



R&R Weekly Column
By Brunello Rosa



Despite Greater Caution, Risk Asset Valuation Still Seems Mis-Aligned With Economic Fundamentals

Last week, equity indices suffered despite a rebound in economic activity in some key economies. This occurred as a rise in COVID-19 cases, especially in the US and Brazil, as well as fresh warnings over the global growth outlook and the Fed's warning of a cap to 'shareholder payouts' all weighed on market sentiment.

On a weekly basis, global equity indices fell (MSCI ACWI, -0.6%, to 524), driven by the US (S&P 500, -0.5% to 3,084) and the EZ (Eurostoxx 50, -1.5% to 3,219). From the beginning of the year, the S&P 500 index is down 7%, Eurostoxx 50 is down nearly 15%, the UK's FTSE 100 is down 18% and Nikkei 225 5%. These figures are very much in line with what we [predicted a few months ago](#), perhaps with the only exception of NASDAQ, which has surprised us as well as market participants with a more positive than expected performance. The NASDAQ is up 9% year-to-date, mostly due to the fact that pandemic has further boosted the use of technology for business continuity.

Have these depressed valuations re-aligned equity indices with economic fundamentals? We don't think so. Last week, the IMF released a [revision of its World Economic Outlook \(WEO\)](#), which featured a significant further downward revision of expected global growth, from the -3% predicted in April to -4.9% predicted now. US growth is expected to be -8.0% in 2020 (a 2.1% downward revision as compared to April's prediction), the UK -10.2% (a -3.7% downward revision as compared to April's), and the Eurozone at -10.2% (a -2.7% downward revision). These new forecasts are now more aligned with our own more pessimistic estimates [made in April](#). This week, we will publish our revised forecasts alongside the Strategic Asset Allocation.

Recently, the OECD went even further than this economic outlook of the IMF. In its [June forecasts](#), the OECD foresees a 6% contraction in global GDP (if no "second wave" of the pandemic occurs – the so called "single-hit scenario"), and -7.6% contraction in case of a second wave (the "double-hit scenario"). It expects the US to lose roughly 7.3%/8.5% of GDP in 2020 (depending on whether or not a second wave occurs), the Eurozone 9.1/11.5%, and the UK a staggering 11.5/14%. So, either these growth forecasts are too grim, or else market valuations are too optimistic.

At the beginning of the year, [we warned that there was a large discrepancy](#) between risk asset valuations, especially equities, and economic fundamentals. The collapse in valuations following the global outbreak of Covid-19, which marked the beginning of the [fastest bear market in recent history](#), had temporarily solved that discrepancy, by bringing valuations closer in line with economic fundamentals. But the rapid recovery in equity indices (pushed by central bank liquidity) led also to the manifestation of the [shortest bear market in recent history](#), with valuations departing again from economic fundamentals.

In our recent analysis, we warned about the possibility that a U-shaped (or W-shaped) recovery could be accompanied by a [V-shaped rally in financial markets](#). However, our [recent in-depth analysis](#) shows that equity valuations seem to be mis-aligned not just with macroeconomic fundamentals, but also with microeconomic variables that serve as an input for equity valuation models, such as expected earnings per share. There is also a mis-alignment with the signals from the credit market, in particular the expected default rates. What is underpinning high valuations seems to be only low interest rates (both current interest rates and expected future interest rates), which is a purely circular argument. Clearly, [central bank liquidity has been underpinning valuations](#) for a long time now. It is perhaps to break the virtuous (but also vicious) circle that, after the easing spree of March/April, most global central banks are now adopting a more cautious stance, with a partial withdrawal of some of the extraordinary measures introduced in the last few weeks.

In any case, the evolution of the pandemic and the global economy remain highly uncertain, and so "prudence" should be the buzzword for market participants at this time.

Our Recent Publications

- [Flash Preview – Riksbank To Weigh QE Expansion In July](#), by Brunello Rosa and Karmen Meneses, 26 June 2020
- ["Something's Gotta Give" – US Risk-Asset Valuations Are Misaligned with Reality](#), by Peter Cecchini, 24 June 2020
- [Where Helicopters Dare - An Initial Assessment Of The Unconventional Policies Adopted by The World's Major Economies](#), by Brunello Rosa and Nouriel Roubini, 25 June 2020
- [Flash Review: RBNZ Remains On Hold and Is Ready To Provide Further Signals In August](#), by Brunello Rosa and Farah Aladsani, 24 June 2020



Looking Ahead

The Week Ahead: US Employment To Improve, China's Manufacturing Expected To Ease

In the US, June labor market data are expected to improve across the board, i.e. *i)* nonfarm payrolls (c: 3.00m; p: 2.51m); and *ii)* unemployment rate (c: 12.3%; p: 13.3). Initial jobless claims will likely continue to trend lower (c: 1.33m; p: 1.48m), but remain high.

