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Value style outperformance in a bear market reflects the paradigm shift in rates

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For more than a year and a half, Value style has been outperforming. This trend has been confirmed and accelerated since the beginning of 2022, despite the bearish market. In this article, we review this structural shift in trend, we discuss the rationale behind this outperformance, and we analyse the prospective elements that could justify the continuation of this trend.

How has Value performed recently?

Value's outperformance began in November 2020 with the announcement of the first vaccines which marked the beginning of economic normalisation. Since then, the Eurostoxx Total Market Value index (dividends included) has risen by 35%, outperforming the Growth style by almost 28% over the period. Even if it has been held back by exogenous factors (Delta and Omicron waves in 2021, Russian-Ukrainian war in early 2022), this trend has been confirmed and accelerated since the beginning of 2022.

With the improvement of the pandemic situation in Europe and the inflation caused by supply shocks (disruptions in supply chains, shortages of raw materials, energy and food shocks with the Russian-Ukrainian crisis), the market acknowledged the paradigm shift in interest rates and refocused on fundamentals, thereby strongly benefiting the Value style, in spite of the geopolitical context and the one-off slowdown in China, all of which are weighing on global indices.

Thus, since the beginning of 2022, the Eurostoxx Total Return (dividends reinvested) is down by 14.3%[(1)]. With a decline of 8.0%[(1)], the Eurostoxx Total Market Value clearly outperformed its benchmark in the market downturn, and even more so the Eurostoxx Total Market Growth, which dropped by 21.6%[(1)].

The market decline can therefore be mainly explained by the underperformance of Growth stocks, which account for a large proportion of the indices, and whose current value is heavily penalised by the rise in rates, particularly anticipated real rates, i.e. net of inflation, as a result of the discounted earnings phenomenon, which occurs in the longer term and is therefore more sensitive to rates.

How can this outperformance be explained?

The correlation between Value and rates, that heavily penalised Value since the financial crisis and the implementation of Quantitative Easing policies[(2)], applies in both ways, and has thus been benefiting since the beginning of the year. A low point in rates was reached in 2020, with the first global pandemic in a century (see figure). Since then, we have witnessed a paradigm shift, driven initially by the rise in inflationary expectations, stemming from various supply shocks and from a demand fuelled by the savings accumulated during the "Covid-19" period; and secondly, by central banks' change of attitude, recognising their misjudgement of the transitory nature of inflation, forcing them to raise key rates and resulting in a rise in real rates.

(1) Source: Bloomberg, 10/06/2022. Performance is calculated net with reinvested dividends.

(2) Economic and monetary policy aimed at lowering interest rates and increasing the money supply. This measure is usually used to stimulate an economy when the traditional operation of monetary policy is no longer effective, for example, when interest rates are low or close to zero.

The fixed-income market has already reacted to this situation with a particularly sharp rise in the Bund(3) since the beginning of the year (+170 basis points), reflecting the forthcoming normalisation of monetary policies in response to an inflation level not seen for over 40 years.

Growth stocks have benefited from the high visibility of discounted cashflows at negative rates, which has inflated their valuation over the last decade. These stocks were the most attractive alternative to negative interest rates and were therefore considered as a safe haven. This is no longer the case in the context of the ongoing normalisation of monetary policies. It should be noted that these Growth sectors have suffered particularly, especially consumer goods and technology, which have dropped by 25.3%(4) and 28.3%(4) respectively since the beginning of the year.

We believe that the underperformance of Growth stocks is not over, as their valuation is still high. As an example, despite the recent market correction, the valuation of the technology sector is still in the 75th percentile, taking a valuation track record from 2015 to 2022. Monetary policy normalisation should therefore continue to weigh on the sector.

Conversely, Value sectors are trading at valuations close to their historical lows, making them more attractive in the current environment.

