Amundi ASSET MANAGEMENT

AMUNDI Equities
The equity network letter

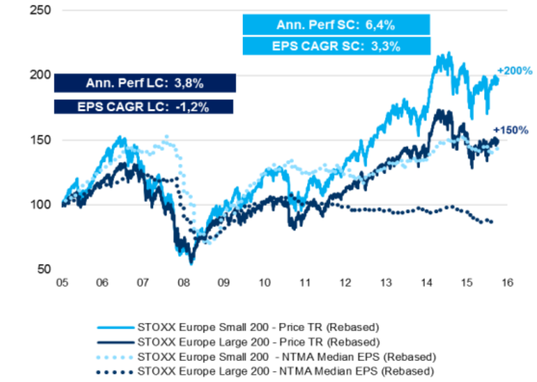
July 2017 – n°63

editorial

Size matters

For more than twelve months, our conviction has been that Europe, and in particular Europe ex-UK, has the means and the strength to strike back. We can even draw a parallel with Japan because Europe has been under the threat of experiencing a lost decade, associated with deflationary pressures. Indeed, the beauty is that Europe, having learnt from past experience and from the Japanese example, has been quick to jump in to put in place radical solutions on the lines of Japan version 2012. All the reforms that have been implemented, notably the banking union, reinforced by the recent quick resolution of the Italian and Spanish banking crises (it took only a few days to decide on the bailout of the Veneto banks in Italy or of Banco Popular, formerly the n°3 bank in Spain) confirm our conviction that earnings headwinds are now behind us in Europe and we are well on track to recover the kind of profits we had before 2008, as elsewhere in the developed world.

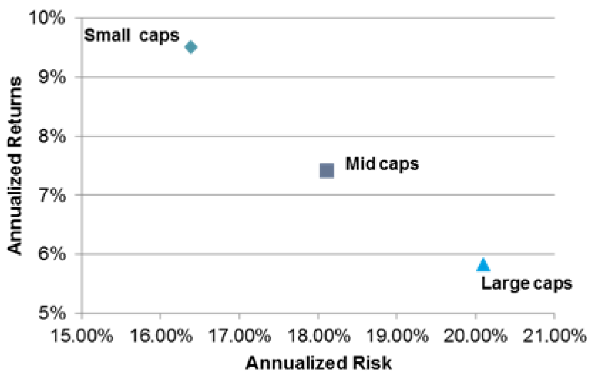
Small caps offer better returns….



Source :Factset, Amundi,

In this recovery mode, the seconds step is to ask what we should buy in Europe. Clearly, continuing the analogy with Japan, if European equities can move back to the kind of profits we had ten years ago, double digit EPS growth is a story to last. But we should also consider this recovery story as a great opportunity – especially in context of persistently low interest rates- to focus on small and mid caps. Why? Because small and mid caps have demonstrated their ability to leverage growth expectations in an economic upcycle, and also to be perfect targets when M&A activity is at its peak. Last but not least, in an equity world where passive funds are rapidly gaining ground year after year, small and mid caps have demonstrated that they can now be even less volatile than large caps, thanks to their lower exposure to hot money which is a big source of market turbulence.

… with lower risk



Source::Factset, Amundi. Data based on MSCI Europe daily

Given that only part of the roughly 100 billion USD that fled Europe last year has found its way back, mainly into large caps and ETFs, we believe that this ongoing rebound will be huge in terms of earnings and flows and will benefit alpha generators. Segments or themes particularly exposed to this recovery mode, such as small and mid caps, or special situations, should logically amplify the upward trend. We are well aware that risks have not disappeared. The main risk that we identify as a potential party spoiler comes from the end of the cycle in the US where earnings momentum, already at an advanced stage, may well run out of steam. However, so far US earnings have been holding up, helping markets to establish new records.

To conclude, when you are on track to see Europe great again, think big but don't forget also to buy small caps.

Romain Boscher & Diego Franzin
Co-Heads of Equities

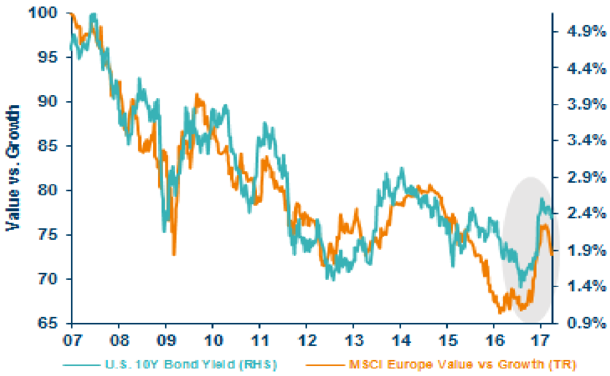
(convictions)

European Value Rally Take 2?

