The Value style, a source of opportunities in a context of rate cuts

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We are coming to a crucial moment in the macroeconomic cycle, that of the beginning of the rate cut cycle initiated by the central banks. The future will tell us whether this decision comes too late in the cycle or not to avoid the recession. Nevertheless, history shows that while equity markets tend to rise ahead of the first rate cut, which was the case in the last year, their growth scenario is then binary: A decline that occurs on average six months after the first decline if a recession materializes or an increase of 20 %[1] on average in the year if the timing of central banks has made it possible to revive growth, maintain employment and support investment.

In this context, should we invest in equities?

Let us first remember that we have been waiting for a recession for two years... During this period the asset class that performed best is that of equities. We therefore find it difficult to justify the lack of exposure to equity markets, since the scenario of a soft landing of the

economy remains topical: The fall in inflation allows real wages to rise, which could support consumption, particularly in Europe where the level of savings remains particularly high. In addition, this cycle of rate cuts is expected to result in a rebound in leading indicators in the manufacturing sector as has been the case in the past, even if the duration of transmission of this impetus to the economy is relatively long (about six months).
Finally, we now see real opportunities in some sectors in cyclical, defensive and broader financial sectors.

Although the market has already risen since the beginning of the year, and more generally since the autumn of 2023, this increase has been focused on certain stocks. The Magnificent Seven[2] in the US and the Granolas[3] in Europe have contributed more than 50 %[4] of the rise in the indices since the beginning of the year. While we can understand this performance for US stocks in view of the upward of EPS revisions[5] since the beginning of the year (nearly 50%)[6], this is not the case in Europe where granolas have experienced downward EPS revisions, which has contributed to inflating their valuations that seem difficult to justify. The concentration level for the 10 largest caps is 34% in the United States, a historic record. It is 22% in Europe, a level that was only reached in 2000 and 2008 in the last 40 years[7]. Nevertheless, the European market seems to offer the most opportunities: In the United States, the S&P 500 is valued to perfection: a P/E[8] of 22x for an expected EPS growth of 15% next year. In Europe, with a valuation close to its historical median at 13.6x the European market for which the expected 2025 EPS growth is 10% looks much more attractive[9]

Why does the Value style represent an opportunity in this context?

While the European market is valued close to its median level, the valuation by investment style is nevertheless heterogeneous. Indeed, Growth[10] is valued on a P/E 12 months forward[11] of 22.3x against 9,7x for Value[12]. The result is a 130% premium[13] which is close to historic levels and which we believe is an anomaly. Indeed, this premium cannot be justified by either interest rates or the evolution of corporate fundamentals.

With regard to interest rates, the market does not seem to have acknowledged in terms of investment style the paradigm shift we have been experiencing since the Covid crisis. If this paradigm is triple (inflation, central banks, interest rates), it feeds on the same source, namely inflation. The decade of financial crisis - Covid was marked in terms of investment style by a marked outperformance of Growth, with an increasingly concentrated market, multiples for growth stocks that have stretched, and a growth premium on value that has steadily increased. Post Covid, the recovery in inflation led central banks to act and rates to rise vigorously, and this has certainly translated into a reversal of trend and an outperformance of Value on Growth: +32% since the discovery of a vaccine and the normalization of the economy[14], +14.6% since 2022[15] and the sharp rise in rates, but also +2.4% since the beginning of this year 2024[16] which is the year of the Pivot of the Fed[17].

That said, this outperformance was very modest given the scale of the paradigm shift mentioned, and was especially marked by the strong progression of fundamentals, ie Value style EPS. Regarding valuation, the Growth vs Value premium remained at the very high level mentioned at the beginning of the paragraph (130%). This premium is de facto at the same level as in January 2022, while the level of US real rates was -0.8 %[18] It is currently +1.6 %[16]. This premium must therefore still normalize in our opinion, with a thawing and normalization of the valuation multiples of growth stocks in particular. This is what we are starting to see on certain areas of the market that are just entering a phase of normalization, like luxury. On the other side of the spectrum, the normalization of ratios must also be carried out on certain sectors still valued below their tenth historical percentile. This is the case for banks (the best sector since 2022 with an increase of +71%)[16], but which is still valued at a 7x PE[19] corresponding almost to a level of recession, while they now evolve in an environment that has become healthy again for their business model (higher rates, curve steepening, recovery in volumes).

I It is also difficult to explain this premium by changes in fundamentals. Indeed, since the Covid crisis trough, growth style EPS has risen 62 %[20] compared to 100%[21] for Value style EPS. Moreover, looking at 2025, expectations remain very high for Growth style. Indeed, while the market expects about +10% EPS growth for 2025 in Europe[4] these expectations are +17% for consumer goods, +33% for technology, and +14% for health[2]. This is despite disappointing momentum for 2024 in these sectors (+1%, -2% and +6% respectively for consumer goods, technology and health)[4]. In contrast, expectations for EPS growth in the Value sectors remain reasonable (+4% for banks, +8% for energy, +8% for automotive)[4]. In other words, we have growth sectors with high multiples, and for which we have high expectations, on the one hand, and value sectors with low multiples, and for which we have modest expectations. Finally, the latter seem more credible: Indeed over the last 14 seasons of publications, Value companies have a positive surprise ratio (relative to the consensus) significantly higher than that of growth[22].

