

## Annual letter for the co-investors of SIH BrightGate Global Income Fund

*“It’s tough to make predictions, especially about the future”  
Yogi Berra*

We would like to start with a quick summary of the fund. The fund closed on 31st December 2019 with a NAV of 113.8, representing a net annual return of 5.3%. The fund was launched on 14th October 2013, and the annualised return since its inception has been 2.1%. The fund’s ISIN code is LU0942882589.

The philosophy of the fund is Buy & Hold, with an investment mandate in global credit with durations of less than 3. The portfolio is relatively concentrated, with between 50 and 55 positions, and gathers our best ideas which we believe offer a more attractive risk-adjusted return than the average credit found in today’s High Yield (HY) markets. Although we like to maintain the positions for as long as we can, our fund is not a traditional Buy & Hold fund, in which positions are bought and maintained until maturity, but instead we constantly evaluate our positions based on their price and the evolution of their business fundamentals. In the current environment of narrow credit spreads and low interest rates, we believe that traditional Buy & Hold strategies are poor candidates for any investor’s portfolio, given that elevated valuations make it difficult to reinvest coupons, using interest payments in the buying of bonds which are increasingly expensive. We believe that the correct reinvestment of coupons is an important, and hardly ever appreciated, source of long-term profitability; our investors can be assured that a large amount of our attention is dedicated to this task.

Regarding the currency hedging policy, the portfolio was completely hedged at the year-end. The only exceptions, which represent less than 3% of NAV, are two Mexican bonds (with the same issuer) in which we are exposed to currency movements but also provide us with high coupons as protection. We do not expect changes in the hedging policy for 2020.

Following this, we will review 2019, how we view the markets and what our positioning will be for 2020. Finally, in this year’s letter we would like to explain in detail the theoretical framework of corporate profits which we use on an internal level. Given that, in the long-run, the largest part of equity returns (and therefore fixed income, assuming stable credit spreads over time) comes from the dividend yield, plus the growth of earnings per share,<sup>1</sup> it is imperative to have a solid theoretical framework that explains earnings growth in the medium term to understand the level of valuations and their sustainability. We trust that our investors will find such a theoretical framework both novel and useful.

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<sup>1</sup> Changes in valuation multiples, whilst the primary determinant of in the short-term returns, have an effect that tends to zero in the long term.

## Summary of 2019

2019 has been a very good year not only for fixed income, but also for all asset classes. The Bloomberg Barclays Global Credit IG index, which is an accurate reflection of the performance of the investment grade universe, has closed the year with a return of 4.4% (in Euros), whereas the Barclays EM Hard Currency Aggregate TR index, which represents the evolution of emerging credit markets, has closed at 9.4%. Finally, our closest comparable by asset class, the Bloomberg Barclays Global High Yield Total Return EUR Hedged index, closed at 9.9%. The lofty valuations that we have come to witness in the fixed income universe over the last few years have progressively encouraged many investors, who were looking for a stable return from coupons, to hunt for yield from the dividends of higher quality equities, inflating in turn their valuations. Although investors clearly understand the adverse profile of today's fixed income valuations (ultimately, its returns are easy to verify), we believe that there is a further misunderstanding concerning the attractiveness of today's equities, which is also unfavourable. Given that, unlike fixed income, equity returns are implicit and not explicit,<sup>2</sup> most investors currently assume, in a simplistic and heroic way, that the risk premium for investing in equities will follow the historical norms – say, a spread of 3-5%. However, the equity risk premium has been far from constant over time. As we will explain in detail in the appendix and as John Hussman explores in one of his [latest articles](#), there is a very high probability that the equity risk premium will currently be negative for investors with a 10-year time horizon.

Moreover, as has become recurring in the last few years, the disparity in monetary policy between the ECB and the FED has resulted in increasing currency hedging costs for investors whose monetary base is the Euro (2%-2.5%, depending on the time of the year). This phenomenon, which we do not expect to disappear in the short-term, has and will continue to put pressure on HY returns, ensuring that the margin of safety for investing in risky credit is extremely low.

In reference to our fund, its performance has been in line with our universe of short-duration peers, despite having held an average cash position (20% of the fund's assets) for the entire year. Unlike the previous year, in which the return was punished by mistakes that could have been avoided and from which we have learnt, this year's portfolio has generally had a positive performance, and we do not expect permanent losses in value in any of our credits. Below, we comment on the aspects of the year that we believe are most relevant for our investors.

