MyStratWeekly
Market views and strategy

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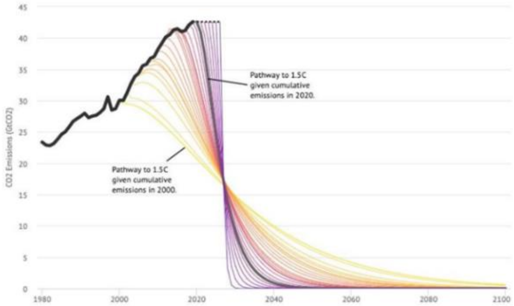
Topic of the week: capitalism without capital

- **Markets have consistently rewarded companies that return cash to shareholders and penalized those that invest. Result: a very clear distortion of cash flows in favor of buybacks and dividend, all at the expense of investment;**
- **This has helped to transfer the capital-intensive part of production to emerging countries. It has also contributed to increased margins and cash flows for businesses;**
- **It is not at all certain, in a post-pandemic world, that this logic of “capitalism without capital” will endure. In this case, the level of profitability of companies would inevitably be affected, and valuations, which are very demanding, could be difficult to justify.**

Market review: When markets change their mind

- **Disappointing growth figures and dynamic inflation figures;**
- **The curve now anticipates rapid rate increases;**
- **This is accompanied by more stress on the curve and flattening on the long part of the curve;**
- **This stress has not yet contaminated the stock market. But..**

Chart of the week



Emission reduction trajectories associated with a 66% chance of limiting warming below 1.5C, without a reliance on net-negative emissions, by starting year. Solid black line shows historical emissions, while coloured lines show different pathways to limit | Carbon Brief

The reduction of greenhouse gas emissions will have to be all the faster as it is implemented later. The gradual adjustment, if it had started in 2020, quickly becomes a very steep slope.

The first consequence is that the objective set seems increasingly difficult to achieve and therefore unlikely.

The second consequence is that the probability of a “too traditional, too violent” adjustment continues to increase. By delaying the deadline, we expose ourselves to a significant climate risk.

Figure of the week

23.5

Source : Ostrum AM

The average age of public infrastructure in the United States. It was 16.5 years in 1970 and the figure has been growing ever since. The need for public investment is very real.

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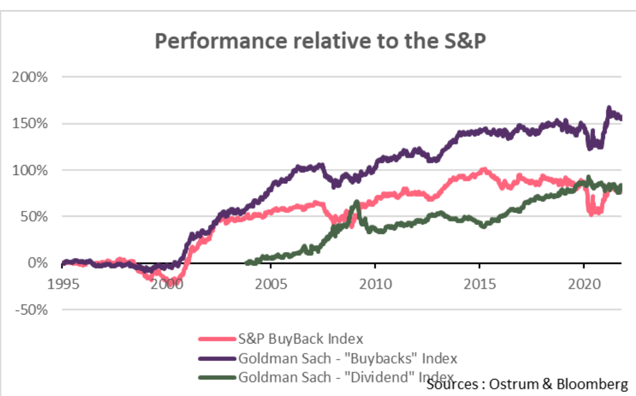
● Topic of the week

Capitalism without capital

The markets have very clearly rewarded companies that returned their cashflow to shareholders, either in the form of share buybacks or dividends. On the opposite, companies that invest are generally penalized. The incentive is very clear for companies: to get rid of the capital-intensive part of their business, use subcontractors for this, and payback shareholders in the form of share buybacks or dividends. The consequence is significantly higher profit margins. This logic, pushed to the extreme, has led companies to set up complex international production chains, with as an ultimate result the problems of bottlenecks that we are currently experiencing. Perhaps it is time to change logic and return to a world where investment is seen as positive.

What markets want…

Let's start with a very simple graph. We use three portfolios of S&P stocks that do a lot of share buybacks as well as those that pay large dividends. The relative performance of these three portfolios is unambiguous: they all generated significant and relatively stable outperformance.



The market very clearly rewards companies that return their cash to shareholders.

One might be tempted to argue that this pattern is due to the fact that the companies that make the most share buybacks or pay the most dividends are the ones that have the most cash flow, and therefore those that are simply the most profitable. While this explanation is indeed valid, it is interesting to note that the Goldman Index of Firms with High Investment Rates and R&D has underperformed the buyback index by 4% per year on average since 1995 and underperformed the dividend index by about 2.5% per year since 2005.

The most relevant explanation is therefore that markets consistently favor the use of cash flows for dividends and buybacks, to the detriment of investment. In fact, the "buybacks" index began to outperform in 2000, when China officially joined the WTO (China joined on December 11, 2001). It seems that from that moment on, the beginning of a frantic globalization, the financial markets encouraged companies to get rid of the capital-intensive part of their business, to use subcontractors for that, and to remunerate the shareholder in the form of share buybacks or dividends.

