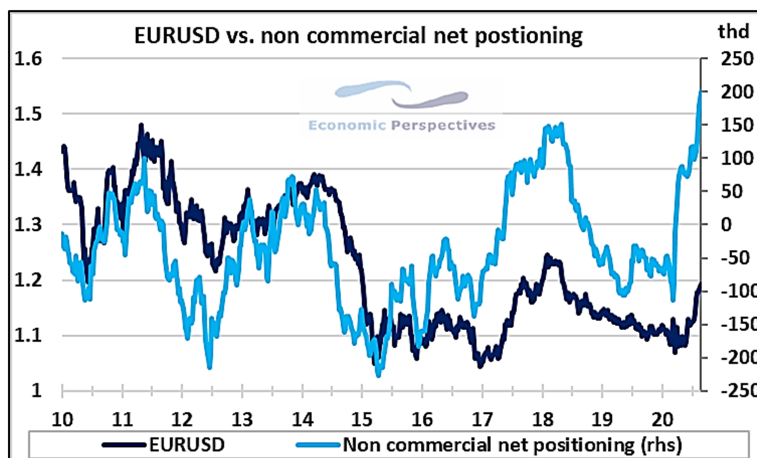
DIARY DATES FOR ZOOM CALLS

On Wednesday 26th August we welcome back Maarten van Mourik to discuss the outlook for the crude oil market: this will be a Zoom call at 2pm. At noon on Wednesday 9th September, Tony Plummer will be our guest presenter, taking a long-term technical perspective on the impact of change.

Peter Warburton

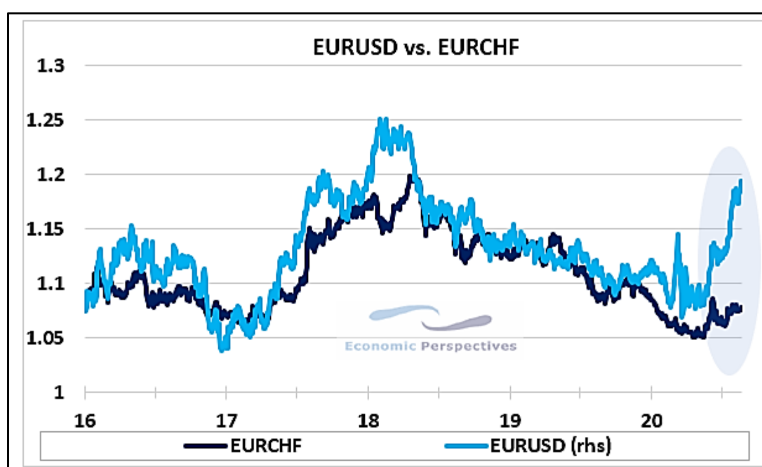
EURO NON-COMMERCIAL NET POSITIONING

In the past few months, the US Dollar has depreciated significantly against other major currencies amid a growing conviction among investors that the recent US Dollar weakness is merely the start of a massive bear retracement for the greenback. Some investment gurus are expecting the USD to consolidate by up to 50 per cent in the coming 3 to 5 years. According to recent surveys from sell side institutions, over 40 per cent of their clients expect global official reserves held in USD to decrease in the coming year, which could support alternative currencies such as the Euro, the Japanese Yen or the Swiss Franc in the medium term. As a result, net long specs on the Euro have recently reached an all time high, reversing from -114K contracts in early March to nearly 200K contracts in August. Popular momentum-based trading strategies such as moving average crossovers are all sending strong 'buy' signals, which raises the following question: is the 'Short Dollar Trade' overcrowded? With the market extremely 'bearishly' positioned against the US Dollar, the risk of a sudden reversal is now very high. Political risk in Europe and many EM countries is trending higher in addition to significant downward revisions in growth expectations for some of the Euro area countries in the context of the recent rise in Covid-19 infections.



EURCHF IS TELLING US A DIFFERENT STORY!

