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INVESTMENT TALKS

# European equity value has further to go in this cycle


**Kasper ELMGREEN**
Head of Equities

**Andreas WOSOL**
Head of European Equity Value

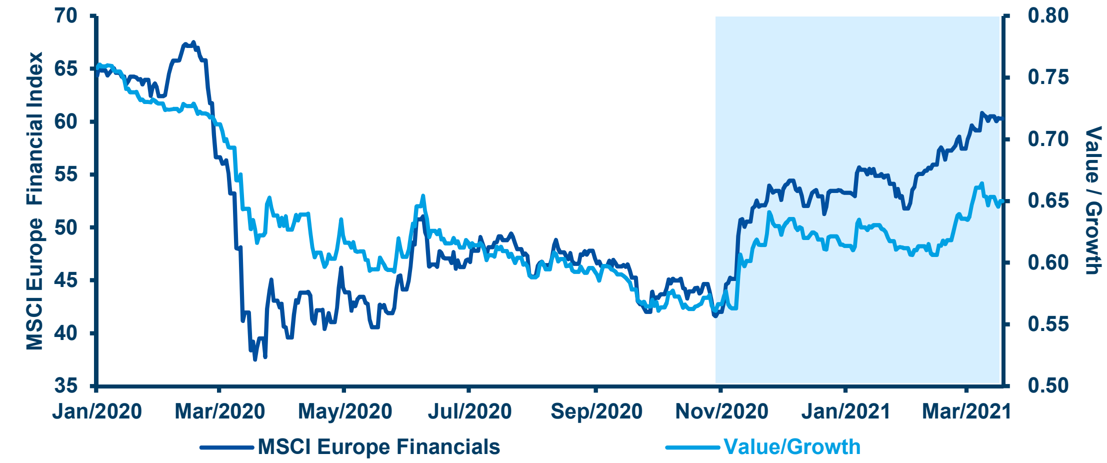

- *Initiated in April based on a cheap quality cyclical stock rebound, the value rotation in Europe has accelerated, favouring deep value names – the segment most impacted by the Covid-19 crisis – in early November, after the announcement of the development of an effective vaccine. Since the beginning of this year, we are in the third stage, led by financials and banks in particular, supported by higher rates and inflation expectations. This means that the rotation is broadening.*
- *We continue to be constructive and favour banks with commercial and retail banking exposure that have dominant positions in their domestic markets.*
- *Other sectors where we see opportunities are related to the re-opening of cyclically exposed areas, such as travel and leisure, retail, autos, and media and entertainment.*
- *While we believe the value rotation is not over and is set to continue, as the recovery continues to materialises, the road may be bumpy, with phases of stops and starts linked to short-term developments in vaccine rollout and Covid-19 news flow. Looking ahead, we see a move in favour of the quality value segment, while it continues to be important to avoid impaired business models.*
- *Investors in Europe can also exploit ESG themes, such as the energy transition, electrification, digitalisation, mobility, and energy efficiency.*

## What are the main drivers of this value rebound and how far can it go?

Since the lows recorded in March 2020, we have seen three different phases of the value recovery. The first was driven by cheap quality cyclicals. This was followed by the outperformance of the deep value Covid-19 stocks from early November amid developments of effective Covid-19 vaccines. Since the start of this year, the acceleration on the vaccine front has changed market expectations with regard to timings for the reopening of economies, moving inflation and real yield expectations higher, a natural tailwind for value as a style. Therefore, the interest rate-sensitive segment of value (financials) has also started to outperform. This means that today the value rotation has become broader in nature.

