Strategy Matters

Policy, rates and growth pricing in European equities

Modest downturn likely priced in, but the inflation overshoot may mean a deeper one

With the market down 9.5% YTD (SXXP) and earnings revisions - at least in aggregate - up again this year we have seen another derating of European stocks. Euro STOXX 50 trades on 12.2x forward P/E and FTSE 100 on just 10.9x. We continue to see value in European equities especially relative to bonds, the gap between the European DY and the German 10-year real rate is above 5%; high outside recessionary periods (Exhibit 1). Of course, relative to nominal yields the gap has closed modestly but even so it remains high versus longer term history, especially in periods of higher rates. Furthermore, payout ratios remain low; so dividend payouts should be more secure even in a modest economic downturn (Exhibit 2).

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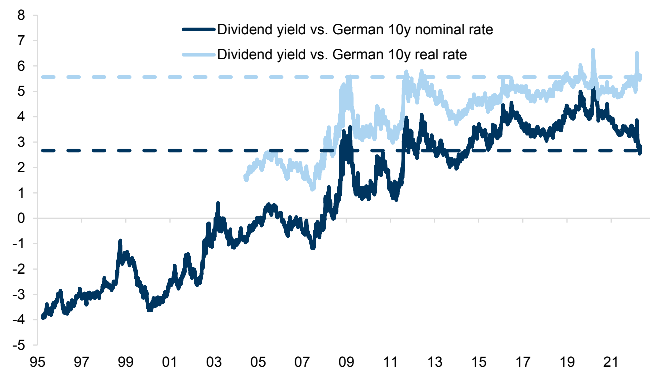
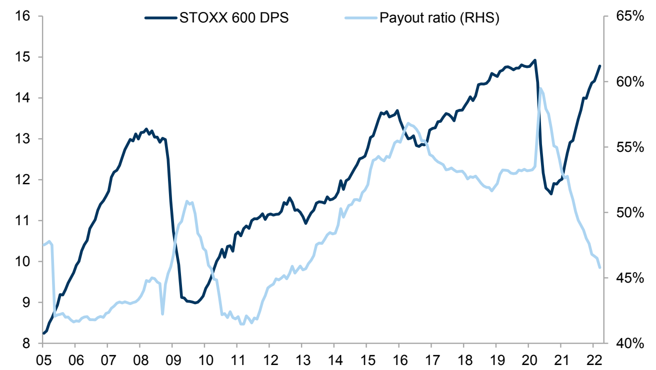
Exhibit 1: Equities still have some cushion compared to real rates
STOXX 600 24m fwd DY vs. German nominal and real rates



Source: Bloomberg, FactSet, STOXX, Goldman Sachs Global Investment Research

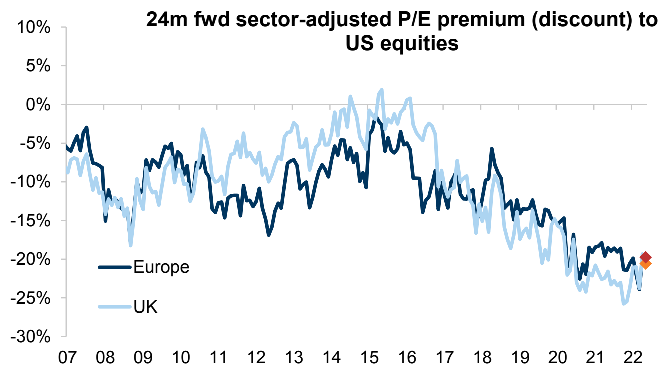
Exhibit 2: ..and dividends look secure - there is space for higher payout ratios
12m fwd DPS and payout ratio



Source: Factset, STOXX, Goldman Sachs Global Investment Research

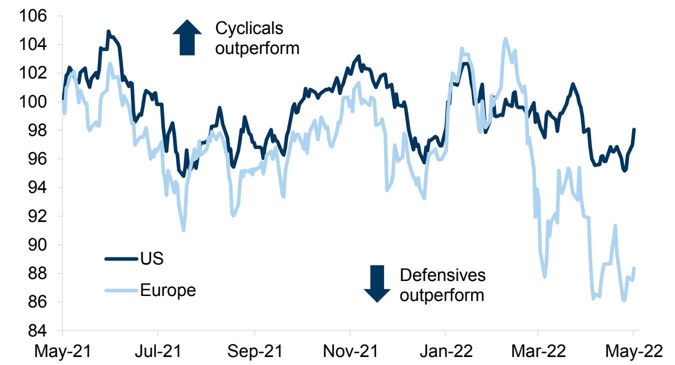
The discount of European equities to the US remains significant even on a sector-equivalent basis, and European cyclicals have sold-off more aggressively than US cyclicals (Exhibit 4).