Our positions in oil continue to represent, a year later, most of our portfolio. Although the price of Brent has increased by approximately 25% during the year, the performance of our positions has been below our expectations. Although our bonds have attractive coupons, the prices of some of them have not made up for the losses of the previous year. In general, our positions in the North Sea have seen a good performance (Siccar and Enquest), those of Kurdistan have been stable, generating high coupons whilst trading above par (DNO and Gulf Keystone), our positions in CRC and Athabasca have lost some value (more in the case of the former) and, finally, our position in Floatel, the only services firm that remains in our portfolio, has been strongly impacted by poor business conditions during the year, in which it did not gain a single relevant contract. However, we remain optimistic and have not changed our opinion about the company. At the current valuation of 40 at which our *1<sup>st</sup> lien* bonds are trading, the company's EV would be about \$160M (a \$400M nominal value of bonds, without counting the cash of the company): this valuation gives us access to four of the latest generation floating accommodation platforms, plus a fifth one in which we are subordinated to the banks, with long and useful lives (greater than 30 years), the possibility of generating an annual EBITDA per platform of roughly \$20-25M with conservative daily rates, an excellent cash conversion (above 60% with respect to EBITDA) given the limited need for investment in these platforms, shareholders with an owner mindset (Oaktree and Keppel) and a sector that is the most consolidated of all related to oil services and that could be consolidated even more if the merger with Prosafe, Floatel's major competitors, is approved. In effect, the merged firm would control more than 80% of all the accommodation platforms with a license to operate in the North Sea. We await the news of new contracts (although at low daily rates) in the coming months and we believe that the firm will not have any liquidity problems during 2020.

The performance of our opportunistic positions has been mixed. Whilst the HC2 bonds have not behaved as we expected, despite positive developments in the firm's different businesses, our Fannie

<sup>2</sup> In fixed income the only variable that can impact future profitability is the default rate, as the coupon and the maturity date (except for those bonds in which the call option is exercised) are known.

and Freddie (*GSEs*) preferreds have strongly increased in value during the year (almost by 100%). However, we believe that the best is still to come. In the coming six months we ought to see advances on various fronts: in the approval of new capital requirements for *GSEs*, in the final cancellation of the *net worth sweep* and in reaching an agreement with the preferred shareholders, which will make it possible for firms to raise capital further down the road. Our position in the *GSEs* is highly attractive not only because of its optionality, but also for the absolute decorrelation with the rest of the market. Finally, our position in Thornburg has not exhibited any significant increase during the year, although recent news makes us feel optimistic, with a potential legal resolution (or an agreement between the parties) in a year or a year and a half.

Finally, and as we announced in last year's letter, we have been gradually incorporating convertible bonds into our portfolio. The convertibles are an asset class in line with the philosophy of the fund and in which we have found attractive opportunities during the year. In general, we believe that structurally it makes sense to have convertibles in our fund for two reasons. Firstly, we look for convertibles that present situations in which the underlying has fallen in a sharp way and the bond has lost its attractiveness for investors who were searching for the potential revaluation without wanting to be invested in stocks.<sup>3</sup> These situations offer reasonable credits with above-average balance sheets because the credits have temporarily been oversold. Secondly, we also look for convertibles in which we believe the strike price can be reached and that present specific catalysts. In the first bucket we have acquired the convertibles, Ence and Teekay Corp. In the second, our positions are HC2, Polys, EZCORP and Turning Point Brands.

### Current positioning and 2020

At the close of 2019, the geographical positioning of our portfolio was 39% in Europe, 54% in the United States and Canada, and 7% in emerging markets. Although Europe is an area in which we have a high proportion of our portfolio, we do not have a single bond in the traditional part of Europe (France, Germany, Italy etc.), but we still believe that, a year later, they are absurdly expensive and will correct sooner or later. Our European exposure is limited to Nordic countries, the UK (in oil companies) and Spain. With respect to emerging countries, all the geopolitical noise of the past year has not been translated into attractive investment opportunities. One year later we find expensive valuations and unfavorable perspectives. Our exposure in emerging markets has been greatly reduced, having closed our last positions in Turkey, Ukraine and Indonesia, and being minimal since the fund's inception. Our latest positions are concentrated in LatAm, Moldova and Georgia. Just as we thought at the beginning of 2019, we believe that during 2020 they will present attractive investment opportunities and we will not doubt, when that occurs, to assign a significant percentage of the portfolio to these names.

On the other hand, the weighting of our portfolio in terms of ratings are: 9.9% investment grade, 39.7% high yield and non-rated 50.5%.

On a sectoral level, the primary weightings of our portfolio are: 7.3% communications, 7.5% consumer discretionary, 3.8% consumer staples, 21.9% energy, 5% financial, 15.6% industrial and 8.5% basic materials.

