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A Value style opportunity to be seized in Europe's equity markets

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Investors have adopted a positioning that seems to suggest they are wary of equities, with this asset class accounting for a historically small share of portfolio allocations. However, although the TINA (There Is No Alternative) argumen in favour of holding equities no longer applies, equities have outperformed bonds and cash by a comfortable margin not only since the start of the year but also for the past 3 years. And although we are taking a relatively conservative approach at this stage of the cycle, we firmly believe it makes sense given current price levels to increase the share of European value stocks held in equity portfolios.

Are equities too dear?

We believe there are two aspects to consider when answering this question. First of all, it depends on the region. The US equity market is indeed overvalued as it is trading on a P/E multiple of 18.4x[1], which is well above its historical median of around 16x[1]. Valuations are being driven upwards by tech mega-caps (the Magnificent 7), which are trading on a P/E multiple of 27x[2]. They are so heavily weighted in the equity market that they add close to 2 points to the index's P/E multiple, which would otherwise be in the region of 16x[2]. A global analysis shows that markets on the whole are trading above their historical medians, whether we are talking about international equities, Japanese equities or even emerging market equities[1]. Europe is the one exception: it is trading on a P/E multiple of 11.9x[1], which is below its historical median. It is therefore the only region that seems to be attractively valued.

Secondly, it also depends on investment style. There is a very sharp dichotomy between the Value style and Growth style in the European index. Growth stocks are trading well above their historical median, on P/E multiples in excess of 19.2x[3]; value stocks, meanwhile, are trading close to their historical lows at 8.7x[2], i.e. 2.4 points below their historical median[3]. Such a divergence is all the more striking as it has reached historical proportions, despite the fact that the Value style has benefited from the recent interest rate environment.

European value stocks have indeed gained +31.2%[4] since the beginning of the monetary tightening cycle, which we can date back to early 2021; this is almost twice as much as growth stocks and far more than govies, investment grade bonds and the money markets[4]. In short, equities as a whole are certainly trading on rather high multiples, but the European value segment is something of an exception. It is trading close to its historical lows despite having outperformed sharply since the beginning of the interest rate normalisation cycle.

(1) Source: FactSet, Goldman Sachs Global Investment Research, Global Weekly Kickstart 02/10/2023.
(2) Source: Goldman Sachs.
(3) Source: Factset, Goldman Sachs Global Investment Research.
(4) Source: Bloomberg 02/10/2023.

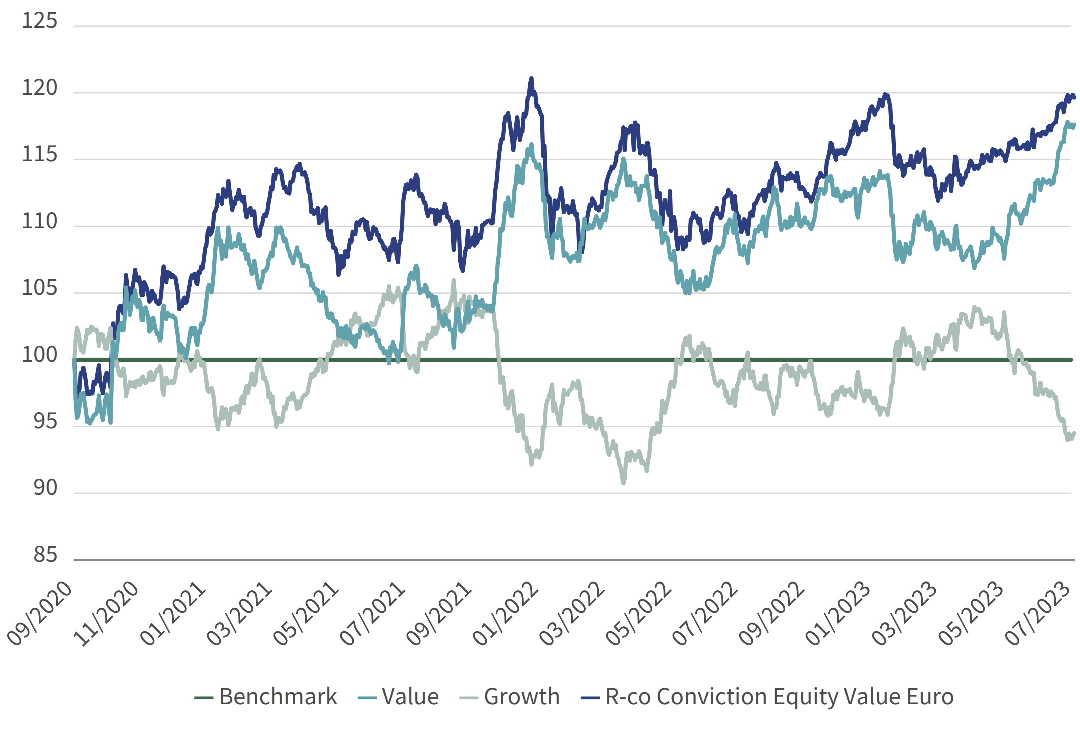
Which arguments can be put forward to emphasise the appeal of European value stocks near term?

