Friday Morning Coffee

European Capital Partners

Nr. 132 — Christmas double edition: A punch in the mouth

One year ago, in the Christmas double edition of December 19th 2019 of our Friday morning coffee we summed up the status in valueland with 4 statements illustrated by graphs :

1. European equities are attractively valued
2. Positioning in European equities remains light
3. Signs of improving business sentiment in Germany
4. Interest rates start to provide support to value

As the boxer Mike Tyson has famously said : "Everyone has a plan until they get punched in the mouth", value managers got a real financial knock-out blow from the pandemic. Low valuations were of little support when the lock-down measures brought our economies to a stand-still. Not only did value stocks fall more than the market overall as investors reallocated capital into perceived quality of technology and into so-called stay home stocks. Also value as an investment style did not manage to recoup its underperformance compared to growth in the run-up of stock-markets since the through in the markets mid-March. With only a couple of trading sessions left and a rally in November, MSCI Europe Value TR has still underperformed MSCI Europe Growth TR by 16.3% this year. While statements 1 and 2 we made in our Morning Coffee a year ago did no longer matter, business sentiment plunged during Covid-19. Parallelly central banks made sure to keep interest rates as low as possible.

We are now approaching a festive season where we celebrate in a difficult context of social distancing measures, where there are still too many Covid-19 casualties and our healthcare systems remain stretched. We will also celebrate in an environment of economic uncertainty where whole industry segments like travel and restaurants continue to bleed cash. From an investment side however, I am strongly convinced that things have started to turn for the better for us value investors.

So again, I will summarize our main convictions in 3 statements and a couple of graphs:

1. The rubberband is overstretched

We often compare the valuation difference between value and growth to a rubberband. The more it stretches, the more unstable it becomes and the higher the probability of a normalization process where value stocks outperform. The rubberband is currently extremely stretched, both in Europe (left graph) and in the US (right graph) as the valuation spread between the most expensive and the cheapest stocks in the market is the highest since the peak of the dotcom bubble.

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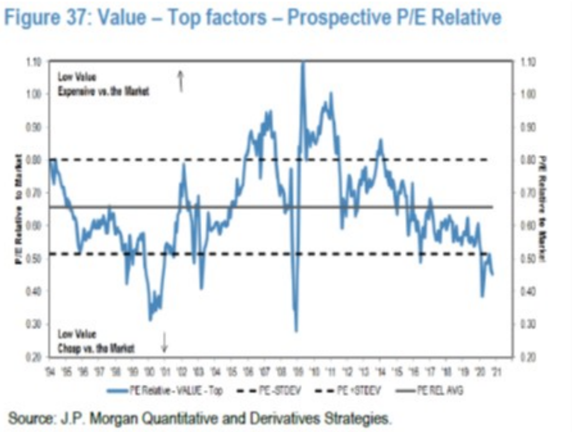
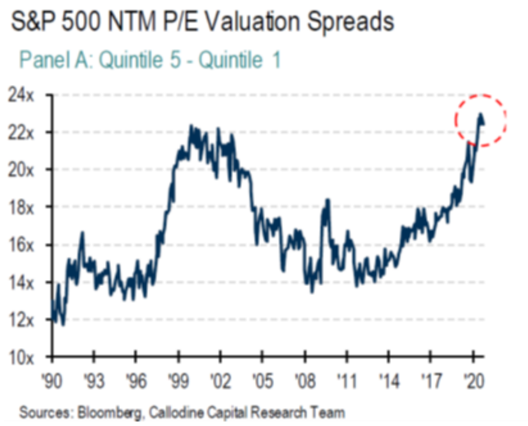


