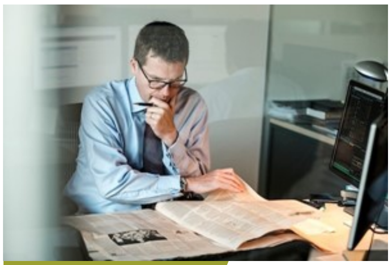


Friday Morning Coffee

European Capital Partners

Nr. 124 — The perfect hedge

It is not a surprise that interest rates are at rock bottom levels. An already anaemic economic activity has been slowed down further by the pandemic pushing central banks to inject unseen amounts of liquidity into our financial systems. For the moment at least these monetary policies are not leading to inflation and hence to higher rates. This environment is not favourable for value investors as the traditional industries they are investing in are facing headwinds. Financials are hurt by shrinking net interest margins and risk higher loan losses in a post Covid-19 world. Cyclicals are held back by lower business activity and energy companies by falling oil prices. This explains why so many investors are loading up their portfolios with what they think is 'defensive growth', stable quality companies like Nestlé or big Techs like the FAANG's. Valuation does not really matter as interest rates are low and the sheer concept of discounting future cash flows with a risk free rate at 0% is questionable.

To us, 3 important lessons of humility from the long history of the (sometimes random) walk on Wall Street are:

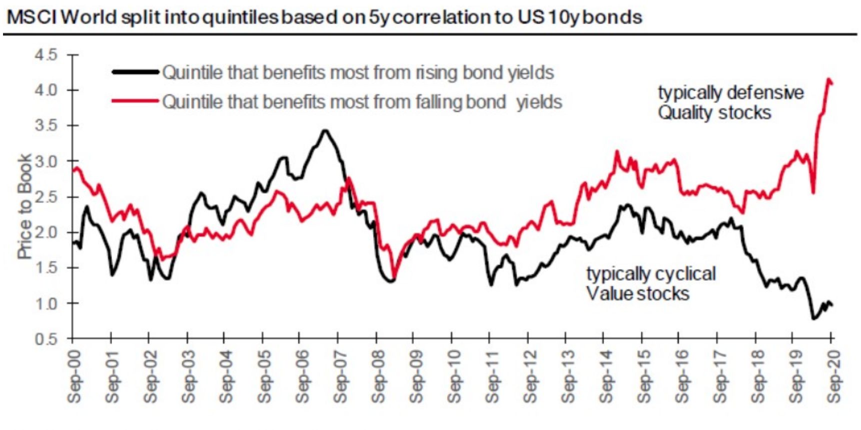
1) We only clearly identify the existence of bubbles once they burst

2) The risk of bubbles is the highest in the most overcrowded trades

3) Hedging is better than feeling sorry

What would happen in the case of reflation and rising bond yields as monetary and government stimulus works as the world gets past the pandemic? If history is any guide, this will not only be bad for bond investors but also significantly hurt the highest valued part of the equity markets.

This is illustrated very nicely in the below graph taken from an excellent research piece published this week by Andrew Lapthorne and his team from SG Research (Global Quantitative Strategy: What is wrong with Value?). It is the defensive quality stocks benefitting most from falling bond yields (red line) that have strongly outperformed and saw their valuations expand. On the other side of the spectrum, the stocks benefitting most from rising bond yields (black line) have been left in the dust.



Source: SG Cross Asset Research/Equity Quant, FactSet, FTSE

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This leads us to the conclusion that it could be an opportune moment to diversify portfolios by adding what appears to us a good hedge against rising bond yields: value stocks.

I wish you a nice weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
October 16th, 2020