After the euphoria experienced in the past year, 2020 begins again as a year of tight valuations in the HY markets, with the real chance that any price changes will wipe out the returns from coupons. In this environment of low interest rates and poor corporate balance sheets, the principal blocks of our portfolio are the following:

- **Oil companies** (18.5% of the portfolio): names that our investors are well aware of and that need no introduction. We believe that: i) the fundamentals of the sector from the supply side are very strong, ii) the belief that the demand for oil will fall due to challenges from the green economy is unjustified and, iii) the spreads versus the rest of the HY universe are in three-year highs. Whilst it is true that in a context of economic crisis these bonds will suffer, the energy sector is right now the only sector within the HY universe that offers elevated returns for reasonable risks.

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<sup>3</sup> Known as *busted convertibles*, given that one can consider that the implicit option is *out of the money* and no longer has any attractions for investors who pursue equity-like returns.

- **Short-term** bonds (17.2%): bonds (Ben Oldman) and/or promissory notes (Europac, America Movil) maturing in less than 2 years, in which the credit risk is very low and will allow us to rotate the portfolio without losses in the event that the market comes to offer us better investment opportunities.
- **Convertibles** (15.2%): our current positions include Ence, EZCORP, HC2, Polyus, Teekay Corp. and Turning Point Brands. We continue to monitor opportunities in this segment and have a couple of potential candidates when their price becomes right.
- Companies that are **uncorrelated with the economic cycle** (12%): lastly, we maintain positions in business models that we believe could be interesting in moments of market stress and that currently yield attractive returns. We have a 7.1% stake in companies related to gold mining and a 2.9% position in bonds completely uncorrelated with the economic cycle (our positions in Thornburg and GSEs). Additionally, we have recently bought a 2% stake in EZCORP convertibles, a US company operating pawn houses, a business with high returns on invested capital and that, also, depends crucially on the price of gold and financing alternatives for consumers.

In summary, the fund has a YTW, net of hedging costs, of 5.6%. We have a position of 12.8% in cash and a duration of 1.8. We believe that these metrics will allow us to obtain a superior return to our competitors in 2020 and at the same time to provide us with enough flexibility when the opportunities arise.

We would like to conclude by thanking you for placing your confidence in us. We trust that future results will continue to maintain such confidence.

## Appendix. The Levy-Kalecki profit equation, the situation around US corporate profits, and the equity returns for the next ten years

The debate about current stock valuations is more heated than ever. Despite the S&P500 closing an extraordinary year in terms of returns, most of them have been generated through the expansion of valuation multiples, more than through profit growth. Given that valuations are at one of their most elevated points in the last century, and that historically heightened valuations have supposed low future returns, the question is how much can an investor who currently invests in the S&P500 expect to obtain (and reinvesting dividends) for a period of, say, ten years.

Although over a decade the returns due to the change in valuations continue to be important, its importance is less significant than in the short term, being the dividend yields and the growth in earnings per share the main determinants of long-term equity returns.<sup>4</sup>

The dividend yield is the easiest factor to make a judgement, as it is an observable variable. As of January 2020, the dividend yield of the S&P500 is 1.8%. The growth of earnings per share, however, encounters many more difficulties. Not only must one speculate about the most likely earnings growth during the following decade, but also must guess the the level of share buybacks carried out by firms, and not just that, but at what price they will do it – thus, although the buyback of shares above its intrinsic value reduces the number of shares in circulation, the final effect is destructive for shareholder returns. Even when assuming that buybacks are immaterial or that they neither generate no destroy profitability, to speculate “only” about earnings growth is a formidable task.<sup>5</sup> ¿Is there some way in which our guesses to that effect would be something more informed?

Wall Street’s *modus operandi* in response to the previous question consists of making a simple bottom-up analysis: adding up the earnings that they expect each firm will generate in the future, they arrive at an aggregated earnings figure that they think is the best estimation, as it is the average of all the analysts covering their respective firms – *the wisdom of crowds*. The method, as well as suffering from analysts’ biased optimism for each one of their firms and aggregating said biases until they reach an aggregated level, also suffers from the logical problem known as the “fallacy of composition”, which is when the whole of a system is very different to the sum of its individual components. For example, the sale of capital goods by a firm to their customers can suppose profits for the former, but not a cost for the latter – as it will amortize them gradually during a determined time period. Or an increase in the salaries of an individual firm might suppose a greater cost, but these salaries represent purchasing power and potential profits for firms operating in another sector. And so forth. The question is, is there a method that would allow us to *consolidate* all these transactions into a few aggregate concepts that allow us to understand what occurs at the macroeconomic level?