We have examined two parameters to work out what the market is currently pricing in: i/ valuation multiples and ii/ earnings growth forecasts.

As far as valuation multiples are concerned, certain value sectors are trading on historically low valuations; they include the Automotive (P/E of 5x)[(5)], Banking (6.3x)[(5)] and Energy (7.6x)[(5)] sectors. At the other end of the spectrum, we have Consumer Goods (21.1x[(5)], propped up by the luxury segment), Technology (19.2x)[(5)] and Healthcare (17x)[(5)]. And yet, in a market looking for 7% growth in earnings per share (EPS) in 2024[(6)], earnings growth forecasts range from 11.9%[(6)] for Healthcare to 15.1%[(6)] for Technology but are lacklustre or even negative for the three Value segments we have mentioned (ranging from +3.0%[(6)] for Banking to a negative -3%[(6)] for Automotive)[(7)].

In other words, we have some relatively dear Growth sectors with high EPS expectations on the one hand, and some rather cheap Value sectors with conservative earnings growth expectations on the other. Of course, none of these sectors would be immune to an economic slowdown. But conservative earnings growth forecasts combined with low valuation multiples in sectors such as mining, energy and banking offer something of a safety buffer, whereas earnings in higher-valued growth sectors, such as technology and luxury, have higher expectations to meet. We reckon this situation could create a particularly interesting risk/reward asymmetry which investors could take advantage of.

Relative performance of the Value and Growth styles and of R-co Conviction Equity Value Euro (part I) vs Eurostoxx dividends reinvested over 3 years



Sources: bloomberg, Rothschild & Co Asset Management, 30/09/2023.

(5) Source: Datastream, Worldscope, Goldman Sachs Global Investment Research.
(6) Source: FactSet, Goldman Sachs Global Investment Research, Global Weekly Kickstart 02/10/2023.
(7) Source: FactSet, STOXX, Goldman Sachs Global Investment Research.

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What about the medium/long term?

Mid-term, the famous "higher for longer[8]" message drummed in by the Fed has only been partly priced in given the Value segment's relative performance vs the Growth segment. The correlation that usually exists between the performances delivered by these investment styles and the level of interest rates has struggled to sustain itself over the past year. Admittedly, the Value style has outperformed, but not to the extent that one might have expected given the hike in interest rates. This is because certain cyclical value sectors have been penalised by macroeconomic concerns, triggered first of all by geopolitical tensions and subsequently by the effects of the second round of monetary tightening. Our view is that an economic slowdown scenario has already been partly priced into these sectors. As we have seen, however, this has not prevented the Value style from outperforming by a wide margin during bear markets (2022) and bull markets (2023) alike! We are convinced that this outperformance merely signals the beginning of a rebalancing between the two investment styles.

Long term, and to expand on what we have just explained, we believe we have experienced a paradigm shift over the past three years on three different levels: inflation, monetary policy and interest rates. We have switched from a deflationary environment (spanning the financial crisis of 2008 to the Covid-19 crisis and prompting central banks to adopt expansionary monetary policies and pull interest rates into negative territory) to the complete opposite, i.e. an inflationary environment (encouraging these same monetary authorities to become restrictive and push interest rates upwards). Why might one expect this situation to last for a long time? Because although yesterday's deflationary factors still persist today (such as technological progress, currently in the form of Artificial Intelligence), they are now being offset by inflationary pressures that did not exist previously: (i) the climate transition, (ii) political and social factors, (iii) deglobalisation, resulting in reshoring, and (iv) ageing populations in developed countries. Such factors underpin our view that we have undergone a paradigm shift with major consequences for those investing in the equity markets, especially as regards investment styles.

Which sectors should we prioritise in such circumstances?

Counter-intuitively, we believe there are two sectors whose fundamentals should allow them to outperform in the current macroeconomic climate. First all, the banking sector: it is delivering very strong earnings growth as a direct result of higher interest margins, which continue to materialise as and when loans are renewed. This gives the sector's earnings a considerable boost and they have been revised upwards by more than 25%[9] year-to-date. However, this has not been fully priced into the sector's stockmarket performance, which is why it is trading on historical lows. It is true that the macroeconomic environment is an uncertain one and that the cost of risk could rise, but the provisions that banks have built up in their balance sheets will enable them to handle any uncertainty. And, ultimately, the positive impact of higher interest rates will remain the more predominant factor, and they are likely to become a permanent fixture.

Energy is another sector to prioritise despite worries about an economic slowdown. Here, too, demand may seem to be at risk. But one needs to bear in mind the positive base effects in China and the fact that stocks in OECD countries are at all-time lows. Both these factors are likely to shore up demand over the coming months. Above all, supply seems to be under pressure since OPEC+ and Saudi Arabia in particular decided to extend their output cuts. Broadly speaking, these two factors are responsible for a supply/demand imbalance amounting to some 2 million barrels per day in the second half of this year[10]. This is why oil prices have risen recently, an increase that has not been priced into the sector's valuation multiples. Despite higher oil prices, the energy sector's earnings have been revised downwards by about -20% from their peak[11], reflecting a contraction in global economic activity. The possibility of economic stimulus in China could boost demand and the oil price.

