Value exposures in European markets

May 2021

Research Signals

We have written several **articles** and monthly **key drivers** reports highlighting a resurgence in the performance of value factors following an **extended period** of underperformance in US markets. With European markets recently hitting new all-time highs, we review market developments from a similar perspective of value investing.

- Since November, European markets have been on a steady path to all-time highs, supported by large increases in ETF flows and a healthy manufacturing sector
- Value factors have regained their footing, particularly since September 2020, as short sellers reduce exposure to undervalued names
- Recent months have seen signs of improving analyst outlook in Developed Europe relative to North America and Developed Pacific regions

Macroeconomic backdrop

To set the stage, we provide a macroeconomic overview of recent market developments. First, we compare European market performance to that of US markets since January 2020, spanning the period heading into the COVID-19 pandemic and the market's recovery phase. For our analysis, we use the IHS Markit ETF Analytics database to compare cumulative returns of the iShares MSCI Europe UCITS ETF and the SPDR S&P 500 ETF as proxies for the respective markets (Figure 1).

While both markets tracked closely during the downturn that ensued during the heightened volatility in the early days of the pandemic, US markets recovered much more rapidly from the 23 March market bottom. However, following the late-October near-term bottom when equities struggled ahead of the US election amid rising numbers of coronavirus cases and new restrictions to curb its spread, the trend changed. Since November, European markets once again moved in lockstep with the US, returning 29.8% compared with 28.8% for the US, as both regions made their way to all-time highs.

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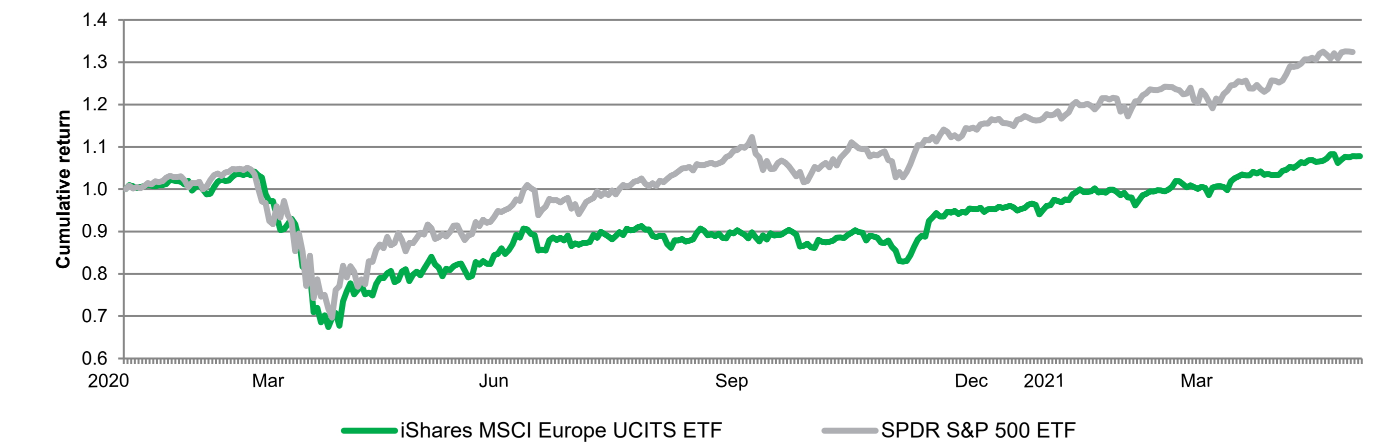
Figure 1

Cumulative NAV return



Source: IHS Markit

Since November, both markets were supported by large increases in ETF flows. In Europe (Figure 2), February was the only month of outflows this year, perhaps on concerns of a resurgence in COVID-19 cases and tightening virus containment measures, while optimism returned in March. Meanwhile, US ETFs (Figure 3) saw a slight decrease in inflows on the back of significant inflows in February, yet still topped $60B for the third time in the past 12 months.

