Amundi ASSET MANAGEMENT

AMUNDI Equities
The equity network letter

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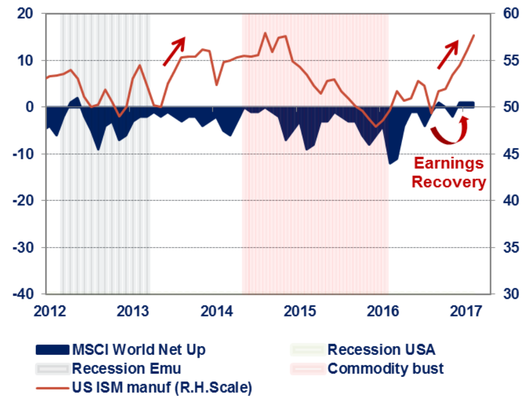
editorial

"Earnings, Earnings, Earnings ...."

When you invest in real estate, the rule of thumb is to be obsessed by three criteria: location, location, location. To some extent, the same golden rule can also be applied to equities. The three criteria that we need to focus on are earnings, earnings and earnings. This conviction is particularly valid in an environment where markets are no longer cheap, as was the case of developed markets four years ago.

Earnings and economic growth
Global earnings revisions and ISM

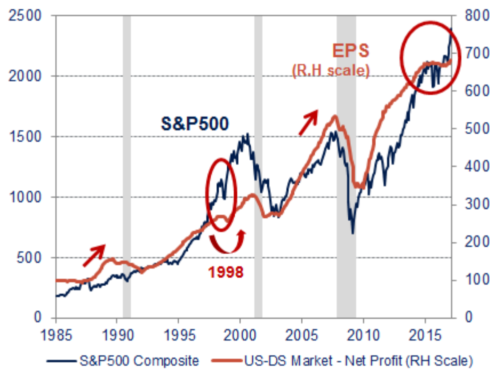


Source :Thgmson Reuters Datastream, Amundi Research,

Going forward, the positive momentum on markets can be sustained only if we meet one major condition: we need to see earnings and earnings expectations trending upwards. Two elements allow us to be reasonably confident on this score: Q4 2016 was probably one of the best reporting seasons in Europe, and earnings forecasts for 2017 are being revised upwards worldwide.

This backdrop encourages us to remain constructive on equities. Nevertheless, markets over the last couple of months have been moving in line with or even faster than the pace of earnings upgrades, which means that valuations are now in stretched territory. This leads us to the observation: yes, markets do have further upside, but if and only if earnings continue to be revised upward. This explains why we are more confident about Europe and emerging markets, where the starting point is less challenging, or Japan, which also has to meet a second criterion, namely a yen maintained around its current relatively low levels. We prefer these markets to the US where the potential seems more limited.

Earnings momentum is driving the market



Source :Amundi Research, Thomspn Reuters Datastream

Romain Boscher
Global Head of Equities

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convictions

Europe: supportive macro but political risk

Recent economic indicators have been surprising positively. This is also true of the Euro zone where the PMI was at 56 in March.

Even though the ECB's main message remains unchanged (We continue to believe that key ECB interest rates will remain at their current level or even be lower for a long period), we note an adjustment in statements from policy makers in the Euro zone.

While revising upwards growth forecasts for 2017 (from 1.7% to 1.8%) and 2018 (from 1.6% to 1.7%), the ECB President Mario Draghi recognised that the recovery in the Euro zone was becoming more solid. He also observed that the cyclical upturn could gain in momentum. The argument of headline vs core inflation has not changed, namely the fact that the difference between the two indices is due to a base effect linked to oil and to a lesser extent to food prices. We can thus find ourselves in a situation where accelerating macro momentum could co-exist with monetary policy accommodation, which would clearly be supportive for European equity markets.

