Almost a year ago, in May 2018, we discussed how U.S. Value stocks were entering their twelfth year of underperformance compared with U.S. Growth stocks. Value stocks in the U.S. had become much cheaper than normal compared to Growth stocks and investor enthusiasm for Growth stocks had been steadily building. But our conclusion was that a regime switch back to Value from Growth was not yet imminent (and had “another few quarters of underperformance ahead before the turning point,”) as the macroeconomic conditions still favored Growth stocks, capital spending by Growth companies was high but not yet excessive, and investor enthusiasm for Growth stocks was not yet euphoric.\(^1\)

Nearly one year later, after a further 13% underperformance of ‘pure’ Value stocks vs. Growth,\(^2\) the regime switch looks more imminent to us, as Value stocks have become even cheaper than they were one year ago; capital spending has accelerated significantly in the past five quarters, outpacing revenue growth and leading to lower free cash flow for Growth stocks; and investor enthusiasm is approaching euphoria, as the number of initial public offerings (IPOs), half of them money-losing unicorns,\(^3\) appears on track to hit a 19-year high this year according to CLSA. In another sign of Growth stock euphoria, money-losing unicorn IPOs returned 120% in 2018.\(^4\) The only driver lacking for a decisive turn in the relative performance of U.S. Value vs. Growth stocks is the economic cycle. As we discussed last year, historically, value stocks start outperforming in the middle of recessions when most of the bad news has been priced in, bond yields have been crushed, and there is nowhere for economic sentiment to go but up. At this point, the U.S. economy is still growing strongly at an underlying pace of 2.25% (cutting through the quarter-on-quarter volatility) and consumer confidence is close to the highest levels

\(^1\) Sergio Parmenov
\(^2\) Cyril Mouillé-Berteaux
\(^3\) Cyril Mouillé-Berteaux
\(^4\) Cyril Mouillé-Berteaux
over the last 50 years. Today, we would argue that a small overweight in U.S. Value stocks (relative to U.S. Growth) is now justifiable on the basis of valuation, sentiment, and corporate behavior, but that a full-blown regime shift into Value is still more than 12 to 18 months away, as it would require the macro cycle to turn into a more decisive slowdown (during which Growth would likely continue to outperform), then a recession.

In this month’s letter we explore a potentially more immediately actionable investment idea: eurozone Value stocks, where we observe a similarly large disconnect as in U.S. Value vs. Growth. Since October 2006, twelve and half years ago, eurozone Value stocks have underperformed the overall market by 32% in total return terms (though only 24% in total return terms due to the superior dividends of the MSCI Eurozone Value Index) and, compared to Growth stocks, eurozone Value has underperformed by a staggering 44% (in the U.S., the underperformance of Value vs. Growth in the same period is 38%). However, in the eurozone, the underperformance is even greater relative to Quality stocks: -48% since October 2006 (Display 1). In absolute terms, Value stocks have risen just 14% since then, but Quality is up a whopping 120%.

The result is that today eurozone Value stocks as defined by the GMA team are as cheap relative to the market as they were during the Global Financial Crisis (GFC), and have only been cheaper during the dot-com growth stock bubble in the 1990s. They trade at a forward price-to-earnings multiple of 8.3x, vs. the market at 12.7x; this represents a discount to the market of 35% vs. the historical average discount of 26% (since 1994, on forward earnings per share). Relative to Quality stocks (GMA team definition), which trade at a multiple of 14.8x, they are trading at a near record low discount of 53% (vs. the historical average 36% discount since 1994, i.e. a 35% upside to get back to the normal discount, Display 2). Historically, from these levels of undervaluation, Value has outperformed Quality by 14% over 12 months.

Display 2: Value Stocks Trading at Near Record Low Discount of 53% to Quality

Relative Forward Price-to-Earning: Eurozone GMA Value vs. Quality

The index data is provided for illustrative purposes only. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

Note: Europe forward price-to-earnings used as a proxy for Eurozone. Shading represents recessions.

Source: MSIM Global Multi-Asset Team Analysis, MSCI, FactSet. Data as of May 15, 2019.