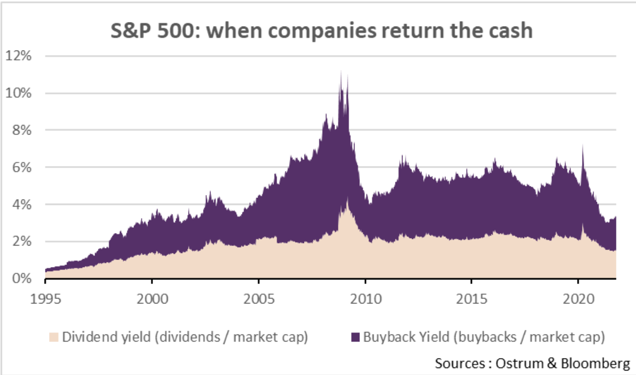
It's called "capitalism without capital". The idea is simple: the capital-intensive part is often the least profitable in a business model and it should therefore be outsourced. The argument is also valid for industrial employment, which has suffered greatly in developed countries. Emerging countries, and first and foremost China, want to recover this part of the activity as part of their development strategy. This allows companies to improve their cost structure. And the market to conclude that companies that do not participate in the movement and keep heavy investments, are companies that have not understood the meaning of the history. It is then normal for them to be penalized.

Financial markets therefore provide a strong incentive for companies to remain cautious about their investment and return cash to the shareholder.

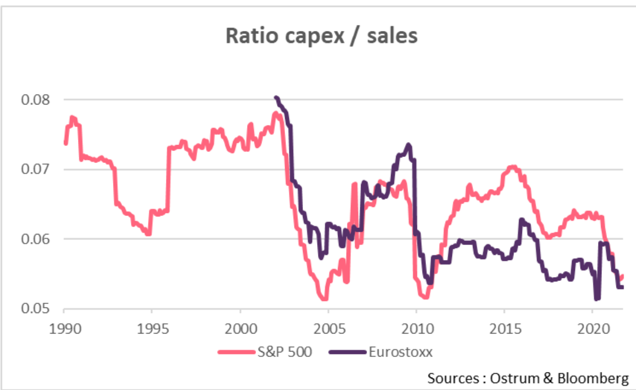
Companies respond

An academic paper goes one step further (Cf. "A Catering Theory of Dividends", June 2004, The Journal of Finance, Jeffrey Wurgler & Malcolm Baker), showing that when markets reward high-dividend companies, all companies tend to increase these same dividends. The logical result is that CFOs simply respond to market incentives to maximize the market value of their business.

The chart below shows that indeed US companies have significantly increased their total yield over the past quarter century. The "total yield", in strategist's jargon, is the sum of the "dividend yield" (the ratio between paid dividends and market capitalization) and the "buyback yield" (the ratio between share buybacks and market capitalization). The amount of liquidity returned to the shareholder was, on a very recurring basis, to the tune of 5% of the market capitalization, which is more than substantial.

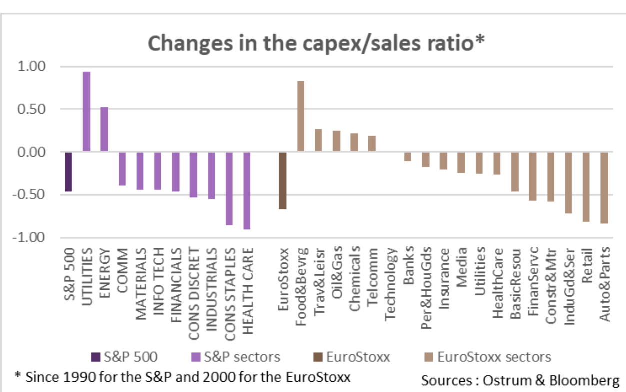


Accordingly, cash flows should be expected to be increasingly used for share buybacks or dividends at the expense of investment. The graph below shows that, indeed, the level of investment in the United States and in Europe has slowed considerably over the past 30 years.

