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The paradigm shift in interest rates has driven Value's performance over the past two years



Anthony Bailly
European equity
manager



Vincent Iméneuraët
European equity
manager

How can Value's outperformance over the past two years be explained?

The paradigm shift that we mentioned in our previous editions is increasingly prevalent. We have shifted from a low-inflation environment (and even deflationary fears) that had sent European interest rates into negative territory, to an inflationary environment, which has triggered a robust surge in rates. It is indeed this change in the inflation regime and the resulting rising interest rates that have driven Value's outperformance over the past two years. As a result, Value has outperformed EuroStoxx with dividends reinvested by more than 12% and Growth by more than 16%⁽¹⁾; and this, with a financial market that has experienced both bullish and bearish phases.

More recently, Value was dragged down this summer by the market's expectation of a Fed "pivot" by the beginning of 2023, driven by the feeling that inflation had peaked in the United States and by the worsening in macroeconomic indicators. But the hawkish talk by central banks at the Jackson Hole conference gave interest rates a lift, and served as a reminder that the fight against inflation was still the current priority of both the ECB and the Fed. They are likely to continue their monetary policy tightening over the next few months or quarters, given the very high level of inflation (8.3% in the United States and 9.1% in the Eurozone in August, vs. targets of 2%)⁽¹⁾. Solid job markets have not made this perilous task any easier. This is why Value has once again outperformed since these announcements, despite falling markets.

The other reason Value has performed so well is related to solid fundamentals. One earnings release after another has shown a steady improvement in Value sectors (Energy, Banks, Automakers, etc.) and have beaten expectations on a regular basis, thus inspiring upward revisions in earnings per share (EPS) forecasts. This is also allowing those companies to weather the looming cyclical downturn with balance sheets that are more solid than during previous downturns.

This, together with the decline in the indexes, explains the historically low level of valuation of the Value style, back to the points reached in 2008 and 2020 (see graph), which makes the segment particularly attractive in view of the historical rebounds.

Can the current macroeconomic uncertainties disrupt this momentum?

The energy crisis, which began with the invasion of Russia, was the trigger for the current crisis. It has been intensifying for more than 6 months, and has worsened with the particularly unfavourable climatic conditions (drought in Europe, but also in China), and generates a still high level of uncertainty. That being said, year-to-date drops of -18% by the EuroStoxx, -20% by the S&P 500, and -28% by the Nasdaq⁽¹⁾ (each in its respective local currency) have already priced in an economic slowdown, even if such has not shown up in several macroeconomic indicators.

(1) Source: Bloomberg, figures as of 21 September 2022. Performances are calculated net of fees and with dividends reinvested. The figures quoted refer to past months. Past performances are not a reliable indicator of future performances futures and are not constant over time. Information in this document constitutes neither investment nor tax advice, nor an investment recommendation by Rothschild & Co Asset Management Europe.



Some sectors have already been hit hard, such as Industry (-26% year-to-date), Autos (-20% year-to-date) and Construction (-18% year-to-date). Defensive stocks have been more resilient (with Telecoms down by 4%, Assurance by -9%, and Utilities by -13%)⁽²⁾. The market defensive posture suggests that it is pricing in the economic slowdown to come, so much so that the Cyclical/Defensive valuation discount is already greater than during the Covid-19 crisis and is at a level equivalent to where it was during the 2008 financial crisis. Cyclical's underperformance vs. defensives corresponds to a Eurozone PMI Composite⁽³⁾ of about 47, which confirms that the recession is already partly priced in.

This raises the question of the intensity of the future slowdown. Several elements of demand support lead us to believe that a violent recession can be avoided:

1. European households have continued to save at a faster pace than during the Covid-19 crisis, so much so that cumulative excess savings is still equivalent to 7% of GDP⁽⁴⁾ in the Eurozone (and to 11% in the United States). This should help support consumption on the eve of a recession;
2. In reaction to the energy crisis, apart from what remains to be done in energy price caps, governments have decided to assist households through support measures that amount to about 2% of GDP⁽⁴⁾ in the Eurozone.

