Confidence must be earned
Amundi
ASSET MANAGEMENT

INVESTMENT INSIGHTS BLUE PAPER | JANUARY 2020

Time for a flight to cyclical value in European equity

Confidence must be earned

Amundi ASSET MANAGEMENT

EQUITY MARKETS IN 2020

Watch out for a value rotation

January 2020

INVESTMENT INSIGHTS INFOGRAPHIC

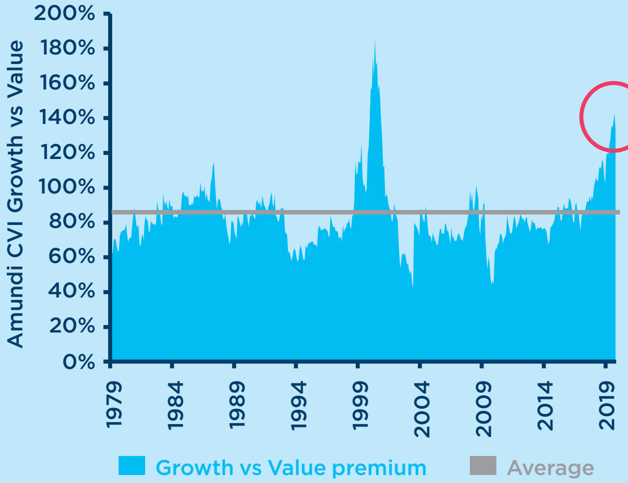
Value vs Growth dislocation could...

The current extreme dislocation of value vs growth offers a window of opportunity.

... reverse amid a cyclical rebound

Bottoming out of economic activity could be the trigger for a rotation towards value. Selection will be key to avoid areas of disrupted business models and focus on names that can best exploit the expected cyclical rebound.

Only 2%of the time over the last 40 years growth vs value premium has been higher



Source: Amundi Composite Value Indicator (CVI), at 26/11/2019.

Improving Purchasing Managers Indexes (PMI) should benefit Value vs Growth

Source: Amundi, Markit, ISM. Bloomberg. Data as at 9/12/2019.

Definitions: **Purchasing Managers' Index (PMIs)** – Indicators derived from monthly surveys of senior executives at selected companies that help in identifying economic trends. **Growth investment 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: materials, industrials, consumer discretionary, staples, healthcare, IT. **Value style** – It means 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.

Amundi ASSET MANAGEMENT

EUROPEAN EQUITY VALUE

Four themes support European markets in the value rotation

1 BOND YIELD STABILISATION

CBs guidance for stable rates combined with a global manufacturing bottoming out should support a stabilization of bond yields. This could benefit some traditional value sectors such as financials and consumer discretionary.

Allocation to financial and consumer discretionary sectors

MSCI EMU	MSCI Europe	MSCI Europe Value
31%	28%	40%

Source: Amundi research, MSCI. Data as of 30 November 2019.

2 SENTIMENT AND VALUATIONS PLAY IN FAVOUR OF EUROPE

A combination of geopolitical improvements is supporting investor interest in Europe, at a time when equity valuations are also attractive.

BREXIT

The probability of a no-deal Brexit has significantly reduced;

A possible US-China mini deal would also be supportive;

Any good news on reforms (banking union) could also support European equities.

3 LIGHT INVESTOR POSITIONING AND POSITIVE MOMENTUM

Investor positioning is catching up with the trend. In fact, recent surveys on global fund managers' allocation are pointing towards an increase to European equities.

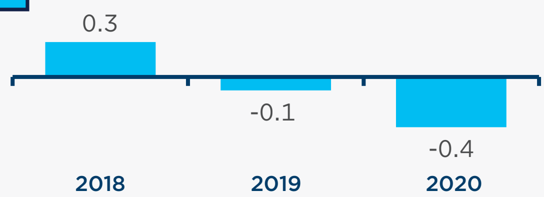
December 2019
19 Month high in global fund managers allocation to European Equity.

Source: BofA Merrill Lynch Global Fund Managers Survey, 15 December 2019.

4 SUPPORT FROM A FISCAL PUSH

With further support to growth in the Eurozone expected from the fiscal side in 2020, we believe the appetite for European equity will continue.

Eurozone Fiscal stance Change in structural government balance, % of GDP



Source: IMF, European draft budgets, Amundi estimates. Data as of 15 November 2019.

Date of First Use: 8 January 2020. Devised by: Investment Insights Unit.