Since it reached its low on 23rd March, the Euro has enjoyed a significant rally against the US Dollar, up 13 figures (+12.5 per cent) and currently trades close to the 1.20 level (the highest since May 2018). While the relative stance of monetary policy (i.e. ECB less aggressive than the Fed) and rising expectations for Eurozone recovery are strong factors behind the momentum we have seen on the pair, the EU 'Recovery Fund' remains the most popular answer among practitioners. The right chart shows an interesting divergence between the EURUSD and EURCHF exchange rates; while the two currency pairs usually rise and fall together, the move on EURUSD was not 'validated' by the Swiss Franc. Therefore, if the EU recovery fund is the strongest factor behind EURUSD strength in recent weeks according to the market, why is the Swiss not depreciating against the single currency? This shows that the strong moves we have seen in the major currencies such as the Euro, Sterling and the Swiss Franc, were mostly due to USD weakness. Has the Euro strength narrative even started yet? Not according to the Swiss Franc.



Yvan Berthoux

CHINA RISE IN TSF, 10Y YIELD AND COPPER PRICES

While most of the major economies reacted aggressively to the Covid-19 shock by injecting trillions of Dollars through both monetary and fiscal policies (Italy's combined monetary and fiscal stimulus amounts to 54 per cent of GDP), investors were surprised that Chinese interventions have been virtually non-existent. PBoC balance sheet total assets are have remained around CNY36tr, similar to the level at the beginning of the year, and the government's 'injections' were slightly over 5 per cent since the start of the year. However, the picture changes significantly when we look at the growth of the Total Social Financing (TSF), which is a broader measure of credit and liquidity to the Chinese real economy, as it shows that credit has been rising sharply since the start of the year. The bottom left chart shows that the annual growth of the TSF reversed from -14% in December 2018 to 28.4% in July 2020 and has been usually a good leading liquidity indicator for risky assets such as equities; we observe that the annual growth in TSF has led world equity prices by 6 months since the Great Financial Crisis. As a result, the reflation trade has been priced in by investors in different assets. For instance, while the US 10Y yield has been trading at depressed levels oscillating around 65bps despite the sharp equity rally, the Chinese 10Y yield has risen gradually from 2.5 per cent in April to over 3 per cent in August. Investors have argued that the constant Fed's interventions since the start of the crisis have completely compressed the term premium and therefore it would explain why the US 10Y yield has not reacted to the rise in inflation expectations in the past few months. On the other hand, Chinese long-term bond yields may reflect a more inflationary outlook. We also saw that copper prices, considered as another leading indicator of the global economy, have rebounded sharply from $2.20 to $3 per pound, inferring confidence in global economic recovery. The bottom right chart shows that copper prices and the Chinese 10Y yield have correlated well in the past 8 years and have both reacted to a sharp increase in the annual growth of TSF. Will the recovery in Chinese TSF combined with a global 'twin deficit' of nearly USD 19tr, or 22% of global GDP, be enough to generate a V-shape recovery in the real economy? We have recently seen that the number of Covid-19 cases has been starting to rise again in most of the developed economies, which could lead the world into a second 'soft' lockdown ahead of the autumn. If the situation has already been deteriorating in the middle of the summer, how bad will the situation become next winter? It will be interesting to see the evolution of Chinese long-term yields and other leading assets in the medium term as liquidity injections will shift inflationary pressures persistently to the upside in the coming months. The Chinese 10Y government bond yield could provide a valuable signal that inflation is about to take off.

Yvan Berthoux

The information in this report has been taken from sources believed to be reliable but Halkin Services does not warrant its accuracy or completeness. Any opinions expressed herein reflect our judgement at this date and are subject to change. This document is for private circulation and for general information only. It is not intended as an offer or solicitation with respect to the purchase or sale of any security or as personalised investment advice. Halkin Services does not assume any liability for any loss which may result from the reliance by any person or persons upon any such information or opinions. These views are given without responsibility on the part of Halkin Services or its officials. No part of this report may be reproduced in any manner without the prior written permission of the issuing company.

Registered Office: 179 Tottenham Court Rd, London W1T 7NZ. Registered in England: 04559723 **www.halkinservices.co.uk**

©2020 Halkin Services Limited. All rights reserved.