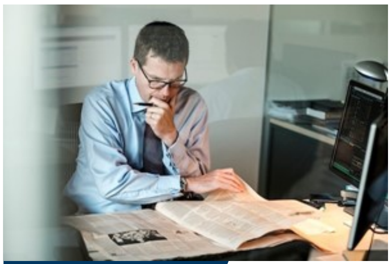
European Capital Partners

Friday Morning Coffee



Nr. 133 — Unbreakable

Happy New Year !

Just a couple of days into the new year, we already celebrated this week in Washington the premiere of a new event, called Insurrection Day under the motto : "How to embarrass the biggest Democracy in the World". We believe this was a sad day not only for the US but also a sad day for all our democracies.

"Today is a painful reminder that democracy is fragile." were the words of president elect Joe Biden this Tuesday when Trump supporters stormed US Capitol disrupting the certification of his victory. However, as he also concluded, "Through war and strife, America has endured much. And we will endure here and prevail now."

Financial markets took the events for exactly what they were: a painful distraction. The really important news was in Georgia: with the Democrats appearing to have a majority in both Houses and more leverage to push their agenda through, the reflation trade is alive and well and more government spending can be expected. Democrats have now far greater freedom of movement. This should result in more fiscal activism with higher coronavirus relief checks and more infrastructure spending. With the events from yesterday the government has now not only the political power but also the legitimacy to put through its political agenda. It will be able to respond swiftly to problems in the battle against the virus. Coordination between the Treasury (run by former Federal Reserve Chair Janet Yellen) and the Fed will at the same time be easier, again a positive for the economy.

Bond markets anticipate exactly this with 10 year bond yields above 1% again and a yield curve steepening further. The steepening of the yield curve is evidencing that investors now anticipate inflation. This is a drastic change from a little more than a year ago, September 2019, where the yield curve was inverted. We have stated many times that increased government spending and ultra-loose monetary policies will ultimately work and lead to higher economic activity and reflation. With the vaccinations being rolled out we should be starting to see light at the end of the tunnel.

source: Bloomberg

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This could therefore be the turning point to a more benign environment for us value investors. Historically steepening yield curves have been positive for our investment style for 2 main reasons :

1. Rising interest rates make value stocks more attractive compared to growth stocks as discount factors increase.
2. Reflation means stronger economic activity. Here the more cyclical businesses which are preferred by value investors, like industrials, energy, and materials, will benefit first. Equally financials, another hunting area for value investors, are benefitting from rising interest rates as their net interest margins increase and credit quality improves once the pandemic is behind us.

To this we would add the benefits from a less conflictual US political leadership that should hopefully improve some of the trade relationships between the US, China and Europe. As the reflation trade now looks unbreakable, we would expect more rotation into cyclicals/value and further pressure on FAANG's

I wish you a nice weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
January 8th, 2021