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# MARKET *view*

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## "Cheap“: a necessary but not sufficient condition

**Key highlights:**

- Although the STOXX 600 is at its lowest level since the Covid crisis, we haven’t yet reached the entry point towards a significant repositioning on European equities.
- In the current, unsettled geopolitical and monetary environment, prioritizing cashflow resilience is critical.
- There are opportunities in certain growth sectors such as healthcare and a few technology segments. In terms of asset classes, high-yield bonds seem to be offering attractive yield spreads compared to government bonds.

The STOXX 600 (broad European index) has reached a new low of 380 for a valuation (Price/Earnings ratio over the next 12 months) of 10.4x, the lowest level recorded since the COVID crisis (10.3x on 18/03/2020). High-yield bonds have also lost more than 15% since the beginning of the year, almost as much as equities. Which begs the question: **Are current levels a good entry point?**

### Multiple compression is to a large extent behind us

Firstly, the relationship between valuation and future performance is not immediate. Over a 30-year period, it is interesting to note that the performance of an investment is nearly the same, whether this investment has been initiated below or above the average valuation level of the STOXX 600 (Price/Earnings ratio at 14.0x). However, valuation levels do matter when extreme levels are reached. By buying the STOXX 600 when the Price/Earnings (P/E) ratio is below 10.0x, we historically observe a probability of positive performance over the following 12 months of 82% and an average performance of 18%. **To reach this attractive entry point, the STOXX 600 would have to fall by at least another 5%**, below 360. Multiple compression is therefore, to a large extent, behind us, but the earnings trajectory (the "E" in P/E) still needs to be estimated.

### All eyes should be on future corporate earnings

Analysts have already done a considerable amount of work revising European companies' earnings downwards. Whereas a few months ago, they were expecting earnings per share (EPS) to grow by 16% in 2023, they are now forecasting an increase of only 3%, a level well below inflation.

It should be remembered that for a constant sales volume, inflation mechanically boosts turnover expressed in Euros. The revision is therefore quite substantial, given that real wages are currently falling. In addition, a global recession could accelerate the decline in raw material prices in Europe and limit a significant decline in profits for 2023. Furthermore, the Euro’s weakness does not only have negative impacts. Companies exporting to the dollar zone will repatriate profits and convert them into Euros: a positive exchange rate effect of around +5% is estimated. The EPS increase of +3% in 2023 is therefore quite credible.

## Which sectors should be favoured?

In this volatile geopolitical and interest rate environment, priority should be given to cashflow visibility and resilience.

Beyond its natural positive sensitivity to the dollar, the Healthcare sector seems to us to offer an attractive risk/return ratio with several major European laboratories (AstraZeneca, Roche, Merck) able to increase their sales by +4/5% over the next few years with good margin levels for reasonable stock market valuations (PE 14/15x).

Within the **Technology sector**, the software/IT services segment (Cap Gemini, SAP) is regaining its appeal after the decline in valuations, especially as, according to our latest contacts, the demand environment seems to remain relatively robust. Digital transformation projects remain at the heart of strategic priorities of large companies in order to increase agility and competitiveness in the face of inflationary/logistical/economic disruptions. The transition to the cloud by major software players is also giving them an increasingly high level of recurring revenue. Conversely, we remain cautious about capital-intensive and indebted sectors with limited pricing power, such **as telecoms or regulated utilities.** Despite attractive valuations, it is also too early to reconsider certain segments of the consumer discretionary sector or industrial stocks, as the down cycle in earnings expectations is not yet sufficiently advanced, in our view.

## Still a bit too early to reposition significantly on European equities

In conclusion, although an asset allocation cannot be reduced to valuation, it is clear that European equities still face the growing threat of a global recession, caused by tightening financial conditions and aggressive central banks. Even though they have already incorporated considerable pessimism, rising real rates continue to squeeze risk premia. Indeed, the decline in equity valuation multiples has been more than offset by the rise in real bond yields. Moreover, the implied risk premium for global equities is likely to return to its long-term averages with the future rate hikes planned by the ECB. **In this context, it therefore seems reasonable to wait for levels below 360 on the STOXX 600 before repositioning significantly on European equities.**

## High-yield bonds have a lot going for them

Even as the risk of recession increases**, European credit offers a credible short-term alternative. This asset class is also attractive compared to European government bonds**. Indeed, European corporate bond yields have risen sufficiently to offer attractive yield spreads over government bonds of the same duration. The risk of fragmentation remains as present as ever and the €200 billion plan contemplated by Germany will accentuate the difference in loss of purchasing power as perceived by the various populations. This will lead to dissension within the European Union, as the resources that Germany can deploy to limit the impact of the energy crisis are not comparable to those of Italy (a debt/GDP ratio of 150% vs. 69%). Moreover, the ECB is far from having completed its rate hike programme. The cocktail of rising rates and volatility is likely to remain bitter for some months to come.

**Within the bond asset class, only high-yield bonds can offer a performance profile close to that of equities over the long term.** In the eurozone, BB-rated bonds represent the best credit quality and the largest proportion of the high-yield universe. They have a YTM of 6.6%, with a spread of 480 basis points over German three-year government bond yields. In comparison, the risk premium on equities is 7.4%. **In short, bonds are regaining virtues that have not been seen for many years. At last, some good news in this difficult environment: yields are back!**

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