Amundi ASSET MANAGEMENT

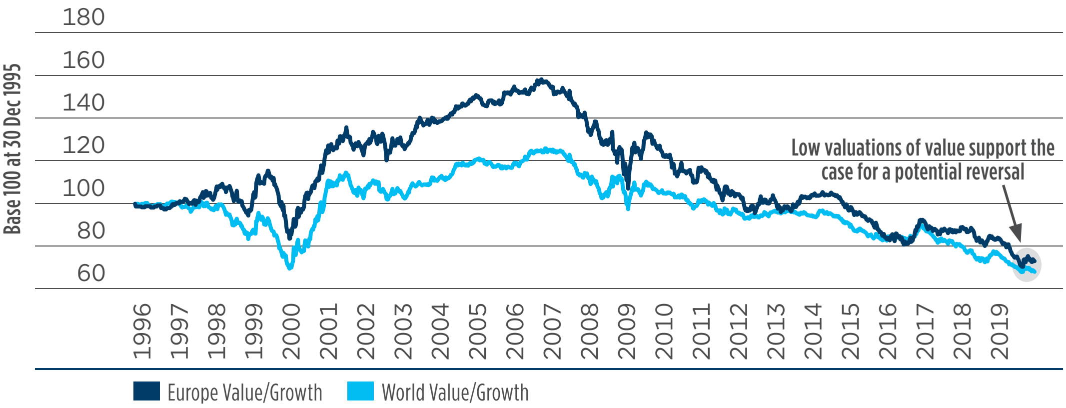
Kasper ELMGREEN
Head of Equity

Andreas WOSOL
Head of Value

Value dislocation could reverse amid a cyclical rebound

When we look fundamentally at the risks and rewards in equity markets for 2020, we find that value offers better opportunities than growth as implied expectations are lower and therefore more attractive for value at this point. The performance of value vs growth has been on a downward trend for a long time, almost 13 years. In our view, the rotation towards value that started in September 2019 is likely to continue in 2020. European equities will benefit from this rotation; Europe is a value market as it is more skewed towards the traditional value sectors of financials, telecoms, mining and utilities, while being underweight in the hyper-growth segment of information technology (IT). In the past, rotations from growth to value have been more pronounced in Europe than the overall global market (see Fig. 1).

Figure 1: Extreme underperformance of value vs growth



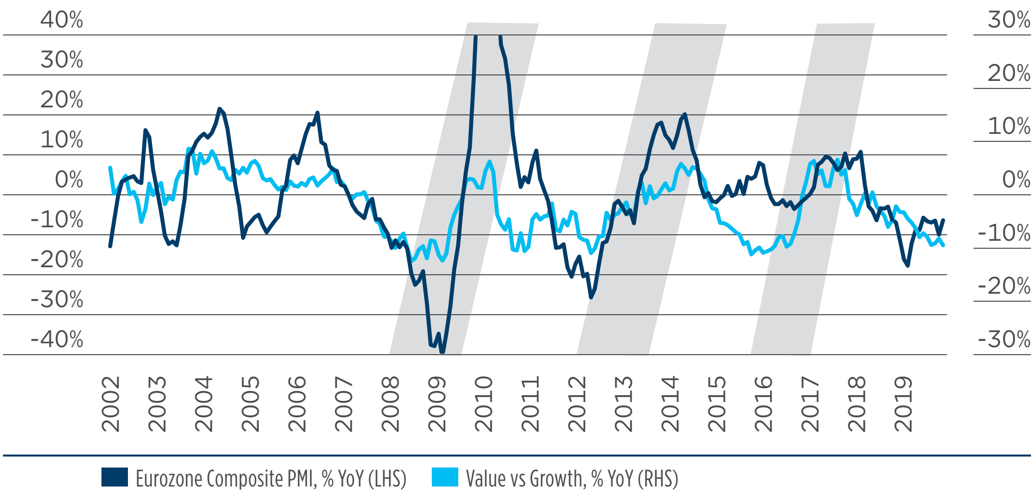
Source: Amundi, Bloomberg, data as at 20 December 2019.

We think that support for the continuation of this trend will come, first of all from a cyclical rebound at a time of extreme undervaluation of value vs growth.

Manufacturing PMI bottoming out

In the long downtrend of value's underperformance there have been three periods of rebound: 2009, 2013 and 2016. All of these occurrences were supported by a top-down fundamental improvement in the economic momentum, with rebound in the PMI indicators.

