DORVAL ASSET MANAGEMENT
DONNER DE LA VALEUR À VOS VALEURS

October : Geopolitics and the equity premium puzzle

October 7th 2024

Dear Clients and Partners,

With October – often a gloomy month – in full swing, rising risks in the Middle East inevitably put investors on edge. It is worth bearing in mind at this point that fear of "black swans" is paradoxically the reason why equity markets offer such attractive long-term returns.

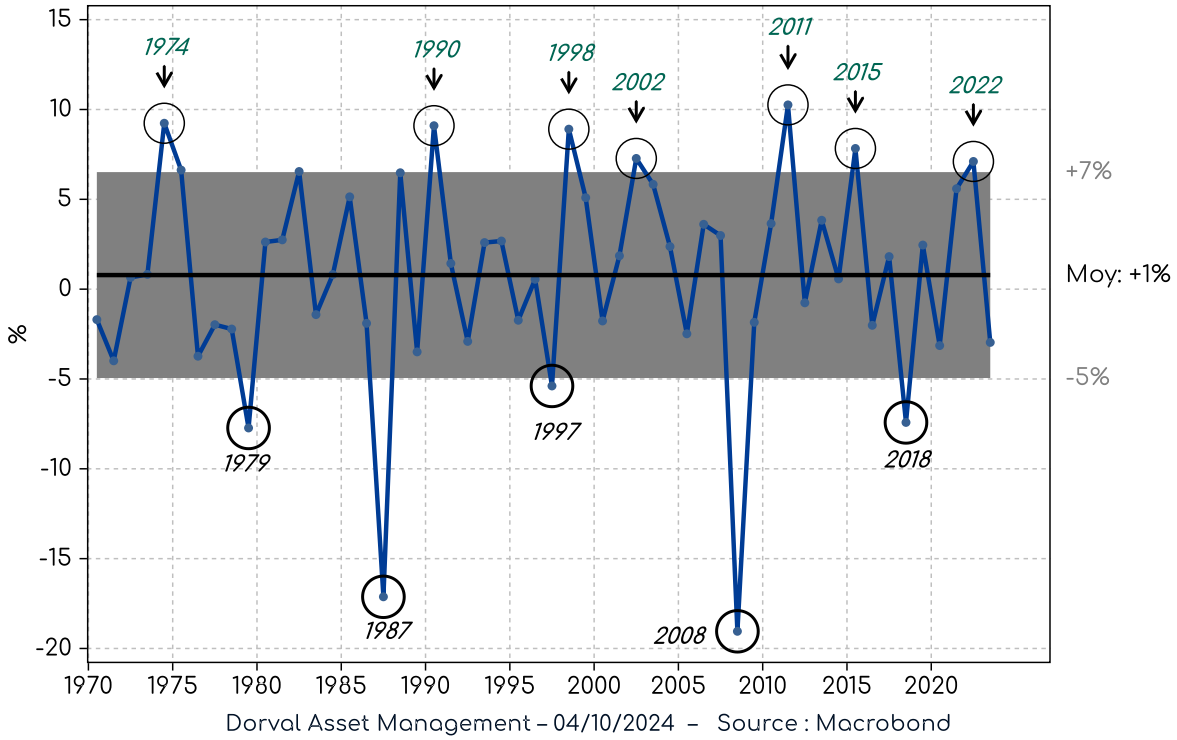
Since the stock market crash of 1929 (24 to 29 October), October has gained a terrible reputation among savers. The events of 1987 (Black Monday, 19 October) and 2008 (where the stock market fell nearly 20% in October, following the Lehman Brothers' bankruptcy) have only reinforced the superstition. Since 1970, the stock market has significantly dropped five times in October (1979, 1987, 1997, 2008 and 2019), with declines ranging from 5% to 20% for the MSCI World in dollars (chart 1). On average, however, the MSCI World has risen by 1% in October since 1970, with a standard deviation of around 6% from this average. And on seven occasions, the market rose by more than 7%.

Stock market performance in October since 1970

Each data point represents how the MSCI World performed (in dollars) between the end of September and the end of October each year

Le mois d'octobre en bourse depuis 1970

Chaque donnée représente la performance du MSCI Monde (en dollar) de la fin du mois de septembre à la fin du mois d'octobre de chaque année



Dorval Asset Management – 04/10/2024 – Source : Macrobond

It remains to be seen how October 2024 will fare. But increased risks in the Middle East, where Israel is reportedly planning a large-scale attack on Iran's oil facilities, are naturally making investors quite nervous. The fall in energy prices since spring has in fact automatically helped stabilise this uncertain period in the global economy. The rise in oil prices remains very modest at this stage (chart 2), but everything will depend on the level of escalation resulting from events, and the reaction of Arab countries. Most geopolitical commentators don't believe that the conflict is going to spread on a wide scale, but only time will tell.

