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Amundi ASSET MANAGEMENT

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INVESTMENT TALKS

A view on small and mid-cap equities moving towards 2018

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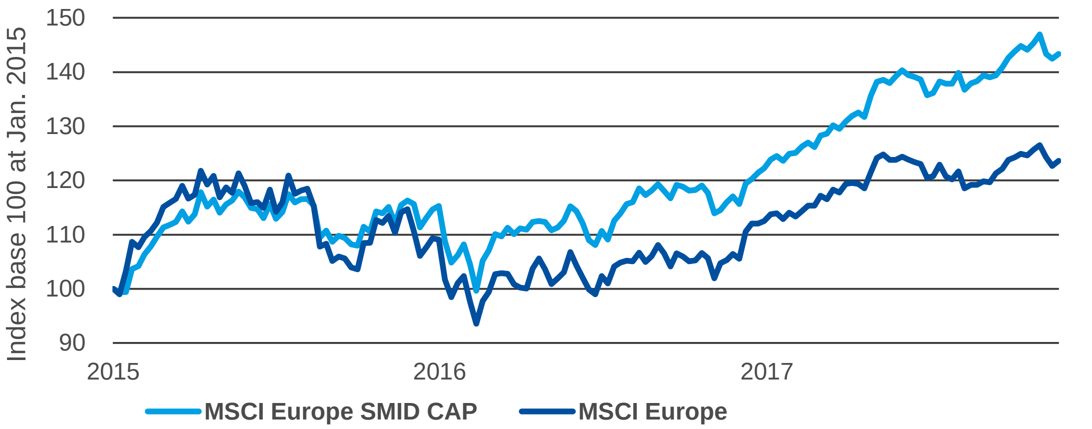
Valuations in European small and mid-cap stocks are not cheap, but this asset class continues to be favoured by the positive economic backdrop, high exposure to domestic dynamics, and possible increase in M&A.

What is your outlook for European small and mid-cap equities in 2018?

CG/CM: The late-recovery is now broadening to all countries in Europe and their GDP components. Owing to accommodative monetary and credit conditions, the growth momentum is expected to continue into 2018, supported also by stronger internal demand. Notable progress in implementing reforms at both the EU and single country level is also supporting the positive outlook for the region. Although some local risks remain, political stability has improved and uncertainty about the EU architecture as a whole has diminished.

This backdrop of economic growth, still accommodative monetary stance, and subdued inflation should continue to favour equity markets, and in particular small and mid-cap companies, which are by nature more sensitive to the cycle. Consequently, we maintain our positive outlook for European small and mid-cap stocks in Europe in 2018, but with some caution as we arrive from a period of strong outperformance for this asset class (see Fig.1). Therefore, investor in search of diversification[1] within the risk allocation could consider an exposure to this asset class with a strong focus on selection.

Fig.1: EU small and mid-cap recent outperformance could continue in 2018



Source: Bloomberg, Amundi. Data as at 28 November 2017.

In your view, what are the biggest opportunities and risks for 2018 not yet priced into the market?

CG/CM: The positive economic backdrop and the return of investor confidence fueled by lower geopolitical risk in Europe should, in our view, create a fertile ground for merger and acquisitions (M&A). This will, we believe, represent a strong driver for the small and mid-cap universe. Corporates are cash-rich and M&A deals look set to further accelerate in anticipation of rising rates, thus creating opportunities for stock-picking investors.

On the risk side, temporary changes in market sentiment resulting from geopolitical issues or a possible increase in credit risk market perception could drive a resurgence in market volatility from the current depressed levels, and result also in higher liquidity risk, especially in small caps.

How should the investment approach change in 2018 compared to 2017 and why?

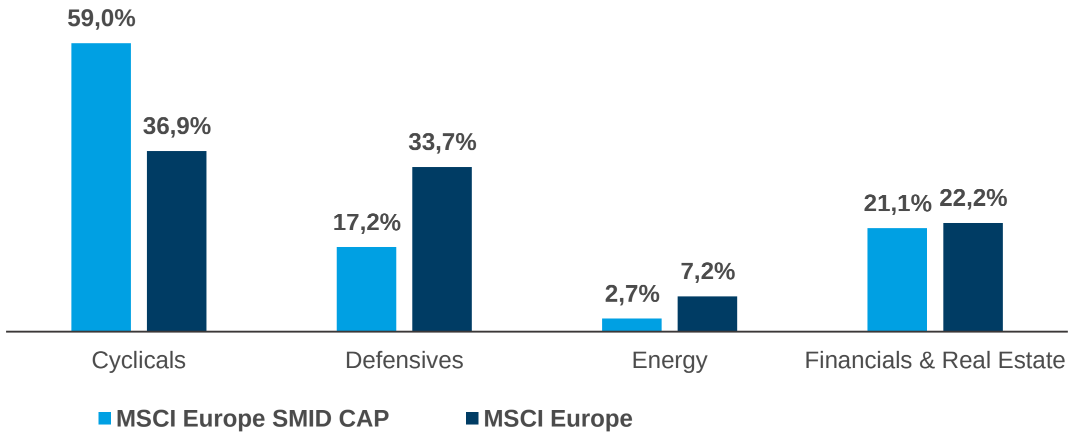
CG/CM: Investors in search for opportunities in small and mid-cap companies should, in our view, embrace a selective bottom-up approach. This is particularly true in general as this asset class could be

[1]Diversification does not guarantee a profit or protect against a loss.