Figure 2: Improving PMIs would benefit value vs. growth in Europe



Source: Amundi, Bloomberg, data as at 30 November 2019.

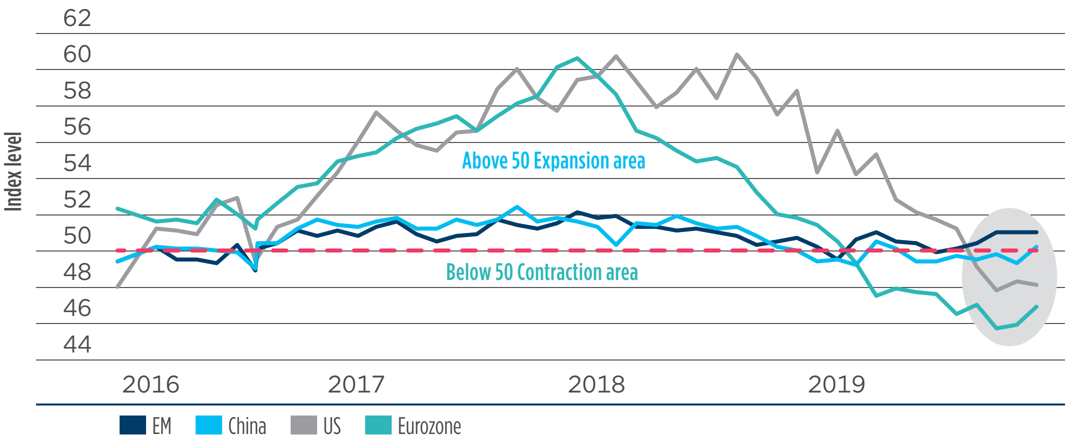
Value style means purchasing stocks at relatively low prices, as indicated by low price-to- earnings, price-to-book, and price-to-sales ratios, as well as high dividend yields. Sectors with a dominance of the value style: energy, financials, telecom, utilities, real estate.

Growth style 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.

Purchasing Managers' Indices (PMIs) are indicators derived from monthly surveys of senior executives at selected companies. These help in identifying economic trends.

In 2019 manufacturing PMIs dropped below 50 in most regions. Europe, (specifically Germany), which is very exposed internationally, has suffered from this drop. The non-manufacturing portion of activity, however, has so far resisted the global downturn, with limited spillover from manufacturing. It is important to note that accommodative monetary policies tend to lead to improvements in manufacturing activity, but with a lag of 18 to 24 months. In the US, short-term rates reached a peak in the autumn of 2018 and this could indicate an improvement in US PMIs in 2020. Recent readings in emerging markets and China's activity indicators also point to resilience in these areas.

Figure 3: Global manufacturing PMIs bottoming out



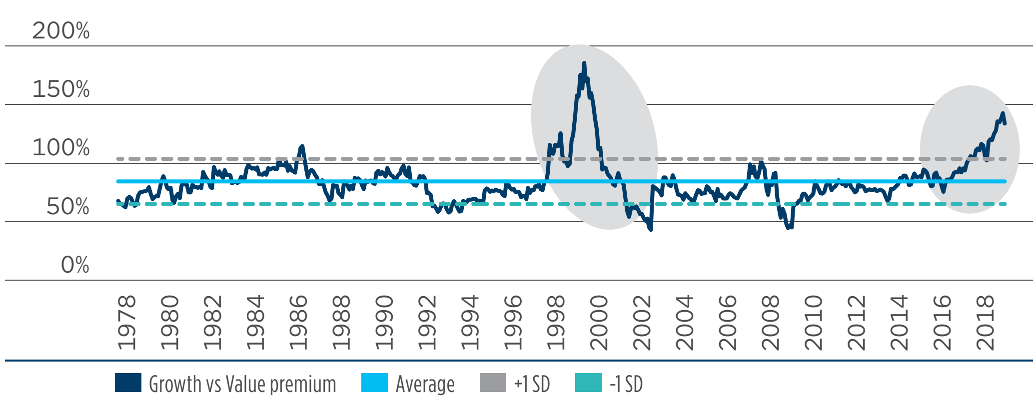
Source: Amundi Research, Refinitiv, Markit, data as 5 December 2019.

"The current extreme dislocation of value vs. growth offers a window of opportunity, but selection remains paramount."

