METROPOLE Gestion

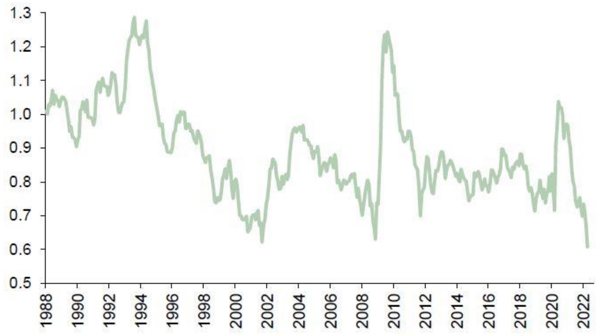
La Lettre

May 2022 - n°234

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



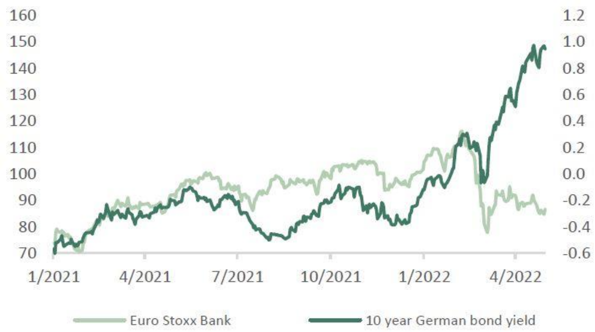
Source : Datastream, BNPP Exane estimates

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

This is a marketing communication.

This material is for information purposes only and represents neither 1) an invitation or solicitation to invest in, or offer to sell the financial instruments described herein, 2) nor any form of investment advice. All information contained herein is general and/or educational in nature. Individuals should consult an investment advisor before making any investment decisions. Future investors must take the necessary steps to determine whether and how much to invest on the basis of the legal, tax and accounting considerations which apply to their specific situation. The distribution of the present material may be restricted by law in certain territories, countries or jurisdictions and investors are required to inform themselves and to comply with any such restrictions in any relevant territory, country or jurisdiction. The opinions expressed in the present material may be modified without prior notice. Past performance is not a reliable indicator of current or future results, and fees and expenses will reduce investor returns. The value of investments and the income from them can go down as well as up and investors may get back less than the amount they invest.

Data provided herein is for informational purposes only and does not reflect actual trading by METROPOLE Gestion or any other client. Client accounts will vary. No assurances are provided regarding future performance or results. The securities mentioned herein are for illustration purpose only and does not constitute any investment advice or recommendation to buy or sell and shall not be deemed an offer to or a solicitation of an offer to buy or sell any securities. The investments cases presented herein are included merely to provide a general example of METROPOLE Gestion’s research and investment process. There can be no assurance that any securities discussed herein will remain in a portfolio or if sold will not be repurchased. The securities discussed herein do not represent the entire portfolio and in the aggregate may represent only a small percentage of the total portfolio holdings. The entire portfolio holdings can be disclosed upon request. It should not be assumed that any of the securities discussed herein have been or will be profitable, or that investments will be profitable or will equal the investment performance of the securities discussed herein.

- METROPOLE Gestion makes no representation or warranty, express or implied, as to the fairness, accuracy, completeness or correctness of information obtained from third-party sources, nor does METROPOLE Gestion accept any liability arising from its use.

- Any opinions expressed herein are statements of METROPOLE Gestion's judgment as of this date and are subject to change without notice, and METROPOLE Gestion undertakes no obligation to update the recipient of any such changes.

- No statement in this material is intended to be nor may be construed as a profit forecast and there can be no assurance that the assumptions and beliefs described herein will prove correct.

- Some of the statements herein may constitute forward-looking statements. Forward-looking statements relate to expectations, beliefs, projections, future plans and strategies, anticipated events or trends and similar expressions concerning matters that are not historical facts. Forward-looking statements in this material involve risks and uncertainty. Forward-looking statements are based on our beliefs, assumptions and expectations of future performance, taking into account all information currently available to us. These beliefs, assumptions and expectations can change as a result of many possible events or factors, not all of which are known to us or are within our control. These beliefs, assumptions or expectations can change as a result of many possible events or factors, not all of which are known to us or are within our control.

METROPOLE Gestion is approved by the French Financial Markets Authority (AMF). For more information, please contact us at the following e-mail address: metropoleg@metropolegestion.fr. This document was published by the asset management company: METROPOLE Gestion SA 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. METROPOLE Gestion SA is holding a license from the Autorité des marchés financiers, 17 place de la Bourse, 75082 Paris Cedex 2, France, under whose supervision it is.