United States

2020: a year of living dangerously

The dichotomy between economic and market trends has widened, in a context of accommodating monetary policy and rising corporate debt. Risks taken by institutional investors (pension and investment funds, life assurance companies) have increased, as has the vulnerability to any adverse shocks or changes in expectations. 2020 – an election year – is unlikely to bring calm. Welcome as it is, the truce in the trade war with China takes in the bulk of existing tariff increases, without producing any fundamental changes in the position of the US administration and its limited appetite for multilateralism.

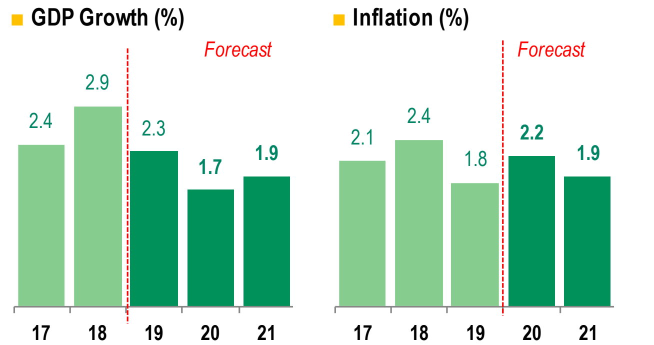
One is taking off, the other coming in to land. Whilst the US economy has been on a slowing trajectory for more than a year now, with the industrial sector dropping into recession, the equity market is still setting new records. In 2019, the Standard & Poor's index of the 500 biggest listed companies gained nearly 30%; at 3,230 on 31 December it was 106% above the record high of October 2007. The Nasdaq tech stocks index surged by 35% in 2019, taking its gains over the past seven years to 200%.

Higher, faster, riskier

Is this irrational exuberance? The fact is that in the United States, rising equity prices display a fairly distant relationship with the slower growth in earnings, resulting in stretched valuations (Figure 2 and IMF, 2019)[1]. With interest rates remaining low, equities' gains are based on an amplification of the leverage effect. In its latest Global Financial Stability Report, the IMF highlights the importance of borrowing in M&A activity and in share buybacks. The increase in the weighting of goodwill in total assets, and the high multiples used in LBO (leveraged buy-out) deals reflect increasingly ambitious bets on the future[2]. Increased risk taking can also be illustrated by the narrowing of spreads on high-yield debt (Figure 2), a market sector that the IMF also considers to be overvalued.

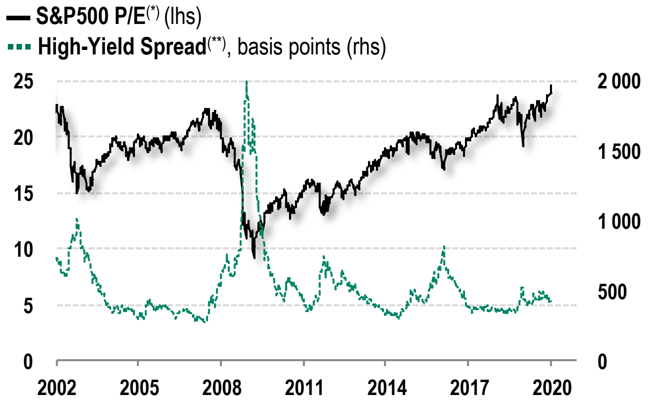
In the current phase of rising asset prices, institutional investors (investment and pension funds, life assurance companies) have played an increasingly important role. Whilst banks have, overall, slowed the expansion of their balance sheets and improved their resilience since the 2008 financial crisis, institutional investors have expanded their activity, taking a growing share of financing. They have also widened the scope of their quest for returns, in a context of falling interest rates on sovereign debt, the traditional core of their investment portfolios. A reallocation has taken place, away from cash and investment-grade bonds, to less liquid and more risky assets such as unlisted private debt, real estate and infrastructure. This has produced greater vulnerability to negative shocks or changes in expectations.[3]

1- Growth and inflation



Source: National statistics, BNP Paribas

2- Increased risk taking



(*) P/E: Price / cyclically-adjusted earnings per share

(**) Yield on speculative-grade corporate bonds – yield on 10-year Federal Government bonds.

Source: Refinitiv, BNP Paribas

In these early weeks of 2020, the increase in tensions between the United States and Iran does not appear to have provided a tipping point. Markets have been bolstered by the prospect of continued monetary accommodation[4], and hopes for the settlement of the trade war between China and the USA.

[1] International Monetary Fund (2019), *Global Financial Stability Report,* Chapter 1, October, pp 1-4. In September 2019, the IMF's valuation model suggested that US equity valuations were more than 2.5 standard deviations above fair value.

[2] Ibid, pp 25-37. 60% of LBO debt is for deals valuing the target company at more than six times annual operating income.

[3] Ibid, pp 41-49.