Figure 2

European equity ETF flows

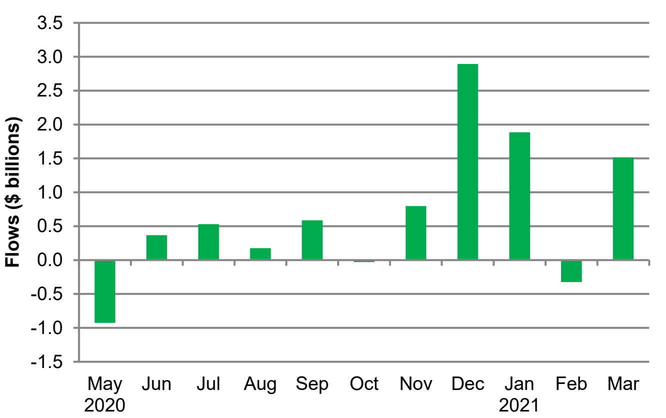


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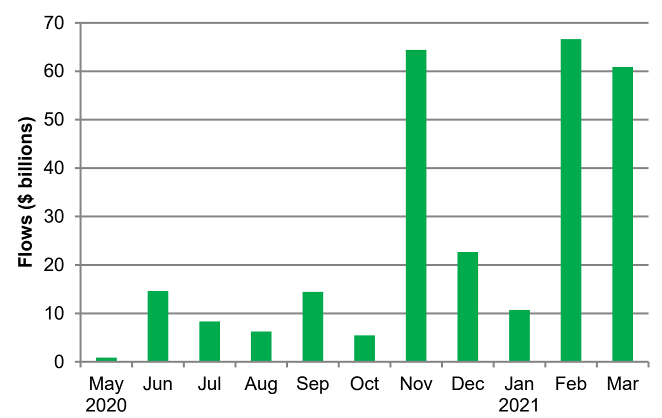
Figure 3

US equity ETF flows

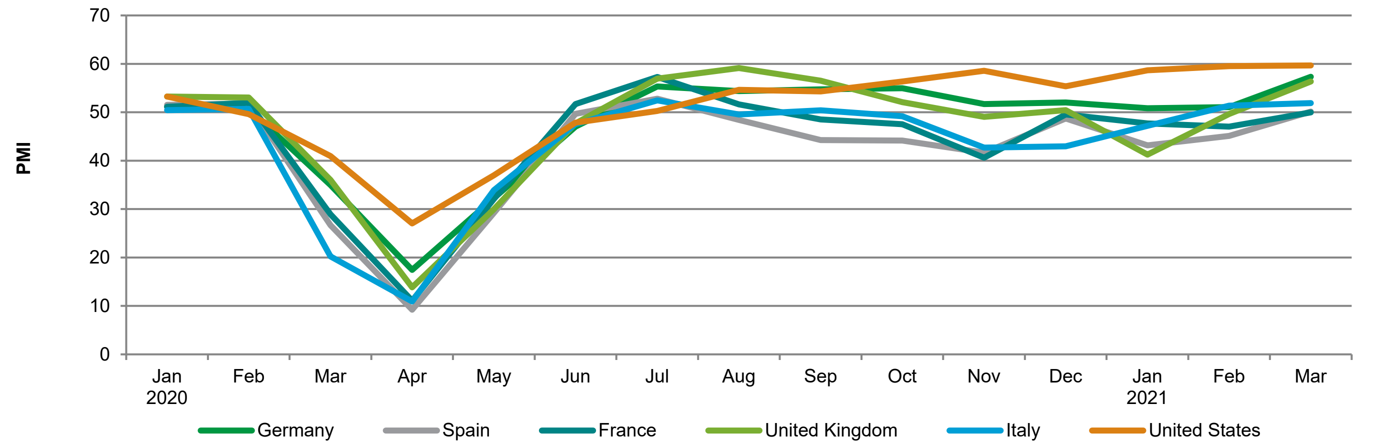


Source:

Economic data, including composite PMI readings, provided another source of good news for equity investors (Figure 4). The US Composite PMI Output Index posted 59.7 in March, up slightly from 59.5 in February, to signal the fastest upturn in private sector business activity since August 2014. In the eurozone, Germany (57.3) led the major economies in March, while the United Kingdom economy (56.4) also showed encouraging strength. Operating conditions were the strongest in the manufacturing sector in each country, while the hard-hit service sector was slower to recover from lockdown measures. Separately, tightening financial conditions via rising bond yields prompted the ECB Governing Council to step up the pace of asset purchases in its March meeting.

Figure 4

Composite PMI



Source: IHS Markit

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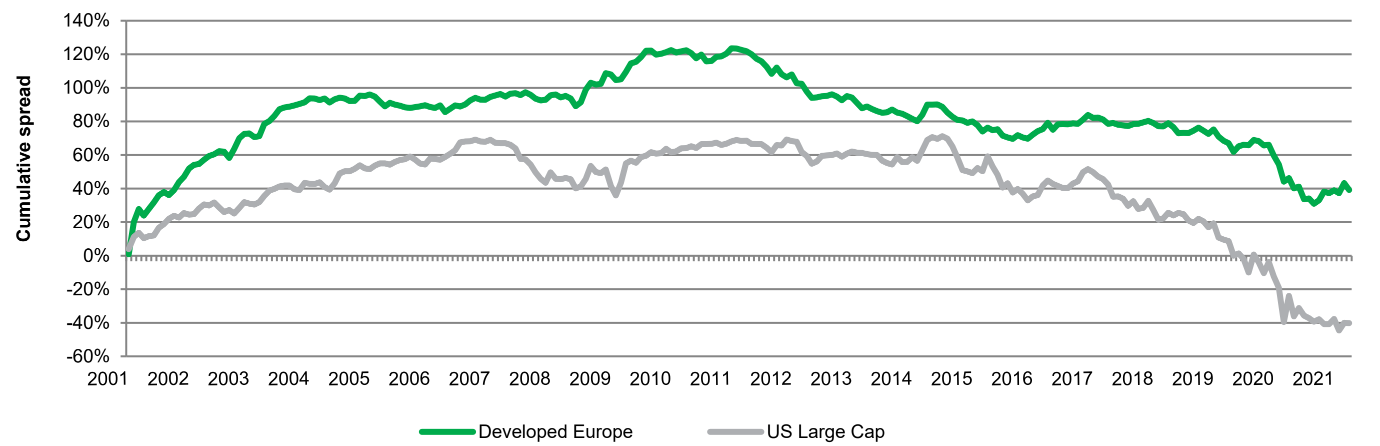
Value factor performance

With this background, we turn now to recent value style dynamics. To begin with, we take a long run view of value factor performance relative to growth. For this analysis, we use TTM EBITDA-to-Enterprise Value and Reinvestment Rate to capture the respective styles. Factor performance is measured as the spread between decile 1 and decile 10 returns. We compare performance over the Developed Europe universe (95% of cumulative market cap for each member country, subject to a minimum market cap of USD 250 m) with that of the US Large Cap universe (90% of cumulative market cap, or approximately 1,000 names).

In Figure 5, we plot the cumulative monthly spread in performance between the value and growth factors over both universes. Following the internet bubble, both regions experienced a prolonged value cycle that lasted, in general, through the financial crisis. However, European markets tacked on an additional leg of value performance into 2011. Following that time, an extended growth cycle ensued, which was more pronounced in US markets. More recently, we find that value has gained some traction once again in both markets, though to a greater extent in Europe, particularly since September 2020.