Extreme overvaluation of growth vs. value

Compared with the previous attempts at a rotation back to value, the current PMI rebound occurs at a time of extreme overvaluation of global growth vs value. In fact, looking at our Composite Valuation Indicator (CVI), a combination of P/ER, P/BV, DY and P/CF, value has rarely been cheaper vs. growth (only 2% of the time in the last 40 years) and these extreme dislocations tend to reverse, offering compelling opportunities for investors. For example, the excess level reached in March 2000 led to an almost 55% outperformance of the global value index vs. the global growth index in the following year.

Figure 4: MSCI World Growth/Value – Composite Valuation Indicator (CVI)



Source: Amundi Research, data as 5 December 2019.

"Investors should look at the European cyclical value space to play the rotation in action."

In our view, PMIs bottoming out could benefit the European market the most (see next chapter), offering opportunities especially in the more cyclical sectors such as industrials (industrials represent 14% of MSCI Europe vs. only 9% of MSCI US). However, selection will be key given some areas of disruption and high valuations (see chapter, "A European equity sector view"). In general, we believe investors should be mindful of expensive areas, while seeking higher quality in the value sectors. In fact, as some more traditional value areas of the market are facing significant structural and cyclical challenges, we believe investors should prefer to pay for quality as this will help to insulate performance in case of rising volatility, while also benefiting from the rotation in action.

Composite Valuation Indicator (CVI) is based on a basket of criteria in absolute terms – trailing price to earnings ratio (PE), forward PE, price to book value ratio (P/BV), dividend yield (DY) and price to cash flows ratio (PCF), ranked in percentile from 0 to 100%, showing the percentage of time this basket was cheaper since 1975 (0% never been cheaper; 100% never been more expensive).

Europe to benefit from rebound of manufacturing PMIs, bond yield stabilisation, easing geopolitical risks and possible fiscal support

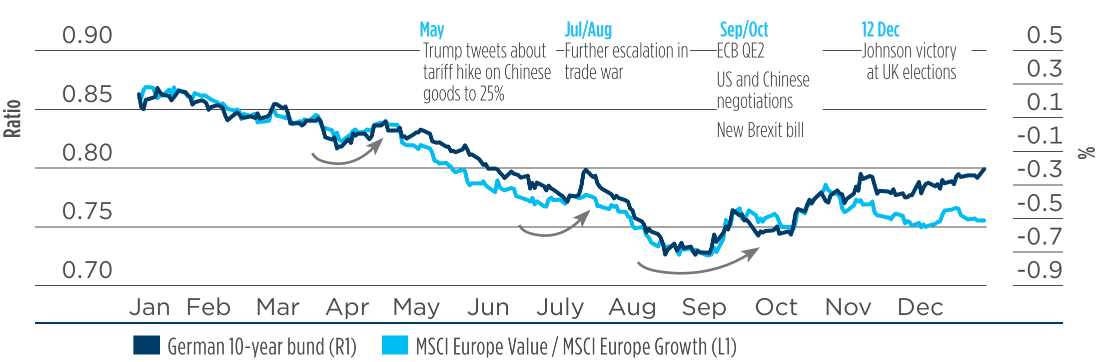
Eric MIJOT
Head of Equity Strategy
Deputy Head of Strategy Research

Alexandre DRABOWICZ
Deputy Head of Equity

2019 was a very good year for equities, with the market developing in three stages. Until May, the rebound could be considered as a countertrend rally. Between May and October, equities were influenced by two opposing forces: geopolitics (Brexit risk and the US-China tariffs negotiation) on the one hand weighing on equities and central banks (ECB, Fed and most central banks in the world) being supportive for risky assets in general, equities in particular, on the other.

Eventually, equity indices broke out in October as the situation improved on the geopolitical side, in terms of both Brexit and the US-China tariffs negotiations. For the first time since 2016, geopolitical forces and central banks have been moving in the same direction, reviving risk appetite for European equities and favouring value vs. growth in the region.

Figure 5: MSCI Europe Value/Growth reacts to easing geopolitical tensions and supportive CBs in 2019



Source: Amundi Research, Refinitiv, data as at 2 December 2019.

"Supportive central banks and easing geopolitical tensions could create a positive environment for European value."

Bond yields stabilisation

The new guidance from the Fed for stable rates and the increase in the Fed balance sheet (buying USD 60 bn a month in treasury bills), the introduction of a "tiering" by the ECB (announced on September 12) to better take into account banks' difficulties and the fact that the Swedish Riksbank began to move away from negative interest rates from December 2019 (the Riksbank was the first to introduce negative rates in July 2009) are all factors pointing to some stabilisation or rebound in bond yields.
The financials and consumer discretionary sectors, which are usually the first to react positively to a rebound in yields, represent 31% of the market cap of MSCI EMU, 28% of MSCI Europe and 40% of the MSCI Europe Value index.