We might add that China has already take several measures to stimulate demand (including interest rate cuts and fiscal stimulus). Their impact has for the moment been cancelled out by the zero-Covid policy, which continues to undermine economic activity, but which, sooner or later, will be withdrawn. The Chinese pharmaceutical industry is pulling out all the stops to find an effective vaccine (CSPC is currently in phase 3 trials), and Moderna is in discussions with the Chinese government, according to some recent reports. In the run-up to the Chinese Communist Party Congress (which begins on 16 October), and as Xi Jinping has just left China for the first time since the pandemic began, there is little doubt that China is seeking the means to once again become the engine of the global economy, as it was in the past decade.

Meanwhile, and although this scenario seems unlikely at the moment, an end to the Ukrainian conflict would constitute a powerful catalyst for Value, much like Pfizer's November 2020 vaccine announcement. This is obviously not our central scenario, but as the Russian army loses ground and China and India's diplomatic support for Vladimir Putin seem to be crumbling, this scenario cannot be totally ignored.

Which opportunities does the market seem to offer at the moment?

Despite current macroeconomic uncertainties, we still believe that banks and energy are now the market's most attractive sectors. They are the two main weightings of our portfolios for two reasons that apply to both of them:

1. their valuations are at historic lows;
2. EPS continue to offer upside potential in the coming quarters with a very low risk of downgrades.

Banks have never been so well capitalised, and rising interest rates are just beginning to feed through to their interest margins and, hence, their profits. Meanwhile, the provisions they set aside during the Covid-19 crisis and have not yet used offer a cushion to the higher cost of risk that could be brought on by a worsening in the macroeconomic environment. So the environment is quite different from previous downturns, which hit the banking sector especially hard, including the financial crisis (with its stretched balance sheets and falling interest rates) and the Covid-19 crisis (with its falling interest rates).

On the energy front, oil & gas markets remain very tight. Reshuffling European gas supplies will take several years, and that will constrain supply in the short term. Crude prices are likely to hold at high levels despite potentially weaker demand, as Russian oil export sanctions (such as the insurance ban) kick in.

Many other factors are exacerbating supply-side tensions, including OPEC's desire to keep prices high (judging by its September meeting, at which it cut production for the first time in two years), oil & gas substitution, low OECD inventories, very low surplus capacities, weak investments in exploration for almost 10 years now, political tensions in Iraq, and the failure to reach a short-term agreement with Iran. As a result, oil & gas prices are likely to remain at higher levels than those assumed in analyst models, and excess cash should remain at exceptional levels, favouring shareholder return and investment in the energy transition (which will help lower the sector discount).

(2) Source: Bloomberg, 21 September 2022.

(3) The Purchasing Manager's Index (PMI) is an indicator reflecting the confidence of purchasing managers in a particular economic sector. When it is above 50 it points to an expansion in activity; and below 50, to a contraction. The composite index encompasses both manufacturing and services sectors.

(4) Source: Goldman Sachs, "The Expenditure Side of the Same Growth Coin", 24 April 2022; and US Daily: The Growth Boost From Excess Savings Is Probably Mostly Behind Us, 16 August 2022.

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Apart from these two sectors, we believe it is still too early to go further in portfolio cyclicality, for two reasons:

1. leading indicators continue to worsen;
2. inflation remains stubborn;
3. the impact of the energy crisis will depend on how cold winter is in Europe.

However, and despite our relatively cautious take on the macroeconomic environment in the weeks and months to come, we are keeping in mind that cyclical stocks' valuations relative to defensive stocks has hit an all-time low. If PMIs continue to worsen and cyclical stocks are impacted once again, we may in the coming months be reinvesting in some sectors, which are sending out some reassuring signals. This is the case of the auto sector, whose volumes are at lows, due mainly to the semiconductor shortage. The US market has shrunk by 26% since May 2021⁽⁵⁾, while the European market is 35% below its August 2018 peak⁽⁵⁾. The steep improvement in supply chains shows that volumes have recovered over the past few months, as order books have expanded constantly. To a lesser extent, this is also the case of the leisure & travel sector, as air traffic is still 25% below its pre-Covid level, according to the IATA⁽⁶⁾.