Exhibit 3: Relative discount of Europe and UK to the US on a global sector basis
24m fwd P/E with Global Equities weights



Source: Factset, STOXX, Goldman Sachs Global Investment Research

Exhibit 4: Cyclicals have underperformed sharply in Europe
GSSTCYCL vs. GSSTDEFS (Europe) and GSSBCYCL vs. GSSBDEFS (US)



Source: Bloomberg, Goldman Sachs Global Investment Research

We believe the European market is pricing in a modest economic downturn, with PMIs falling to around 50 (Exhibit 5). If we look at cyclicals vs. defensives that pair is down c.12% over 12-months; though difficult to calculate, we note this would be roughly consistent with PMIs declining to the high 40s (Exhibit 8). Given the most recent survey data is much stronger than this, we think the market is likely pricing in a modest recession, mostly a couple of negative quarters in the next 12-months. Our economists expect Europe (and even the UK) should avoid recession but the potential is reasonably high given the Ukraine war impact on energy prices and supply chains.

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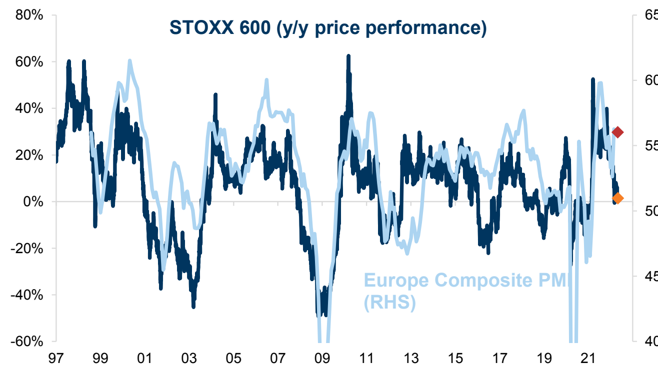
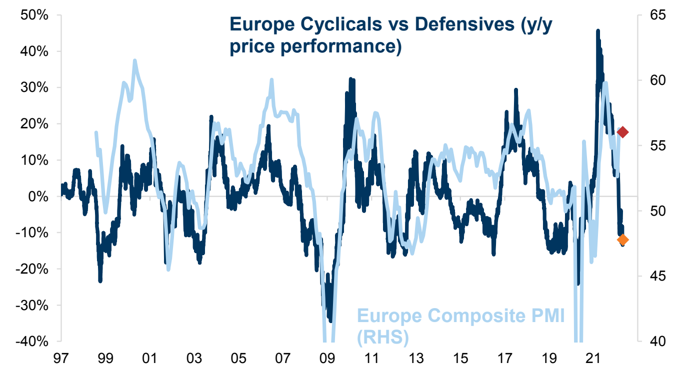
Exhibit 5: SXXP is pricing a decline in PMIs...
STOXX 600, y/y price performance



Source: Haver Analytics, STOXX, Goldman Sachs Global Investment Research

Exhibit 6: ...and European cyclicals are pricing in moderation in growth
Europe Cyclicals vs. Defensives, y/y price performance

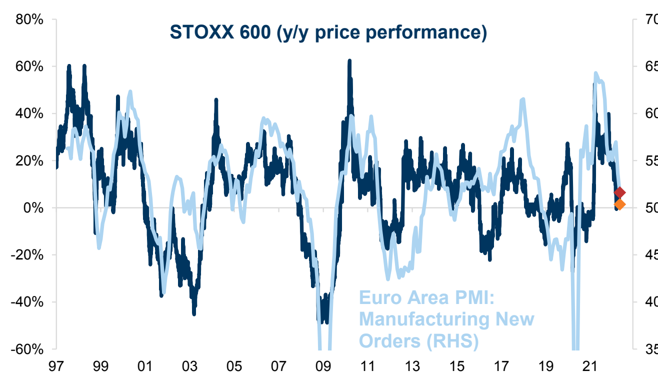


Source: Datastream, Haver Analytics, Goldman Sachs Global Investment Research

PMIs remain strong but other indicators - those looking at orders/shipments or more sentiment-based surveys - have declined sharply. While the PMIs are considered by our economists as the best indicators of growth they have the problem that they are largely contemporaneous. They don't forecast growth in 6-months' time, which the market focuses on. Again, looking at returns on the overall market versus the new orders component of the PMI suggests the market declines in recent months have been consistent with a slowdown in this component to about 50 (Exhibit 5).