[4]In 2019, the US Federal Reserve cut its Fed Funds target rate by three-quarters of a point, taking the upper bound from 2.50% to 1.75%. Since October

Pressure on margins and investment

A scenario of calmer waters ahead is far from guaranteed. Granted, a deal between Washington and Beijing was signed on 15 January. 'Phase 1' of this agreement will bring a pause in the escalation of tariffs and, on the Chinese side, an increase in imports, notably of farmed products, guarantees on respect for intellectual property rights and greater market openness in the financial sector. The fact remains that the roots of the conflict – the battle for technological leadership – go deep[5] and that any real de-escalation in a possible 'Phase 2' has been pushed down the road, most probably beyond the presidential election on 3 November. Most of the tariffs enforced by the Trump administration will therefore continue to apply in 2020. This will take the average tariff on imports from China from 3% (in 2017) to 19%, increasing the cost of Chinese imports by some USD70 billion[6].

For US companies, the additional costs come at a moment when the effects of the 2018 tax cuts are diminishing and no longer serve to offset narrower operating margins. Pressure on earnings is rising, whilst the leverage is increasing; such a configuration often precedes or comes alongside an inversion in the US economic cycle (Figure 3 and Box 4). The tide has already clearly turned in the shale oil and gas sector, which has seen marginal returns fall and is cutting capacity in response.

Although employment and consumer spending are showing little sign of slowing, company investment has been falling since the autumn of last year. It is now the main vector by which the US economy is coming in to land. Surveys of purchasing managers suggest that this trend had not improved as we moved into 2020[7]. GDP growth has slowed, with the respective New York and Atlanta Fed's nowcasts suggesting a rate between 1% and 1.8% per year.

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2019, it has also increased the size of its balance sheet in response to tensions in the repo market.

[5]Even while it was negotiating with the USA, the Chinese government announced its plan to replace, within three years, foreign IT equipment (computers, software, etc.) in use across government with Chinese equipment. See Financial Times (2019), *Beijing orders state offices to replace foreign PCs and software,* Dec. 8.

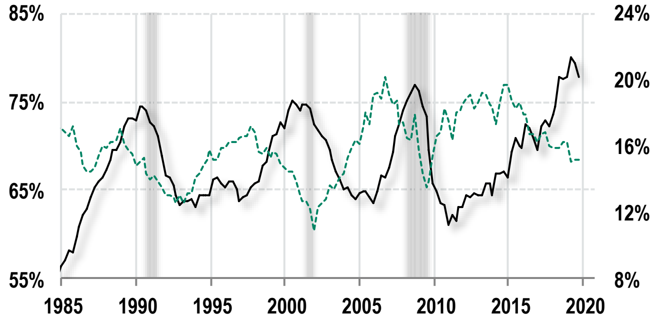
[6]Estimated impact in 2020. Under the terms of the Phase 1 agreement, the US administration cancelled proposed tariffs on a final list of products (list '4B'), consisting mainly of consumer goods, and also cut the tariff rate applied in September 2019 on USD 100 bn in imports from 15% to 7.5%. The earlier tariff increases (25% on USD 250 bn in imports) have been confirmed. In the final analysis, nearly two-thirds (65%) of US imports from China will be subject to tariffs.

See: Brown C.P. (2019), *Phase One China Deal: Steep Tariffs Are the New Normal*, Peterson Institute for International Economics, December 19.

[7]At 46.8 in December 2019, the industrial orders index calculated by the Institute for Supply Management (ISM), which has traditionally been strongly correlated with company investment, is at its lowest since April 2009.

3- Debt grows, margins shrink

— Net debt of non-financial companies (lhs)
▪▪▪ Net operating income of non-financial companies (rhs)
% of added value



Shaded areas: periods of recession

Source: BEA, NBER, Federal Reserve (Flows of Funds)

4- The leverage effect

To understand the link between financial leverage and the return on equity, the balance sheet and profit account of companies can be written as follows:

(1) ***A= E +D***

(2) ***NP = EP - I***

Where ***A*** *is the total economic asset,* ***D*** *the total net debt,* ***E*** *the shareholder equity,* ***NP*** *the net profit,* ***EP*** *the economic or operating profit,* ***I*** *the interest rates burden (for simplicity, income taxes are ignored).*

By definition, the financial leverage is equal to the net debt to equity ratio, e.g. :

(3) ***L = D / E,***

*The economic return of asset (**er**) is the ratio of operating profit to total economic asset:*

er = EP / A *;*

*The return on equity (**roe**) is the ratio of net profit to equity :*

(4) ***roe*** *= NP / E*

= (EP – I) / E *following (2)*

= (re.A – i.D) / E *where i is the market interest rate*

= [re.(D + E) – i.D] / E *following (1)*

➲ ***roe = er + (er – i).L*** *following (3)*

Le financial leverage ***L*** *raises the return on equity above the economic return if it exceeds the market interest rate. The leverage effect declines with the rise in market interest rates and/or the fall in economic return. In a case of reversal (**er** < **i**) the return on equity comes under pressure, which could speed-up the deleveraging process.*

Source: Vernimmen (2010), BNP Paribas