***"Today the value rotation has become broader in nature".***

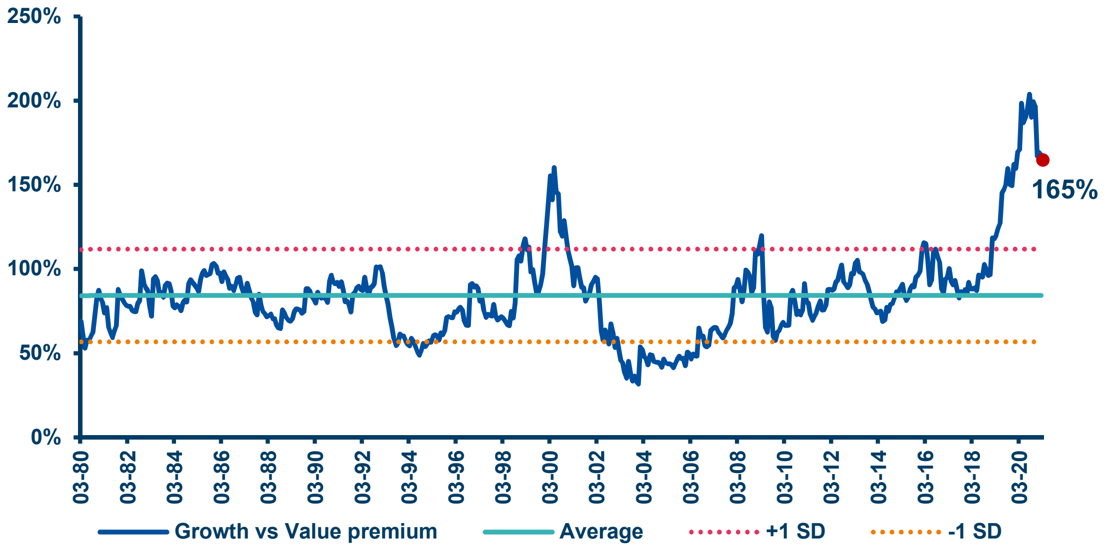
**Figure 1: Since November, value has started to outperform growth**




Source: Amundi, Bloomberg. Data as of 17 March 2021.

The next phase will likely be about the re-opening and the earnings recovery. Despite the recent good performance, value still remains at depressed levels when compared to growth, and, importantly, to our assessment of intrinsic value – which suggests that the move has further to run.

**Figure 2: MSCI Europe growth vs value composite premium (P/E, P/BV, DY)**




Source: Datastream, Amundi Research, data as of 22 March 2021. Composite premium is based on a basket of criteria – trailing P/E, P/BV, dividend yield.

***"We are transitioning from a liquidity to a growth-driven regime. This will not move in a linear manner: we expect bumps along the way".***

We know from history that value assets are usually of short duration compared to growth. In turn, they tend to outperform in periods of rising yields and inflation expectations, the environment we are in today. **That said, there is a rotation within the value segments depending on the maturity of the yield and inflation regime.**

For some time now, we have been in a below-trend and falling yield and inflation environment, which typically benefits the quality value segment of the market. Since late last year, we have been in a below-average-but-rising yield and inflation expectations environment, which has supported deep value. If we transition to an environment that is characterised by above-average yields and inflation, this would be more supportive of quality value again.

We are transitioning from a liquidity- to a growth-driven regime. This will not be a linear path, we expect bumps along the way. With the value rally now encompassing more areas of the market, we continue to see this as being an attractive entry point into this sphere.

Value as a style is pro-cyclical and therefore has an inherent sensitivity to the expectations regarding the economic environment. As a result, the transition from vaccine deployment to reopening of economies and tangible improvements in economic activity could be accompanied by short-term news flow-driven risk-on/-off periods. In addition, uncertainty could remain regarding yields, inflation, speed and timing of the recovery, and fiscal stimulus. So far, each of these areas has moved in favour of value, but we could see short-term bumpiness in their trajectories. **Against this backdrop, we believe that a strategy which can capture all facets of the value spectrum is a preferred approach. As always, it remains important to avoid impaired business models.**

## In European equity value, where do you see key areas of opportunities?

Financials have started to perform strongly in the reflation trade. Prior to this, we saw a value rally without the participation of financials as more cyclical stocks were preferred by investors. However, financials, especially banks, are natural beneficiaries of higher growth and higher yields.