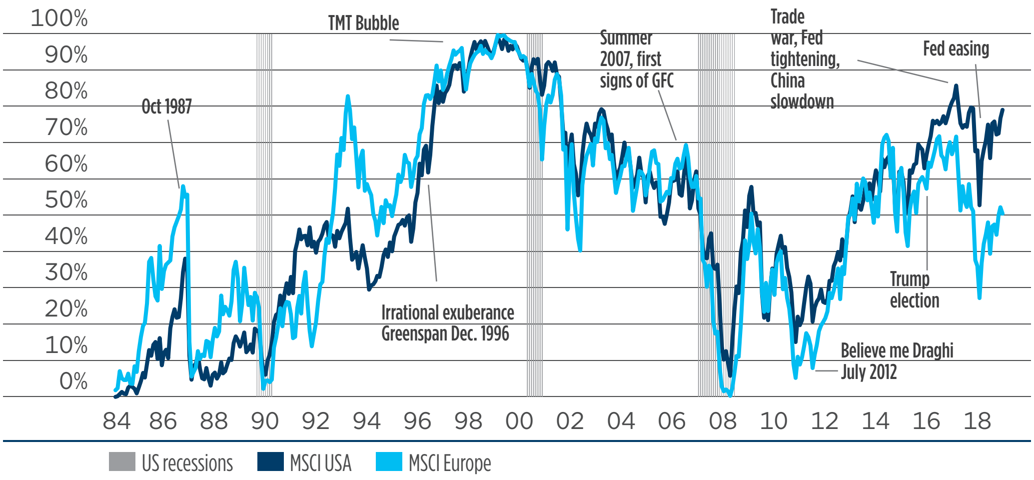
"European equity valuations are relatively attractive, supporting the case for this asset class."

Sentiment and valuations play in favour of Europe

A combination of geopolitical improvements is supporting investor interest in Europe. The Boris Johnson victory in the UK's December election should pave the way for an orderly Brexit that could help reduce the perceived risk of European assets. The Brexit deal, once agreed, will be definitive (not withstanding some implementation issues). This is in stark contrast to the US-China mini deal. Although the US-China deal would be positive, it may prove to be temporary (ahead of the US Presidential elections), at least in investors' minds. In addition, any good news on other reforms, especially on the banking union, a top priority for Christine Lagarde, can only bring additional support for equities. The easing of geopolitical risks for Europe comes at a time when the region is relatively attractive from a valuation standpoint

Amundi
ASSET MANAGEMENT

Figure 6: Europe and US Valuations (CVI)



Source: Amundi Research, Refinitiv, Markit, data as 5 December 2019.

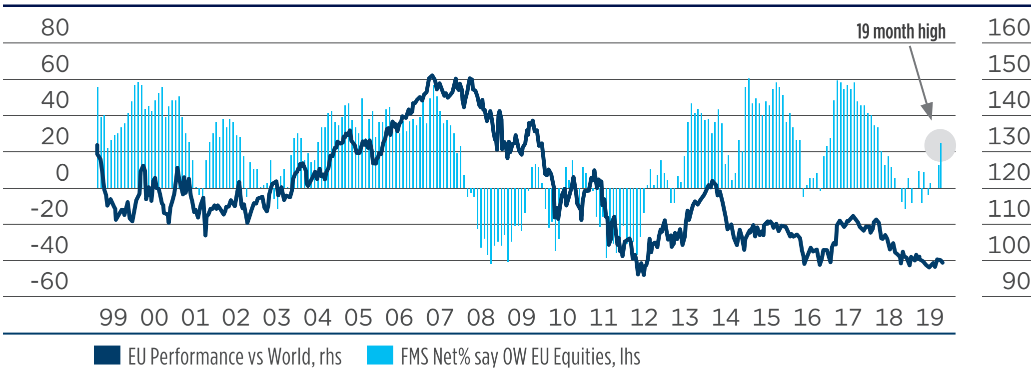
Whichever way we compare the valuations of US equities with European equities, Europe appears a lot cheaper than the US. Using the Shiller P/E ratio for instance, Europe is trading at a discount of 38% (18x for Europe vs. 29x for the US). The US market has an advantage in holding a lot of the disrupters (GAFA and IT more generally). However, with financials and energy making up 25% of its market, Europe can be used as a proxy for value for global investors. Selection will be key in this space, as Europe has a lot of disrupted models (banks, automobile, etc.), but the region is also home to high quality companies that have strong business models and are focused on improving their ESG profiles (see chapter, “A European equity sector view”).

