Confidence must be earned

Amundi ASSET MANAGEMENT

INVESTMENT TALKS

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European equities: look for the winners to play the reflation trade, value revenge, and ESG disruption

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- ***Today, all eyes are on Europe.*** *While the strongest national European football teams are animating a great competition, which is also signalling a sort of return to normality for Europeans, investors' appetite for European equities is back and for good reason. We are not going to embark on fanciful predictions about who is going to win Euro 2020, but we do believe that detecting the winning companies with strong fundamentals, which are able to adapt to the rising inflation trend, will be key going forward, as the reflation trade matures.*
- ***European equity has outperformed global, US and emerging stocks so far this year,*** *reflecting the economic reopening and a catch up trend in earnings. At today's level, equities still look attractive, particularly relative to fixed income. However, higher selectivity is required. Fundamental bottom-up investors should look for those companies where implied expectations do not reflect fundamentals. A long-term view should be preferred to a short-term one.*
- ***As inflation accelerates*** *around the world, but remains moderate,* ***investors should consider real investments*** *such as equities and real assets. Within equities, they should identify companies with* ***high pricing power,*** *which is the ability to pass on price increases to consumers.*
- ***The growth vs. value rotation*** *reflects higher growth and inflation expectations. The valuation dispersion between growth and value stocks remains at historically high levels even after the recent rebound. The market value segment usually benefits from an environment of inflation normalisation as a result of improved macro and micro fundamentals.*
- *We see* ***good income opportunities in some pro-cyclical market areas.*** *The dividend theme is back and dividend yields are attractive compared to relative government bond yields. This gap is particularly attractive in Europe. Banks appear to be a clear choice for income investors this year. Outside of the financial sector, investors could find good income stories at the single-stock level in areas such as energy and utilities.*
- ***ESG is the most significant structural driver for the asset management industry, and Europe is the natural hunting ground for it****. European companies have developed innovative solutions to ESG challenges, such as renewable energy, energy efficiency and waste reduction, and they could capitalise on such innovation when ESG priorities start rising outside of Europe. Large asset managers have the responsibility to help drive this trend through their active ownership. Our belief is that better ESG practices will not only improve sustainability, but they will also improve the risk-adjusted return of the investment case.*

The European football championship has given a sense of normality to European citizens, as well as a sense of relief, if not euphoria. Do you see the same feeling in equity markets?

Equity markets, which are forward looking, already started reflecting the eventual reopening last year, with the acceleration that followed the positive vaccine announcements from Pfizer and BioNTech on 9 November 2020. Since then, markets have moved higher to reflect the increased likelihood of an economic reopening and the strength of the recovery, supported by huge monetary and fiscal support. Within equity markets, European equity has outperformed global, US, and emerging stocks slightly so far this year. At today's level, equities still look attractive both overall and relative to fixed income. However, high selectivity is required, as much good news is already priced in. There are still good opportunities, but selectivity and agility will be needed to pursue them, as they are more relative in nature.

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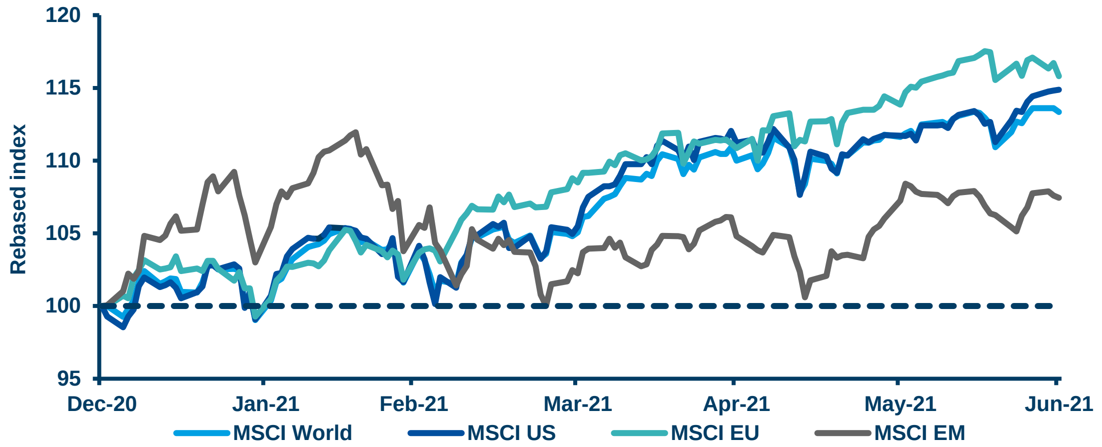
Equity market performances, rebased as of 31 December 2020 = 100



Source: Amundi, Bloomberg. Data as of 30 June 2021. Data refers to MSCI indexes in local currency. The MSCI World and EM indexes are measured in dollars. For each index the total return performance is considered.

As Europe reopens after lockdowns and economic growth accelerates, what are the main drivers and areas of opportunity for investing in European equities?