The answer is affirmative, and came independently from two economists, one American and the other Polish, in the 1920s and 1930s, respectively. The former was Jerome Levy and the latter Michał Kalecki.<sup>6</sup> Kalecki, who was one of the first economists to work with concepts of national accounting (which was developed in that era), arrived at the “profit equation” in a very elegant and simple way.

If we start from the GDP identity and suppose a closed economy, without government (assumptions that we will remove later), and with two types of households, capitalists (who save a part of their earnings) and workers (who save none of their wages), the GDP accounting identity on the income side and on the expenditure side is:

$$Wages + Profits = Capitalist consumption + Workers Consumption + Investment$$

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<sup>4</sup> The profitability of a share can be broken down into the sum of the dividend yield, the growth of earnings per share and the change in the valuation multiple.

<sup>5</sup> In reality, there is abundant historical evidence that shows that during the parts of the cycle with very elevated valuations, the level of share buybacks is greater, and vice versa, when the valuations are more depressed the volume of new shares issued is greater. All in all, the effect of share buybacks on profitability in the long term can hardly be positive.

<sup>6</sup> Due to its simplicity, from now on we will follow Kalecki’s explanation, but Jerome Levy was the first to arrive at the profit equation independently. Nowadays, his grandson, David Levy, follows in his grandfather’s footsteps as the head of his company, *The Jerome Levy Forecasting Center*, in which they carry out not only macroeconomic analysis of the American economy but also of the rest of the world. For a detailed explanation of the profit equation by David, consult his thorough analysis in the following link [Where Profits Come From](#).

And as we have assumed that workers do not save (workers' wages is equal to their consumption), the former equation can be reduced to:

$$\text{Profits} = \text{Investment} + \text{Capitalist consumption}$$

The previous equation is an accounting identity, a logical truism that is always satisfied, but this does not allow us to determine the causality of the equation (is the investment and capitalist consumption what determines the volume of profits or vice versa?). Accustomed to thinking at the microeconomic level, we would conclude that if profits are not earned there is no possible investment, but at a macroeconomic level this is not the case. As Kalecki brilliantly explains:

*“The answer to this question depends on which of these items is directly subject to the decisions of capitalists. Now, it is clear that capitalists may decide to consume and to invest more in a given period than in the preceding one, but they cannot decide to earn more. It is, therefore, their investment and consumption decisions which determine profits, and not vice versa”.*<sup>7</sup>

If now we remove our previous assumptions and introduce a government, an open economy, a split by institutional sectors (households, businesses and government) instead of savers (capitalists and workers) and the possibility that households save, we are left with this equation:

$$\text{Profits} = \text{Investment} + \text{Dividends} + \text{Government deficit} - \text{Current account deficit} - \text{Household savings}$$

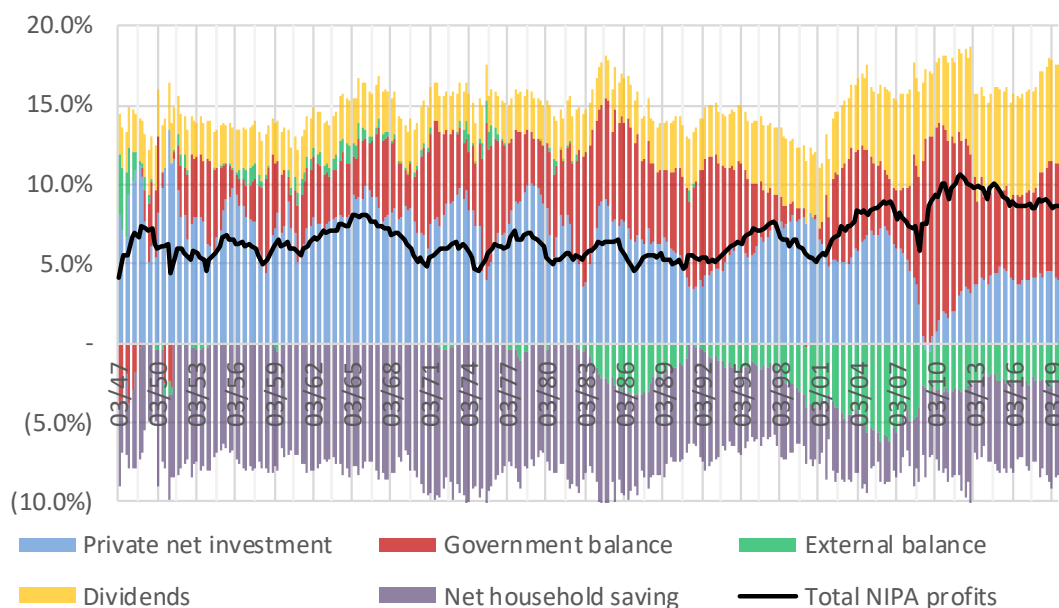
This equation has three advantages regarding the *bottom-up* framework utilized by the majority of analysts. The first, is that it helps us to understand how corporate earnings have been generated at a macroeconomic level, showing us if they are sustainable, and most importantly, if it is consistent with the behavior of the rest of the macroeconomy. Secondly, it is an equation that uses concepts seen in modern systems of national accounting, and therefore has direct application. Thirdly, national accounting series are homogenous over time, which allow us to extract conclusions from the past and view these in the light of actual experience.