The extreme underperformance of eurozone Value stocks and their attractive valuations make them a potentially very interesting investment over the coming year. Clearly, as discussed earlier for US Value stocks, undervaluation is a necessary but insufficient condition for a shift in favor of eurozone Value stocks. Such a regime shift likely requires a change in the macroeconomic conditions that have disadvantaged Value stocks; the principal ones being: 1) the scarcity and instability of economic growth in the eurozone over the past 12 years, making earnings growth scarce and potholes frequent, thus cheap stocks stayed cheap for a reason; 2) the absence of inflation, partially related to (1) as two recessions and weak growth have created a huge amount of spare capacity in the eurozone (unemployment nearly doubled to 12.1% by 2013 and a negative output gap persisted for nine years) but also related to massive penetration of cheap goods from China and Eastern Europe, cheap labor from Eastern Europe, and to increased pricing transparency due to the internet and e-commerce, all resulting in a lack of pricing power for usually cyclical Value stocks; 3) negative policy rates and zero government bond yields in core EMU, causing a flight from low-duration Value stocks to long-duration Growth and Quality stocks; and lastly, 4) the structural transformation/restructuring of entire industries heavily represented in Value such as banks, where earnings fell 80% and returns on equity are still just half of pre-GFC levels.

Obviously, if eurozone economic growth, inflation, and bond yields were to all rebound to more ‘normal’ levels (2% growth, 2% inflation, and 3-4% bond yields), most market participants would expect a regime shift towards Value stocks. While such a simultaneous rebound in economic growth, inflation and yields is too heroic a forecast given continued structural headwinds in the eurozone and globally, one, economic growth, does appear to be reversing, even as investors seem to be extrapolating past weakness. The second half of 2018 saw the worst non-recessionary six months of eurozone GDP growth in nearly 20 years: 0.7% quarter-over-quarter seasonally adjusted annual rate for two quarters. This was significantly lower than any economist expected at the beginning of 2018 and a huge deceleration from the supercharged 2.5% of 2017. Earnings unexpectedly slowed from 14% in the fourth quarter of 2017 to 2% in the fourth quarter of 2018, with cyclical stocks’ earnings going from 20% outperformance vs. defensive stocks’ earnings to 10-15% underperformance. This unexpected collapse in economic and earnings growth brought back the worst fears of eurozone investors: the specter of yet another recession, which would have been the third in a decade! No wonder Value stocks underperformed both Quality and Growth by 11% (from January 2018 to today) – though most of the underperformance occurred between May and August 2018. After a modest rally in September-October, Value has fully relapsed and sits at 12-year lows. But while Value has been making new (relative) lows, economic growth has actually been healing in the eurozone. This, we believe, is creating an opportunity. 2018’s disappointing economic growth was partially driven by one-off factors we expect to reverse this year - some of which are already reversing (Display 3):
• The switch in auto emissions standards massively depressed auto production last year. Car sales have rebounded and auto production is in the process of normalizing. We expect that reversal of this (along with weather-related disruptions in water levels and shipping on the Rhine river in 2018) will account for a 40 basis point rebound from the second half of 2018’s weak GDP growth.

• For the first time in 10 years, the eurozone is actually seeing fiscal stimulus across most major countries: 75 basis points from Germany, 50 basis points from France, 50 basis points from Italy, and 50 basis points from Spain. Even assuming a 0.75x multiplier, this stimulus could add 30 basis points to eurozone growth.

• The euro—which last year at this time was up +8% year-over-year—is now down -2%, helping to redistribute global growth towards the eurozone. The currency impact on growth goes from -10 basis points in 2018 to +5 basis points in 2019 (a +15 basis point positive impulse).

• Italy was in a recession during the second half of 2018, as the populist left-right coalition’s fiscally irresponsible policies caused a +213 basis point blowout in Italian 10-year bond spreads in mid-2018. This has partially reversed with a roughly -90 basis point rally in spreads, allowing Italy to exit recession in the first quarter of 2019. Even if Italian growth is stagnant in 2019, its contribution to eurozone growth would be a +10 basis point positive impulse compared to the second half of 2018.

