ODDO BHF ASSET MANAGEMENT

A new paradigm ?

MONTHLY INVESTMENT BRIEF

JULY 2019

2019 continues to be marked mainly by macroeconomic data that continue to worsen and central banks' aggressive reactions to that data. Investors are now pricing in no fewer than five interest rate cuts in the United States and the resumption in quantitative easing (QE) by the European Central Bank. Anaemic inflation is serving as an alibi for the Fed and, in the absence of tax harmonization, Mario Draghi uses the last months of his mandate to avoid a recession in the euro zone at all costs. Interest rates will remain low for a long time, perhaps a very long time...

How should risky assets be priced in this new paradigm?

Historical valuation models still place lots of emphasis on discounting future cash flows. Portfolio managers leave mostly unchanged their discount rates, composed of an estimated long-term return plus a risk premium. Do they sufficiently take into account the reduction in the risk-free rate?

Growth stocks that are most sensitive to interest rates (such as luxury goods, beverages, real estate and, to a lesser extent, utilities) have recently performed completely differently from cyclicals. Justifiably so, as investors have focused above all on growth at all cost in an environment of slackening growth.

What should be done now when the valuation gap is becoming extreme between growth stocks and cyclicals?

Let's analyse the impact of a change in assumptions:

1. A cut in the discount rate

No need to be a great mathematician to understand that repricing would be huge in this case. The theoretical price of a stock based on discounting cash flows 10 years out rises immediately by 8% if the risk-free rate falls by 1% (from 5% to 4%, for example). We would then enter into a new paradigm in which cash flow growth and extent would become a discriminating factor in pricing shares. This valuation gap would then no longer be an anomaly but, rather, the new standard.

2. Factoring negative interest rates into risk premiums

The risk premium, measured as the gap between the estimated dividend yield (1/PE) and the 10-year risk-free rate, is moving back to the peaks last observed during the market collapse in late 2018.

On some stocks, the expected rate of return is 12% (with a P/E of 8) and good visibility on future cash flows. Can one decently fail to invest in stocks like this when all so-called risk-free assets offer zero or even negative yields?

3. Evaluating the disruption

A first reply to this requires a fundamental analysis of possible future disruptions in certain sectors, whether regulatory or Schumpeterian (i.e., creative destruction) in nature. But here as well, it would require us to reinvent ourselves and not just analyze traditional structured data, but also look as quickly as possible at Big Data, which alone is able to detect the new trends.

So, back to the average and catch up on discounted equities or a new standard and continuation of the current trend that favors growth companies? We would be tempted to choose the first hypothesis given the high expectations of a rate cut in view of the economic situation.

At a minimum, if the analyst / fund manager succeeds in selecting companies with such attractive risk premiums, able to withstand the current technological and geopolitical upheaval, then the performance of this type of portfolio will be sustainable over time, even in the event of a cycle reversal.

Thus, in dealing with these changes, we use artificial intelligence in the investment process of our thematic strategies. Exploring new universes to serve our clients better.

Laurent Denize
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ODDO BHF Asset Management

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