In this respect, the commodity sector is also looking more appealing these days. It is undervalued and trading below its historical median. And earnings growth forecasts for the sector have already been revised downwards by -50%[12], whereas downward revisions in previous recessions have averaged just -30%[13]. The sector therefore seems to have already priced in a particularly adverse scenario at a time when leading industrial indicators appear to have bottomed out.

How is the R-co Conviction Equity Value Euro fund positioned in these circumstances?

The fund maintains its bias in favour of Value stocks. Our current approach seeks to navigate our way through the cycle by reducing the fund's cyclical bias in preparation for the macroeconomic slowdown we expect to materialise and increasing the share of defensive stocks in our portfolio allocation. This share currently stands at 35%[14], close to its historical highs. It includes an overweighting of telecoms in particular (Deutsche Telekom, Orange, KPN) and food & beverages (AB Inbev, CCEP, Danone), but also an increased allocation to Sanofi in the healthcare component. As mentioned previously, the heaviest weightings are assigned to the banking and energy sectors but also, to a lesser extent, the commodity and real estate sectors. Real estate is likely to benefit from the end of the monetary tightening cycle and gain value.

(8) Higher interest rates, for a longer period of time.
(9) Source: FactSet, Goldman Sachs Global Investment Research, Global Weekly Kickstart 02/10/2023.
(10) Source: IEA, Kepler Cheuvreux estimates.
(11) Source: Bloomberg 02/10/2023 : EPS 12mfwd Stoxx600 Energie.
(12) Source: Bloomberg 02/10/2023 : EPS 12mfwd Stoxx600 Matières Premières.
(13) Source: Bloomberg, FactSet, STOXX, Goldman Sachs Global Investment Research.
(14) Source: Rothschild & Co Asset Management.

Conversely, we remain very much underweight on growth sectors, particularly consumer goods and technology. They seem overvalued to us and 2024 earnings growth forecasts for these sectors strike us as being too optimistic, especially given today's macroeconomic uncertainty and high interest rates.

How has the fund performed recently and longer term?

Interest rate hikes have underpinned value stocks, which have outperformed the Eurostoxx index by 24% over the last 3 years[(15)] and the growth index by 32.4%[(16)]. But this outperformance is still only a partial reflection of this paradigm shift we have talked about. It is worth noting that the value investment style has persistently outperformed in a succession of bear and bull markets alike. The R-co Conviction Equity Value Euro fund, meanwhile, has outperformed the Eurostoxx index by 24.2%[(17)] during this period. The fund has outperformed its benchmark index by 3.2%[(18)] since the start of 2023.

This performance sets it apart from the rest of the value investment universe, all the more so as the fund's volatility year-on-year is now close to that of the Eurostoxx; this is unusual for a value fund which is more cyclical by nature[(17)]. Conversely, we would emphasise the fact that volatility in the growth universe, which is considered a safe haven and immune to macroeconomic ups and downs, has moved in the opposite direction. Its volatility has now overtaken that of the market and that of the value universe.

Completed writing on 2 October 2023

(15) Source: Bloomberg 02/10/2023 – du 01/10/2020 au 29/09/2023.
(16) Source: Bloomberg 02/10/2023.
(17) Source: Bloomberg 02/10/2023 – du 01/10/2020 au 29/09/2023 – part I.

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Performances	Since the beginning of 2023	2022	2021	2020	2019	2018	Since inception	1-year volatility
R-co Conviction Equity Value Euro C EUR(1)	12.7%	-9.6%	26.3%	-9.9%	17.6%	-18.0%	117.8%(1)	15.7%
R-co Conviction Equity Value Euro I EUR(2)	13.2%	-9.1%	27.1%	-9.2%	18.5%	-17.4%	88.8%(2)	15.7%
Euro Stoxx ® NR(3)	10.0%	-12.3%	22.7%	0.2%	26.1%	-12.7%	-	15.2%

(1) Inception date: 20/05/2005.
(2) Inception date: 30/12/2009.
(3) Benchmark.
Source: Rothschild & Co Asset Management, 30/09/2023.

Synthetic risk indicator : 5 out of 7

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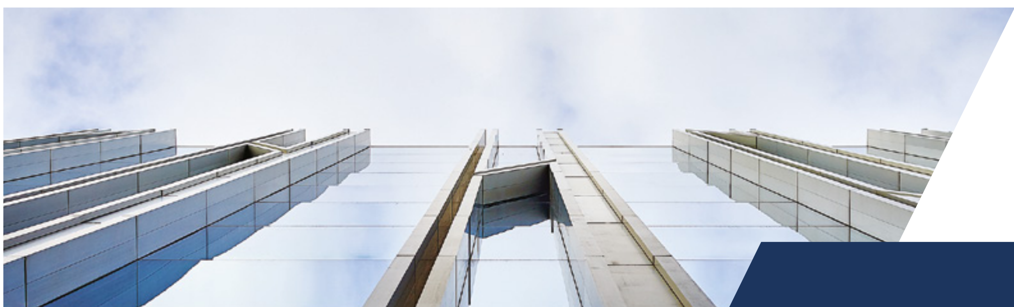

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