METROPOLE Gestion

La lettre

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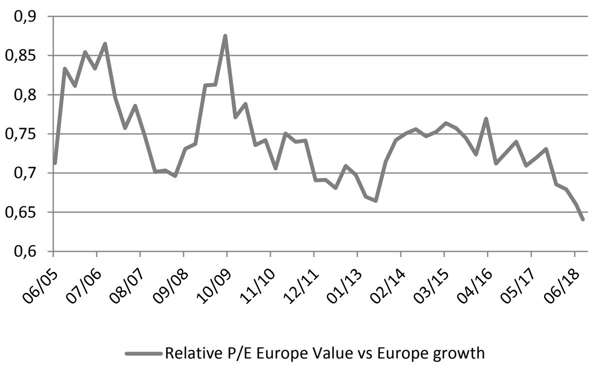
Is the business and market cycle reaching an inflection point?

Over the summer, the combination of a number of causes for concern has disrupted the European equity markets. Factors ranging from an economic environment with all the airs of a cycle peak in the US, the monetary tightening under way, the flattening of the US yield curve trade tensions, the Turkish crisis and more generally the financial imbalances in certain emerging countries, the weakening of leading indicators such as the PMI in the Eurozone, worries about a meltdown of Italy's public finances, and the possible failure of the Brexit negotiations, are all raising fears of a sudden downturn in the global economic and market cycle. These fears have triggered a rise in risk aversion and a general withdrawal by investors into so-called defensive and "quality" stocks, regardless of their valuation. This shift has resulted in an underperformance of the Value investing style, specific to periods of market stress. It is unjustified on several accounts.

In the US, the stock market shows certain signs of a peak in the cycle: market indices are at their highest, as are corporate margins and profits, now 65% higher than at the last peak back in 2008, in an economic environment of full employment. This is the longest lasting bull market in history. The cycle peak does not, however, mean the end of the cycle. If a factual analysis of the economic data is to be trusted, economic activity shows no signs of either weakness or overheating, with a manufacturing PMI leading indicator at 54.5 and underlying inflation running at 2.4%. In addition, the current monetary tightening and the flattening of the yield curve are not early indicators of an inflection in the business cycle. Historically, over the last 60 years the US economy has never entered into recession when the real short-term interest rate is negative, as it is at present (-0.40%). US monetary policy remains accommodating, in keeping with the economic realities, and this is a fairly positive sign. Likewise, the current flatness of the yield curve has not in the past been synonymous with falling stock markets, but is a recurrent phenomenon during phases of rising Central Bank key interest rates. Europe is a long way from a cycle peak, and actually lags well behind the global economic cycle after undergoing two successive recessions in 2009 and 2012: corporate margins are gradually improving but have still not gone back to the peak reached over 10 years ago. European corporate profits are still 18% below their previous peak in 2008. European businesses are currently just entering a recovery phase and showing excellent health: the massive restructurings of the last decade have considerably reduced their fixed costs and their debt is down to one of the lowest levels in the past 20 years. European corporate earnings announcements for Q2 2018 confirm this outlook, with average revenue growth of 6% and profits up 11%, a swifter rise than in Q1. One example is Italian group **CNH Industrial**, which reported 12.8% revenue growth at constant exchange rates and an increase of 140 basis points in operating margin, resulting in 56% growth in earnings per share. In this context, the decline in the manufacturing PMI for the Eurozone is more of a baseline effect, down to 54.9 from the exceptionally high level of 60.6 recorded back in December, and hence indicating a continuing economic recovery at a sustained pace.

Our investment decisions are guided first and foremost by the valuation of European companies. In that respect we see significantly undervalued stocks across whole swathes of the stock market in business sectors such as telecoms (**Orange**, **Vodafone**), media (**Pearson**, **Publicis**), food retail (**Carrefour**), industry (**ABB**, CNH Industrial), banking (**Unicredit**, **Banco Santander**) or energy (**TechnipFMC**, **Royal Dutch Shell**). We are also finding out that the risk aversion currently driving the markets has widened valuation gaps between stocks that investors have turned away from and those sought after for their supposed defensive features or growth potential. The gap has never been as wide since the 2000 internet bubble.



Source: Consensus Bloomberg – Data at 31/08/18

The valuation of Italian bank Unicredit, for example, has fallen to 0.6x tangible book, close to the all-time lows reached at the height of the 2012 Eurozone crisis, whereas the bank has reduced its non-performing assets to the level of pre-crisis 2008 and increased its capital by 50%.

