Rothschild & Co
Asset Management

January 2023 | Rothschild & Co Asset Management Europe

Fund update
R-co Conviction Equity Value Euro

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Market trends on the month

On the whole, inflation figures surprised on the downside in December (receding from 7.7% to 7.1% in the US)[1], but what investors really homed in on was central banks' insistence on sticking to their hawkish policies. One of these banks was the BoJ, which late in the month joined the historic and global wave of monetary tightening that marked 2022.

After unbridled optimism since October, the markets were brought back down to earth and the reality of financial conditions that may be with us for some time to come. With dividends reinvested, the MSCI World fell by 4.2% (in $) and the S&P 500 by -5.8% (in $), while the Euro Stoxx's outperformance of November spilled over into December, when it lost just 3.5%[1].

In the US, the Fed's 50 basis point rate hike (from 4.25 to 4.5%) was expected, but its raising of its end-2023 forecast from 4.6% to 5.1% was less so. This revision was corroborated verbally by Jerome Powell, who, in reaction to a job market that is still just as resilient (with job creations at 263k vs. 200k expected – the eighth consecutive above-forecast month), reaffirmed the need to slow economic activity to rein in inflation once and for all. There are, however, some signs of slowdown in the US. The ISM manufacturing index, for example is in contraction territory (at 49.0 vs. 50.2 in November), and retail sales shrank by 0.6%[1] to a 12-month low.

In Europe, the ECB also raised its rates by 50 bps (to 2% vs. -0.5% last June), while flagging other rate hikes to come. These announcements were made easier by natural gas prices, which, for the first time since Russia's invasion of Ukraine, were back to levels that prevailed prior to the war, and by leading indicators, which turned up (with the PMI Composite up by 1 point to 48.8, an upside surprise for the second consecutive month, and the rebound by the IFO German Business Climate Index). However, this hope of a soft landing in Europe is still being tempered by worsened macroeconomic data, including a dip in retail sales (-2.7% YoY) and in manufacturing outlook (-2% MoM))[1].

And in China, economic activity figures continued to decline on the month (with retail sales down by 5.9%, and manufacturing output and investment slowing), as they continued to be impacted by the regime's zero-Covid policy. However, the yearend in Asia was highlighted by the about-face in public healthcare policy and the country's reopening, suggesting a possible change for the 2023 growth outlook. However, the government's lack of transparency on the healthcare consequences of this about-face is preventing the visibility that investors want, as reflected in the 2.3% decline in the Shanghai Composite index on the month[1].

Interest rates reacted to the central banks' clarion call, with a 27 bps rise in the US 10-year yield (+33 bps in the case of real rates) and, most of all, a spike in German yields (+63 bps by the Bund and +65 bps by real rates), which ended 2022 at their year's high[1].

(1) Source: Bloomberg, 31 December 2022.

In reaction to still limited revisions in earnings per share (EPS) forecasts (-0.6% on the month for 2023 EPS[2]), the European market was derated, with the P/E of the Euro Stoxx dividends reinvested slipping from 12.2x to 11.7x. The derating diverged in terms of style, with growth stocks' P/E slipping from 19.8x to 19.2x, while value stocks' P/E rose from 8.4x to 8.6x. Growth's premium over value thus shrank from 135% to 123%, which is still near its all-time highs and leaves almost intact the potential for normalisation that we were hoping for based on interest rate trends in 2022.

Fund performance & positioning

Amidst the spike in bond yields, financials (Banks +1.0%, Assurances -0.9%) outperformed growth sectors (Consumer Goods -6.5% and Technology -7.6%) by far. Value fell by 2.1% on the month, thus outperforming the market by 1.4%, and growth by 2.5%. All in all, for 2022, the performance gap between value and growth was close to 12% (11.8%). We might add that over the past more than two years and Pfizer's November 2020 announcement of a vaccine (which restored visibility to the global economy), this gap has widened to 25.6%.