“Investors are turning more positive towards European equities.”

Investor positioning is catching up with the trend

Given that flows to European equities were particularly negative in 2019, improving sentiment, coupled with appealing valuations, should revive investors’ appetite for this asset class. In fact, recent surveys on global fund managers’ allocations are pointing towards an increase to European equities, with the percentage of asset allocators saying they are overweight EU equities having jumped to a 19-month high in December 2019.

Figure 7: Net % of fund managers saying they are overweight EU equities



Source: BoFA Merrill Lynch Global Fund Managers Survey, 17 December 2019.

“With further support to growth in the Eurozone expected from the fiscal side in 2020, we believe the appetite for European equities will continue.”

Additional support from European fiscal policy and New Green Deal

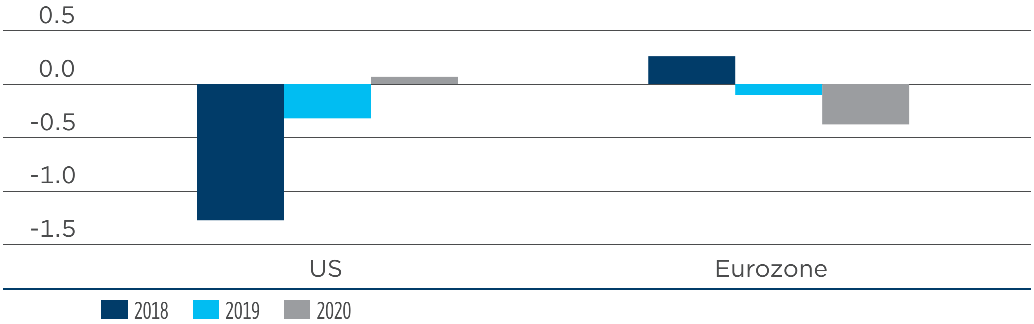
An additional boost could come from supportive fiscal policy in the Eurozone in 2020. We expect the fiscal stance (i.e. change in the structural deficit) to continue to ease and bring a roughly 0.2 percentage point contribution to Eurozone GDP growth in 2020, primarily accounted for by Germany and the Netherlands. However, this easing will not be coordinated across the region, but would be intended to address country-specific political equilibriums. Another aim of this fiscal easing would be to invest over the long term rather than boost demand on the 2020 horizon. Should the economic outlook deteriorate, with a further spillover of the recent growth slowdown into labour markets, we believe that a short-term oriented sizeable fiscal stimulus would occur.

GAFA Google Apple Facebook Amazon

Shiller P/ER is a valuation measure that uses real earnings per share over a 10-year period to smooth out fluctuations in corporate profits that occur over different periods of a business cycle.

Amundi
ASSET MANAGEMENT

Figure 8: Fiscal stance – change in structural government balance, % of GDP

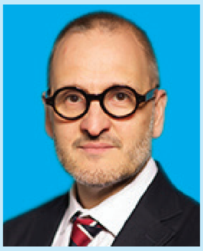


Source: IMF, European draft budgets, Amundi Research estimates. Data as of 15 November 2019.

Nonetheless, from a long-term perspective, a combination of low interest rates and limited room for additional monetary easing would gradually change the attitude towards fiscal deficits and debt. This could lead to changes in the European fiscal rules and new positive developments for the area (i.e., new European fiscal tools with a stabilising role).

In addition, the recent call for a new "Green Deal" to make the EU the first climate neutral continent by 2050 could further stimulate the economy and increase business innovation. This new deal will likely further drive the transformation of European corporate businesses and will bring opportunities to many companies to further reinforce their leadership in the climate and ESG spaces, while other companies will radically transform their business models to embrace a more sustainable path.

In this transforming world, selection will be paramount to avoid areas of disrupted business models and focus on names that can best exploit the expected cyclical rebound, while embracing a long-term sustainable path.