Figure 5

Value versus growth cumulative monthly performance



Source: IHS Markit

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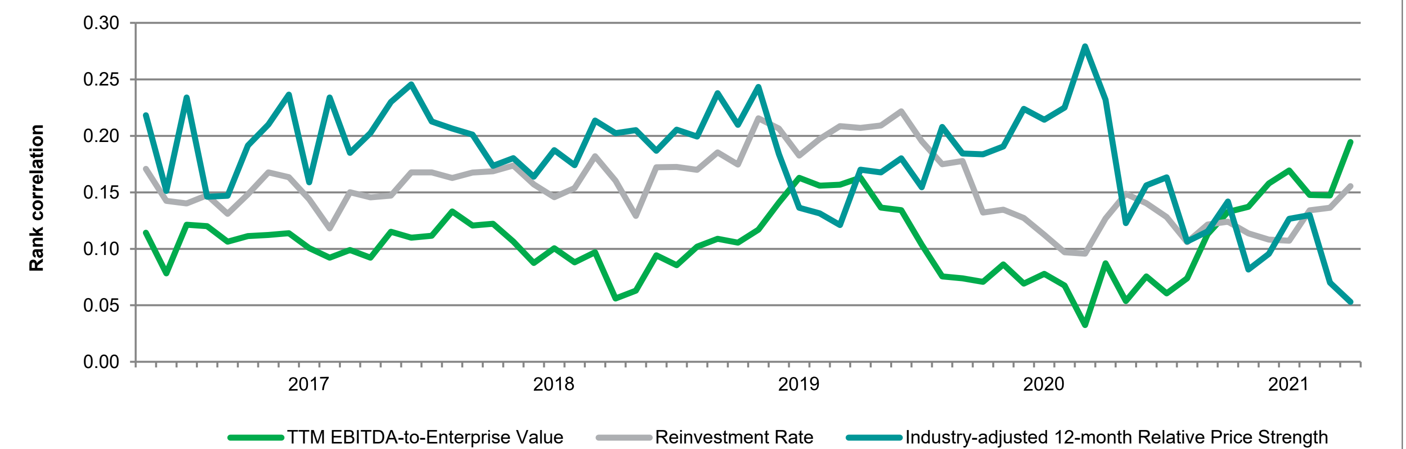
To evaluate these developments closer, we turn to the securities lending market to take the pulse of investor sentiment towards value and growth styles in addition to momentum which we gauge by Industry-adjusted 12-month Relative Price Strength. For this analysis, we examine the correlations in monthly cross-sectional factor ranks of each style factor with Utilization, a Short Sentiment signal sourced from the IHS Markit Securities Finance dataset which captures the proportion of inventories sitting in lending programs out on loan. A lower correlation indicates higher demand to short the stocks most favorably ranked by the respective factors (Figure 6).

Our results indicate that short sellers have looked favorably upon value stocks since early 2020, with a decreasing trend in demand to borrow the most undervalued names. The relationship with growth stocks has seen little change in trend over the same period; however, high momentum stocks have been more heavily shorted based on the decreasing pattern in rank correlations.