After a decade in the doghouse, Value Equities in Europe saw a resurgence of interest last Summer as bond yields moved higher and investors looked for ways to play the reflationary trade. Given the high correlation between European Value and 10 years treasury yields, this led to a 6 month value rally versus growth. Then, just as investor interest was peaking – the value rally appears to have taken a pause for a breath since January this year. Year to date, the Value index in Europe has delivered just half of the broad market index (MSCI Europe).

This short recess does not undermine the case for increasing exposure to European Value. Value moves with reflation trades, which tend to drive nominal earnings. This faded so far this year, plus political risk took over in Europe. The market-positive outcome of both elections now allows investors to re-focus on fundamentals. Falling political risk in Europe is, in our view, the trigger for the continuation of outperformance of Europe and, in particular, value areas of the European market.

The correlation between US bond yields and European Value is very strong



Source : JP Morgan March 2017

The market looks undeniably fair-valued at this point and without clear earnings growth to act as a catalyst will likely move sideways at best. The attractiveness of value investing does not lie in the aggregated valuation of the market but rather in the valuation dispersion levels – the difference between the cheap and the expensive parts of the market. In our view, the sustainability of any rally in Value will be predicated on better earnings delivery and the elevated valuation dispersion levels.

Value, by definition, is cyclical and finds best support through an encouraging economic backdrop and its conversion into greater earnings growth. Q1 earnings session delivered the best earnings beats in 7 years. Within that number, the greatest number of earnings beats have occurred in cyclical sectors. A continuation of this trend should see a reacceleration of the reflationary trade and within that the outperformance of European Value once more.

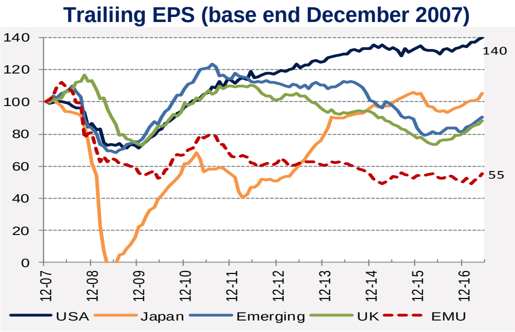
All that said, the quick money has been made. One of the risks to “value” investing is that investors are just looking at the “price” of the asset and not paying due consideration to the actual “value” of that company. Sometimes companies are considered value for a reason, because the business model is broken or its earnings power is not sustainable. To really participate in this opportunity set savvy investors should combine “value” with earnings power. In our view, the “sweet spot” for the next stage of value outperformance will identify those companies which offer appropriate margins of safety (value) but can also demonstrate the ability to deliver sustainable earnings. This is more likely to be stock specific than one particular sector.

Andreas Wosol
Senior Portfolio Manager,
European Small Cap Equity & Country Strategies

The Renaissance of Europe?

We have been positive on Europe relative to other regions since the inception of the Global Concentrated strategy over three years ago. However, in the last nine months our confidence has grown and we see Europe as the most attractive region globally, followed by Japan and Emerging Markets. Why is our confidence so high?

Firstly, we see the economic outlook as particularly supportive. Europe has struggled to deliver consistent nominal growth since the Eurozone Crisis of 2011. This has held back earnings per share and depressed ROEs. Over the past 12 months evidence has been growing that nominal growth is accelerating and that this is as much about internal EU growth as factors outside Europe. We think that there is a period of "return mean reversion" ahead of us which will see European corporates delivering higher ROEs as accelerating growth disproportionately rewards the bottom line. Banks are suffering particularly from depressed cyclical earnings and ROEs; leadership from the banks sector will be key to outperformance of European equities.



Source : Amundi Research, Thomson Reuters Datastream

Secondly, politics are much more supportive to Europe than they have been for some time. Over the past decade Germany has been the driver of European growth: its export driven manufacturing economic model has been particularly well placed to benefit from the expansion of manufacturing capacity in emerging markets. France and Italy have fared less well over this period. We expect the German economy to continue to do well but there is now the prospect of reform driven growth acceleration in both Italy and more importantly France. Macron's reforms – if successfully implemented – could awaken France's animal spirits and see a sustained uplift in economic performance, exactly as experienced by Germany post the Schroder reforms of the 1990s. In Italy the changes are less dramatic but most importantly the banking system is being properly restructured and recapitalised and this alone should help economic performance.

In absolute terms we see this as very positive since valuations remain depressed as the earnings cycle has not properly improved and has significant future potential. Longer term estimates of value, for example the Schiller P/E, point to Europe as a mispriced region. But we also note the relative attractions of Europe and contrast with the US where profit shares are at record highs and declining and politics remain complex and very uncertain. From our perspective European equities should continue to shine over the coming quarters.

