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Europe: what if the cost of capital starts to rise?

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Since 2007, the sharp drop in interest rates has lifted the valuations of all assets, with the longest duration assets gaining the most. The UK's decision to leave the European Union has caused another flight to "safety", with a series of record lows in bond yields and record highs in bond prices. With the German 10 year yield dropping to -20 basis points, and the Swiss yield curve negative looking out 50 years, it is worth investors asking themselves the question of how their portfolios will perform if bond yields were, one day, to rise.*

Interest rate impact

The Neptune European Opportunities Fund sees rising yields, i.e. a rising cost of capital, as the pre-eminent threat for capital markets in the coming years. This threat is perceived to be more significant than Chinese economic momentum or Brexit. The Fund is therefore positioned to generate alpha in the event of a stable or rising cost of capital.

If the cost of capital were to rise, there are two mechanisms through which equities can be impacted. First via earnings from higher interest rates, and second via multiple compression from a higher discount rate. Our assumption is that if rates are to rise, it will likely happen slowly over time, and so the impact on earnings from higher interest rates is likely to be small. It is the impact on multiples which is likely to be more powerful in generating alpha.

Nestle

Nestle is a good example of a company that has seen solid multiple expansion in the last 5 years, despite no increase in organic growth. The market has been correctly willing to pay higher and higher multiples for this company as interest rates have fallen. The scope of multiple expansion has been high because of the stability of Nestle's earnings and the perceived likelihood of the company generating earnings many years into the future. It is this visibility of their earnings that provides Nestle its positive beta to falling rates. The multiple has moved from 14x to 22x earnings since 2010. However, the beta to interest rates works both ways. If rates were to rise, Nestle (or Unilever) would be susceptible to multiple compression in the same way they have benefited from multiple expansion. The perception of safety of companies of this kind might change.

Banks: earnings & valuation should rise

The Neptune European Opportunities Fund has a strong value bias. We are not looking to invest in companies that have seen large scale multiple expansion since 2007. We are looking at the reverse. We focus on companies that the market has punished as the cost of capital has fallen. The most obvious sector that has suffered as a result of falling rates has been the banks. Banks remain a clear overweight for the Fund. They are the only sector that in time could see both an earnings expansion as the cost of capital rises and multiple expansion. Dividend yields are now north of 6% in 2016 with pay-out ratios at 50%.* We believe it is an extraordinary opportunity to find a sector on trough margins and trough multiples at the same time. We anticipate this sector to be the stand-out performer for the rest of 2016 and into 2017.

Where is the margin of safety?

How else to defend a portfolio against a rising discount rate? We believe value is the best defence in this environment. Short duration companies – those that will return their market capitalisation in earnings quickly – will see less multiple compression. We focus on companies with high and rising free cash flow yields, that can pay high and rising dividends. In the first half of 2016, we found many interesting companies in materials and industrials, and to a lesser

extent in the energy sector. Within materials, Europe has many chemicals companies soon to trade on double digit free cash flow yields. The Neptune European Opportunities Fund has an overall gross dividend of 4% this year.*

The other best form of defence is to avoid expensive companies. Companies trading at high multiples of earnings and/or high multiples of cashflow, will be more vulnerable. We see the majority of these companies that are at risk of multiple compression in consumer staples and healthcare.

The political and economic outlook

Today's record low yields are a result of high levels of fear. The pre-eminent investor anxiety is that the EU will break-up. We argue that these risks are overblown. In order to have a referendum on EU membership in another European country, you first need to have a government in power which wants to hold a referendum. There are none in power today. At a minimum we would need to see a change in government with an anti-EU party in power. As we have argued previously, it is difficult to map out a path in a specific country where this is likely in the medium term. Whilst the UK economy is likely to slowdown in the near term, the UK's role in European economic momentum is not significant, with the UK buying just 7% of EU exports. Whilst EU growth can dip a little, a recession is unlikely. The European economy ought to prove fairly resilient in the second half of 2016.

**Source: Neptune & Bloomberg, 18 July 2016.*

Important information

Investment risks

The Neptune European Opportunities Fund may have a high historic volatility rating and past performance is not a guide for future performance. The value of an investment and any income from it can fall as well as rise as a result of market and currency fluctuations and you may not get back the original amount invested. References to specific securities are for illustration purposes only and should not be taken as a solicitation to buy or sell these securities. Please remember that forecasts are not a reliable indicator of future performance. The content of this document is formed from Neptune's views as at the date of issue. We do not undertake to advise you as to any change of our views. Neptune does not give investment advice and only provides information on Neptune products. Please refer to the Prospectus for further details.