Figure 6

Correlations with Utilization



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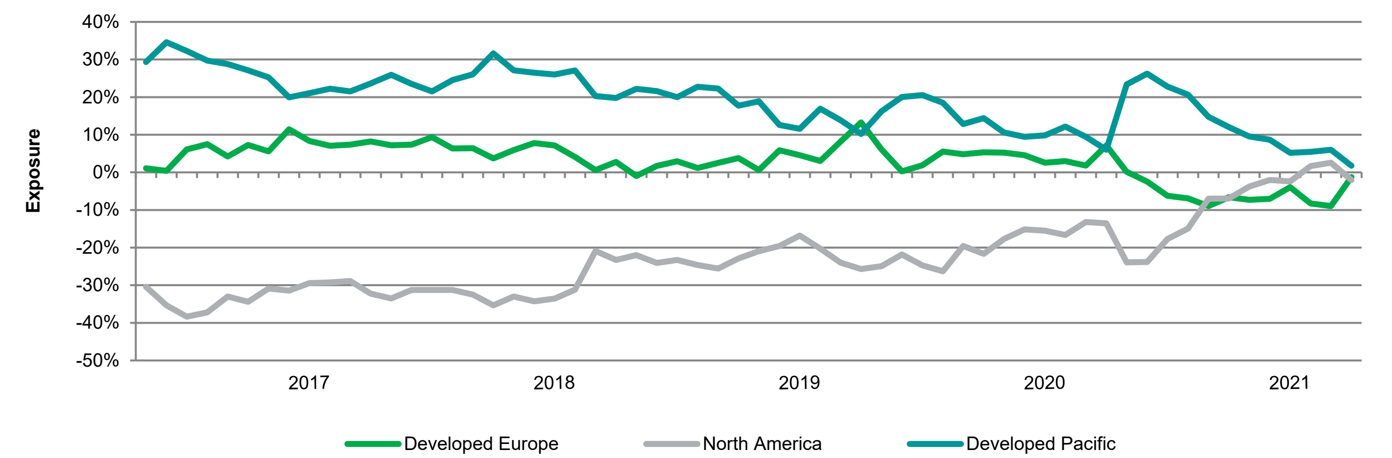
We round out our review with an examination of Developed Europe regional exposures to several forward-looking signals relative to North America and Developed Pacific, as ranked within our Developed World universe. We report the active exposure of each region which is computed as the percentage of names of each region in the factor's top decile less the bottom decile.

The first factor we study is Forward 12-M EPS-to-Enterprise Value (Figure 7), to capture the relative valuation of each region with respect to analyst outlook. Since the start of the pandemic, North America saw an increasing trend in attractiveness relative to the other regions as measured by forward looking valuation, while Developed Pacific experienced the reverse trend. However, while Developed Europe exposures were also on a general downtrend, we draw attention to the bounce in March this year, indicating an increase in names present in the top decile compared with the bottom decile, an interesting development despite the market's continued climb to new highs. Comparing to the multi-year trend, we currently observe a rare convergence in valuation exposure by region.

Figure 7

Forward 12-M EPS-to-Enterprise Value active regional exposures



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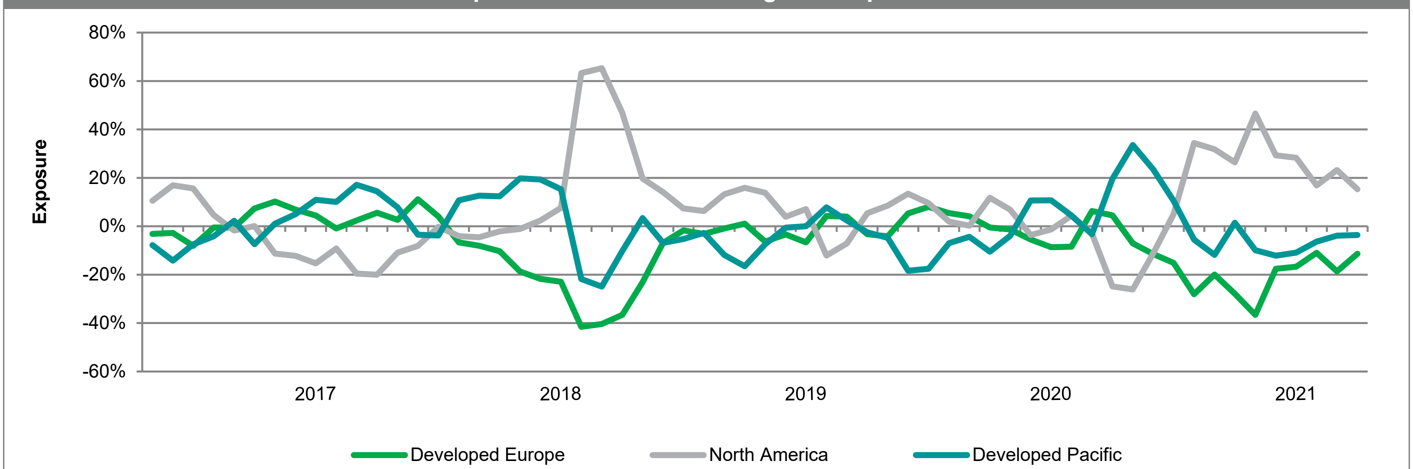
The next factor we focus on is 3-M Revision in FY2 EPS Forecasts: Dispersion Relative (Figure 8), to assess the relative movement in analyst outlook. Based on this analysis, analysts were the most optimistic on prospects in North America in the initial stages of the pandemic, though the enthusiasm tapered off in the final months of 2020. At the same time, Developed Europe firms began to receive more positive positioning from the perspective of earnings expectations.

