Newsletter

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INDEX House View

For investors who have passed through decades of economic cycles, current market moves continue to be defiant towards traditional economic theory. These are indeed strange times. Fears of an inflation spike seem to be reducing, as we enter the second half of March. The rise in US bond yields seem also to be stumbling somewhat, which does not necessarily mean there isn't further upside to it – looking at the 34-year long trend in US rates, the 10-year t-bill yield can go up to 2.6% from the current 1.63%, reaching its technical upper limit. US inflation is picking up slightly, now reading 1.7%. This metric too is within its long-term trend band, meaning that it is perfectly normal for inflation to rise after a period of stagnant consumer demand – a point that is anyway debatable, since high-street demand has been more than matched by online demand during 2020, making the argument that inflation remained constant rather than decrease during the lockdown period in developed markets.

In simpler words, macroeconomic trends are telling us that major metrics are simply normal. Markets might be on their way to recognized that, as a sharp correction in growth stocks – see tech and semiconductors – and other stretched industries happened in the past three weeks. We interpret this as a pause in investors' greed rather than a change in risk attitude. With the excuse of rising yields, a good number of participants (institutional, we think) might have thought that 1.63% on US 10-year t-bill is a great risk-free parking spot, worthy of exiting overvalued stocks and wait for some good equity opportunities – 1.63% nominal rate minus 1.7% inflation is a close-to-zero real rate of remuneration of your capital.

At the same time, good opportunities have recently emerged in our list of target stocks. Late in 2020 we decided to renew our market approach by placing 50% in stable, quality, solid and unique businesses, and 50% in growth stocks with solid tech, a pathway to commercialization, strong market positioning or absolute reign over operating costs. This strategic approach provides a strong basis of quality from companies that rarely see a downward adjustment of more than 30%, which essentially embodies the concept of margin of safety. The remaining portion of the strategy provides concentration on stocks with a high probability of future superior earnings growth and returns, as they contribute to the building of new industries or to the structural change of existing ones. This approach has already produced meaningful results so far into Q1, and we believe it is a good adaptation of our long-term Value Investing style to current market conditions.

This approach is also supported by the change in administration in the US, apparently towards a more professionalized approach towards global alliances and rivalries. Recently, tech bans were lifted against Chinese stocks, with a consequent market value jump – see Xiaomi. In wider terms, positive developments on the global pandemic situation are also impacting positively a general economic recovery, or at least encouraging the beginning of it. China itself is living better economic times as the pandemic gets reined in by way of vaccines – industrial production better than the past two years, investments in real estate going through the roof (equaling 2010 levels, post GFC), GDP on its way up to normalization, trade balance perfectly normalized, international transactions with the rest of the world picked up considerably (equaling pre-GFC levels in 2008). Europe is still fighting with gross political mistakes in distributing vaccines, in fact delaying economic recovery, but markets remain unperturbed by this last-minute changes – the most inclusive equity indexes, such as BE500, have reached pre-Covid 19 levels already. Last, Japan is passing through some volatile times towards economic normalization, but its weight in global GDP is only about 4%.

In this environment of general positive expectations on global economic recovery, investors do not seem to have changed their risk stance from March 2020. Yes, certain sectors cooled down, but more probably for rotational or profit-taking reasons rather than for a generalized risk-off sentiment. Many hedge fund managers have commented that it is impossible to bet against the market, specifically going short on entire indexes, geographies or industries – but it can work on single names. We tend to concur with this assessment, since we find no imminent risks that could diminish the excess of capital around, invert expectations on nascent industries or on changes to existing ones, or change the major monetary authorities' approach to the overlevered world they themselves created. It is in these conditions that we find opportunities in the equity world, as fixed income is very far from giving an adequate remuneration of capital.

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