R-co Conviction Equity Value Euro lost just 3% in December, ending the year at -9.6%, thus outperforming its benchmark by 2.7%. The fund's outperformance on the month is due mainly to allocation. While the steep underperformance of growth sectors naturally helped, more than half of the fund's outperformance was generated in December by its overweighting of banks. Stock-picking had little impact on the month, with some good news (Sanofi +4.9%, Saint-Gobain +4.4%), but also some bad news in the auto sector (Stellantis -10.9%) and at the most highly leveraged companies (Faurecia -10.3% and Alstom -8.2%)[3].

As reflected in the aforementioned soft data in Europe, the scenario of a moderate dip in economic activity in Europe gained in credibility in December, thanks to a winter that has thus far been mild. The market's decline on the month was therefore driven more by government bond yield trends than by macroeconomic concerns, and cyclical stocks, which were a big driver of the previous weeks' rally, took only a modest hit in December. As has been the case for several months, cyclicals' valuations remain close to their all-time lows.

2023 EPS forecasts have been revised only slightly, and EPS are still expected to rise by +7.3% (ex commodities and energy[4]). This still looks too high to us in a scenario of moderate recession. The market is likely to consolidated further during the fourth-quarter reporting season and the release of initial management guidance for 2023. Possible disappointments on cyclicals could be excellent opportunities for projecting one's investments to 2024. Even so, and as we had mentioned last month, we have continued to add to the portfolio's cyclical exposure, encouraged in this direction by the announced reopening of the Chinese economy. The lack of clarity on this latter point led us to raise our weighting of cyclical stocks by just 1% more, with a defensive pillar that is now at 24%.

We expanded our cyclical exposure through several switches. We took advantage of higher interest rates and the underperformance of the technology sector to keep our underweighting of the sector from drifting too much by increasing our exposure to STMicroelectronics (-8.3% in December) and Capgemini (-8.8%). We were likewise opportunistic in buying into weakness in Deutsche Post (-7% in December and -34% in 2022). These increased exposures were financed mainly by profit-taking in the energy sector *via* TechnipEnergies and TotalEnergies (+20% and +40.5% in 2022). These trades were also meant to reduce our overweighting to a sector that could take a hit from possible diplomatic progress after having been by far the top performer of 2022 (+20.3%). But, as this is not our baseline scenario, we are keeping our overweighting of energy high, at +4.5%. In addition, we reduced some defensive holdings in EDP and Danone, as well as the telecom sector *via* Deutsche Telekom and KPN.

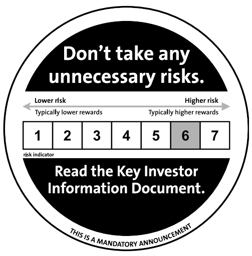
And, lastly, our main conviction for 2023 remains the banking sector. This was the case even before soft data improved in Europe, but a further improvement in the economic outlook would boost a sector that, through higher interest rates, should see a considerable increase in its profitability, whereas forecasts are still relatively modest (+7.6% on 2023 EPS[5]). An increase in PMIs towards and above 50 has tended to trigger steep reratings in the sector, whose valuations are still low. We made a few pair-trades within the banking sector, taking profits on CaixaBank (+59.4% in 2022) and building up our positions in UniCredit (+3.7% in 2022) and Société Générale (-2% in 2022), whose sensitivity to rising interest rates is expected to increase more slowly than that of the Spanish banks.

Completed writing on 6 January 2023

(2) Source: Bloomberg, 6 January 2023.
(3) Source: Bloomberg, 31 December 2022.
(4) Source: Europe Weekly Kickstart GS, 19 December 2022.
(5) Source: GS Europe Weekly Kickstart, 16 December 2022.

Performances	2022	2021	2020	2019	2018	2017	Since inception [1]	1-year volatility
R-co Conviction Equity Value Euro C EUR	-9,63%	26,30%	-9,85%	17,64%	-18,01%	14,74%	93,27%	22,68%
Euro Stoxx ® NR[2]	-12,31%	22,67%	0,25%	26,11%	-12,72%	12,55%	85,09%	19,69%

(1) Inception date: 20 May 2005.
(2) Benchmark.
Source: Rothschild & Co Asset Management Europe, 30/12/2022.



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