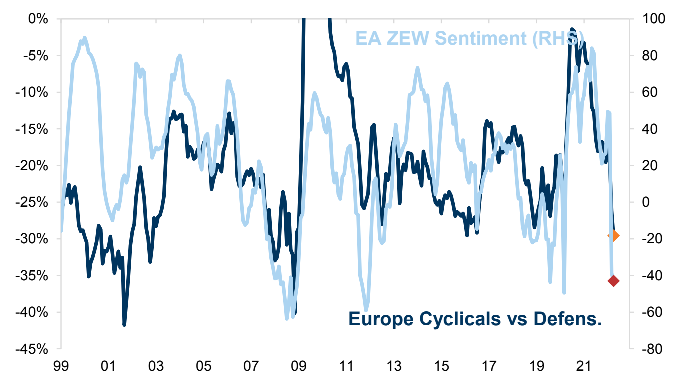
Cyclicals now trade at a 30% discount to defensive sectors, toward the bottom of the range in the last 20 years, but if the sentiment surveys are correct then the discount could deepen further (Exhibit 6). And if there is any curtailment in Russian gas supplies to Europe the impact could be a significant recession across Europe, with Germany/Italy impacted the most given their reliance on Russian gas.

Exhibit 7: EA New order series has fallen to close to 50 and is more consistent with market returns...
STOXX 600 y/y performance and Euro Area PMI: Manufacturing New Orders



Source: Factset, Haver Analytics, STOXX, Goldman Sachs Global Investment Research

Exhibit 8: ZEW Sentiment points to more downside risk to cyclicals...
Europe Cyclicals vs Defensives (P/E Premium (Discount)) and EA ZEW sentiment



Source: Datastream, Haver Analytics, Goldman Sachs Global Investment Research

Another approach showing how recession is priced in is by looking at the share of companies with very low valuations (Exhibit 9). These typically rise sharply either at the outset of a recession or when a recession is expected by markets. Currently one in six

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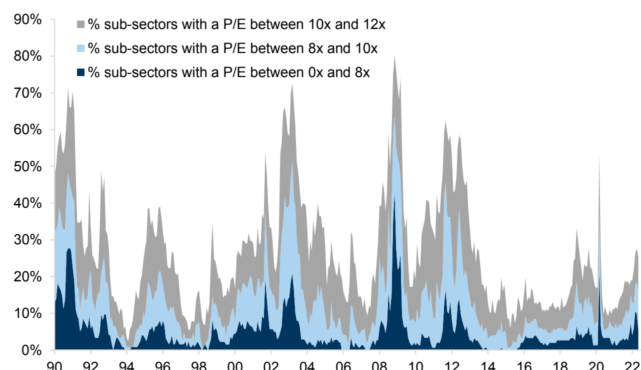
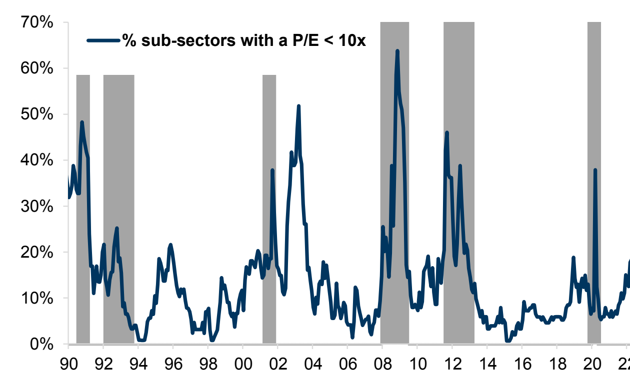
sub-sectors in Europe (c.15%) have a 12-month forward P/E below 10x. This suggests that a recession is not fully-priced in; these having occurred in the past (early 90s, 2001, 2008/09, 2011/12, February 2020) with typically 30-40% of sub-sectors trading below 10x forward earnings.