Value outperformance in 2022 can therefore be attributed, firstly, to the very good performance of energy and commodities sectors, which benefited from the rise in underlying prices in a tense geopolitical context in Europe; and secondly, to the rather defensive Value segment, which held up particularly well, as shown by the positive performance of the telecommunications sector. On the other hand, the cyclical component (banks, construction, automotive, leisure and travel) suffered from fears about Growth and performed more in line with the market.

Will Value stocks' outperformance be sustained?

The recent rebound in interest rates remains low compared to the sharp decline witnessed since 2008. The Bund is now at a level of 1.5%, a level it has not reached since 2014. Closing the performance gap since then implies a potential outperformance of Value over Growth of 35%.

In the second half of the year, Value's outperformance could be achieved through its cyclical component. In fact, the automotive, construction and leisure & travel sectors are already experiencing a clear economic slowdown. In view of investment needs, accumulated household savings and government support, we are more constructive on the growth scenario. This belief is supported by the continued high PMIs on both sides of the Atlantic. As long as the inflection point is not reached on inflation, investors' concerns about a recession scenario may still lead to volatility and a new leg down in the markets. Nevertheless, we feel that we should reach an inflection point on the three issues that are worrying investors in the coming months: inflation seems to be close to its peak in the US, health concerns are easing in China and the Russian-Ukrainian conflict seems to be de-escalating. In such scenario, the potential for performance in these sectors is very high.

In addition to these elements, the sector that currently seems to offer the most potential is the banking sector, given its sensitivity to interest rates and the context of monetary policy normalisation. Its year-to-date performance, however, has been highly decoupled from sovereign rates, reflecting market fears of rising default rates. Even in the event of a slowdown, the very positive impact of rates on the sector does not seem to be taken into account, and this decorrelation is an opportunity to take a position in the sector.

Furthermore, new elements have been identified that argue for more consistent inflation in the long term than in the last decade: sustainable transition that raises commodity prices but not only, relocation, and the ageing of the population that reduces the share of people in employment as well as the savings capacity of households. In this new era, after their normalisation phase, interest rates should reflect these new circumstances and remain at higher levels; arguing for a continued Value style outperformance.

How can Value perform in a recession context?

In a recession scenario, valuation is not the primary issue. Such a scenario cannot be ruled out in view of the rapid rise in interest rates, which could affect business investment, impact the real estate sector, and cause a recession.

Several elements can nevertheless be pointed out. First of all, it is important to bear in mind that the balance sheets of Value companies have become much healthier than in the pre-Covid-19 situation. Banks are the best example, with solvency ratios that are much higher than in previous cycles. The same applies to all industrial sectors, which have seen their net debt/equity ratio improve significantly. The fear of a Value Trap(5) seems limited in this cycle. We are now in an environment where cyclical companies have both healthier balance sheets and more attractive valuations, offering Value managers investment opportunities with stronger fundamentals than in previous cycles.

(3) Bond issued on behalf of the German government, equivalent to the French OAT. The Bund interest rate, which has a maturity of 10 years, is considered the benchmark for the German market but also for European markets.

(4) Source: Bloomberg, 10/06/2022. Performance is calculated net with reinvested dividends.

(5) Securities that have been heavily discounted and are wrongly seen as good Value investment opportunities.

The figures quoted relate to the past months. Past performance is not a reliable indicator of future performance and is not constant over time.

Moreover, there are some defensive sectors that are completely compatible with a Value bias and that can help navigate the downturns in the economic cycle: telecommunications and retailing are just a few examples, and we could add energy or even commodities in the current geopolitical context.