If we apply the Levy-Kalecki profit equation to the US economy, this is the resulting graph:

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<sup>7</sup> Kalecki, M. (1956), *Theory of Economic Dynamics: An Essay on Cyclical and Long-Run Changes in Capitalist Economy*.

**Graph 1: Levy-Kalecki profit equation (NIPA profits from national accounting), United States, 1Q'47-3Q'19, as a % of GDP**



Source: Bureau of Economic Analysis and own elaboration.

As one can see in Graph 1, corporate profits have been historically fluctuating between 5% and 10% of GDP, without a clear long-term trend.<sup>8</sup> The most noteworthy is that the profits (as a percentage of GDP) of the last decade have been above the historical average, being the mean 9.7% since the third quarter of 2008 as opposed to 6.4% for the period 1947-2008.

Graph 1 also shows us how different the sources of profits have been over time. During what is considered the “golden years” of capitalism (the 1950s and 1960s), profits were generated through net investment in the private sector (firms and households) and by an ever-increasing government deficit, whereas elevated household savings were the main detractor. Since the fall of Bretton Woods at the beginning of the 70s and as a result of the permanent position of the US as a debtor versus the rest of the world, current account deficits have been a drag to US profits. Corporate profits as a share of GDP reached a historical maximum in the wake of the 2008 housing crisis, thanks to the elevated government deficits. Since then, profits have been supported by them (in recent years, more concretely, by the corporate tax cuts of the Trump administration), lower household savings and elevated dividend payments – which are partly consumed by households and return as earnings to firms.<sup>9</sup> Finally, despite living in a time of economic innovation and of needing an increasingly young capital base due to technologies becoming obsolete, net investment volumes have been falling during the last decade, not exceeding in any year 5% of GDP – which has supposed that the capital *stock* of the economy has aged over the last decade. Although from this macroeconomic perspective the philosophy of *downsize and distribute* over the last three decades (to buy back shares and to not invest for the long-term, so criticised by individuals such as [Larry Fink](#) or [James Montier](#)) can make sense for shareholders of (some of) the individual firms in question, at a macroeconomic level the lack of investment has punished the generation of US profits as a whole.

From this long-term point of view, the current level of earnings with respect to GDP is reasonable and has little upside potential. If one expects earnings to stay at this level, then one would expect the growth of earnings to be the growth of GDP. Although it is futile to guess how much future GDP growth

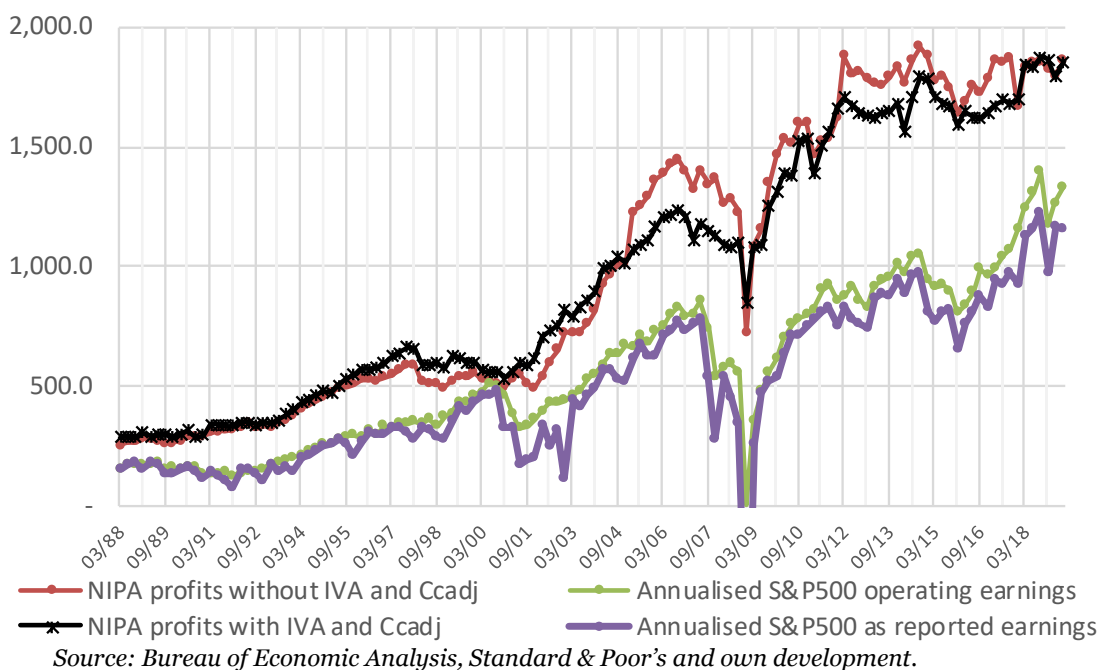
<sup>8</sup> Corporate earnings do not include the part known as “mixed income”, arising from those firms that are not incorporated (for example, sole proprietorships or *partnerships*). Given that in these firms it is difficult to separate the added value between labour and capital, mixed incomes are a different part from wages and corporate earnings in national accounting.