Adding the absence of the one-off factors with the positive impacts of fiscal stimulus and the euro suggests eurozone could grow as much as +100 basis points faster than the weak second half of 2018. Already, in the first quarter, the eurozone economy rebounded, growing +1.5%. By summer, the eurozone could be growing at a +1.7% pace, +75 basis points above its potential growth rate of +1.0%.

In addition, exports to emerging market economies, particularly Turkey and Russia (but also China), took a hit in the second half of 2018 due to Turkey’s maxi-devaluation and ensuing recession, Russian sanctions and ruble devaluation, and China’s growth slowdown and trade war fears. Just assuming these impacts do not recur (exports to Turkey are unlikely to halve a second time in 12 months!) would add an additional +75 basis points to EMU growth that we don’t take into account in our estimates.

Historically, when economic growth has been accelerating, particularly from recessionary or near-recessionary levels, Value stocks have outperformed. This makes their year-to-date underperformance puzzling. We do concede that it is unlikely that the rebound in economic growth will do much more than stabilize inflation near 1.0%, possibly trending to 1.20% over the next year, and stabilize Bund yields around 0.0%. However, we strongly believe that a rebound to a +1.7% GDP growth rate reduces the downside risk of a relapse into recession and deflation, where monetary policy is no longer effective, and which would likely cause longer-dated Bunds to rally into strongly negative yield territory. The market’s perception of this tail risk likely discouraged flows into Value stocks from Quality and Growth stocks in this and prior years. When GDP growth goes unexpectedly from +2.8% to +0.7%, as it did in 2H 2018, investors understandably worry and extrapolate the slowdown into a potential recession, particularly given the past decade in the eurozone. However, as we have shown above, much of the slowdown was due to one-offs, stimulus is coming, and the economy is already responding. Inflation and bond yields are clearly less likely to go lower than previously thought if growth continues to improve.

Risks to this benign scenario abound: Italy’s political coalition is unstable and their fiscal plans unsustainable (though, incredibly, it should be noted that Italy will be a net creditor by 2021 according to Standard & Poor’s); a hard Brexit is still a possibility (though there appears to be no majority for it — nor for anything else!); U.S.-China trade tensions are heating up again, and auto tariffs are a distinct possibility (though fighting trade wars on two fronts is typically avoided).

The question is whether we, as investors, are getting paid to take the view that the eurozone economy will be better over the next year than it has been recently, and whether inflation and bond yields are likely to stabilize at or above current levels. It is our assessment that, given the extreme undervaluation of eurozone Value stocks and expensiveness of Quality and Growth stocks, not much needs to go right for Value stocks at worst to have a decent 6- to 12-month rally (wreaking temporary havoc on most investors’ Quality and Growth-centric portfolios), and at best to move into a more durable Value regime.

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Display 3: EMU GDP Growth to Rebound to Above Potential

Multiple Factors to Drive Rebound

<table>
<thead>
<tr>
<th>Factor</th>
<th>2H 2018</th>
<th>German One-Offs</th>
<th>Fiscal Easing</th>
<th>Euro</th>
<th>Italy Stabilization</th>
<th>Q4 2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP Growth</td>
<td>0.7%</td>
<td>0.4%</td>
<td>0.3%</td>
<td>0.2%</td>
<td>0.1%</td>
<td>1.7%</td>
</tr>
</tbody>
</table>

Two additional observations tilt us toward pro-Value positioning. Value companies have disproportionately suffered in the past decade from two recessions and two global slowdowns which caused recession fears (2015-16 and 2018), but, at the same time, Quality companies were still benefiting from their ability to generate strong sales and earnings growth due to favorable industry dynamics. This allowed Quality companies to outgrow Value companies’ cash flows in both recessions and expansions—clearly an extremely attractive attribute: cash flow growth in (almost) all environments! This is very different than what occurred before the financial crisis when Value companies’ earnings fell dramatically in recessions but outgrew Quality companies’ earnings in expansions. But now it would appear that, as the business model of many Quality companies is threatened by new and old disruptors, their new-found ability of the 2010s to out-earn in recessions and expansions may also be threatened (Display 4).