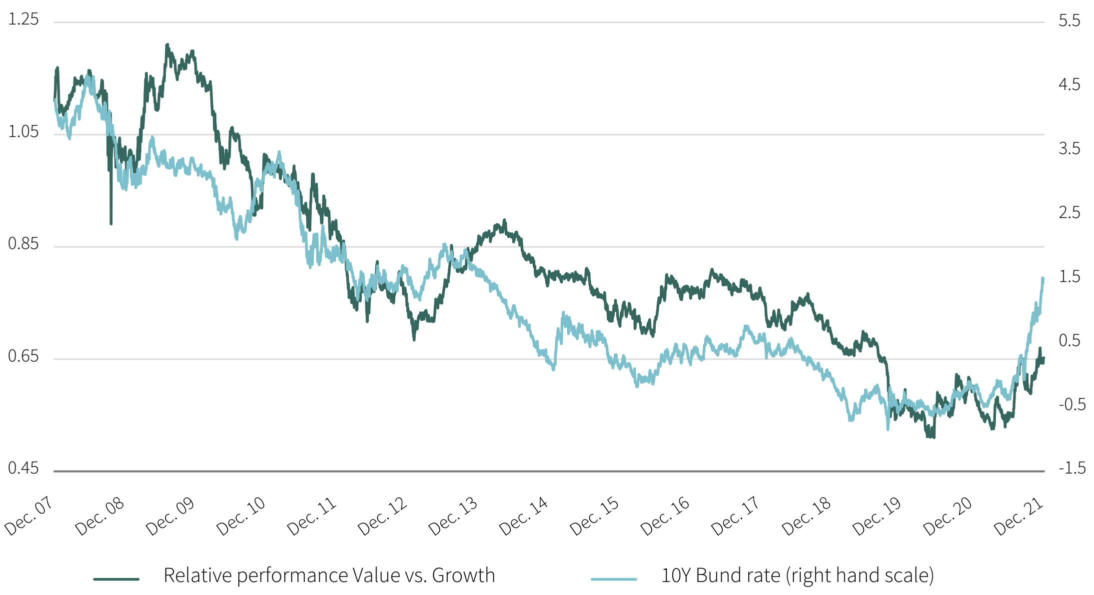
Finally, the Growth theme could be subject to a Growth Trap(6), defined by still high valuations, which do not yet take into account the change in the interest rate regime and long-term growth adjustments, with stronger regulatory action on quasi-monopoly or tax optimisation situations, and the closing of some markets (in China).

Conclusion

We are therefore witnessing the end of the 2014-2020 period, which was marked by fears of deflation, zero interest rates and the expansion of central banks' balance sheets. Value stocks, which are still heavily discounted, generate high dividends and benefit from an indexation to inflation which protects them in the current environment. Investors who have largely avoided these stocks in favour of Growth stocks over the past 10 years may be led to rediscover their benefits.

Completed on 13 June 2022

Relative performance – Value and Growth vs. 10-year Bund



Source: Rothschild & Co Asset Management Europe; Bloomberg - 10/06/2022

(6)The investment mistake of assuming that a company is a good investment simply because there is reason to believe that it will grow over the next few years.

The figures quoted relate to the past years. Past performance is not a reliable indicator of future performance and is not constant over time. Performance calculated in Euros and net of reinvested dividends

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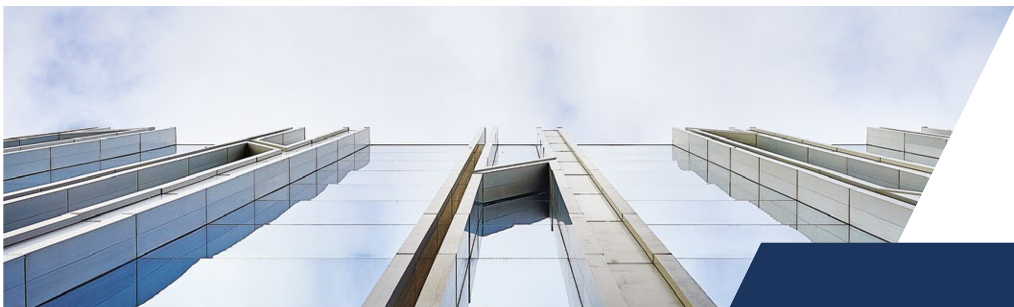

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