<sup>9</sup> As the graph shows, the improved performance of the balance of payments has contributed to an increase in the profit share of approximately 3% during the last decade. Although one cannot assert from the graph, the improvement has come almost exclusively due to the improvement in the US energy balance as a result of *fracking*, having reached the US for the first time in a while a balance of zero (imports minus exports). Although one would be able to conclude prematurely from a sectorial point of view that *fracking* firms have generated negative earnings and that therefore their contribution to the US economy is negative, their effects to aggregate profits goes beyond that, for example through the payment of (high) wages that tend to be consumed domestically or through investment in machinery, as both concepts are beneficial for firms of other sectors. This is an excellent example of how a macroeconomic perspective offers a superior understanding to the traditional and narrow *bottom-up* frameworks.

will be, given our current stage of the economic cycle it is reasonable to think that it will grow in real terms between 1% and 2%, so our best estimation of future earnings growth (in real terms) is between 1% and 2%.

The series of corporate earnings that we have used from national accounting are not, obviously, the earnings of the firms from the S&P500, as they represent the earnings obtained by all the firms within the US and not just the 500 components of the index. As we are interested in making an estimation about the returns that the S&P500 will give in the next decade, it is natural to question how different both earnings series are. In the following graph one can see the comparison, in dollars, of the NIPA earnings versus the profits earned by S&P500 firms:<sup>10</sup>

**Graph 2: NIPA Profits vs. S&P500 Operating Earnings, for the United States, 1Q'88-3Q'19, in billions.**



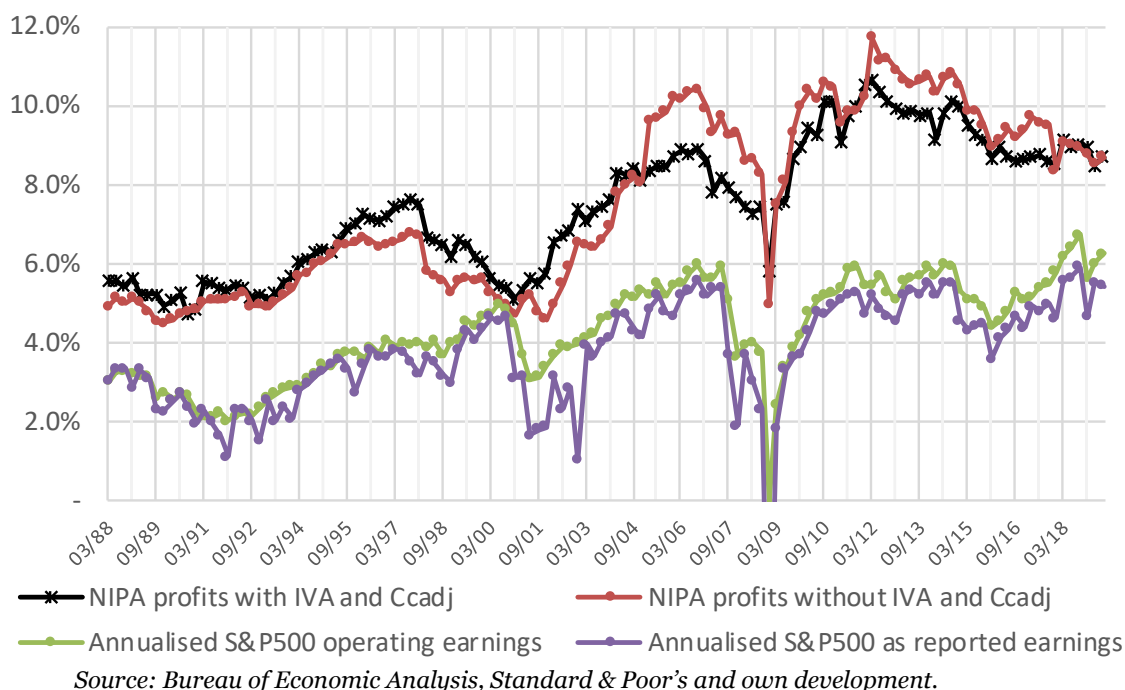
As one can verify, whilst the earnings of the entire American corporate sector have remained generally constant over the last 6 years (in the range of 1.8 trillion dollars), the S&P500 earnings (both those reported and operating)<sup>11</sup> have moved from 1 trillion to 1.4 trillion in the third quarter of 2019, representing an increase of 40%. The following graph shows the same information, but compares both series in relation to the GDP:

<sup>10</sup> The main difference between NIPA profits from the national accounts and the earnings of the S&P500 is that the former are earnings obtained by firms whose activity is developed in the US, whereas the latter are obtained by firms that tend to have international operations. To understand the rest of the differences, see Hodge, A. (2011), [Comparing NIPA Profits with S&P 500 Profits](#), Bureau of Economic Analysis.

<sup>11</sup> Standard and Poor's offer historical series about both reported earnings (that comply with GAAP standards, and excluding discontinued operations), and operating earnings, not a GAAP concept in which the firms have freedom to remove one-off items. As one should expect, such a freedom always works in the same direction, making the operating earnings to be higher than the reported ones.



**Graph 3: NIPA Profits vs. S&P500 Operating Earnings, for the United States, 1Q'88-3Q'19, as a % of GDP**

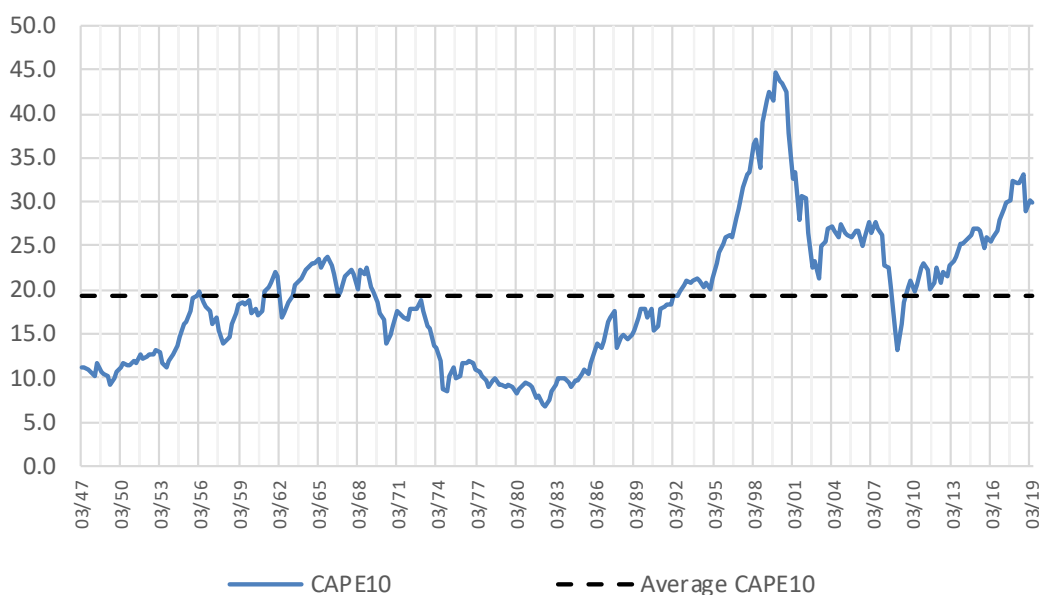


One can clearly see how, during the last economic cycle, the returns from the S&P500 have been increasingly gaining share in terms of total earnings in the US economy. A large part of this phenomenon has been the well-documented dynamics of sectoral concentration that has occurred over the last few years.<sup>12</sup> However, another significant part includes the differences in how the accounting is carried out, with the S&P500's accounting being all the more optimistic than that of national accountants. At the end of the 90's, in the midst of the .com bubble, the reported earnings for the members of the S&P500 increased in a consistent manner, whereas aggregated earnings notably reduced having reached a maximum in 1995-97 (in reality, in accordance with the accounting of the S&P500 firms their earnings were equal to those of the economy as a whole!). However, as the aggregated earnings are given strictly by macroeconomic considerations as we have previously seen, the earnings of the S&P500 have a ceiling above which they are unable to grow. That is to say, a reasonable assumption is to presume that the earnings of the S&P500 will grow in line with NIPA earnings during the coming decade, and that in turn (if the profit share remains constant with respect to GDP) they will grow in line with GDP— between 1% and 2% (in real terms).

