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Do recent events call into question the style rotation in favour of Value?



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The Russo-Ukrainian crisis has stoked a great deal of volatility on the equity markets. Could it also undermine, in the medium term, the style rotation into Value that began early in the year?

Our view is that, while this new shock will obviously have an impact on growth, such an impact should remain limited and is unlikely to rein in the rise in bond yields that has favoured the Value stocks so far this year. With that in mind, the recent considerable underperformance of cyclical sectors vs. defensives could reverse itself quickly in the event of an easing in geopolitical tensions.

What are the macroeconomic impacts of the Russo-Ukrainian crisis?

Russia's invasion of Ukraine and the resulting Western sanctions have triggered repercussions on the Eurozone macroeconomic scenario. The consensus is now pricing in a scenario of more persistent inflation and weaker growth, driven by higher commodity prices, additional disruptions in supply chains, and a dent in household confidence.



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Regardless of how the conflict plays out, and how fast it does so, there seems to be little chance that the sanctions levelled against Russia will be lifted any time soon. They are already resulting in higher energy prices, which is the true channel through which the conflict is spilling over into the Eurozone and reinforcing the inflation trajectory in the short and medium term. Recent statements from central banks have indicated that combating persistent inflation has been their priority and that they are therefore likely to continue to normalise their monetary policies. Meanwhile, new debt will be issued to fund Europe's energy and military independence just as the ECB is dialling back its asset purchases, and this is likely to exacerbate upward pressure on European rates.

As for Eurozone growth, most economists have revised their forecasts downward by about 1.5%, based on an average oil price of more than \$100/bbl. over the full year 2022. Growth forecasts for 2022 are now hovering around 3% (including 3.0% by JP Morgan⁽¹⁾, 2.9% by UBS⁽²⁾, and 2.5% by Goldman Sachs⁽³⁾), which is still well above its long-term potential (1-1.5%)⁽⁴⁾. This is at odds with the stagflation scenario that the markets appear to have been pricing in little by little, judging by the recent underperformance of cyclical.

Value strategy: A Value strategy is one that seeks out companies that are underValued by the market at a given point in time, i.e. whose stock market valuation is lower than it should be in relation to the company's earnings and asset Value. Value investors select stocks with low price-to-book ratios or high dividend yields.

Cyclical stocks: Cyclical stocks are highly correlated to economic cycles. They therefore benefit strongly from periods of recovery and expansion but are also the first to be affected by an economic downturn.

(1) Source: JP Morgan, 18/03/2022.

(2) Source: UBS, 14/03/2022.

(3) Source: Goldman Sachs, 10/03/2022.

(4) Source: Natixis, 05/03/2022.

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While we are not casting doubt on the scenario of persistently high inflation, we are confident that growth will remain robust. Notwithstanding current tensions, let's keep in mind that engines of growth elsewhere remain powerful, including (i) household savings, which remains high (at about 6 percentage points of GDP in the Eurozone); (ii) the need to build inventories back up, as they have shrunk to post-Covid lows; (iii) the capital expenditure needed for upgrading production facilities; and (iv) the roll-out of stimulus plans in the Eurozone, which, are likely to be expanded in light of recent announcements regarding Europe's energy and defence independence.

How has the market priced in these tensions?

After dropping by 12%⁽⁵⁾ between the start of the conflict on 24 February and its 8 March low, the EuroStoxx has almost completely made up the lost ground, as investors have little by little priced in a de-escalation scenario. However, since the Russian invasion, the underperformance by cyclical sectors vs. defensive sectors (-7 points, according to Goldman Sachs) shows that the market is pricing in a scenario that points towards a contraction in the economy.

By way of illustration, the banking sector has almost completely wiped out its early-year relative outperformance. It is now 33%⁽⁵⁾ off its mid-February highs and its valuation is below where it was in 2019, with a P/B (price/net book Value) ratio of 0.6x, even though European bond yields are at a high since late 2018 (including 10-year Bund yields at more than 0.45%⁽⁵⁾). This implies some doubt on an improvement in interest margins (despite the normalisation of monetary policies) and an increase in future defaults, which would undermine plans to return cash to shareholders. However, these assumptions look overdone when set against the macroeconomic environment described above and against the sector's especially solid balance sheets.