Figure 8

3-M Revision in FY2 EPS Forecasts: Dispersion Relative active regional exposures



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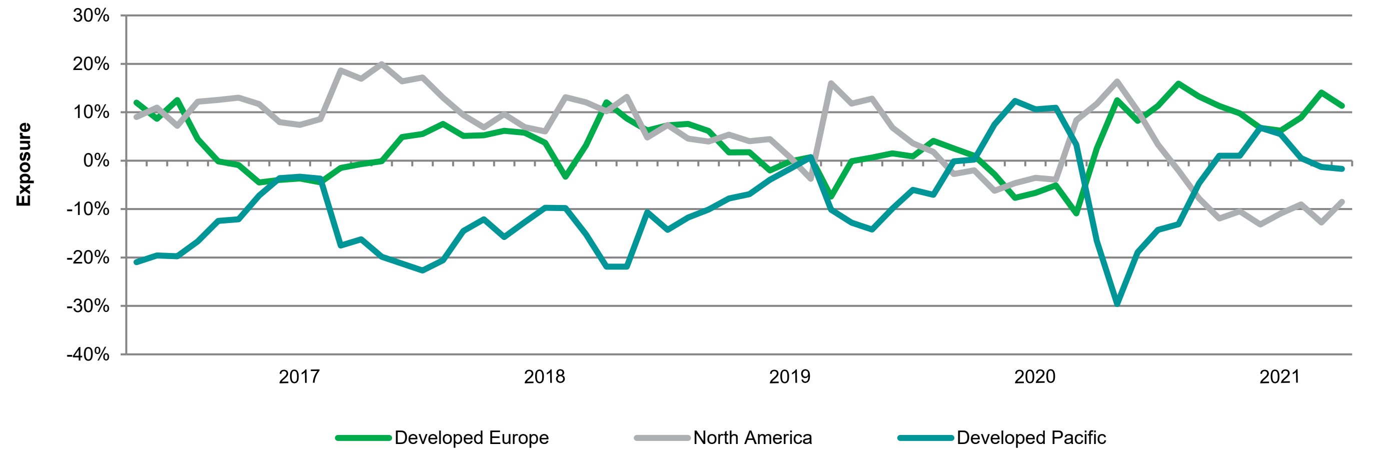
Finally, we study 2-Year Ahead EPS Growth (Figure 9), to capture the growth outlook across each region. Here we find that Developed Europe's relative exposure compared with the other regions was on a downward trend in the second half of 2020 as increasing COVID-19 infections brought on concerns of additional lockdown measures; however, an uptick is observed in 2021. On the other hand, Developed Pacific has recently come off its positive trend since the start of the pandemic, while North America has remained in negative territory since mid-2020. A striking long-term observation is that the North America exposure is at its lowest across the past five years, while Developed Europe is near its five-year high of 10% exposure.

Figure 9

2-Year Ahead EPS Growth active regional exposures



Source: IHS Markit

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In summary, European markets have kept pace with the US since November, supported by large increases in ETF flows and an upturn in the manufacturing sector, as both regions made their way to all-time highs. From a style perspective, value has regained some traction, particularly since September 2020, as short sellers reduce exposure to undervalued names. Finally, analyst expectations are showing early signs of improvement in Developed Europe relative to North America and Developed Pacific regions.

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