Finally, the last component for our estimation of stock returns are the changes in valuation multiples. As we mentioned at the beginning of the Appendix, the changes in valuation multiples are the most unpredictable and those that have the most impact on short-term performances. However, in the long-term its importance gradually declines. To gain some perspective, the following graph shows the evolution of one of the most followed indicators, Shiller's CAPE10, since the end of World War II, as well as its historical average ever since:

<sup>12</sup> For an interesting account of the concentration process, view Tepper, J & Hearn, D. (2018), *The Myth of Capitalism: Monopolies and the Death of Competition*.

**Graph 4: Cyclical Adjusted Price-Earnings (CAPE) Ratio, S&P500, 1Q'47-3Q'19, in relation to average earnings over the last ten years**



Source: Robert Shiller webpage and own elaboration.

As one can appreciate, the graph shows the well-known fact that valuations have not been so expensive since the end of the World War II – with the exception of the .com bubble, in which on the other hand high valuations were more confined to a segment of the market. A correction of, let us say, at a multiple of 25x, still above the historical average (which we believe is reasonable, as we think that future valuations will be above their historical average, for reasons that we will explain in another letter), would assume a fall of 16.6%, or 1.8% if annualised. A reversal to 20x would suppose a fall of 33% (or approximately 4% if annualised). The previous arithmetic does not take into account, of course, the sudden movements that are usually the changes in valuation multiples, having a much more disproportionate influence for an investor with shorter time horizon.

Finally, if we compile a table of all the aforementioned analysis, our best guesses of the S&P500's returns, and its spread regarding government fixed income, they are the following:

**Table 1: Summary of future return scenarios for the S&P500, for ten years' time, in relation to ten-year government bonds**

	Historical average (CAPE10 20x)	"New Normal" (CAPE10 25x)	Constant multiple (CAPE10 30x)
Dividend yield (as of 13/Jan/20)	1,8%	1,8%	1,8%
Earnings growth per share	1,5%	1,5%	1,5%
Changes in CAPE10	(4,0%)	(1,8%)	-
<b>S&amp;P500 annualised return, in real terms</b>	<b>(0,7%)</b>	<b>1,5%</b>	<b>3,3%</b>
Inflation	2,0%	2,0%	2,0%
<b>S&amp;P500 annualised return, in nominal terms</b>	<b>1,3%</b>	<b>3,5%</b>	<b>5,3%</b>
YTW 10Y US Treasury (as of 13/Jan/20)	(0,5%)	1,6%	3,4%
Equity risk premium	0,8%	5,1%	8,7%

Although we are not as pessimistic as John Hussman's article, which we mentioned in the introduction, there is definitely a reasonable possibility that the equity risk premium is negative for the next decade. In any case, this differential is far below the historical norms, suggesting that in relative terms that valuations of equities are also extremely inflated.

### Summing up:

- The Levy-Kalecki profit equation allows for a better understanding of corporate earnings as opposed to traditional *bottom-up* analysis. At a macroeconomic level, the earnings are not given by cost efficiency or technological change, to provide some examples, but instead by five well-defined macroeconomic variables that provide an organic understanding of the behaviour between earnings and the rest of the economy.
- US profits, as a share of GDP, have been at historically elevated levels during the last decade, despite the fragile investment performance. Given that they are currently at 8%, it is most reasonable to assume that they will grow in the future in line with GDP, or a range of 1%-2% in real terms.
- S&P500 earnings have grown in recent years at a rate above that of aggregated earnings, suggesting that the concentration of profitable firms has increased significantly over the last few years. Given that the earnings of the S&P500 cannot rise above the aggregated earnings of the entire economy, and that the latter are given by macroeconomic variables, it is most rational to assume that the earnings of the S&P500 will grow, at most, at the rate of aggregate earnings – between 1% and 2% in real terms.
- Given the current dividend yield of the S&P500, 1.8%, and without bearing in mind the changes in the valuation multiple, the S&P500's expected real earnings for the decade will be between 2.8% and 3.8%. If we assume a reversal in the historical series of CAPE10 at a level of 20x, annualised earnings (real) fall at -0.7%; for a level of 25x, annualised earnings will be 1.5%.

At this point, it is difficult to see any merit in Keynes' dictum about the incentives of market participants, in which "[w]orldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally". In our opinion, when the likelihood of any wager is so against you, unconventional paths are the only ones that make sense.

Jacobo Arteaga  
Portfolio Manager

Javier López Bernardo, Ph.D., CFA  
Portfolio Manager

