METROPOLE Gestion
ODDO BHF ASSET MANAGEMENT
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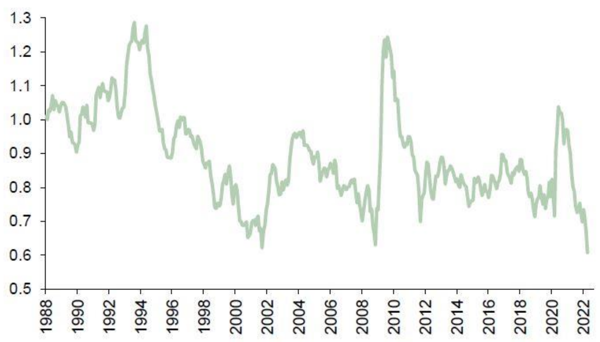
European cyclical stocks: valuations that have already priced in a recession scenario

European cyclicals have significantly underperformed against defensive stocks since the start of the year. In response to accelerating inflationary trends, some investors fear a radical change of course by central banks that would plunge the economy into recession. The war in Ukraine, which has added to inflationary pressures, and the recent lockdown measures introduced in China have only exacerbated such fears. These uncertainties have triggered a fall on cyclical stocks that now seems excessive. As compared to defensives, cyclical stocks in Europe are now valued at a level similar to that last seen during the subprime crisis.

Cyclicals (ex-Techs) / Defensive Relative PE



Source : Datastream, BNPP Exane estimates

Quarterly earnings announcements paint a very different picture of reality, however. Data releases show demand remaining strong, with trends at this stage showing no signs of faltering, in line with the April PMI releases for Eurozone manufacturing and services sectors that continue to be highly positive. Despite inflation, consumer trends remain positive as households unlock some of the savings built up over the past two years while investment is taking full advantage of government-backed support programmes. At the same time, companies are having to cope with rising energy and raw materials costs, and with ongoing disruption to supply chains. Recent announcements from cyclical companies show, however, that these negative factors are largely offset by the positive effect of operating leverage and/or passing on price increases to customers.

As we mentioned last month*, the valuation of auto manufacturing stocks has priced in another sharp fall in production, even though global automotive production is already 19% down from its peak, reached in 2018. Yet the sector still shows signs of remarkable resilience, as witnessed by the record Q1 operating margin (16.4%) announced by Mercedes for its Cars & Vans division. In the industrial sector, Signify, the world leader in lighting solutions, shows similar characteristics. Despite the company announcing Q1 organic growth of 6.4% and a solid operating margin of 10.5%, the stock's current valuation prices in a downgrading of revenue forecasts this year reflecting the kind of scenario last seen in the 2009 recession, coupled with a sharp fall in profitability. Even if such a scenario cannot be entirely ruled out, it is worth remembering that Signify is a key player in energy transition, enabling companies, local authorities and even households to reduce their energy consumption and greenhouse gas emissions.

European banks also find themselves in a similar situation, with the sector significantly underperforming since the outbreak of war in Ukraine. Despite the rise in interest rates (+110 basis points on the German 10Y yield since the start of the year), which will have a positive impact on interest income, some investors have proved highly cautious, fearing a sharp increase in the cost of risk due to a weakening of the economy that would hit sector profitability.

Euro Stoxx Bank vs 10Y German bond yield

Source : Bloomberg, data as of 03/05/2022

Initial earnings announcements from the sector, by Banco Santander, Bankinter and Lloyds, have shown no deterioration in the cost of risk, although banks exposed to Russia and Ukraine may well see at least a temporary deterioration in the quality of their loan portfolios. Eurozone banks currently enjoy high solvency ratios that will enable them to absorb any provisions with ease.

Current valuations of bank stocks thus reflect a rise in the cost of risk that is by no means certain, without allowing for the very real positive impact on net interest margin from rising interest rates. Banco Santander, for example, is currently trading at a Price/Tangible equity value ratio of below 0.6x even as the bank is forecasting a return on tangible equity in excess of 13% this year.

In view of these factors, our portfolios maintain a strong exposure to banks and to discounted industrial companies, a positioning geared to the regime shift currently under way, marked by a move away from globalisation but also by the transformations associated with energy transition and the digitisation of industrial processes, in a world of structurally higher inflation than in the past.

Source:

**Geopolitical risks are also driving the current regime shift.*

Disclaimer

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Before investing in any asset class, it is strongly recommended that potential investors acquaint themselves in detail with the risks to which such asset classes are exposed, in particular with the risk of capital loss.

12, Boulevard de la Madeleine 75009 PARIS – France –Tel: +33 (0)1 58 71 17 00 – Fax: +33 (0)1 58 71 17 93
www.metropolegestion.com - E-mail : metropoleg@metropolegestion.fr
Limited company with a capital of 1,200,000 € - SGP 02/026 – RCS PARIS B 442 661 195 – APE 6630Z