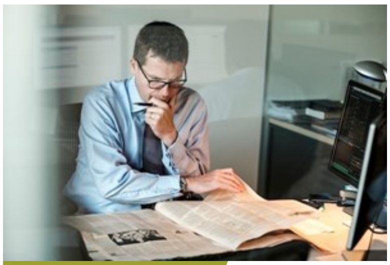

Friday Morning Coffee

Nr. 111 — The Real Deal

Bond veteran Bill Gross is taking a break from his retirement on the golf course and is back with an interesting, entertaining, and well written monthly investment letter (https://williamhgross.com/investment-archive/). As value investors, we take note that he is focussing in his July piece on the reasons why the Fab 5 US Megatech stocks (Microsoft, Google, Apple, Amazon, and Facebook) and growth stocks in general have done so well in the stock market in the recent past compared to value stocks. From his bond perspective, he makes the link to real interest rates, the nominal rates minus inflation. He refers to the Gordon dividend discount model that is stating that the price of a stock is the present value of its future dividends :

$$P = \frac{D}{r - g}$$

Where “P” equals stock price, “D” equals the current dividend, “r” the required rate of return, and “g” the expected growth rate.

According to Gross, the massive central bank intervention and government spending we have seen since the financial crisis and that has culminated during the COivd-19 pandemic has ruined the “apparent logic of this formula’s logical approach to investing” because the price of dependable growth stocks is now much more influenced by declining real interest rates than by anything else. Indeed the long term growth rate of Microsoft and alike is not influenced by the pandemic, if anything, it may even have increased recently due to accelerating digitalization. Gross is proving his point by measuring real interest rate with the so-called TIPS, the treasury inflation-protected securities. According to Gross, 85% of the stock price performance of Microsoft over the last 2 years could be explained by the movement of the TIPS: each time the TIPS went up, the stock price of Microsoft went up and vice versa.

What does this mean for the European value investor?

On the graph below we show the performance of growth against value and real interest rates in Europe over the last 2 years. Growth stocks have outperformed value by 33% (white line). The yellow line is a European counterpart of the TIPS, in our example the Amundi Euro Inflation ETF which is a good proxy for real interest rates in Europe. We conclude that the dynamic is the same in Europe than the one described by Bill Gross: real interest rates can be seen as an important driver of relative performance of growth stocks against value. Each time the price of inflation-adjusted bonds rise (i.e. real interest rates fall), growth outperforms strongly and vice-versa. This was strongly visible during the initial phase of the Covid-19 crisis.

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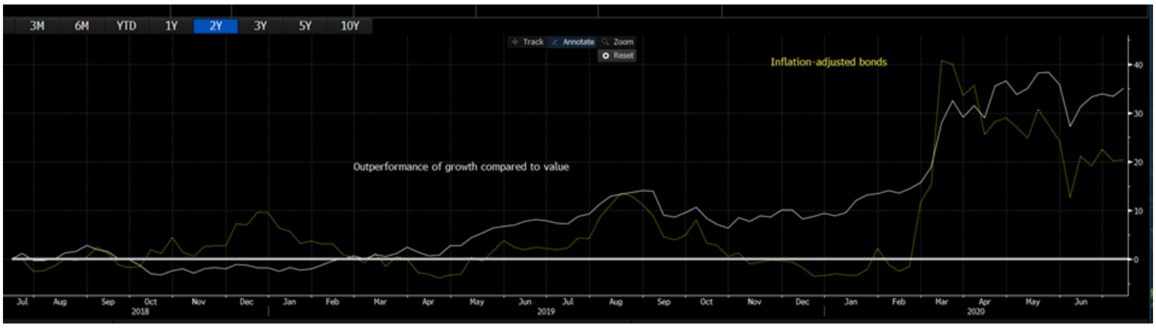

Source: Bloomberg

To us, investing is all about the future and not about the past. Here, according to Gross, "the ongoing decline in real rates, …, have seen their best days.". As value investors, we definitely hope the bond guru is right.

I wish you a nice weekend,

Léon Kirch, CFA

Partner & Chief Investment Officer

July 17th, 2020