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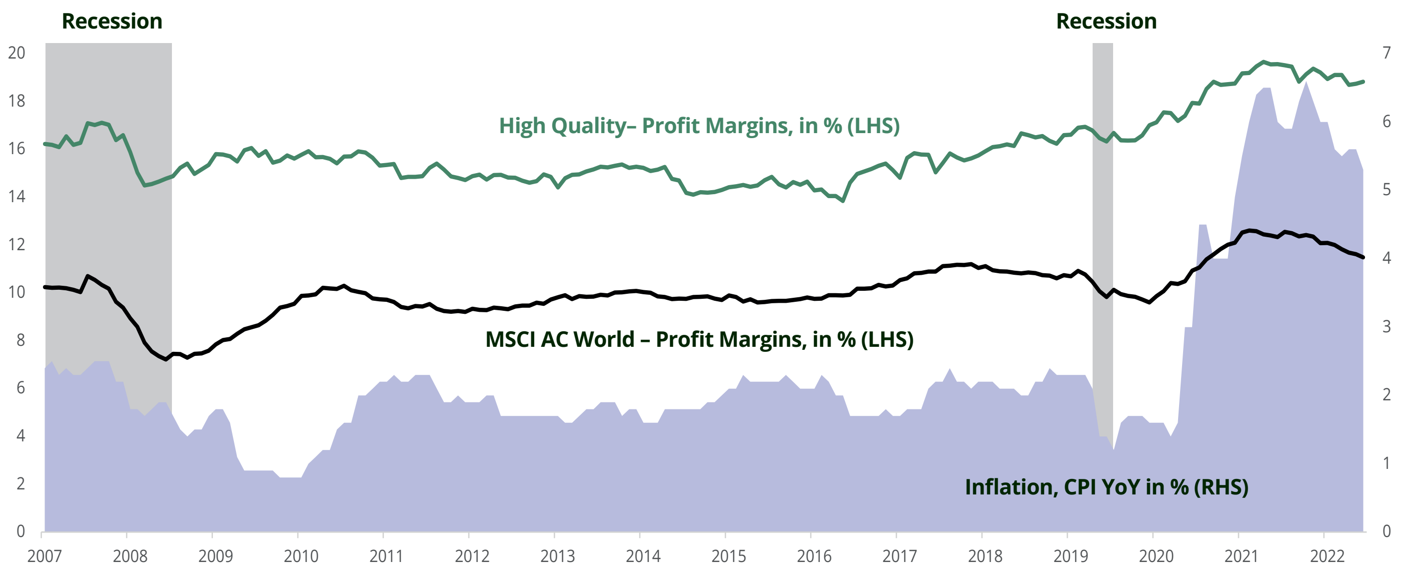
CAN ONE BE RIGHT TOO SOON?

27/07/2023 | KEVIN THOZET

A quality bias in equity selection appears to be the best approach to achieve asymmetry.

Evolution of profit margins for high quality companies and the broad market, in %



Source: Carmignac, Bloomberg as of June 2023

Equity markets entered bull market territory in June, rebounding by more than 20% since October's low. This was helped by a hypothetical Fed pivot, as core inflation rolled over last autumn and backed by an uptick in (retail) investor activity due to the chase-the-rally sentiment this year. This has pushed equity indices to one-year (and even multi-year) highs.

The corollary of the disinflation path has been a ceiling on long-term interest rates, supporting the valuation performance driver of equity markets. Indeed, the inversion of the yield curve[1] has cushioned the "typical" blow of monetary tightening[2] to equity markets. Economic resilience coupled with corporate pricing power, has provided additional breadth to the rebound, with the earnings performance driver joining the party this year.

The aftermath of this is multifaceted. The yield curve1 is the most inverted it has been for 40 years. But the second half of the year could be different as effects of monetary and fiscal tightening[2] hinder economic growth in the developed world. And investors' positioning is now far from depressed levels, **the risk-reward profile for equity markets appears more symmetrical. In this environment, we favour quality companies that display several attractive attributes.** Thanks to their economic moat they benefit from higher profit margins that also tend to be much more stable over time. And their capacity to maintain market share and the stability of their customer base provide some profit margin protection. This is a valuable characteristic following a period of dwindling sales volumes and rising prices. Indeed, going forward, one of the key questions for equity investors is how disinflation and an economic slowdown will impact spending with the risk of price wars pushing down margins.

Quality companies also tend to display lower solvency risk and the quality of a company's balance sheet counts even more when the cost of capital increases (as it has today).

It is true that these companies are more inclined to see valuation multiple compression. What's still missing today is a cooler job market, along with more palpable signs of an economic slowdown. But both are underway. This will provide an additional tailwind to quality stocks as upward pressure on interest rates abates. And, with the bulk of interest rate hikes behind us, earnings should be back in the driving seat – even more so with the Q2 results season kicking off.

As saying[3] goes "far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in corrections themselves". As we ride the market volatility, implementing a quality bias to equity selection appears to be the best approach to seek asymmetry.

[1]**Yield curve:** A Yield Curve represents a graphical representation of interest rates for bonds with similar credit quality but different maturity dates.

[2]**Monetary tightening:** When central banks aim to slow an overheating economy – which can drive up inflation – through a combination of higher interest rates and reduced liquidity injections into the market.

[3]**Peter Lynch**

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