Despite growing tensions in the Middle East, the price of a barrel has barely risen so far

Malgré les tensions croissantes au Proche-Orient, le prix du baril n'a que très peu remonté pour l'instant

Dorval Asset Management – 04/10/2024 – Source : Macrobond

With bad memories associated with October and the current geopolitical tensions, we can't help but think of how most savers see the stock market: a very volatile market where you can sometimes lose a lot of money in a few days. This is undeniably true, but the frequency and duration of these negative events are significantly overestimated. That is actually one of the reasons why equities perform so well over time, because investors value equity markets as though the risks are much higher than they actually are.

This equity premium puzzle has been extensively studied by specialists since a famous article published in 1985 by Rajnish Mehra and Edward C. Prescott. According to them, the theoretical equity risk premium (against bonds) should be less than 1%, whereas historically, equities earned an average of 3% to 6% more per year than government bonds over a long period. In 1988, Thomas Rietz suggested that the abnormally high equity risk premium could be partly explained by fear of very rare but extremely serious events, such as economic depressions and world wars, an idea that was seconded by the economist Robert Barro in 2005. Conclusion: As long as global tensions do not turn into a lasting economic and financial catastrophe, equity investors receive an excessive risk premium, and therefore largely make more profit than money-market and bond investors.

This is what we have seen since the beginning of this turbulent decade. Despite COVID-19, the war in Ukraine, inflation, high rate hikes and geopolitical and trade

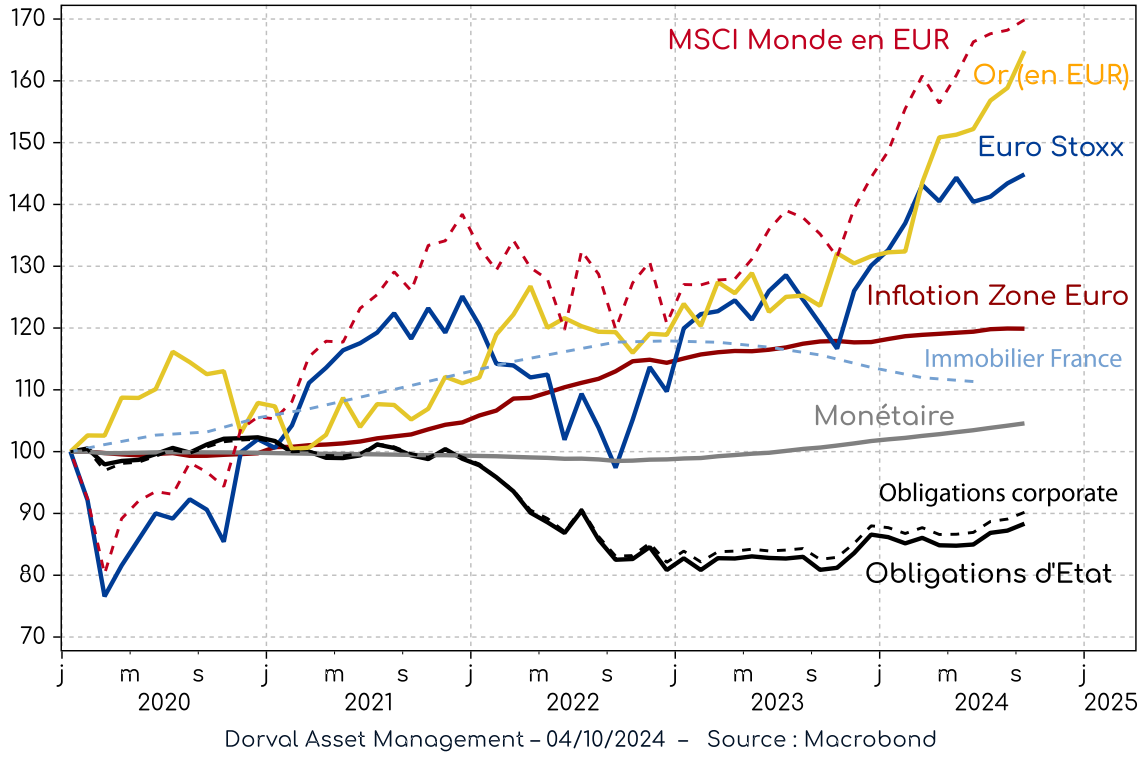
tensions, global equities (+70%) and European equities (+45%) performed better than all other conventional liquid assets, and rose significantly more than inflation (chart 3). Only gold has been able to compete with equities over this period. Despite equity markets performing extremely well, according to our calculations, the prospective equity risk premium remains promising across the board compared to government bonds, standing at +2.9% for the S&P 500, +3.5% for the MSCI World, +4.7% for the MSCI World Equal Weighted and +7.1% for the Euro Stoxx 50.

A very turbulent decade, and yet...

Total return performance of different asset classes, vs inflation

Une décennie très agitée, mais....

Performances "total return" de différentes classes d'actifs, vs inflation



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MSCI World in EUR / Gold (in EUR) / Euro Stoxx / Eurozone inflation / French property / Money market / Corporate bonds / Government bonds

Our exposure rates are as follows:

- Dorval Convictions: 65% net exposure to equities, comprising 60% Euro STOXX 50 SRI core basket, 6.5% financials basket, 7% small-caps basket. Hedged using Euro STOXX 50 futures.

Dorval Asset Management

Public limited company with share capital of €493,876

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