Another example of a cyclical sector hit especially hard: autos. Despite their particularly high margins due to their favourable mix and strong capacity to pass on higher costs in 2021, the market has punished sector stocks severely, pricing in a scenario that would combine: (i) a level of production that is unchanged vs. 2021; (ii) the reversal of much of the price increases put through last year; and (iii) a significant increase in the impact of input costs on margins. This pessimistic take already appears to have been priced in to the companies in our portfolios, with Stellantis and Mercedes currently trading at P/Es of 4x and 7x, respectively.

What is our scenario for the coming weeks?

Obviously, it is hard to say how the situation will develop. Diplomatic channels are chaotic but at least are still open and, most importantly, are firmly supported by the international community. Meanwhile, time is not in Russia's favour, as it is quickly becoming isolated, both diplomatically and economically. In light of this, a conflict-easing trajectory during the spring looks like the most likely scenario.

After spiking to almost \$134/bbl. on 8 March, oil has pulled back. The markets are reacting in knee-jerk fashion to hopes and disappointments in resolving the conflict. For the moment, they are pricing cyclical and financial sectors at end-of-cycle levels, and we see this as a good opportunity to grab these risk premiums, as we believe, like the consensus, that the economic cycle has not been broken by the crisis.

Hence, and despite the current nervousness and lack of visibility, the pro-Value trajectory of strong economic growth and a tightening in monetary policies, still looks to be on track.

How the fund is positioned and the main changes it has made

Amidst this steep volatility, we have made a few adjustments to the portfolio: (i) in adding to our exposure to banks, which we feel have been hit hardest even though they have limited exposure to Russia and Ukraine; this is especially true of BNP Paribas and Intesa; and (ii) *via* some cyclical stocks, which we believe have been punished excessively by the market; Stellantis and Alstom are the most patent examples.

Meanwhile, we took advantage of lower prices to do some switching within the leisure sector, setting up a position on Ryanair while selling our position in Sodexo. Market conditions provided us with an opportunity to add exposure to this quality airline, with its solid balance sheet, a strong growth outlook and an especially attractive competitive edge in its fuel hedging. In contrast, Sodexo whose multi-local and defensive character had offered some resilience, appears to have relinquished its strategic options (divesting its Benefits & Awards business), with its recent appointment of Sophie Bellion, who is the daughter of the company's founder, as CEO, despite expectations that someone from outside the company would be brought in.

We sought to maintain our overweighting of the energy sector by adding to our position in Technip Energies, which has been hit by its Russian exposure but which looks to us especially well positioned to benefit from the energy-independence plan being battled about in Europe. We financed this addition by reducing our exposure to TotalEnergies and ENI, which have held up well during the period.

(5) Source: Bloomberg, 23/03/2022.

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And lastly, within the more defensive pillar, we sold off part of our position in AB InBev, which is exposed to higher wheat and hops prices, and added to Danone, which has a more defensive profile and was bid up in early March on its strategic review, which confirmed the far more pragmatic character of its new governance.

Completed on 23 march 2022



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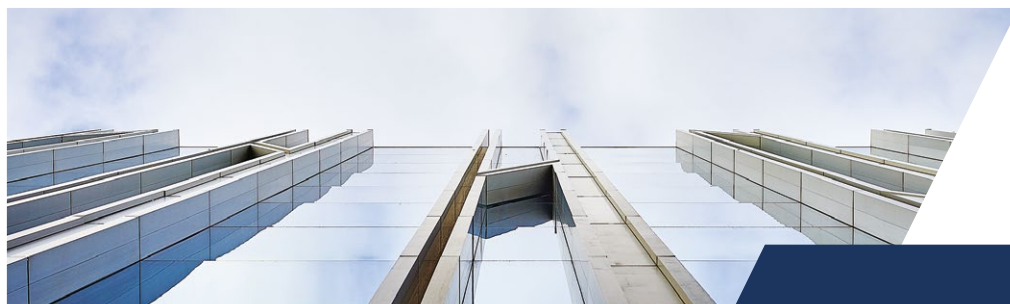
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