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MARKET VIEW

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How should investors react to the rise of long-term rates?

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A pertinent question for stocks from a valuation standpoint is whether profit growth expectations can continue to increase enough to offset the rise in the discount factor linked to the rise of long-term interest rates – 10-year US treasuries are now trading at 1,60%.

US equities are already pricing in a lot of earning growth: analysts' expectations for the S&P 500's EPS* growth are 24% for 2021 and another 15% for 2022. Worth noting is that long-term EPS growth expectations have skyrocketed for both US and Emerging Markets (EM) equities. In short, the main problem with US equities is that their valuations are expensive at a time when inflation and interest rates are set to rise.

What should investors do?

The equity rally is entering a risky period and we recommend a slightly more cautious stance.

Financial markets may resume selling off if evidence from the real economy corroborates the thesis of higher inflation. And make no mistake, next inflation figures are going to be much higher than the previous ones due to base effects and a transitory distortion between offer and demand.

We are not becoming bearish; we are adjusting our positioning in line with the new developments of the market. Bond yields have risen briskly over the past six months. However, they remain very low in absolute terms. While rising yields can produce a temporary stock market correction, they need to move into restrictive territory in order to trigger a recession and an accompanying bear market in equities. We are not there yet.

Concretely, higher US bond yields entail that global growth stocks will underperform global value stocks. The former is much more expensive and, hence, is more vulnerable to a rising discount rate.

Also, global equity portfolios should underweight the US, adopt a neutral stance on EM and overweight Europe and Japan. Even for Europe, we favor mostly small cap equities on an EPS growth perspective. The market-cap weight of growth stocks is the highest in the US followed by EM. In that sense, European and Japanese bourses are less vulnerable to rising bond yields. Finally, investors do not own enough energy, material, industrial and financial stocks. Conversely, they still own a lot of technological companies. The concentration of the five biggest tech caps in the S&P remains on extreme levels, even if falling a bit from their peak. Long duration stocks are at risk and their weight in the US indices is increasing the probability of a market stalling or even correcting somehow. In the technology sector, stocks with a reasonable valuation or more cyclical profile, look less at risk than higher-growth names.

*EPS: Earnings Per Share

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In a nutshell

We move from an overweight in equities to a neutral and buy the dip stance, with a significant rotation in the portfolios. We are still confident that once the market has repriced the increase of rates in the risk premium, the macro economic rebound will drive EPS sharply higher, hence valuations.

A cautious stance is granted on government bonds everywhere. Favor High Yield bonds that are more immune to a raising long-term rates environment and break evens that have further to go.
On a longer perspective we still favor quality stocks with high free cash flow generation with limited leverage. We do not forget we still live in a world where the potential growth remains subdued.

The case for commodity stocks and financial shares (with a preference for insurance companies)

A physical deficit in the metal's markets, particularly for copper and aluminum, should also persist this year. While the boom in electric vehicle (EV) production represents a long-term threat to oil, it is « the road to heaven » for many metals. A battery powered EV can contain more than 80kg of copper compared with 23kg for conventional autos. By 2030, the demand from EVs alone should amount to close to 4 million tons of copper per year, a big slug of demand in a market that consumes about 26 million tons per year. Ongoing strong demand for metals from China should also buoy metals prices. While trend GDP growth in China has slowed, the economy is much bigger than it was in the 2000s. China's annual aggregate consumption of metals is five times as high as it was back then. The incremental increase in China's metal consumption, as measured by the volume of commodities consumed, is also double what it was 20 years ago.

On a ESG* standpoint, you need to be selective and make sure the chosen companies are compliant with conservative guidelines. Nevertheless, our approach relies on a best-in-universe approach and allows us to support companies during their transition phase towards a better ESG profile.

Along with commodity producers, financials including insurance companies which generate high Free cash Flows will propel value indices. While credit growth is unlikely to revert to its pre-GFC** days, it has been trending higher in both the US and Europe. Moreover, the fading pandemic should lighten the burden of insurance or reinsurance companies. Analysts are starting to take note of improving strong financial institutions earnings prospects. EPS estimates for insurance, for instance, are rising more quickly than for tech companies on both sides of the Atlantic. Not only is the "E" in the P/E ratio likely to rise, the ratio itself will increase. Currently, US and European financial institutions are trading at 14 and 10-times forward earnings, respectively, a huge discount to the broad market in general, and tech stocks in particular.

*ESG: Environmental Social & Governance criteria
**GFC: Great Financial Crisis

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