Exhibit 9: Recession risk is growing as the share of low-rated companies rises...
12m fwd P/E - 173 sub-sectors in Europe



Source: Datastream, Goldman Sachs Global Investment Research

Exhibit 10: ...in previous recessions 30-40% of European sub-sectors had a P/E below 10x
12m fwd P/E ratio - 173 sub-sectors in Europe



Source: Datastream, Goldman Sachs Global Investment Research

But the recession risk is clearly rising, a year ago just 5% of sub-sectors traded below 10x.

Given the balance of risks we continue to take a mixed view on cyclicals, with UWs in Chemicals, Construction & materials and most Consumer cyclicals, and a neutral recommendation on Autos and Industrials. Our favourite cyclicals remain Banks (OW) which we (ultimately) see as benefiting from higher rates and Commodity-cyclicals, OW Energy and Basic resources.

Rates up – but the usual relationships are reversing

While growth expectations have re-priced lower, rate expectations have moved considerably higher. The German 10-year bund yield is up c.115bp YTD as investors have begun to price in more persistent inflation and CB tightening. Nominal yields are higher than they have been since 2018. In the last decade the relationship between bond markets and equities has been relatively clear – falling BYs has been supportive of equities (esp. long duration ones such as Tech). And in terms of sector relationships periods of rising yields have typically favoured Banks, Value and Cyclicals and conversely impacted Tech, Healthcare and high-quality defensives such as Consumer staples.

But in recent weeks these relationships have not held true to the typical ones seen since the end of the GFC. For example Banks have lagged the rise in yields and Healthcare has performed well despite the rise in long rates.

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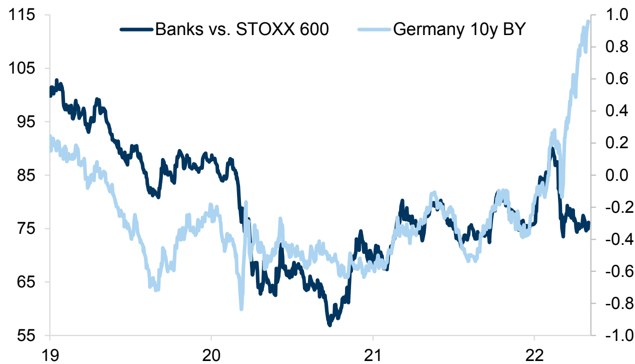
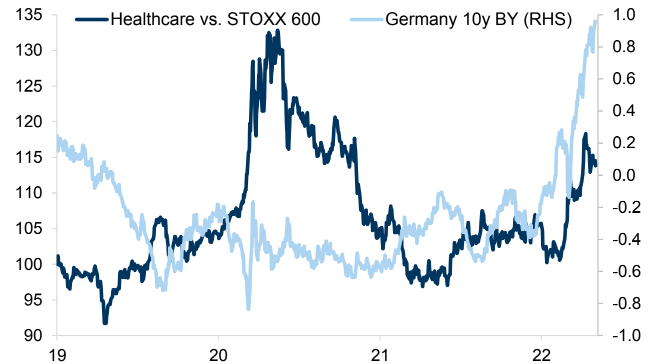
Exhibit 11: German yields have risen - but Banks performance has failed to rise with them...
Relative price performance



Source: Datastream, STOXX, Goldman Sachs Global Investment Research

Exhibit 12: ...Meanwhile Healthcare has outperformed, even though typically it's a bond-proxy sector
Relative price performance

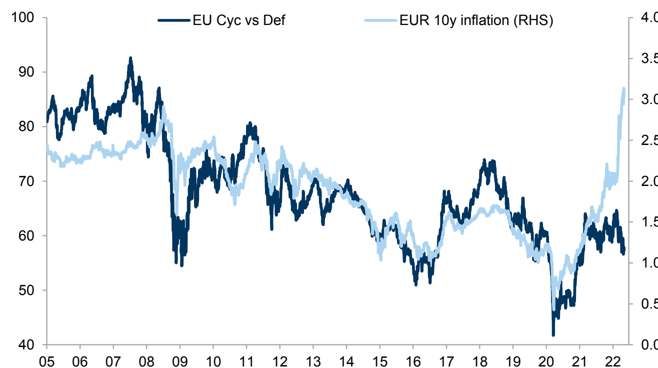


Source: Datastream, STOXX, Goldman Sachs Global Investment Research

This shift in the relationship to bond markets is a function of the causes of rising yields – yields are rising not because of better real economic growth (as has been the typical reason for rising yields in recent years) but because inflation expectations are rising and term premia are rising as CBs withdraw policy support.