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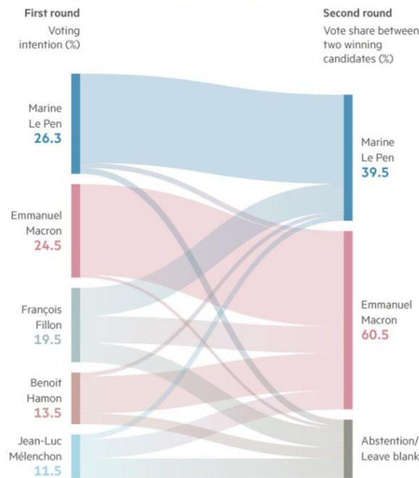
Latest surveys in France point to a Macron victory in the second round



Source : IFOP, 9 March 2017

There remains of course the political risk, which the markets have not yet fully discounted, notwithstanding the recent performance spread .between the CAC and FTSEMIB on the one hand and the Dax on the other. While US investors are steering clear of the European market, European investors have barely started to hedge their positions.

There is the Italian risk of early elections. Matteo Renzi's resignation from his post of Party leader has triggered a decision to hold a Party convention this spring, which drastically reduces this risk.

And then there are the French presidential elections. Even if Emmanuel Macron looks likely to win comfortably in the second round, what a decline in the *Front Républicain*, the coalition of parties against the far right, in fifteen years (82% for Chirac, 18% for Jean-Marie Le Pen). In addition, the number of undecided voters among Macron supporters is higher than in the Marine Le Pen camp. Lastly, the security environment adds to the uncertainty. Two remarks can be made about the programmes. Marine Le Pen's plan to organise a referendum on exiting the Euro will take about ten months. Emmanuel Macron's economic programme looks relatively promising (flexi-security in employment and agreements on work conditions concluded at the company level) while his affirmed confidence in Europe should reassure markets.

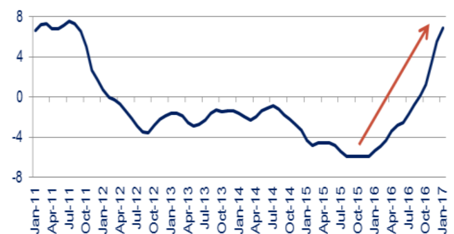
Once again, we are faced with a binary risk. However, this time round the strength of the underlying economy is less of a debate.

Laurent Ducoin
Head of Europe Stock Picking

China: extended positive surprises into 2018?

We have observed positive surprises coming from China, and we think they can't be missed by investors, as they are not priced in at all or very much under-estimated. And these positive surprises from both bottom up and top down will continue to help stabilize the Chinese economy, hence to help shape the longer than expected global upturn cycle likely into 2018.

China PPI, %



Source Bloomberg, Amundi Research

1. Strong PPI recovery: The key indicator allows us to spot the very initial stabilizing in October 2015 in PPI (Producer Purchasing Index). (1). Real interest rate is negative now in China and is down by over 10%, which is significant. Real interest rate is calculated by one year benchmark lending rate 4.35% - (-5.9%) = 10.3% in Oct 2015, vs. 4.35-6.9% = -2.6% in Jan 2017. (2). Earnings revision ratio (0.92 reading now while heading to 1.0 reading the bull market threshold) for China continues to surprise to the upside after PPI recovery. (3). NPL ratio declines unexpectedly. Given corporates' earnings recovery, their ability to repay debt or interest is also rising hence NPL declining
2. Private capacity expansion: this has been regarded as the fundamental signal that economy restarts healthily, where we believe it starts to happen in China. PPI recovery has transmitted to CPI, and downstream sectors in China has expanded their private capacity with unexpected growth as high as 60%. Why? During two five year plans time (11th and 12th, is 10 years), private sectors in China, have actually shifted and restructured quietly, and the pickup in private capex indicated their transformation has been complete finally
3. Public capacity expansion: Infrastructure investment has been one of the key driver to stabilize the overall Chinese economy from top-down. Sales of excavators used for construction have been strong ever since last September with the most recent February reading at 298% yoy growth. Without a pipeline of construction projects in infrastructure or property, for at least the next two to three years, there wouldn't be public capex expansion as strong as this time.
4. Property inventory strong destocking: Strong destocking in Tier 1 and Tier 2 cities have been captured by the market. However surprisingly destocking in Tier3/4 cities are significant as well. Who are the buyers? They are the workers in Tier1/2 cities, and they go back to buy in Tier3/4 cities. Given the low inventory across the board, property new starts and property investment will certainly surprise to the upside in 2017 and likely 2018.