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***"We prefer banks with commercial and retail exposure that have dominant positions in their domestic markets".***

**Figure 3: Europe banking sector is benefitting from yield curve steepening**

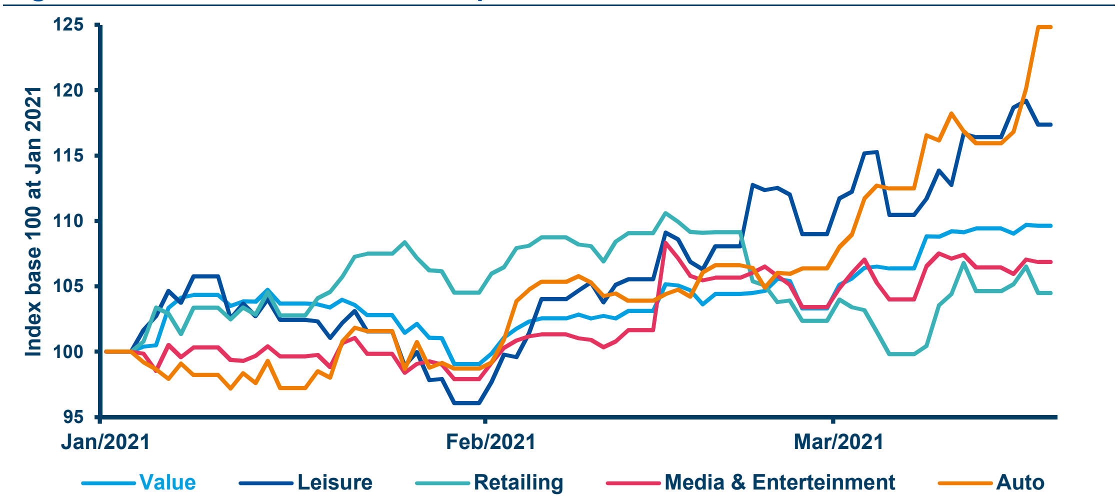

Source: Amundi, Bloomberg. Data as of 17 March 2021.

As we start to emerge from the Covid-19 crisis and economies begin to recover, this will allow banks to move from a balance-sheet-management focus to a focus on growing revenues and earnings as lending increases, lending rates rise, and repayment risk is less pronounced than in a recessionary environment, a scenario in stark contrast with that seen in recent years. **We have a constructive view on the banking sector**. However, we would continue to be very selective.

We prefer banks with commercial and retail banking exposure that have dominant positions in their domestic markets. Balance sheet strength remains an important focus for us. Despite the recent rally, and the brighter outlook for the sector, we have not strayed from our higher-quality focus in the banking arena.

In terms of areas of opportunity, we believe value can be found in most areas of the market and should not be pigeon-holed into just one or two sectors. Today, we see good investment cases emerging in most of the re-opening of cyclically exposed areas, such as travel and leisure, retail, autos, and media and entertainment.

**Figure 4: Selected sectors and value performance in so far in 2021**




Source: Amundi, Bloomberg. Data as of 17 March 2021.

**Concerning ESG themes,** while value stocks are, on average, less well ranked in terms of ESG than growth stocks, investors can find attractive structural themes to play, such as the energy transition, electrification, digitalisation, mobility, and energy efficiency.

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## Definitions

- **Cyclical vs defensive sectors:** Cyclical companies are companies whose profit and stock prices are highly correlated with economic fluctuations. Defensive stocks, on the contrary, are less correlated to economic cycles. MSCI GICS cyclicals sectors are: consumer discretionary, financial, real estate, industrials, information technology and materials, while defensive sectors are consumer staples, energy, healthcare, telecommunications services and utilities.
- **Curve steepening:** A steepening yield curve may be a result of long-term interest rates rising more than short-term interest rates or short-term rates dropping more than long-term rates.
- **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** 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.



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**Chief editors**

**Pascal BLANQUÉ**
*Chief Investment Officer*

**Vincent MORTIER**
*Deputy Chief Investment Office*



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