Ultimately, we believe that markets have broadly discounted all the threats hovering over global economic activity and are exaggerating the risks. Experience of past crises has taught us that valuation anomalies are invariably self-correcting. It has also taught us that periods such as these provide unparalleled investment opportunities and entry points. That is the reason why despite uncertainties, we are making no change to our investment strategy of picking undervalued stocks.

Performances*

PERFORMANCES	2018	2017	2016	2015	2014	2013	1 yr.	3 yrs.	5 yrs.	10 yrs.	Since inception	Volat. Vol. bench NAV
EUROPEAN AND EUROZONE EQUITIES												
METROPOLE SELECTION A												
FR0007078811	**-3.34%**	**8.03%**	**-0.53%**	**9.19%**	**-0.02%**	**28.44%**	**0.59%**	**1.47%**	**28.77%**	**62.67%**	**207.72%**	**10.38%**
STOXX Europe Large 200 NR	-0.40%	8.92%	1.88%	7.70%	7.09%	19.68%	3.65%	11.13%	41.05%	65.68%	138.12%	10.56%
Performance gap	-2.94	-0.89	-2.41	1.49	-7.11	8.76	-3.06	-9.66	-12.28	-3.01	69.60	615.44
METROPOLE EURO SRI A												
FR0010632364	**-3.51%**	**4.27%**	**2.93%**	**6.73%**	**1.24%**	**27.74%**	**-1.83%**	**1.80%**	**28.09%**	**50.50%**	**58.39%**	**10.99%**
Euro STOXX Large NR	-0.18%	10.81%	3.97%	8.66%	4.30%	22.69%	3.19%	16.57%	49.06%	47.50%	48.91%	11.29%
Performance gap	-3.33	-6.54	-1.04	-1.93	-3.06	5.05	-5.02	-14.77	-20.97	3.00	9.48	316.78
METROPOLE AVENIR EUROPE A												
FR0007078829	**-6.82%**	**13.26%**	**3.64%**	**9.49%**	**-1.70%**	**28.99%**	**-2.28%**	**5.71%**	**34.50%**	**112.86%**	**240.26%**	**10.60%**
STOXX Europe Small 200 NR	2.50%	18.10%	0.52%	15.68%	4.93%	26.73%	9.33%	25.85%	68.16%	131.36%	366.09%	10.38%
Performance gap	-9.32	-4.84	3.12	-6.19	-6.63	2.26	-11.61	-20.14	-33.66	-18.50	-125.83	680.52
METROPOLE FRONTIERE EUROPE A												
FR0007085808	**-2.70%**	**15.33%**	**0.89%**	**6.19%**	**-1.86%**	**18.97%**	**-1.32%**	**11.56%**	**30.88%**	**-4.87%**	**105.78%**	**8.31%**
STOXX Europe Large 200 NR	-0.40%	8.92%	1.88%	7.70%	7.09%	19.68%	3.65%	11.13%	41.05%	65.68%	153.28%	10.56%
Performance gap	-2.30	6.41	-0.99	-1.51	-8.95	-0.71	-4.97	0.43	-10.17	-70.55	-47.50	411.57
BONDS & CONVERTIBLES												
METROPOLE CONVERTIBLES A												
FR0007083332	**-4.24%**	**-0.67%**	**1.98%**	**2.88%**	**0.71%**	**7.22%**	**-3.79%**	**-3.92%**	**4.45%**	**31.77%**	**63.22%**	**3.09%**
ECI-EURO	0.87%	6.99%	-0.21%	6.08%	3.06%	9.81%	3.64%	10.87%	23.72%	50.34%	90.55%	4.01%
Performance gap	-5.11	-7.66	2.19	-3.20	-2.35	-2.59	-7.43	-14.79	-19.27	-18.57	-27.33	326.44
METROPOLE CORPORATE BONDS A												
FR0010695874	**-3.06%**	**0.26%**	**0.51%**	**0.96%**	**3.78%**	**3.68%**	**-2.96%**	**-1.64%**	**4.48%**	**-**	**48.23%**	**2.54%**
FTSE MTS 3-5 Y	-1.42%	0.14%	1.46%	1.39%	5.93%	2.32%	-1.53%	1.01%	9.46%	-	29.15%	2.15%
Performance gap	-1.64	0.12	-0.95	-0.43	-2.15	1.36	-1.43	-2.65	-4.98	-	19.08	296.46

Past performances are not necessarily indicative of future results. The mutual funds may lose value.

*Data as of 31 August 2018