



R-co Club – taking an alternative view

The summer has seen an intense period of news, especially at the political level, which has fuelled volatility in financial markets. In this context, Didier Bouvignies and Ludivine de Quincerot explain the strategy implemented through R-co Club.



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In global politics, the escalation of the Sino-American trade war continued to raise serious concerns among investors throughout the summer. This was exacerbated by the rhetoric of the new British Prime Minister Boris Johnson, increasing the likelihood of a “no-deal Brexit”. Uncertainty was further compounded by events in Hong Kong and Latin America, particularly in Argentina. On the economic front, the United States, which had so far shown some resistance to the global slowdown, finally published indicators pointing to a contraction, with a Markit business confidence index in the manufacturing sector below 50 and the start of a spill-over to the service sector.

In this turbulent environment, investors showed a significant preference for the “safest” assets, first and foremost government bonds, whose rates fell sharply (by around 50 basis points for the 10-year Bund and T-Bills), causing German 30-year bonds to fall into negative territory and causing an inverted US yield curve, thus increasing the probability of a recession to around 30% according to the Fed’s predictive model. On the other hand, gold, the most symptomatic asset in times of stress, has appreciated by nearly 20% and gold mines by 40% since the beginning of the year.

The apparent resilience of equity markets over the period conceals a strong divergence between sectors. The most defensive sectors (healthcare, utilities, non-durable consumer goods) saw their valuations rise following the downward trend in interest rates and the consistency of their results, while others, with medium-term results that are much more exposed to the cycle and rate levels (industrial goods, construction, banks) or with business models that could be called into question in the event of a sharp economic downturn (automotive, media), suffered seriously.

In this context, R-co Club’s performance suffered from a positioning characterised by low bond sensitivity. Its overexposure to peripheral bonds, particularly Italian bonds (which had an unusual trajectory with a 160 basis point decline over three months), as well as exposure to Spanish bonds, were focused on too short maturities to offset the negative impact of its negative sensitivity to

R-co Club

R-co Club is a flexible diversified allocation fund with no geographical constraints, invested in equity and fixed income products. It adopts a fundamentally conviction-based management approach aimed at generating medium-term performance by harnessing risk premiums and the appreciation potential of major asset classes.

Stock picking within the equity category favours stocks with attractive valuations in relation to their profitability outlook. The interest rate category is designed to be diversified in the range of issuers and flexible in terms of sensitivity and allocation.

Its management philosophy is based on strong investment decisions, avoiding the influence of short-term “fads”, sometimes against the prevailing consensus.

German bonds. The overweight exposure to equities only played a minor role, as our investments were mainly in securities with low valuations that did not benefit from the decline in interest rates, as was the case for growth stocks.

Therefore, this Autumn, two questions arise for the asset allocator. From a macroeconomic perspective, can a recession be avoided? From a portfolio manager point of view, which assets still have significant profit potential at current valuation levels?

Currently, it is very difficult to find arguments to support the view that a global reversal can be avoided. However, without ignoring the warning signals outlined above, there is evidence that suggests that it is possible, beyond the political context (an important element), to maintain moderate growth and, consequently, to normalise the valuation of the various asset classes.

Firstly, let us consider the conclusions we can draw from the movement of the yield curve. Historically, and reliably (in 7 out of 10 instances), this inversion has been a precursor to a recession. Nevertheless, currently, this inversion has taken place without a sharp rise in key rates, which have therefore not significantly affected household repayment capacity, corporate investment or the construction sector... This inversion has occurred because

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of the fall in long-term rates, and is therefore not recessive in its nature, as it may have been in the past. Also, it has not had the same impact on the real estate sector as in previous inversions which occurred under tighter monetary policies.

Secondly, although almost all business confidence indices in the manufacturing sector are contracting, the service sector is showing sustained resilience, particularly in Europe, delaying the phenomenon of contagion. Also, households are benefiting from a positive purchasing power dynamic linked to lower commodity prices, continued job creation and higher salaries. This purchasing power has not been exhausted and has led to an increase in savings rates in several major countries (8.5% of disposable income in the United States, 18% in Germany and 14% in France), contrary to what had been observed in previous end-of-cycle periods.

Thirdly, regarding Sino-American tensions, even if both sides seem to be locked in on their positions, it is important to remember that in any negotiation, it is customary to “bare one’s teeth” before making any concessions. Moreover, while Donald Trump has a significant advantage thanks to a very negative trade balance with China, the Chinese have the advantage of time, thanks to Xi Jinping’s “lifetime” mandate, while the current American President will start his re-election campaign in 2020.

