Friday Morning Coffee

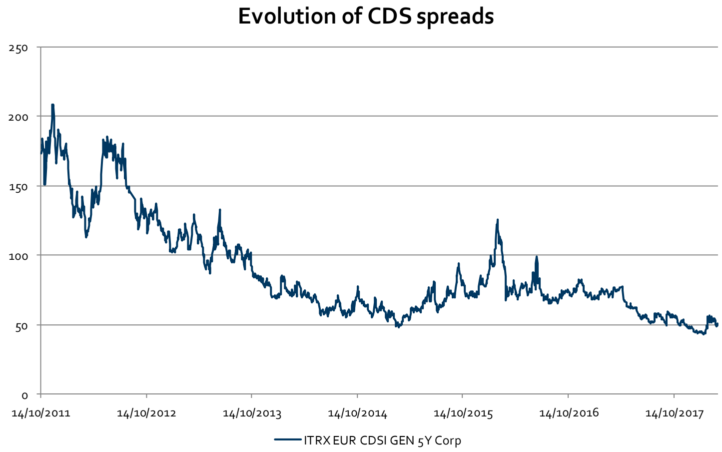
Nr. 2 — *Short Bonds Or Go Long European Value Equities?*

As an investor, you must be wondering right now if it is this still a good time to be long bonds. Interest rates have started to move up as the market is building in higher inflation expectations.

The equity nerds we are would have expected the yield curve to steepen in the way we learned at business school. However, this did not happen and we are scratching our heads as the difference between the US 10-year and the 2-year bond yield, a good measure of the steepness of the yield curve, is at low last seen before the 2007-2009 recession.

On the other hand, the inflation-linked bonds, the so-called TIPS, are sending the opposite signal as they started to move upwards with higher inflation expectations. From our humble perspective, we suspect that the bond market has not fully adapted yet to the new reality and long-term interest rates will continue to move upwards. So, to us, buying bonds with longer maturities, in effect taking duration risk, does not appear a profitable strategy.

And what about taking credit risk by buying corporate bonds? Unfortunately, the spreads of high yield bonds have been coming down continuously over the last years and are at record lows. Just have a look at the CDS spreads of investment grade European corporates.



Source: Bloomberg. ITRX EUR CDSI GEN 5Y Corp from 14/10/11 to 15/03/18

One conclusion from the above would be to go short bonds altogether. In theory, this should be a winning strategy. It is however, from our point of view, extremely difficult to put it into practice. In essence, to successfully implement a short strategy, having the right timing is essential. If you assess wrongly the timing of increasing rates, you could lose big time before being proven right.

This is why Keynes famously said *"Markets can stay irrational longer than you can stay solvent".*

The following note gives the opinion of the Investment team at the time of the publication. Please refer to important notice at the end of the document.

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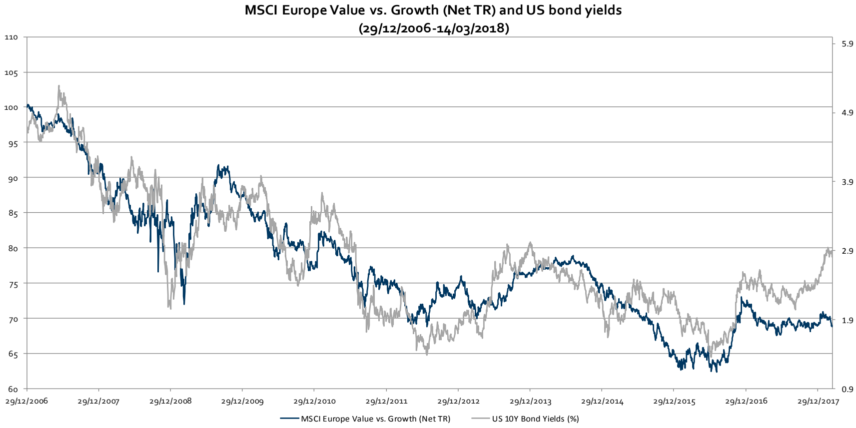
Fortunately enough, we may have an alternative for you: instead of shorting bonds, you can go long European value stocks.

Indeed, **history has shown that European value stocks have a strong tendency to outperform growth stocks when bond yields are going up** as this graph illustrated very convincingly.



Source: Bloomberg.

The reason of this correlation is rather simple. The value of a stock is the present value of the cash flows (or dividends) its underlying business is able to generate going forward. A so-called growth stock has a longer duration than a value stock. Indeed, a lowly valued company is expected to generate strong cash flows in the near future and not, as its growth peers, in a distant future when its growth prospects materialize. In rising rates, the present value of the income stream of the near future, i.e. value stocks, appreciate in value relative to those in the distant future, i.e. growth stocks. In other words, Value as an investment style starts to outperform Growth.

After another year of underperformance in 2017, since the beginning of the year, value has performed in Europe broadly in line with growth. We are not trying to call a false dawn here, but expect value to make a comeback soon if yields continue to move upwards.

I wish you a good weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
March 16th, 2018

Important notice