Nicholas Melhuish
Head of Global Equities

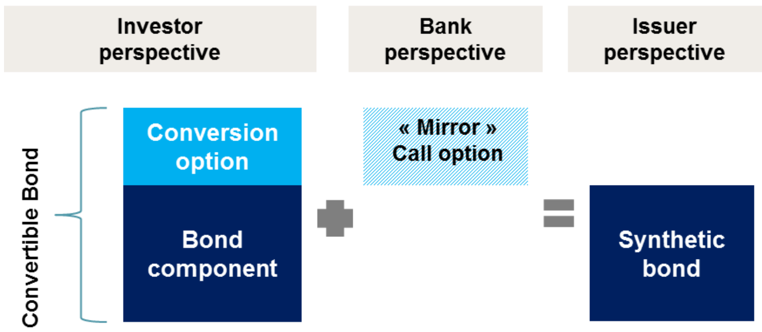
focus

Financial Innovation in Convertible Bonds – 2 years later

Over the years, the convertible bond market has seen several financial innovations, some temporary and some sustainable. Fresenius (German health care group), a traditional issuer of High Yield bonds is the initiator of the most recent innovation. The Group was the first issuer to devise and launch a non-dilutive convertible bond for € 500m in 2014. Since then, a trend emerged with around 15 issuers of non-dilutive convertible bonds in the past two years, representing over 20% of the new issues in Europe over that period.

The financial innovation of non-dilutive convertible bonds lies in the fact that simultaneously to the convertible bond placement, the issuer will purchase from banks identical options mirroring the one embedded in the convertible. Thus, a "synthetic straight bond" is recreated for the issuer.

Non-Dilutive Convertible Bonds



Source: Amundi

The **issuer benefits from an arbitrage** of the OTC options market versus the convertible market, which results in **reducing his funding cost** below the level achievable in the straight bond market. Furthermore this financing method does not bear any risk of dilution and allows to widen his investor base.

From an investor's perspective, a non-dilutive convertible bond is identical to a classic convertible bond, although there are some differences regarding some specific clauses (as can be the case amongst classic convertibles). In case of conversion, the investor will not receive the underlying shares but the equivalent in cash ("cash settlement"). This is equal to selling the convertible or the underlying shares.

Non-dilutive convertible bonds are only accessible to issuers for which there is an active options market, as this is required to provide the mirror option. This is generally the case for large cap issuers who tend to be investment grade names. As a consequence, from an investor perspective, this innovation led to:

1. An **improvement of the European CB universe**, with more blue chip issuers (large cap, investment grade)
2. A **strengthening of the overall bond floor** as IG credits are more resilient in case of market stress
3. An improvement, i.e. **reduction of the distance to the bond floor**, which increased due to the lower spreads. At issue the bond floor of an IG issuer is around 95% or higher, while it frequently stands around 85% for high yield or unrated issuers. A lower distance to the bond floor means that the **equity risk of investors is reduced**.
4. **Access to new issuers**, which are dilution adverse and therefore do not issue classic convertible bonds (e.g. LVMH, Total). These are often **« Best in class » with attractive equity stories**. For example Vinci issued a non-dilutive convertible bond in February 2017 and issued a tap 3 months later (in May) after the convertible bond had rallied 10%.
5. **Corporates coming to the market irrespective of their share price**. For example Technip issued on the basis of a share price at a multi-year low, when the barrel had dropped to $ 25 (beginning of 2016). This was a highly attractive level to get exposure to an oil price rebound.

In our view these **advantages clearly outweigh the negatives**:

1. Lack of new issue discount. The secondary market does not offer a discount either. This is more than compensated by the potential equity upside, even over the short/medium term (see examples above of Vinci and Technip) and the strong credit quality.
2. The dividend adjustment clause is symmetrical on the upside and downside. These symmetric adjustments are also increasingly seen in classic convertible bonds.
3. There is no takeover protection. However this is less relevant for large cap, "best in class" issuers, which will more frequently be the bidder than the target.

Ultimately the investors need to decide between the absence of a new issue discount and the benefits that non-dilutive convertible bonds may offer: convexity, credit quality, low distance to the bond floor, equity story, … At Amundi, we will always **take this decision on a case by case basis**, in line with our bottom up selection process.

Convertible bonds disappear from the market either in case of redemption at maturity or via « the top » in case of conversion and this potentially before maturity. Thus, the **primary market is crucial** to preserve a stable convertible universe. New issues participate to the dynamism of the market and have ensured the **full renewal of the European universe in 4 years**. **Non-dilutive convertible bonds strongly contributed** as they represent a large proportion of recent new issues.

The striking growth of non-dilutive convertible bonds over the past 2 years highlights that this innovation is a **win-win evolution for both the issuer and the investor**.

Sabine Duchesne, Stephan Eckhardt
Investment Specialists – Volatility, Overlay & Convertibles

July 2017 – n°63

Romain Boscher
Co-Head of Equities

Diego Franzin
Co-Head of Equities

Nicholas Melhuish
Chief Investment Officer, Equities – Amundi London

Patrice Lemonnier
Head of Emerging Markets Equity Group

Yasunori Iwanaga
Chief Investment Officer – Amundi Japan

Alexandre Drabowicz
Head of Development & Investment Specialists, Equity Strategies

Sudeshna André
Investment Specialist, Equity Strategies