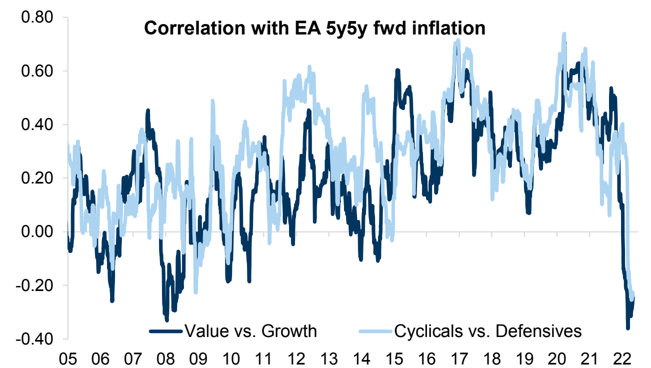
Honing in on the most recent relationships in Exhibit 14 below, we note those with inflation has moved from positive to negative for Value vs. Growth and Cyclicals vs. Defensives. This means that higher inflation is now seen as negative for cyclicals and value stocks. This is a complete reversal from recent years, but it is not inconsistent with the those observed prior to the GFC.

Exhibit 13: A large gap between cyclicals vs. defensives and breakeven inflation



Source: Datastream, Goldman Sachs Global Investment Research

Exhibit 14: The relationship with inflation has moved from positive to negative for Value vs. Growth and Cyclicals vs. Defensives
Based on weekly changes rolling 6-month correlation



Source: Bloomberg, Datastream, Goldman Sachs Global Investment Research

Relationships with BYs - whether real, nominal or inflation expectations - are far from historically stable over time. Even the Value trade – which we often associate with rising BYs - wasn't consistently positively correlated to BYs prior to 2000 (Exhibit 15).

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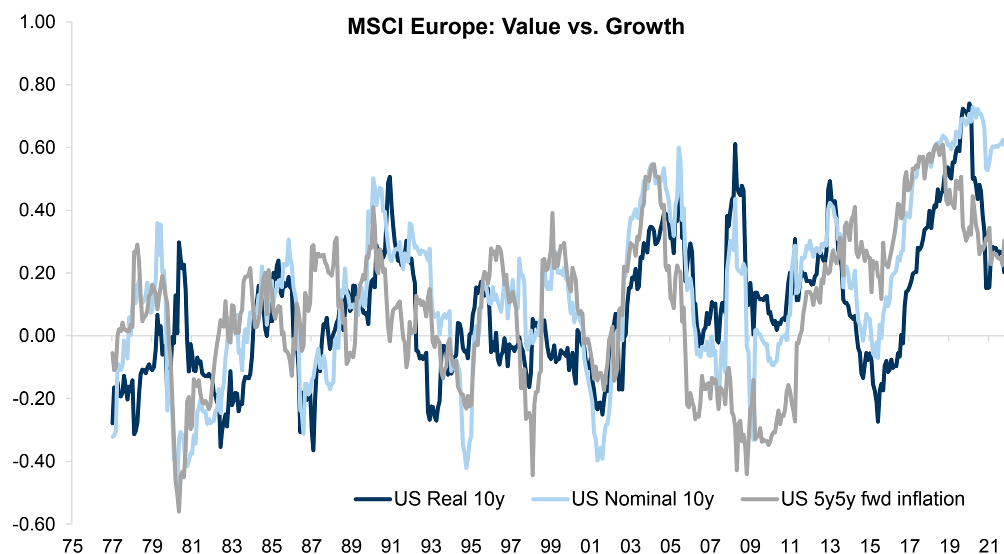
Exhibit 15: Even Value vs. Growth wasn't consistently positively correlated to BYs prior to 2009
2-year rolling correlation of monthly price returns with monthly changes in yields



Source: Datastream, Worldscope, Bloomberg, Goldman Sachs Global Investment Research

Higher inflation likely here to stay – prefer High and stable margins

We note cyclicals and value contain lots of different stocks/sectors with different exposures and ability to pass through prices, indeed we have argued that a factor/style approach would not be the correct one in the post-pandemic world. Energy stocks for example, which are both value and cyclical, still have a positive relationship with inflation. At the sector level we find some sectors have maintained their 10-year relationship with BYs and inflation pricing while others seeing the opposite relationship to shifts in yields in recent months.