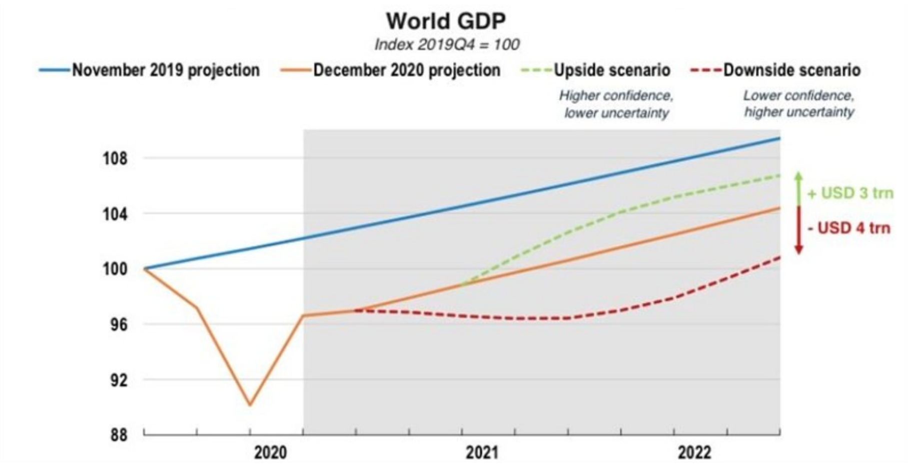
source: JPMorgan



source: Bloomberg, Callodine Research

2.Normalization will happen rather sooner than later

Covid-19 is an external choc and its impact is limited in time. We know since October that vaccines are going to be deployed on a large scale over the coming months and we could well end up in the most positive scenario forecast by the OECD presented on the graph below by the green line. In the meantime, both governments and central banks support the economies.



source: OECD

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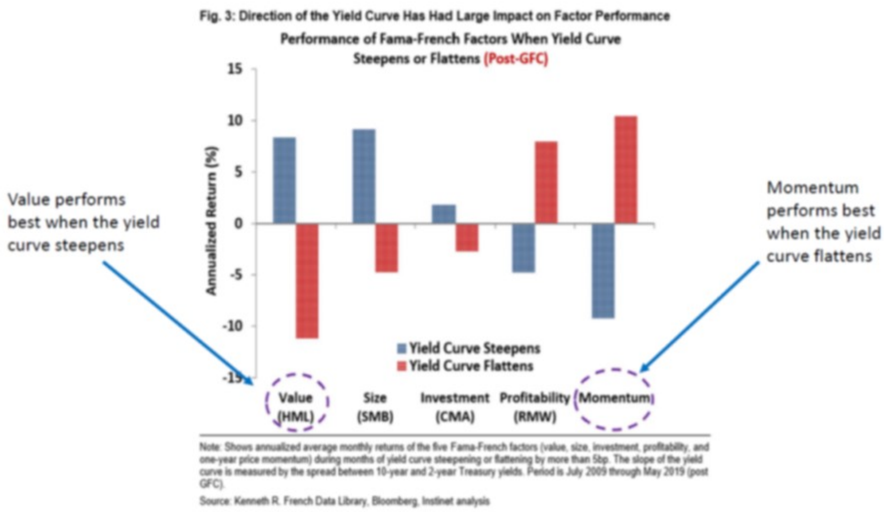
3. Mr Market starts to anticipate rising interest rates.

To us the number one trigger to a return in favour of value is reflation due to better economic conditions. Better economic conditions ultimately lead to higher interest rates. The yield curve starts to steepen in the US as investors start to anticipate higher interest rates. Since August last year where the yield curve was flat to slightly inverted the gap between the 10 year yield and the 2 year yield for Treasuries has increased to 81 bps. This has not happened in Europe yet, we would however expect a similar pattern once economic conditions normalize.

source: Bloomberg

Such an environment is extremely supportive for value as can be seen from the graph below.



source: Simon Ree, author of the Tao of Trading

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For 2021, the going in position for us value investors appears very promising. At ECP, we believe that the rotation into value, of which we saw only a glimpse in November 2020, has much further to go for the reasons mentioned above. Therefore, we have our boxing gloves on and will not let anyone punch us. 2021 could well show an epic return of value in round 8 !

The whole team of ECP wishes you a Merry X-Mas and a good start into the new Year.

Stay safe,

Léon Kirch, CFA

Partner & Chief Investment Officer

December 18th, 2020