Fundamental bottom-up investors should look for opportunities to invest in those companies where implied expectations are too low compared to estimates. A long-term view should be preferred to a short one. It seems that -- even if the reopening narrative is well understood overall – it is not yet reflected in a few segments of the equity market. We see opportunities in areas such as media, travel, leisure and industrials.

We are witnessing bouts of inflation as demand resurges. Which areas could investors look at to generate inflation-adjusted returns?

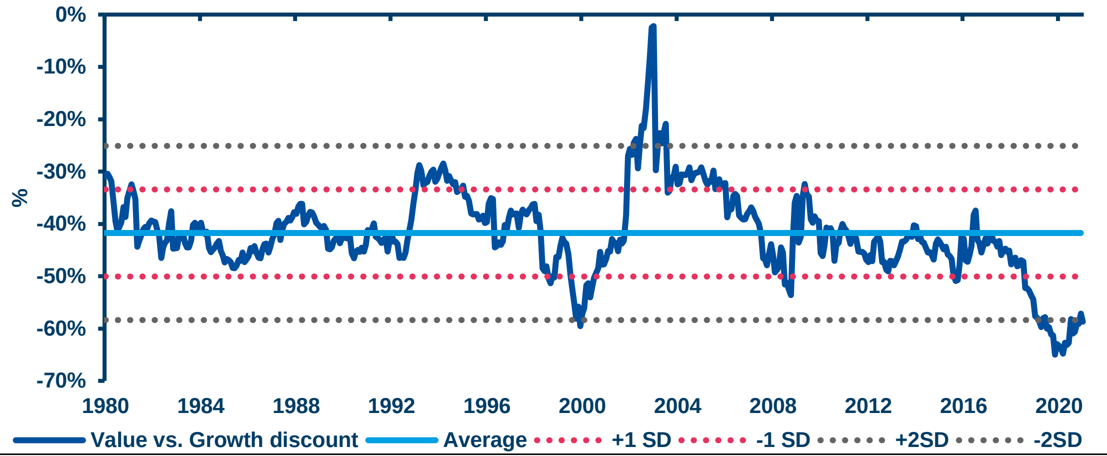
When faced with inflation, investors need to be very careful with nominal investments, such as bonds, and consider real investments as equities or real assets. Within equities, investors should **identify companies with high pricing power,** which is the ability to pass on price increases to consumers. Pricing power varies wildly across companies and industries. Generally, it is higher for those companies that have a product or service which has a level of branding or intellectual property which protects it from competition. It could also be a regulated industry where pricing is adjusted for inflation, such as toll-road operators. In addition, companies with higher margin levels typically exhibit less earnings and cash-flow sensitivity to rising input costs than companies with low margins. This rule will align with those investors who tend to invest in quality businesses, as they often have these features.

Value has outperformed growth since November 2020, both in Europe and the United States. Recently, this trend has paused somewhat. Do you still see room for value stocks to outperform and do you foresee any change to this theme going forward?

"Periods of low, but rising inflation tend to return pricing power to those sectors that have been losing it for years, as is happening with the post-Covid-19 recovery, favouring the value segment."

The rotation of value over growth leadership can be explained by the inflection point in the cycle, reflecting higher growth and inflation expectations. Since 2000, the dominant secular trend has been one of weak growth, disinflation – or low inflation – and even lower bond yields, which resulted in an extreme market bifurcation. **The valuation dispersion between growth and value stocks remains at historically wide levels even after the strong rebound, meaning that value has never been that cheap vìs-à-vìs growth**. The market value segment usually benefits from an environment of inflation normalisation from low to higher levels as a result of improved macro and micro fundamentals. This is the situation where we are currently. **Periods of low, but rising inflation tend to return pricing power to those sectors that have been losing it for years**, **as is happening with the post-Covid-19 recovery, favouring the value segment**. Value performance has a historic link with inflation and the direction of bond yields. We may transition from the current recovery regime into a mid-cycle or expansion regime, which could see yields move higher and inflation settle to a higher level than the pre-pandemic one. Such a scenario would continue to benefit value stocks, even as growth momentum slows. The drivers of this inflection point have not changed, but the valuation dispersion remains extreme, which gives confidence in the rotation continuing. However, **such a rotation will not happen in a straight line and active stock picking will be key.**