In China, manufacturing PMI is expected to ease to 50.4 (p: 50.6).

The Quarter Ahead: A Lower-Than-Expected Growth Outlook

The **IMF's June projections** highlight that the pandemic is likely to 'have a greater negative impact than initially expected; the global economy is forecasted to shrink by -4.9% (p: -3.0), driven by sharp contractions in both: *i)* DMs: -8.0% (p: -6.1); and *ii)* EMs: -3.0% (p: -1.0). The crisis is expected 'to cost governments more than USD 10tn' in lost revenues and policy measures. As a consequence, in 2020 global public debt is likely to hit 101% of global GDP, surpassing the record level reached during WWII. Finally, the IMF warned that in the future 'elevated debt levels could constrain the scope of further fiscal support'.

In the US, according to the latest polls Joe Biden is ahead of Donald Trump in the race to win November's Presidential election. Rising COVID-19 cases in the largest states – i.e. California, Texas, and Florida – are forcing a partial reversal of the staged re-openings. The Fed: *i)* stated it will cap share buybacks and dividends by the largest banks, after stress tests indicated that 'COVID-19 could trigger USD 700bn of loan losses and push some lenders close to their capital minimum'; but *ii)* stopped short of banning dividends as some European regulators have done during the crisis.

In the EZ, ECB president Christine Lagarde stated: 1) the EZ is 'probably past the lowest point of the crisis', but the economic recovery could be 'restrained' if households save instead of spending; 2) between February and May, households savings rose by EUR 214bn, to reach a record high of EUR 7.3tn - as savings were 'partly forced'; and 3) some industries – including airlines, hospitality and entertainment – will 'be hurt irremediably'.

Last Week's Review

Real Economy: Economic Data Improve, But COVID-19 Cases Hit New Records; Weaker Outlook

In the US, May 'new home sales' climbed by 16.6% m-o-m (c: 2.9; p: -5.2). Supported by a rise in car and light truck orders, May 'durable good orders' surged by 15.8% m-o-m (c: 10.9; p: -18.1). Consumer spending rose by a record 8.2% m-o-m (c: 9.0; p: -12.6), slightly missing consensus and remaining well-below pre-pandemic levels. Due to declining social benefit payments, personal income fell by -4.2% m-o-m (c: -5.6; p: 10.8). Weekly initial unemployment claims continued to fall (a: 1.48m; c: 1.30m; p: 1.54m), but at a slower rate than in previous weeks. The PCE - the Fed's preferred inflation gauge - slowed to 0.5% y-o-y (p: 0.6) while core PCE remained flat at 1.0% y-o-y (c: 0.9; p: 1.0).

In the EZ and Japan, services PMIs rose sharply (EZ, a: 47.3; c: 41.0; p: 30.5; Japan, a: 42.3; p: 26.5), while remaining in 'contraction'. Similarly, the manufacturing PMI ticked upwards in the EZ (a: 46.9; c: 44.5; p: 39.4) but fell to 37.8 (p: 39.4) in Japan, as the sub-components for 'output' and 'new orders' declined for the 18th consecutive month.

In Germany, the IFO business confidence index rose for the 2nd consecutive month to 86.2 (c: 85.0; p: 79.7), with: *i)* both the 'expectations' and 'current conditions' components in recovery; and *ii)* the latter improving for the first time since January.

In Turkey, the CBT unexpectedly kept its interest rate unchanged at 8.25% (c: 8.00) and indicated that it would focus 'on maintaining a sustained disinflation process' amid signs of recovering economic activity.

Financial Markets: Fresh Outbreaks Threaten To Derail The Economic Recovery, Equities Down

Market drivers: Despite a rebound in economic activity, market sentiment suffered from: *i)* a rising number of COVID-19 cases; and *ii)* fresh warnings over the growth outlook.

