MV CAPITAL MANAGEMENT

Weekly Market Flash

Asset Repricing in 2020

December 20, 2019

If you spend enough time immersed in the chatter of financial news outlets you will invariably come across the phrase “asset repricing.” As 2019 draws to a close there is much use of this phrase as a way to describe the (to many) surprising resilience of risk assets, particularly equities, over the past twelve months. But what does “asset repricing” actually mean, how does it affect stock prices, and can we expect to see more of it in 2020?

The Basics

To understand the basic mechanics of asset repricing, put yourself in the shoes of an equities analyst at some large securities firm. The analyst may cover anywhere from five to twenty-odd stocks, where “cover” means to research all the goings-on at these companies, make assumptions about their future prospects for growth and profitability, and arrive at projected target prices. “Company ABC should make more inroads into the domestic Chinese market which will improve top-line growth, but the associated marketing and administrative expenses will put downward pressure on profit margins. As a result, our 12-month target price for ABC stock is $55.”

The analyst will input all her various assumptions into a spreadsheet model – typically a discounted cash flow (DCF) or discounted dividend stream (DDS) model. The model will then produce a single number – the net present value of the future cash flows or dividends as the case may be. That number – the NPV – translates directly to the target stock price that will appear on the analyst’s quarterly report to the firm’s investing clients. “Repricing” means a change to that target number driven by external factors, which we will now explain in the context of what happened in 2019 (and what may happen in 2020).

Rates and Risk

The two most influential external factors driving an asset repricing are benchmark interest rates and prevailing risk, with the latter expressed as a premium (spread) to the benchmark rates.

In late 2018 investors expected the Fed to continue its rate hike program, so all those analyst DCF models had those rates baked into their assumptions. In early 2019 the Fed did a major U-turn: not only calling off any future rate hikes but clearly communicating the intention to start lowering rates (which intention, as we all know now, they delivered on in full). Now the analysts had to go update their models. Where, specifically? In the discount rate – the interest rate at which future cash flows are expressed in present value terms. The lower the discount rate, the higher will be the present value of a future cash flow (this, by the way, is the fundamental axiom of finance, from which all else flows).

So the discount rate came down, and the net present value (i.e. the analyst’s “target price”) went up. Writ large on the market itself, stock indexes rallied sharply for the first three months of the year.

It’s All Relative

But we said above that repricing involves two fundamental external drivers. What about the other one – risk? Risk – the spread between risk-free benchmark rates like US Treasury securities and riskier assets –

was a moderate factor in the asset repricing that took place in early 2019. The spread between Treasuries and riskier assets didn't change too much as the Fed pivoted to its dovish policy position. For example, at the beginning of 2019 the spread between the 10-year Treasuries and Moody's Baa corporate bonds – low investment grade – was 2.43 percent. Three months later, as the second quarter began, the spread was 2.30 percent (slightly but not much tighter, which added a small net positive to the discount rate repricing). Since then, though, spreads have continued to tighten. The Treasury – Moody's Baa spread is currently just around two percent – nearly half a percent lower than where it was at the start of the year. The gradually tightening spreads meant that asset repricing would continue to benefit share values even as the Fed cuts leveled off and (for the time being, anyway) remain stable.

To Understand Stocks, Watch Bonds

What does this mean for 2020? Any number of things, obviously, because nobody knows what events may emerge at some point to upend current expectations. For now, though, there does not seem to be much of a case for interest rate repricing as long as the Fed maintains the "stay the course" approach outlined at its recent December meeting. But the same may not be true for risk spreads. This is particularly of note in the high yield (junk) bond market where risk spreads currently appear more optimistic than present circumstances may warrant. In a recent Moody's report the rating agency noted that high yield bonds have sharply rallied (i.e. yield spreads have narrowed) in the absence of observable improvements to underlying business sales and/or profit margins.

The high yield market has in the past served as a sort of canary in the coal mine, an early warning signal about impending risk asset trends. While the current environment remains benign for all intents and purposes, a change in sentiment may make its first reveal in the form of higher junk bond yields, then spreading onto investment grade debt and beyond. Asset repricing is a two way street. Upcoming earnings and sales reports will give an indication of where we are in relation to a rethink of current levels.

Masood Vojdani
President & CEO

Katrina Lamb, CFA
Head of Investment Strategy & Research