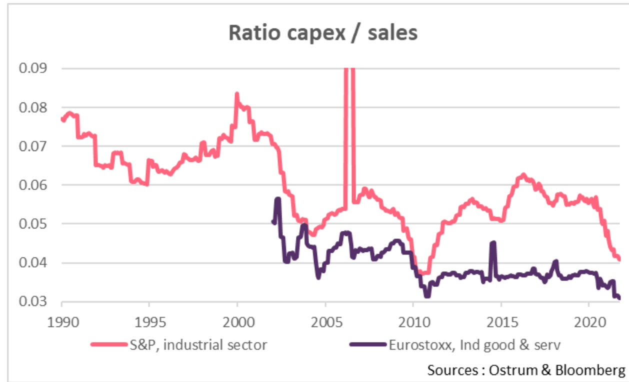


It could be argued that this result is linked to a composition effect, with the lighter investment sectors taking a larger place in the index. That is not the case. The chart below shows the investment-to-sales ratio trend for the S&P 500 and Euro Stoxx sectors.

In the case of the S&P, 8 of the 10 sectors saw their ratio decrease, only the utilities and energy sectors increased. In the case of Euro Stoxx, we get a similar result, with 14 of the 19 sectors having lowered their ratio. Only food, travel, energy, chemical and telecoms have increased.



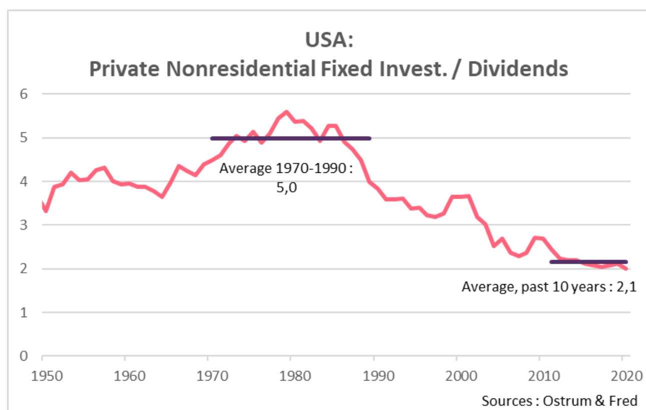
It is particularly interesting to note that the industrial sector illustrates our thesis very well. In the industrial sector in the United States, the investment-to-sales ratio has almost halved in the last 30 years! The data, which unfortunately are not as long, in Europe, however, show a decline of a comparable magnitude.



What to do with all that free cash flows if companies manage to operate with a much lower capital stock and less investment needs?

Finally, we can also see this evolution with the ratio between dividends and investment. Unfortunately, reliable data are only available in the case of the United States. The chart below shows the ratio of non-residential investment data (GDP data) to aggregate dividend payment statistics for the economy as a whole. For every dollar of dividend, U.S. companies invested $2 over the past decade when they had invested $5 over the 1970s and 1980s.

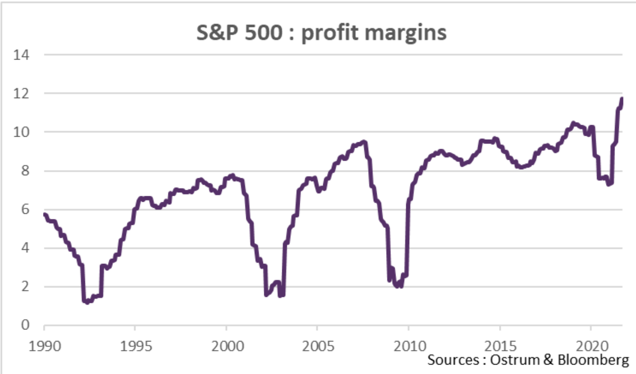
The change is striking.



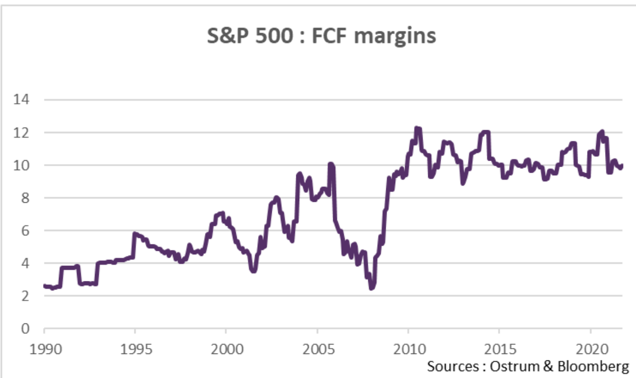
Too profitable?

As a result, companies have specialized in the part of their business that is the least capital-consuming and therefore the most profitable.

Again, the figures available for Europe are not reliable enough over several decades, so we use the S&P 500 figures as an illustration. Profit margins have continued to grow and are currently at record levels.



The very low cash consumption makes the dynamic of free cash flow margins even more spectacular.



The dilemma then for any good CFO is to validate investment projects that do not dilute the level of margins. With such comfortable profit margins and high liquidity flows, it is difficult to find investment opportunities that have a marginal return high enough. In the event of margin dilution, markets are generally quick to penalize the company.