Display 4: Quality Companies’ Ability to Out-Earn in Recessions and Expansions Threatened

Europe Quality vs. Value - Price and Forward Earnings-Per-Share

The index data is provided for illustrative purposes only. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.
Source: MSIM Global Multi-Asset Team Analysis, MSCI.
Data as of May 15, 2019.

The second observation is that investors have become so enamored with Quality stocks in Europe (and Growth stocks in the U.S.) that Quality has now become Momentum. By that we mean that a large percentage of Quality stocks have now become Momentum stocks—defined as the stocks with the best performance over the past 12 months. Our work shows that usually only a quarter of Quality stocks are in the top Momentum cohort, but that today, 39% are, a historical rarity. Momentum stocks are typically drawn from the more speculative areas of the market such as technology, internet, and biotech (and in prior cycles, media, telecom, and commodity stocks). In speculative sectors where actual cash flows can be hard to assess (or to come by!), price Momentum may be considered a positive attribute (though when extreme, prone to reversal). But, for steady Quality companies to find themselves in that position indicates to us that animal spirits and speculation, not fundamental investment decision-making, have taken over. Usually, that kind of enthusiasm tends to reverse. In fact, when Value stocks are as cheap as they are today relative to Quality and that many Quality stocks are Momentum, Value has historically outperformed Quality by 15% in the subsequent year.‡

In summary, we see in eurozone Value stocks multiple attractive attributes: extreme undervaluation relative to Quality stocks, an economic recovery which favors Value over Quality, a possible structural shift in the ability of some Quality companies to keep compounding earnings at an above-market pace (and above Value companies) in economic expansions, and signs of exuberance in investor behavior with Quality having become synonymous with Momentum. As a result, we have begun to actively tilt our portfolios towards Value and away from Quality. This means overweight positions in eurozone Value stocks (on a sector-neutral basis) funded by underweight positions in eurozone Quality stocks. It is not yet clear to us whether this is simply a Value ‘trade’, (i.e. a 6- to 12-month period of 10-20% outperformance of Value stocks over Quality as we saw in 2009, 2013 and 2016), or the beginning of a Value regime, which could see Value stocks outperform by 30-50% over 5 to 10 years (as we saw in 2000-2006 and the 1990s). In either case, we believe that buying Value in the eurozone will be profitable over the next 6 to 12 months.

‡ Two-factor back-test 1995-2019 (Best quintile valuation of Value vs. Quality and highest quintile of Quality stocks in top momentum cohort).
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FOOTNOTES

2 The MSIM Global Multi-Asset team defines ‘pure’ Value as the cheapest stocks, using 5 value factors, relative to the most expensive stocks on a sector-neutral basis (i.e. the same percentage of names in tech and financials as the overall market, but within each sector, the cheapest stocks are bought and the most expensive ones are sold; each stock in the cohort is given equal weight). Source: MSIM Global Multi-Asset Team Analysis.
4 Source: MSIM Global Multi-Asset team analysis; based on median returns; CLSA, ‘Bits & Pieces’ May 3, 2019.
5 Source: MSIM Global Multi-Asset team analysis; Bloomberg; Data as of April 30, 2019.

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6 We use MSCI Eurozone Quality indices to avoid confusion around the definition and construction of a Quality index; MSCI defines quality as high Return on Equity, low Debt to Equity and low Earnings Variability.
7 Source: MSIM Global Multi-Asset team analysis; For the eurozone, data based on MSCI Eurozone Value and Quality Indices; for the U.S., data based on Russell 1000 Value and Growth Indices. The overall market refers to the MSCI Eurozone Index.
8 The MSIM Global Multi-Asset team defines Eurozone Value stocks in the same ‘pure’ way as value names in the US (footnote 2), with the exception of using market capitalization rather than equal weight for each security. Quality stocks are defined in similar fashion, using Return on Equity as the criterion for Quality.
9 Source: MSIM Global Multi-Asset team analysis; based on the MSCI Eurozone Styles Indices (Value, Quality, Growth).
10 Source: MSIM Global Multi-Asset Team estimates; assumes labor force growth of ~50 basis points and productivity growth of ~50 basis points.
11 Source: MSIM Global Multi-Asset Team analysis.
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