Which sectors should be prioritized in this environment?

The current environment remains complex and uncertain. Macroeconomic concerns are real, with inflation on the one hand remaining resilient, notably in its core component due to services, and rising unemployment in the United States on the other. However, we still believe that soft landing[23], the narrow path on which central banks are trying to navigate for several quarters now, remains a possibility. The impetus of the rate-cutting cycle should gradually spread to an economy that may be slowing down, but is still far from collapsing. Against this backdrop, we prefer 1/ sectors with a negative correlation to falling interest rates and a rather defensive profile, 2/ financials, whose normalization has yet to be confirmed by the market, and 3/ cyclical sectors whose valuations already factor in a scenario of sharp economic slowdown.

Regarding the correlation with interest rates, the real estate sector has been particularly affected by rising rates over the past three years, leading to an unprecedented discount compared to the value of its assets. This situation has already begun to reverse, as evidenced by the sector's outperformance of +9.6%[16] since the ECB's first rate cut announcement (06/06/2024). We benefit from this by investing in Vonovia, whose exposure to German residential real estate is structurally favorable due to the supply-demand imbalance. Furthermore, falling rates should naturally relieve interest charges, which will benefit earnings per share (EPS) growth in heavily indebted sectors. This is particularly true for capital-intensive sectors such as Telecom and Utilities, where we are overweight. For Utilities, our view remains constructive, as the gas market remains tight despite the addition of new capacity in the future. Lastly, some high-quality stocks in the food and beverage sector now offer more attractive valuations, like Pernod Ricard, whose P/E ratio has dropped from 22x to 17x in 18 months[16] amid fears of declining consumption and exposure to China, fears that seem excessive.

Banks remain the sector we are the most overexposed to. While the market has indeed welcomed EPS growth and the return of cash, it is still far from having acknowledged the normalization of the sector in the long term, with a valuation ratio that remains at a recession level. Moreover, even if short term rates are led to fall, in our opinion, there is still room for improvement in NII[24] and EPS growth: The steepening of the curve should benefit them, as part of the loan stock remains to be upgraded at current interest rates, and volumes are beginning to pick up.

Finally, some cyclical sectors seem particularly attractive like basics materials. When we look at periods of recession, EPS fall from a high to a low of 30% on average on this sector. Since their last high on 12/05/2022, these EPS have fallen by -56 %[16]. Given (I) an PE of 10.5x that remains below its median level of 16x. (II) The very low expectations on a China that is slow to restart (III) leading indicators at the low point on the manufacturing part, the time seems opportune to invest in a sector that seems already to have integrated an adverse macroeconomic scenario, and which could very strongly rebound if the soft landing were to materialize in the coming months.

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[1] Sources : Datastream, Goldman Sachs Global Investment Research 25/09/2024
[2] Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia &Tesla
[3] GlaxoSmithKline, Roche Holding, ASML, Nestlé, Novartis, Novo Nordisk, L'Oréal, LVMH, AstraZeneca, SAP et Sanofi
[4] Sources: Bloomberg, Datastream, Goldman Sachs Global Investment Research 25/09/2024)
[5] Earnings Per Share
[6] Sources : Factset, Goldman Sachs Global Investment Research (25/09/2024)
[7] Sources : Datastream, Goldman Sachs Global Investment Research (25/09/2024)
[8] P/E (Price to Earnings) is a financial indicator that measures a company's valuation by comparing the price of its share with its earnings per share (EPS).
[9] Sources : Factset, Goldman Sachs Global Investment Research, MSCI Europe Value and MSCI Europe Growth
[10] The growth style investor focuses mainly on the earnings growth potential of companies in the hope that sales and earnings growth will be higher than that of its sector or the market average.
[11] Forward: Refers to forward looking measures of financial performance.
[12] We speak of value strategy when the investor is looking for companies undervalued by the market at a given moment, that is, whose market valuation is lower than it should be with regard to the results and the value of the assets. of the company. Value investors select securities with low price to book ratios or high dividend yields.
[13] Sources : Factset, Goldman Sachs Global Investment Research, MSCI Europe Value and MSCI Europe Growth
[14] Sources : Eurostoxx Value Index et Eurostoxx Growth Index, Bloomberg from 06/11/2020 to 25/09/2024
[15] Sources : Eurostoxx Value Index et Eurostoxx Growth Index, Bloomberg from 31/12/2021 to 25/09/2024
[16] Source : Bloomberg as of 25/09/2024
[17] Federal Reserve Board
[18] Source : Data from 06/01/2022, Bloomberg.
[19] Sources : Factset, Goldman Sachs Global Investment Research
[20] Source: Bloomberg, MSCI Europe Value and MSCI Europe Growth from 01/07/2020 to 25/09/2024
[21] Source: Bloomberg, MSCI Europe Value and MSCI Europe Growth as of 25/09/2024.
[22] Source: Morgan Stanley 25/09/2024
[23] A soft landing is the goal of a central bank when it seeks to raise interest rates just enough to stop an economy from overheating and experiencing high inflation but not enough to cause a severe downturn.
[24] Net interest income is the difference between the income generated by a bank's interest bearing assets and the expenses incurred in paying its interest bearing liabilities.

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