Healthcare has gone from being historically very negatively correlated to inflation to now being positively correlated – a function of its pricing power and (relative) immunity to growth slowdown. Interestingly Tech is not strongly positively or negatively correlated to inflation either in the last 6-month or 10-years, we see this as a function of offsetting forces. All else equal, higher inflation means higher rates and is probably unhelpful for a long-duration sector like Tech, but everything else is rarely equal. Higher inflation expectations can often (but not always) push down on real yields also Technology is generally a sector with high margins and good pricing power.

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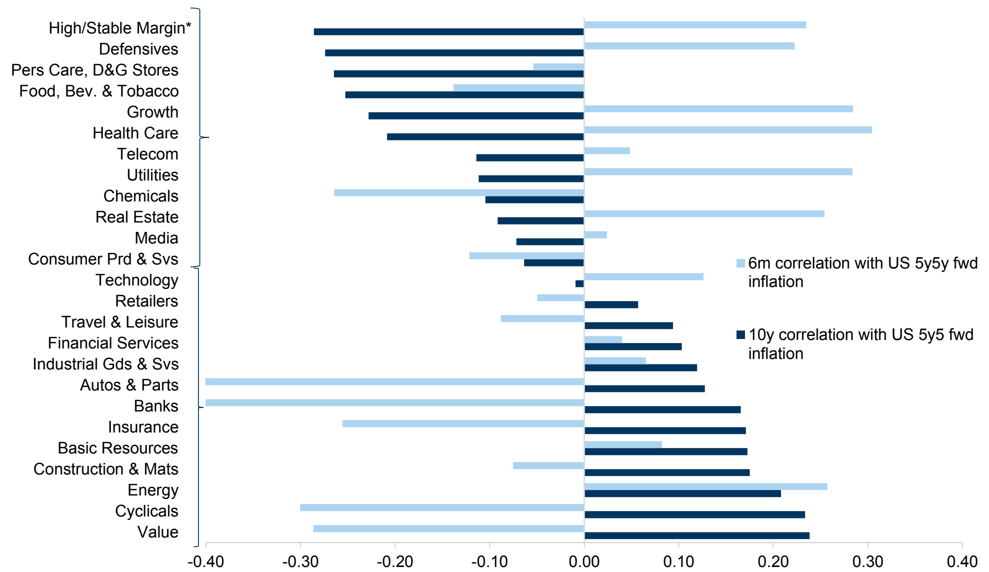
Exhibit 16: Relationships between inflation and sector performance have shifted sharply in recent months
Correlation with relative price performance of Europe sectors and factors to the market, w/w returns - *High/Stable margin basket (GSSTMARG)



Source: Datastream, STOXX, Worldscope, Bloomberg, Goldman Sachs Global Investment Research

Our rates strategists argue that in Europe, despite the less positive growth sentiment, they expect core yields to be well-supported by the inflationary backdrop. The (supply-driven) nature of the inflation shock suggests inflation risk premium could be persistent. In terms of protection against high/sticky inflation we think two sources offer good protection:

1. We continue to like our **High & Stable margin basket (GSSTMARG)**; We screen for SXXP ex Financials companies with higher EBIT margins than their sector peers (5-year median) and a lower standard deviation of margins than their sector peers (10-year coefficient of variation). It has outperformed in the last year and valuations have risen but we think this just reflects the new environment of lower real growth and higher inflation and the desirability therefore of companies that offer higher/stable margins (Exhibit 17).
2. **Energy stocks** remain positively correlated to inflation expectations, valuations relative to the market remain close to lows, payout ratios are low (and set to rise in our view) and the results season so far has proven that the stocks are delivering on cash flows and return to cash to shareholders see, ENI, BP, Repsol and Total.