Equities: w-o-w, global equity indices fell (MSCI ACWI, -0.6%, to 524), driven by the US (S&P 500, -0.5% to 3,084) and the EZ (Eurostoxx 50, -1.5% to 3,219). US banks fell sharply, after the Fed warned them to cap 'shareholder payouts'. EMs rose marginally (MSCI EMs, +0.3% to 1,004), driven by gains in India (Sensex, +1.3% to 35,171).

Bonds: w-o-w, fixed-income rose (BAML Global, +0.3% to 294.9), DM yields fell (10y UST, -6bps to 0.64%; German bunds, -6bps to 0.48%)

FX: w-o-w, the USD weakened (DXY, -0.2% to 97.433). The EUR and CHF strengthened (EUR/USD, +0.4% to 1.122; USD/CHF, +0.5% to 0.948).

Commodities: Due to concerns about: *i)* the spread of the coronavirus; and *ii)* the strength of the recovery: 1) the prices of most industrial commodities fell; 2) oil prices declined (Brent, -2.8% to 41.0 USD/b.); and 3) gold maintained its haven appeal (Gold, +1.6% to 1,771 USD/Oz.).



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Abbreviations, Acronyms and Definitions

a	Actual	LN	Northern League, Italy
AKP	Justice and Development Party, Turkey	MSS	Five Star Movement, Italy
ann.	annualized	m-o-m	Month-on-month
ARS	Argentinian Peso	mb	Million barrels
avg.	Average	mb/d	Million barrels per day
bn	Billion	MENA	Middle East and North Africa
BoC	Bank of Canada	MHP	Nationalist Movement Party, Turkey
BoE	Bank of England	mn	Million
BoJ	Bank of Japan	MPC	Monetary Policy Committee
bpd	Barrels per day	NAFTA	North-American Free Trade Agreement
bps	Basis points	NATO	North Atlantic Treaty Organization
BS	Balance sheet	OECD	Organization for Economic Cooperation and Development
c	Consensus	Opec	Organization of Petroleum Exporting Countries
C/A	Current account	p	Previous
CB	Central bank	P2P	Peer-to-peer
CBB	Central Bank of Bahrain	PBoC	People's Bank of China
CBK	Central Bank of Kuwait	PCE	Personal Consumption Expenditures
CBT	Central Bank of Turkey	PE	Price to earnings ratio
CDU	Christian Democratic Union, Germany	PM	Prime minister
CNY	Chinese Yuan	PMI	Purchasing managers' index
CPI	Consumer Price Index	pps	Percentage points
DJIA	Dow Jones Industrial Average Index	pw	Previous week
DJEM	Dow Jones Emerging Markets Index	QCB	Qatar Central Bank
d-o-d	Day-on-day	QAR	Qatari Riyal
DXY	US Dollar Index	QE	Quantitative easing
EC	European Commission	q-o-q	Quarter-on-quarter
ECB	European Central Bank	RE	Real estate
ECJ	European Court of Justice	RBA	Reserve Bank of Australia
EIA	US Energy Information Agency	RRR	Reserve Requirement Ratio
EM	Emerging Markets	RUB	Russian Rouble
EP	European Parliament	SWF	Sovereign Wealth Fund
EPS	Earnings per share	tn	Trillion
EU	European Union	TRY	Turkish Lira
EUR	Euro	UAE	United Arab Emirates
EZ	Eurozone	UK	United Kingdom
Fed	US Federal Reserve	US	United States
FOMC	US Federal Open Market Committee	USD	United States Dollar
FRB	US Federal Reserve Board	USD/b	USD per barrel
FX	Foreign exchange	UST	US Treasury bills/bonds
FY	Fiscal Year	VAT	Value added tax
GCC	Gulf Cooperation Council	VIX	Chicago Board Options Exchange Volatility Index
GBP	British pound	WTI	West Texas Intermediate
GDP	Gross domestic product	WTO	World Trade Organisation
IMF	International Monetary Fund	w	Week
INR	Indian Rupee	w-o-w	Week-on-week
IPO	Initial public offering	y	Year
IRR	Iranian Rial	y-o-y	Year-on-year
JPY	Japanese yen	y-t-d	Year-to-date
k	thousand	ZAR	South African Rand
KSA	Kingdom of Saudi Arabia	2y; 10y	2-year; 10-year