Luc MOUZON
Head of European Equity Research

With the contribution of Chris MORGAN
Equity Investment Specialist

A European value sector view

In general, investors with a bottom-up perspective should move away from expensive stocks in expensive sectors and instead seek higher quality in the value sectors. In other words, we are seeing value in quality, and quality in value. The reason is simple. In terms of the very expensive segments of the market, such as information technology (IT) and consumer staples, while the companies are attractive, the valuation multiples leave little room for disappointment. We believe that investors can find attractive relative valuation opportunities in these expensive areas. In the more traditional value areas of the market, we can see some significant structural and cyclical challenges.
In case of a rotation towards value, investors could find opportunities in banks and some of the more traditional asset managers, the auto sector (in particular restructuring opportunities), communication services (in particular advertising and broadcasting) and the medical technology space within healthcare.

Financials: the value in Value

When we consider a rotation towards value, financials is the obvious sector to watch. We can classify the financials sector into three sub-sectors, each with its unique characteristics:

- First, the **banking sector** is **cheap, relative to both the broader market** and historical long-term averages. This low valuation can be somewhat justified given the negative interest rate environment that we have in Europe, the elevated geopolitical risks and the ongoing regulatory overhangs that plague the sector. However, we still see plenty of alpha-generating opportunities for stock pickers given the intra-sector volatility, depressed valuations and generally bearish sentiment. With this in mind, we continue to **favour higher quality banks with robust capital ratios and strong competitive positions** in their underlying markets. In order to see a broad-based and sustainable rebound in the sector, interest rates must move into positive territory. Furthermore, a move towards fiscal stimulus by European governments would be an additional positive for the sector.
- **The insurance** sector has overcome the negative headwinds from low interest rates, cementing the sector as a **higher quality area within financials**. Despite a challenging backdrop, the sector has successfully lifted its return on equity (RoE) towards 20% from 12% five years ago. Looking forward, **we have a positive fundamental view on the sector**, supported by our expectations for robust earnings growth and a dividend yield of about 6%. Specifically, **we prefer names that offer differentiated business models and idiosyncratic growth opportunities**. Should we see a rebound of value within the insurance segment, we would expect the life insurers to benefit most as these names have been the most penalised by low interest rates.
- Finally, in **diversified financials**, we saw a good backdrop for asset managers in 2019. Companies that have been highly innovative in terms of technology are generally more expensive. However, if value as a style rallies some of the other asset managers that have been trading at a discount to their fair value could benefit as well. Of course, for this segment of the market to deliver a strong performance in absolute terms, a continuation of the positive market environment is needed.

"In financials we favour high quality banks with robust capital ratios and we are positive on insurance companies amid the robust earnings growth outlook."

Overall, should we see a significant rebound in the performance of "value" relative to "growth", banks and some of the more traditional asset managers should outperform at the expense of both insurers and financial technology names. That said, fundamental stock pickers should focus on the strength of the underlying business model rather than on top-down sectoral calls.

"In capital goods selection is key as valuations are not cheap. In the auto sector we favour restructuring opportunities that could play well in case of a value rebound, while in chemicals we prefer specialty players."

Cyclicals: strong performance in 2019, but pockets of opportunities remain

- **Capital goods not so cheap**. One year ago, **capital goods** would have stood out as a value segment. But its strong performance in 2019 has led the sector to trade above its long-term historical average. This is a sector that is very closely related to the strength of the underlying economy. The current valuation of the sector still implies that earnings growth will be delivered next year, but this is not guaranteed across the board so selection is key. The sector has multiple sub-segments and caters to many markets, and this gives bottom-up stock pickers the opportunity to sift the wheat from the chaff. For example, the changing underlying dynamics such as IMO 2020[1] (in the case of energy) and increasing digitalisation (in the case of industrial production), could be themes to play in this space. The capital goods space is not a blanket value play and **there is quite a high level of dispersion in the sector between the cheap and the expensive names**. However, this is an attractive environment for stock pickers.
- **The auto sector** is the quintessential value opportunity among cyclicals. On the one hand, this segment of the market has experienced significant volatility over the past 12 months given the changing structure of the industry (with the move towards autonomous driving and electric vehicles). This, coupled with the continuing geopolitical noise that is impacting growth, has seen this area struggle. The auto sector looks very cheap relative to history and we expect a natural outperformance here in case of a rebound. Specifically, **we favour restructuring opportunities**, given that these companies can continue to grow margins despite flat (or even declining) top-line growth.
- **The chemicals sector** is trading at the upper end of its valuation range. This high valuation is a result of the strong performance of the defensive sub-segments such as gas and food ingredients. In a more favourable environment, we would expect to see a reversal, which would benefit the more 'cyclical' chemical stocks. However, it is difficult to make a top-down bet on the sector, and as a result we prefer **specialty chemicals**.