Here too it is an incentive to remain extremely parsimonious on investments, and thus to return excess cash to the shareholder.

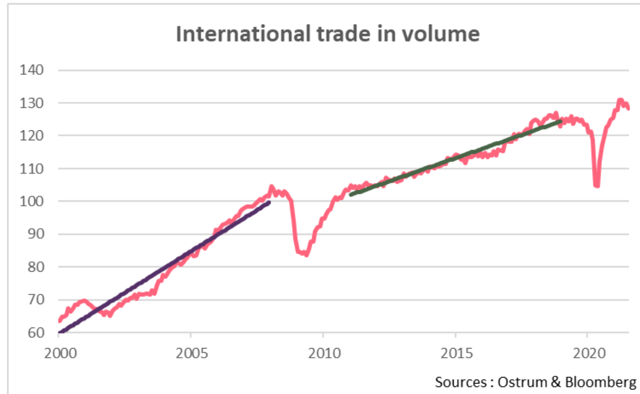
A logic pushed too far?

The consequence of all this is that many companies have used subcontractors as much as possible. Production chains have become much more efficient, but also much more complex. For example, it is estimated that in order to produce a car, 33 countries participate on average, more than a dozen for an electric bike.

While this trend has improved the profitability of companies in developed countries, it has also generated an unprecedented wave of investment over the past two decades in developing countries. The latter have picked-up the capital-intensive part of production.

Yes, but the quid pro quo is that these production lines are also very fragile. That's what the covid episode showed unambiguously. Production efficiency, and therefore profitability, has therefore been accompanied by increased vulnerability or fragility. This point was not necessarily taken into account completely.

The chart below shows the changing dynamics in international trade. The increase was very strong in the decade 2000-2010 (the one that followed China's entry into the WTO), it was more reserved over the last decade. The progression is tending to fade even more since the Covid episode.



There are three major reasons for this slowdown:

- Transportation costs have increased, pushing up logistics costs on international production lines.
- The cost differential has, in part, faded. For example, the wage differential between Western and Eastern Europe is less extreme than it used to be.
- The risk factor must be taken into account, either in the case of components that pose a safety risk (car brakes for example) or because the production line carries a risk because of its complexity.

Conclusion: dilemma

There was a time, in the last two decades to put it simply, when the interest of markets, companies, and globalization were aligned. The markets wanted companies as capital light as possible to improve their profitability. This has contributed to a very rapid wave of globalization made possible by China's accession to the WTO. If this logic has been pushed too far, as we said earlier, we enter into a conflict of interest.

From a strictly financial point of view, the logic is intact, and the market should continue to favor companies that operate with a lighter balance sheet and limited investment needs. From a more functional point of view, companies, but also states, will probably want to take a step back. The objectives then become divergent. It is not at all certain, in a post-pandemic world, that the logic of "capitalism without capital" is tenable. In this case the level of profitability of companies would inevitably be affected. And then the valuations, currently very demanding, could become difficult to justify.

Stéphane Déo

Market review

When the markets change their mind

The inflation outlook forces the curve to anticipate a different rate trajectory.

Economic figures this week have remained solid even though disappointments continue. US GDP was lower than expected at 2.0%, with a particularly disappointing level of investment. On the other hand, the French GDP was solid, +3.0% over the quarter and the level of activity has already returned almost to the pre-crisis level whereas it took 4 years during the last crisis to correct the decline. The figures therefore remain solid but the indicators of economic surprises, whether global, European or American, are now firmly in negative territory.

Inflation figures, on the other hand, continue to gallop. The “core PCE”, an indicator favored by the Fed, was 4.5%, although down, but on levels that remain very high. European inflation rose to 4.1%, with mainly core inflation at 2.1%. This is the first time since 2002 that core inflation has exceeded 2%. It should also be noted that industrial prices in Europe are increasing in the various countries at a rate of 10-15%, which is a dynamic for future prices.

As a result, the curve completely changes its perception of inflation, and correspondingly the trajectory of central bank policy rates. European and US 10-year inflation swaps have gained over 20 bps since the start of the month. The 5-year in 5-year European swap has increased above 2% for the first time in 7 years. The curve is now consistent with an inflation view that remains

This has had a significant impact on the expectations of rate hikes. There were already 10 rate hikes through the world over the month of October. Latest examples, this week the Central Bank of Brazil announced a 125 bps increase, the Bank of Canada announced the end of its QE and brought the prospect of rate hikes closer together.