Despite the rebound, value remains at depressed levels



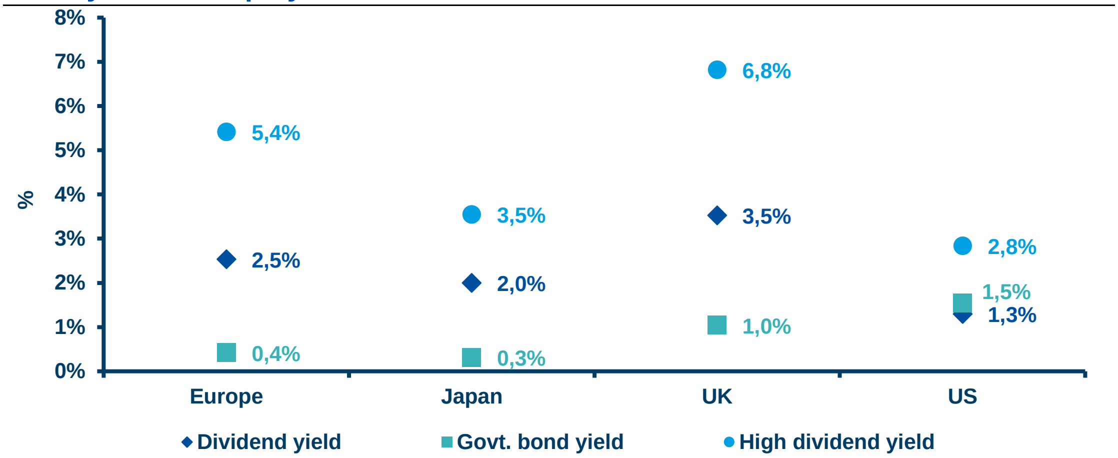
Source: Amundi Research, Datastream. Data as of 2 July 2021.

"We see good income opportunities in some of the more pro-cyclical market areas; banks appear to be a clear choice for income investors this year."

Amid ongoing low real rates, do you see a role for equity – particularly dividend stocks – in an investor's search for income? Which sectors should investors look at?

With an aging population, income remains a structural need. However, with inflation ticking higher, generating **real income** is proving to be elusive for investors. Equities are among the few asset classes whereby investors could generate an income through dividends, while enjoying the benefits of potential capital appreciation over the long term. Within equities, **we see good income opportunities in some of the more pro-cyclical market areas.** Firstly, **banks appear to be a clear choice for income investors this year**. During the 2020 Covid-19 crisis, many European banks were forced to suspend dividends to protect their balance sheets. Today, regulation is easing and attractive dividends are returning. Obviously, a rising tide does not lift all boats and a focus on selectivity is important. Outside of the financial sector, **investors can also find good income stories at the single-stock level in areas such as energy and utilities.**

Bond yields vs. equity dividends



Source: Amundi, Bloomberg. Data as of 1 July 2021. Dividend yield refers to the past twelve months.

"Our belief is that better ESG practices will not only improve sustainability, but they will also improve the risk-adjusted return of the investment case."

Recent weeks have been full of ESG news. A Dutch court ordered a major oil player to reduce emissions more than the company had planned. What broader implications could this ruling have on the energy sector?

In our view, ESG is the most significant structural driver for the asset management industry and for many other industries. Europe has an advantage as far as ESG is concerned. European companies have operated under a different set of rules and different pressure from stakeholders for years. This has helped foster innovation to seek solutions to ESG challenges, such as renewable energy, energy efficiency and waste reduction. This represents an opportunity for Europe and European companies can capitalise on this when ESG priorities start rising outside of Europe. Regardless of the starting point, there will be a need for further ESG improvement across the board. We, and other asset managers, have a responsibility to help drive this trend through our active ownership. For our part, we engage with companies on a daily basis when our investment teams or ESG teams meet companies. Helping ESG improvement is part of our active ownership. Our focus is multi-faceted and really focusses on identifying the material ESG aspects for each company. **Our belief is that better ESG practices will not only improve sustainability, but they will also improve the risk-adjusted return of the investment case**. Climate change is widely recognised as one of the most significant global challenges.

More broadly, which areas or sectors within European equity should investors look at in search of distinctive ESG opportunities?

There is a common misconception that value equity does not fit well with ESG or thematic investing. **We believe this is not true and that the broad European market can offer investors a large pool of ESG opportunities across a wide spectrum of industries and investment styles**. Value opportunities could be found across the entire value chain of such secular themes, as they act as enablers of these trends. In our value approach, we focus on themes such as the electrification of the auto sector. The digitalisation trend can be played through media and entertainment, while some areas of the industrial sector (e.g., capital goods) offer good exposure to thematics such as energy efficiency, digital factory/mobility and the energy transition.

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Definitions

- **Alpha:** The additional return above the expected return of the beta-adjusted market return; a positive alpha suggests risk-adjusted value is added by the money manager compared with the index
- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Beta:** Beta is a risk measure related to market volatility, with 1 being equal to market volatility and less than 1 being less volatile than the market.
- **Growth style:** It aims at investing in the growth potential of a company. It is defined by five variables: 1. long-term forward EPS growth rate; 2. short-term forward EPS growth rate; 3. current internal growth rate; 4. long-term historical EPS growth trend; and 5. long-term historical sales per share growth trend. Sectors with a dominance of growth style: consumer staples, healthcare, IT.
- **Quality investing**: It aims at capturing the performance of quality growth stocks by identifying stocks with high return on equity (ROE), stable year-over- year earnings growth, and low financial leverage.
- **Value style:** It refers to purchasing stocks at relatively low prices, as indicated by low price-to- earnings, price-to-book, and price-to-sales ratios, and high dividend yields. Sectors with dominance of value style: energy, financials, telecom, utilities, real estate.

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