Can Value's outperformance be sustainable?

In the short term, we are seeing an unusual decorrelation between Value/Growth relative performance and the level of interest rates. This recent decorrelation is due to fears of macroeconomic slowdown that the market is pricing in for 2023 and that are penalising the aforementioned cyclical Value stocks. However, it is necessary to go back to February 2014 to see a level of the Bund⁽⁷⁾ comparable to the current level and since then, Growth has outperformed by almost 50%⁽⁸⁾, thus leaving a wide gap to fill. This provides an opportunity to shift the focus to the theme, and thus take advantage of the paradigm shift that has begun.

As we consider the longer term, we are convinced that we are coming out of an abnormal period of low interest rates, linked to the abundance of liquidity poured by central banks over the last 10 years. We believe that after the phase of monetary normalisation (which will include the current tightening and a subsequent pivot), inflation will stabilise at levels above those of the past decade. This is reflected in the 10-year inflation expectation levels in index-linked bonds, which have risen in two years from 1.6% to 2.4% in the US and from 0.7% to 2.4% in Europe⁽⁸⁾.

Among the major challenges currently facing our economies, the most recent are pushing towards structural inflationary pressures:

1. environmental constraints, which are increasingly present and will require an unprecedented investments and raw materials;
2. the impacts of deglobalisation, with the reorganisation of supply chains, reshoring, and the reshuffling of energy markets;
3. political trends in Western countries, with the need to reduce inequalities and to rein in populism; this is likely to push low wages upward and also help narrow the gender gap in wages.

In this context, central banks are likely to have to deal with these inflationary pressures in the future, in contrast to the past decade when they have been fighting deflationary pressures. This argues for interest rate levels that should also remain higher than during the 2010-2020 period. If the Covid-19 pandemic has acted as a catalyst for the change in the interest rate paradigm, it is the inflationary pressures mentioned above that are driving it. This paradigm shift, which was reflected in the end of the continuous decline in interest rates and which reflects the new inflationary regime, also marked the end of the underperformance of Value over Growth.

The next decade, in terms of investment style, must be measured against the major challenges facing our economies. Convinced that the latter will drive significant inflationary pressures, shifting exposure to Value now makes perfect sense.

Completed on 22 September 2022

(5) Source: Exane, WARD's Automotive Group, August 2022.

(6) Source: International Air Transport Association (IATA), July 2022.

(7) 10-year German bond yield.

(8) Source: Bloomberg, 21 September 2022.

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MSCI Europe Value – 12m forward P/E since 2005



Source: Bloomberg 15/09/2022
PE: PER, pricing earning ratio,

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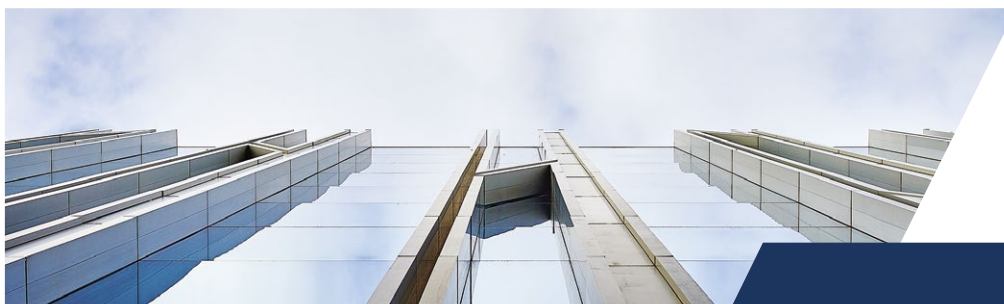
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