Christine Lagarde did not announce anything substantial during the ECB press conference, the plan to replace the PEPP will be announced at the 16 December meeting. Despite this, expectations have changed considerably. The future EONIA contract is now expecting positive rates over the 3 months to the end of 2023. This contract moved more than 30 bps over the month! As far as the Fed is concerned, the December 2022 contract expects more than two rate hikes, again with a very rapid change in expectations since the September 22 FOMC.

The short part of the curve therefore steepened considerably in both the United States and Europe. With more aggressive central banks and sluggish growth figures, the long part of the curve flattened out. Deformation of the curve typical of a mature cycle with anticipated rate increases that push the “belly” of the curve upwards, while the long part moves little. We can also note that the 20-30-year part of the Treasury curve has even reversed over the week.

The message sent by the curve is therefore twofold: (1) inflation is more persistent than expected and central banks will be forced to be more aggressive, (2) growth will suffer.

This significant change in curve also resulted in a spread of peripheral yields. Especially Italy where the 10-year spread gained 16bp over the week, while spreads on short parts were also under pressure.

Last symptom, not surprisingly given the movements recorded, the volatility indicators on the curve bounced back. The MOVE (a measure of the expected volatility in the Treasury market) has exceeded 70, a level largely in the first decile of its historical distribution. In Europe, we look at the volatility of swaptions, which also gives us an idea of the stress level of the IF markets. The 10-year-old in 1-year touched 65 while it was at 35 at the beginning of the year. On the other hand, the VIX remained very zen this week, under 18 and the V2X, the equivalent for Europe, under 19. So there is significant market schizophrenia between stress on the curve that is in the top decile of its historical distribution, while stress on equities remains very moderate. Historically this kind of divergence is not tenable and therefore is not sustainable. And in general, the interest rate market contaminates the equity market.

In a context of monetary tightening and sluggish growth, it is indeed likely that the equity markets will be more heckled in the future. While waiting for the season of results remains very good with surprises on the turnover and even more marked on the profits: a sign that the margins have held very well. This is the source of support for the equity market. Nevertheless the season of the results is only a glance in the rearview mirror, the question will quickly arise of the future trajectory of the profits. With very high margin rates, the outlook can only be less euphoric. And the market will then be very vulnerable to stress contamination from the interest rate market.

Stéphane Déo

Main market indicators

G4 Government Bonds	02-Nov-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.66 %	-1	+4	+4
EUR Bunds 10y	-0.17%	-5	+6	+40
EUR Bunds 2s10s	50 bp	-4	+2	+37
USD Treasuries 2y	0.45 %	+1	+19	+33
USD Treasuries 10y	1.53 %	-7	+7	+62
USD Treasuries 2s10s	108 bp	-9	-12	+29
GBP Gilt 10y	1.03 %	-8	+3	+84
JPY JGB 10y	0.08 %	-3	+2	+6
€ Sovereign Spreads (10y)	**02-Nov-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	35 bp	+1	+0	+12
Italy	124 bp	+12	+20	+12
Spain	69 bp	+5	+5	+8
Inflation Break-evens (10y)	**02-Nov-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	164 bp	+5	+13	-
USD TIPS	250 bp	-19	+12	+51
GBP Gilt Index-Linked	401 bp	-10	+20	+101
EUR Credit Indices	**02-Nov-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	88 bp	+1	+3	-4
EUR Agencies OAS	46 bp	+3	+3	+5
EUR Securitized - Covered OAS	43 bp	+2	+5	+11
EUR Pan-European High Yield OAS	312 bp	-12	+3	-46
EUR/USD CDS Indices 5y	**02-Nov-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	51 bp	+1	0	+3
iTraxx Crossover	260 bp	+6	+1	+19
CDX IG	52 bp	+1	-1	+2
CDX High Yield	302 bp	+4	-2	+8
Emerging Markets	**02-Nov-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	358 bp	+1	-5	+7
Currencies	**02-Nov-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.159	-0.09	-0.31	-5.17
GBP/USD	$1.361	-1.13	+0.01	-0.43
USD/JPY	¥113.78	+0.33	-2.5	-9.25
Commodity Futures	**02-Nov-21**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$84.4	-$1.3	$5.9	$33.8
Gold	$1 788.2	-$4.8	$18.6	-$110.2
Equity Market Indices	**02-Nov-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	4 631	1.22	6.28	23.28
EuroStoxx 50	4 297	1.73	6.48	20.95
CAC 40	6 933	2.46	6.37	24.88
Nikkei 225	29 521	1.43	2.61	7.57
Shanghai Composite	3 506	-2.56	-1.75	0.94
VIX - Implied Volatility Index	16.00	0.13	-24.35	-29.67

Source: Bloomberg, Ostrum Asset Management

Additional notes

Ostrum Asset Management

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