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Global Emerging Markets portfolio positioning: We maintain an overweight in sectors benefiting from long term structural growth, mostly internet, health care and consumer (mostly leisure and tourism). Valuations for these sectors have become more attractive and we see signs of improving corporate governance as companies are becoming more disciplined in their investment spending. Tighter regulations in general will also benefit the current leaders.

Elsewhere, we maintain an approach of favouring companies with strong balance sheet, attractive dividend yield and understandable investments projects. It includes companies in sectors like energy, real estate, utilities and industrials. Contrary to the street, we remain sceptical on companies exposed to infrastructure spending. Like in the past cycles, we think most of these projects are aiming at maintaining a certain level of economic growth in China with a still very uncertain return on capital.

Mo Ji
Chief Economist, Asia ex-Japan

Patrice Lemonnier
Head of Emerging Market Equities

Why is it time to return to European small caps?

At a time when European equities are being supported by a large number of market drivers (weak euro, economic recovery, positive inflows), small and mid caps seem to be one of the asset classes best positioned to benefit from this supportive environment. Admittedly, the market rally triggered by the rise in long-term rates since summer 2016 and accentuated by the Trump effect at year end was at the beginning more favourable for large caps (the MSCI Europe Large Cap ended the year up 3% vs 0.9% for the MSCI Europe Small Cap). The massive sector rotation initially benefited the most liquid stocks. The banking sector, exposed to yield curve steepening and mainly comprising large caps, thus surged 37% in H2, driving up the large cap index. However, once the initial euphoria is over, should not European small caps benefit more from the reflation trade? This is what we observe at the start of 2017. As of end February, small caps were up 4.2%, once again outperforming large caps (by 200 bp).

The relative performance of European small cap has yet to reflect the rebound in European PMIs

Source DB

The gradual rise in bond yields from very low levels and the return of modest inflationary pressure testify to the improved economic climate. Leading indicators are signalling an acceleration of global growth. This environment is extremely supportive for small caps which historically react very positively to signs of economic recovery.

A scenario of accelerating global growth and a gradual economic upturn in Europe is traditionally favourable for small and mid caps which are more cyclical in nature. Empirical studies show that top line growth of small caps amplifies GDP growth by 2.5. Any acceleration of economic growth should therefore feed through to a sales recovery and margin expansion, thanks to stronger operating leverage and higher profit growth. Ex-financials profit growth for European and more specifically Euro zone small and mid caps should once again be higher than that of large caps in 2017 and 2018. In terms of valuation, European small caps remain attractive relative to both large caps and US small caps which are at a more advanced stage of the cycle. Profits of European small caps are in fact still well below 2007 pre-crisis levels, and thus have significant catch-up potential which, on unchanged p/e levels, will continue to underpin the asset class.

The other performance driver will be the acceleration of mergers and acquisitions that we expect with rising interest rates. Over the past 30 years, 90% of M&A operations have been in small caps. They are ideal targets for big groups seeking to grow in specific niche markets. The 20 to 40% premiums on recent operations involving our funds testify to the often large gap between market valuations and the intrinsic valuations of the companies. In this context of reflation and accelerating growth, European small caps should thus have a good year and the very low levels of correlation should open up opportunities for stock picking.

The political scene in Europe and notably in France remains of course a big unknown, and could lead to temporary spikes in volatility. Over the long term however, small caps have proved to be less volatile than large caps. This is why above all we are looking to invest in companies with regular long-term growth, good visibility and proven pricing power. These could be leaders on niche markets, or specific repositioning or restructuring stories leading to earnings growth. We invest in companies where profit growth is underpinned by secular (ageing population, automation, outsourcing or Internet) or cyclical (recovery of construction market and more generally of capex, stabilisation of commodity prices, increased defence spending, dollar appreciation) trends.