Investors should focus on structural winners that could continue to grow and gain market share vs competitors due to their product, technology or strategic leadership.

subjected to high dispersion of returns across single names, especially if M&A activities are to further revamp, and this is also increasingly relevant as we move in 2018.
In fact, given the recent very strong performance of this asset class, valuations appear not particularly compelling, but still reasonable. Reflecting this, both Price Earnings (PE) and Price to Book (PB) ratios are more elevated than their large cap peers. We note that these valuation levels are justified by superior earnings growth, which will continue to be the key variable to drive further market appreciation.
Selecting stocks able to continue to deliver earnings growth will become increasingly relevant. In this search, investors should focus on structural winners that have the potential to continue to grow and gain market share vs competitors due to their product, technology or strategic leadership.
Overall, we remain constructive on the outlook for small and mid-cap equities. In fact, given their higher domestic exposure compared to the large-cap peers, we think they could benefit the most from the domestic recovery. In addition, their bias towards more cyclical sectors could be a tailwind for the asset class (see Fig.2). Small-cap stocks' premium vs large cap remains justified, in our view, due to their profile of higher growth, and their ability to identify business niches with more favourable dynamics, to maintain more flexible structures, and to be able to react more quickly to new opportunities and challenges.

Fig.2: Breakdown of sectorial allocation of European small and mid-cap vs large cap



Source: Datastram, Amundi Research. Data as at 28 November 2017.Cyclicals = Materials + Industrial + Consumer Discretionary + Information Technology, Defensives = Consumer Staples + Health Care +Telecom+Utilities.

Italy has been one of the most dynamic market in 2017, thanks also to the introduction of new investment vehicles. Do you see this trend continuing?

CM: The newly created investment vehicles gathered record flows in 2017, far beyond the Government's initial expectations and contributed to the very strong performance of the Italian Small and Mid-Cap index (+ 31% in 2017, with the European Small and Mid-Cap Index returning + 19%).
Year-to-date new net flows were c.€7.5bn as of 3Q 2017, with a revised estimation that now stands at €10bn in 2017 and €50bn in five years. Equity offerings have increased and are expected to increase even further to meet the investor demand. In 2017 to-date Borsa Italiana has announced approximately 30 new listings, aiming for a number close to 40 IPOs by the end of the year.
Furthermore, several placements have increased the free float of SMEs already listed, with founders and/or major shareholders reducing their holding and favouring increased liquidity in the shares. 2017 has also seen a renewed interest for SPAC (Special Purpose Acquisition Company), reaching a total of 18 listings at Borsa Italiana as of today. These investment vehicles allow SMEs to increase growth and accelerate their path towards listing. SMEs look at SPAC as a way to combine the capital raise and listing with a reduction in the time, burden and uncertainty connected with the listing. SME owners also often appreciate a more entrepreneurial-friendly approach that SPAC may offer (compared, for example, to Private Equity), since SPACs do not require entrepreneurs to give up control of the company. We believe that the strong investor demand will continue to support the Italian market into the new year. We are aware that the huge inflows into the market could create valuation distortions, and for this reason we believe investors should carefully reassess each investment case. Political elections in Italy in early 2018 may also create some additional short-term volatility.

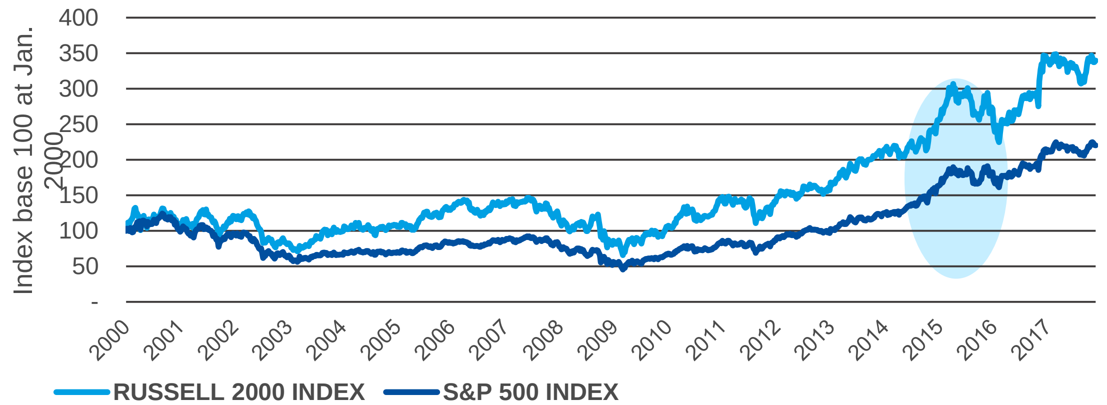
We are cautious on U.S., small and mid-cap equities: they could benefit from the potential tax reform, but their valuations are very high and we see little room for outperforming large caps.

Moving to the U.S., what is the outlook for small and mid-cap?

MP: While the potential tax reform is a good argument for these more domestically-oriented stocks, we should note that small caps and some mid-caps in the U.S. are extremely expensive. They had a great 14 years run between 2000 and 2014, when the outperformance came after massive underperformance in the late 1990s and what was a cheap valuation compared to large cap stocks.

Starting in 2015 they have been volatile against large caps and overall slightly down. We expect this trend of volatility and under-performance to persist in the next years. On one hand, they will benefit from domestic-oriented policies (like the tax reform), while on the other, the fact that they are so much more expensive than large caps (Price Earnings Russell 2000 trailing 49 times versus S&P500 22 times) will set them up for underperformance in the long run. As such, we doubt the next 15 years will be as good as the past 15.

Fig.3: Little room for US small and mid-caps to outperform large caps



Source: Bloomberg, Amundi. Data as at 28 November 2017.

With the contribution of:
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AMUNDI INVESTMENT INSIGHTS UNIT

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