Finally, the highly accommodating policy of Central Banks inevitably reduces the cost of debt, both for households and governments. Public expenditure is already making a positive contribution to growth, a situation that is tending to increase in favour of negative rates, prompting a reconsideration of Maastricht criteria. Thus, Germany, which is currently facing a technical recession largely due to its exposure to the dynamics of world trade and the difficulties faced by the automotive sector, might consider introducing stimulus measures.

In this environment, finding the right assets is a complex exercise. Traditionally, in periods of yield curve inversion, bonds have the greatest potential, as the examples in 2007, 2001 and 1993 demonstrate. However, for the time being, German bonds have a nominal rate of -0.7% and a real rate of -1.6%, compared to a nominal rate of around 4.5% in 2007 and 5% in 2001.

“Households are benefiting from a positive purchasing power dynamic linked to lower commodity prices, continued job creation and higher salaries...”



In the equity markets, risk premia have been boosted by a decline in interest rates and an excess dividend yield compared to the yield on 10-year German bonds, which is approaching 4.5%. This trend is even more obvious in the equity markets, where companies offer dividend yields of more than 7%, but nevertheless have relatively low visibility on their recurrence, due either to their high exposure to the cycle or to uncertainties about the sustainability of their business models.

While investors must generally be cautious when faced with significant flow movements, since the beginning of the year, bond funds and ETFs have raised USD 330 billion worldwide while equity funds have had an outflow of USD 200 billion over the same period, even though 30% of global debt and 60% of eurozone debt is at negative rates.

In times of high uncertainty, it is always tempting to reduce exposure. However, this would overlook the fact that during the current cycle there have been many phases of uncertainty, and panic-selling has generally proved quite costly. Once again, even if recent data has strengthened the argument for a likely recession, let us remember that in recent years, and particularly in 2016, the end of this

global growth cycle that began in 2009 has been predicted on many occasions. Therefore, to us, it seems premature to adopt a more defensive strategy, which, given the current valuation of all assets, would amount to increasing the share of money-market instruments in the portfolio.

Although, unlike bonds, money-market instruments do not carry any downside risk if the scenario improves, they are set back by a negative current yield and are confronted with a comparison with European equities, whose 13x PER allows a dividend of nearly 4% (taking into account share buybacks) without excessive distribution in addition to a strong potential in a context where fears would be allayed. Let us also bear in mind that European equity markets have practically stagnated in the last four years, despite the observed growth, the fall in the unemployment and the reductions in key rates.

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(1) Source: Bank of America Merrill Lynch, data as of 29/08/2019



In conclusion, these arguments, which certainly contradict the prevailing pessimism, suggest that the particularly high valuation of bond-related assets, and low valuation of stocks affected by the current concerns and falling interest rates, are proving to be effective in a scenario of easing fears around the Sino-American trade dispute, fiscal stimulus initiatives, and, more generally, in a context where consumers have the ability to restore the morale of industry.

With its high equity exposure and low sensitivity to interest rate risk, R-co Club, both within its bond and equity portfolios, is adopting an alternative view whereby the worst would be avoided, as opposed to a majority view that has seemingly already resigned itself to the idea that rates will not rise again. As a reminder, between June 2016 and March 2017, they rose by 50 basis points and stocks with modest valuations rose by 26% in six months.

Within the equity category we prioritise European assets by recommending a selection of large-cap stocks with low-cost valuations. These valuations

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seem attractive to us, both historically and relative to other asset classes, especially in an environment where there are no longer any real safe haven investments.

However, given the advancement in the economic cycle, the new holdings we included in the portfolio in 2019, while retaining a significant restructuring potential, are less exposed to the economic cycle than those we invested in between 2012 and 2017. Indeed, the improvement in their results will result more from the change in their competitive positioning and better operational efficiency than from the acceleration of the growth of their end markets. ■

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Performance	2019	2018	2017	2016	2015	2014	5 years	1-year volatility
R-co Club	4.0%	-12.7%	10.3%	-0.6%	8.1%	2.6%	7.4%	11.9%
40% Euro EMTS Global + 30% Euro Stoxx [®] Dividendes Réinvestis ^(C) + 20% MSCI Daily Total Return Net World Ex EMU \$ converti en € + 10% EONIA	12.8%	-4.1%	5.3%	5.1%	6.2%	10.8%	30.5%	7.2%

Source: Rothschild & Co Asset Management Europe, 30/08/2019

The figures quoted relate to previous years, past performance is not a reliable indicator of future results.



Recommended investment period: 5 years

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