TalkingPoint Schroders

MARKETS

Is now the time for value stocks in Europe?

Value stocks are unloved and underowned in Europe, but signs of a pick-up in inflation could see them reverse their underperformance.

20/05/2016

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30 Minutes
Unstructured
Learning Time

Quantitative easing by central banks has distorted stockmarkets, with the result that growth stocks have outperformed strongly while value areas of the market have languished in their wake[1].

The divergent performance of these style groups has now reached extreme levels and may be due for a reversal. Signs that inflation is re-emerging in Europe could be the catalyst for value to return to favour.

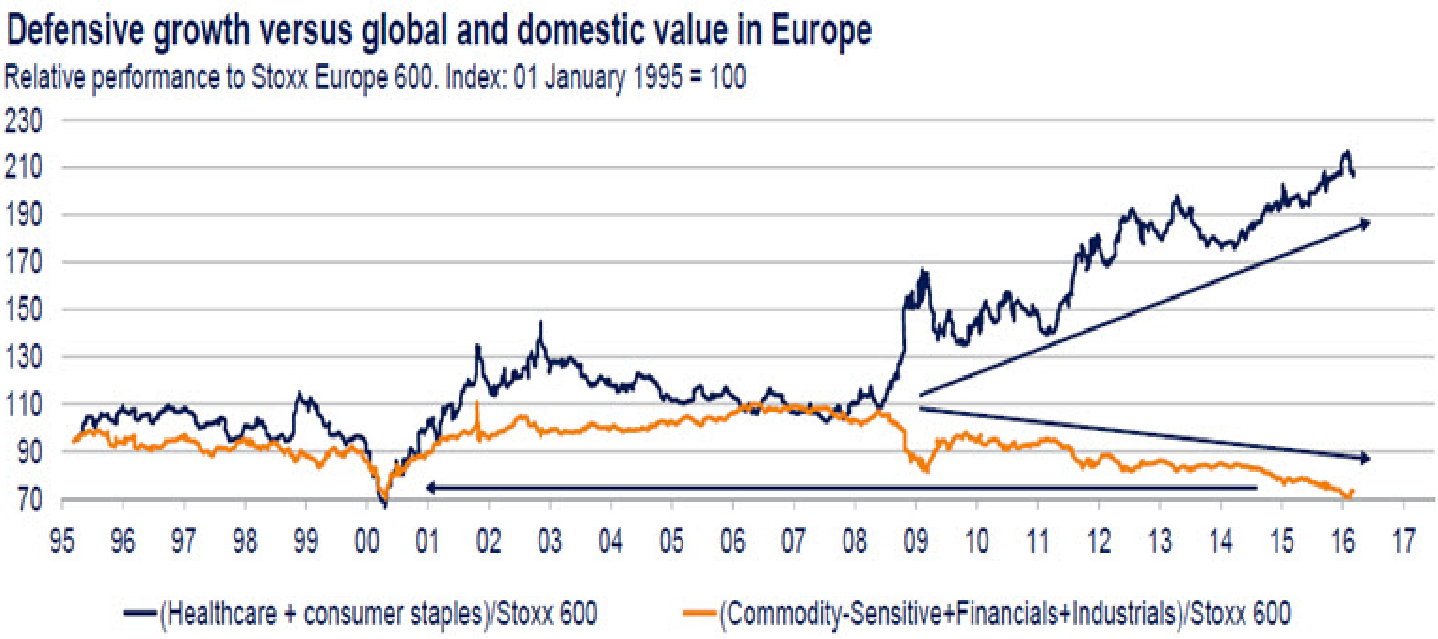
Growth has outperformed value

Since the global financial crisis, the impact of quantitative easing and low bond yields has seen quality and growth areas of the market vastly outperform value stocks.

There are now very few fund managers who have an overweight allocation to value stocks, examples of which are commodity-sensitive stocks, financials and industrials.

As a result, quality and growth areas of the market such as healthcare and consumer staples have become a very crowded trade.

Extreme levels are being reached, both in terms of the relative performance of growth and value and in terms of where the market is positioned.



Source: Kepler Cheuvreux, as at March 2016. Past performance is not a guide to future performance and may not be repeated.

In our view, value stocks are almost as cheap as they have ever been and a reversion to the mean would offer significant double-digit upside.

Return of inflation could boost value

We see the return of inflation as the likely catalyst for this. Inflation expectations are currently at very low levels, in Europe as well as globally, but there are three signs that it may be poised for a pick-up.

1. The oil price is unlikely to fall forever. Even a stabilisation at current levels would add 1% to OECD inflation figures this year.
2. Europe's labour market is tighter than one might realise from headline unemployment figures. Certain pockets of industry are experiencing relatively high wage inflation (e.g. engineering) and there have been minimum wage increases in various countries.
3. After 10 years of underinvestment, there is little slack in Europe's factories so capacity utilisation is running at around average levels. Any further upturn in demand could see price increases come through.

While these signs may not yet be visible in the official European inflation statistics, it is notable that US inflation is back to normal levels and we would expect Europe to follow in due course.

Clearly, a return of inflation would have implications for investors in terms of the kinds of companies we would want to own.

Banks represent value opportunity

Financials are a part of the market that could be significant beneficiaries, both banks and insurers.

Bank share prices in particular have come under heavy downward pressure and an end to increasingly negative interest rates would be crucial for their performance.

If banks were to return to their mean average discount to the wider market, this would imply 50% outperformance from current levels.

Some defensive parts of the market could be beneficiaries too and we would highlight the telecoms sector where inflationary pricing is starting to return.

Oil stocks to benefit from inflation

Another big beneficiary of a return of inflation could be the oil stocks. Oil companies were actually not the major gainers from the oil price boom of a few years ago because their costs rose exponentially.

However, the recent oil price drop has forced companies to rein in their costs and, assuming this discipline continues, we see oil as a value sector that offers significant upside potential for investors.

In conclusion, there is an enormous disparity between value stocks – which are little-owned and very cheap – and quality/growth stocks – which are widely owned and expensive.

A return to a more normal inflation environment would have positive implications for value stocks, and this is where we feel the greatest opportunity in European equities lies at the moment.

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1. Growth stocks are those with high rates of growth, both current and projected forward, while value stocks are those that have been under-priced by the market and have the potential to rise in value.↩