Caroline Gauthier
Co-Head, Europe Small & Mid Caps

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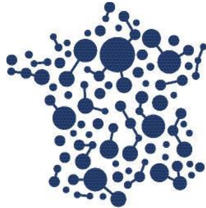
focus

Investing in equities at the heart of the French regional economy: the attraction of midcaps



At BFT IM, a fully owned subsidiary of the Amundi group, we have developed a specific investment strategy for French equities. This strategy combines:

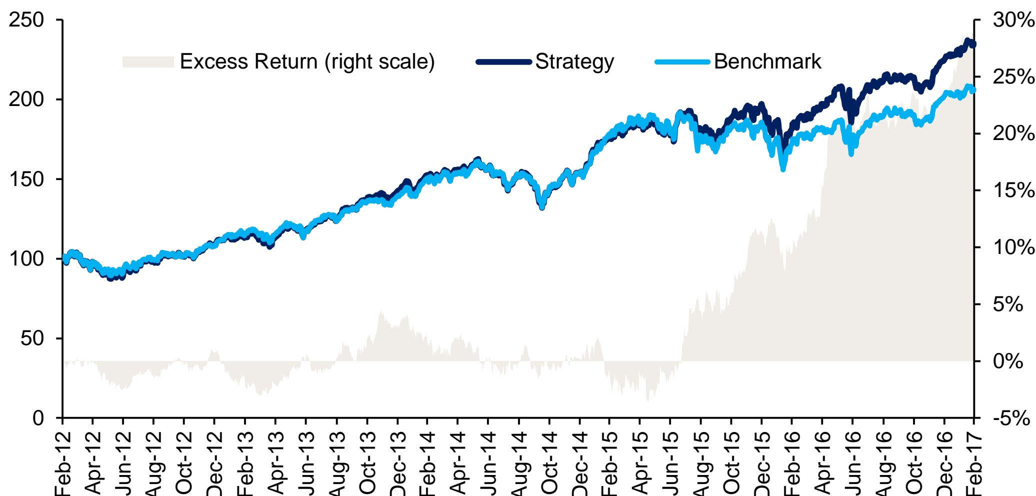
- investing in companies exposed to regional economies,
- focusing on the positive momentum of midcaps,
- focusing on the valuation potential of these stocks.

Midcaps at the heart of stock selection

Our strategy covers stocks over the entire market capitalisation spectrum. Company profiles differ greatly depending on the segment in which they are positioned. **Mid cap companies (with market cap of 1 to 5 billion euros) form the core of our investment universe. They are often leaders on their respective markets and seek to develop their knowhow abroad or on markets related to their original expertise. The French midcap segment is one of the best performers in Europe.** As of end January, French mid caps (CAC Mid & Small NR) was up 100.3% over 5 years, outperforming other European mid cap indices: MSCI Mid Germany (88.7%), MSCI Mid Europe (70.6%), MSCI Mid EMU (67.9%) and MSCI Mid UK (64.4%).
Our objective is to participate in this rise while remaining extremely selective in our choices.
Small caps (market cap below €1bn) obviously offer the strongest growth potential. These –most often single business- companies allow exposure to specific and fast growing themes. Confidence in the management's strategy is an essential criterion in our investment decisions in this segment.
Lastly, more opportunistically, we invest in larger companies which have greater visibility due to their established market share. These companies often have more stable profiles. By combining stocks from all three segments we are able to seize all opportunities and thus optimise our portfolio diversification.

Valuation: a fundamental criterion in stock selection

On the basis of regular contacts with company managements, we try to identify companies whose expertise and fundamentals are not fully valued by the market. This valuation discount can be estimated by comparison with peers or with the company's own history. We select companies presenting clearly identified triggers for improving their earnings outlook. Our target is to invest in growth, but at fair value.
The final portfolio is concentrated around 50 stocks with an average holding period of 3 to 4 years.
Over the past 5 years, our strategy has generated a total gross performance of 135.16%, i.e. 18.63% annualised.



Fabrice Masson
Head of Equities,
BFT IM

Source BFT IM – net performance of French Midcap Strategy from 28/02/2012 to 28/02/2017, benchmark: CAC Mid and Small NR.

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