"The key theme within consumers is the multi-year growth of the Chinese middle class that investors can play through luxury, as well as beauty and personal care."

Consumers: cheap names could prove costly

When investors think about value, consumer stocks would be among the last places they would look. Although we are positive on the underlying business fundamentals, valuations within the sector are now close to fully discounting future cash flow growth. **The key theme within this segment is the multi-year growth of the Chinese middle class** that investors can play **through luxury, as well as beauty and personal care,** both areas where we have a positive view. We also favour categories that can benefit from the **growing strength of ecommerce in all regions**, while avoiding areas that can be disrupted by the move towards online, irrespective of their cheap valuations. The long duration compounding growth sectors such as food, beverages, home and personal care and luxury have been major beneficiaries of the quality, growth and momentum outperformance of the last decade. They are clearly at risk in case of a top-down driven value/growth rotation. Therefore, **we would urge caution on blindly buying the 'value' end of the consumer sector**. This is because a number of business models continue to be severely disrupted. Chief among these are food retailers (discounters and online) and general retailers (mainly online). On the relative value side, we focus on asset backed plays (house builders and hotels) that are at little risk of disruption. Ultimately, if there is a strong reversal in the performance of value as a style, the consumer area of the market is not expected to perform well, given that it is already expensive. Relatively speaking, we would expect food retailers and house builders to benefit, at the expense of the higher rated names in food nutrition and luxury.

[1] On 1 January 2020, the International Maritime Organization (IMO) will implement a new regulation for a 0.50% global sulphur cap for marine fuels.

"We see opportunities in communication services within companies adapting to the more competitive landscape."

Technology and communication services: opposite ends of the valuation spectrum

This is an interesting sector, where on the one hand, IT has been the darling of the market, whereas on the other, sentiment towards communication services has soured. The IT sector tends to be more of a play on growth rather than value. This is justified, in our view, as the sector is poised to continue to deliver mid-teens earnings growth, helped by the improved macro dynamics that we have seen in recent months and the more bullish commentaries from companies themselves. From a value perspective, we see the biggest opportunities in **communication services, where a combination of competitive and structural issues has scared investors away**. We don't dispute that these issues exist, but the very depressed valuations in the sector suggest that these issues are structural in nature. **Companies are taking the correct steps to adapt to a more competitive backdrop by making new investments and undertaking M&A** to plug any gaps in their product offerings. Specifically, we see strong value opportunities emerging in the areas **of advertising and broadcasting**. Of course, for these areas to perform we would need to see positive developments on the macro front, but in case of a value rally they should be clear winners.

"In the pharmaceutical sector, investors should favour companies with high levels of innovation."

Healthcare: not cheap, but innovation is key

We have seen a marked acceleration **in the pace of innovation in the pharmaceutical sector in recent years.** Against this backdrop, **we expect a further increase in earnings growth** towards 10%, which, coupled with a dividend yield of about 3.5%, offers quite a compelling investment case. Reflecting this, we should see a further re-rating of the pharmaceutical sector. **Investors should favour companies with relatively high levels of innovation as this remains the main value driver in the sector** and provides protection against future price pressures. Elsewhere, there are pockets of value in the medical technology space. The expected normalisation of operating performances and the extreme intra-sector valuation dispersion provide a positive risk/reward opportunity in some of these names.

With the contribution of

Ujjwal DHINGRA
Investment Insights Unit Specialist

Laura FIOROT
Deputy Head of Investment Insights Unit

AMUNDI Investment Insights Unit

The Amundi Investment Insights Unit (AIIU) aims to transform our CIO expertise, and Amundi's overall investment knowledge, into actionable insights and tools tailored around investor needs. In a world where investors are exposed to information from multiple sources we aim to become the partner of choice for the provision of regular, clear, timely, engaging and relevant insights that can help our clients make informed investment decisions.

Discover Amundi investment insights at our website www.amundi.com/

Amundi
ASSET MANAGEMENT

Chief Editors

Pascal BLANQUÉ
Group Chief Investment Officer

Vincent MORTIER
Deputy Group Chief Investment Officer

Important Information

Date of First Use: 8 January 2020.

Visit us on:

Discover Amundi Investment Insights at
http://www.amundi.com

Amundi
ASSET MANAGEMENT

REF-2638