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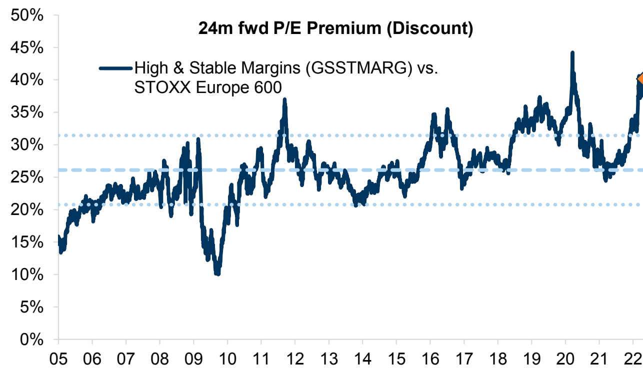
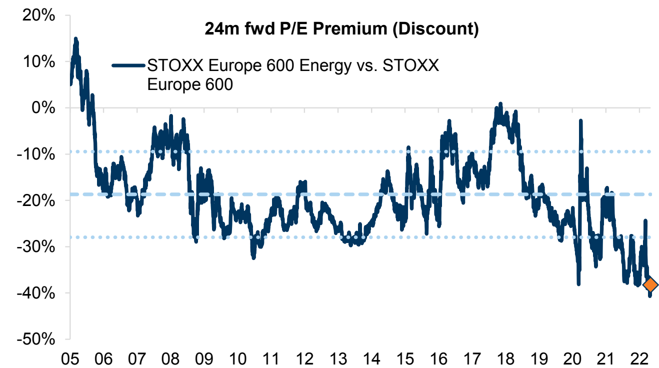
Exhibit 17: High & Stable Margins retain good relative value, in our view
High & Stable Margins (GSSTMARG) vs. STOXX Europe 600, 24m fwd P/E Premium (Discount)



Source: Factset, STOXX, Goldman Sachs Global Investment Research

Exhibit 18: STOXX Europe 600 Energy trade at decade lows vs. Market
24m fwd P/E Premium (Discount)

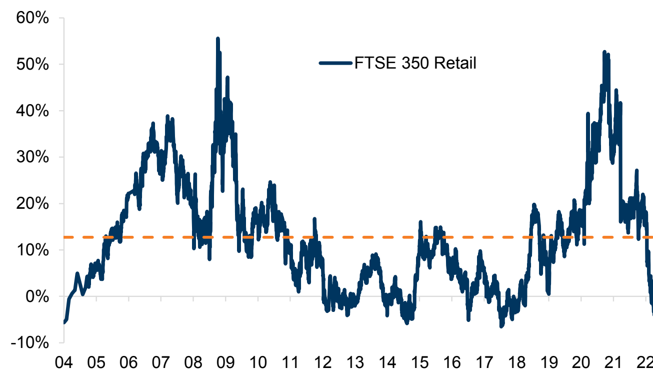


Source: Factset, STOXX, Goldman Sachs Global Investment Research

Consumer cyclicals are at a deep discount; but too early to rotate

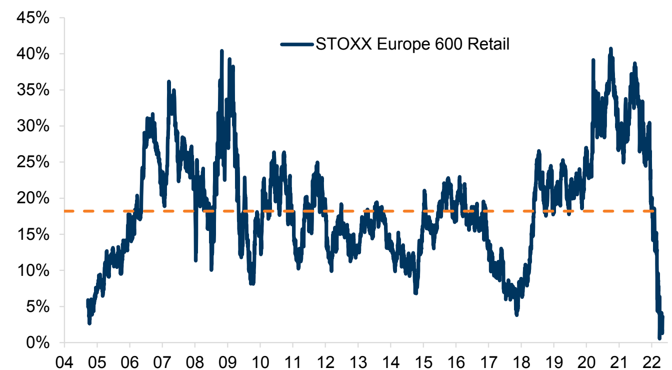
Consumer cyclicals have sharply underperformed, and as we highlighted recently the retail sector in the UK is on relative valuation lows (Exhibit 19), as is Europe (Exhibit 20).

Exhibit 19: FTSE 350 Retail sector relative valuation have fallen to recessionary lows...
24m fwd P/E relative to market



Source: FactSet, Goldman Sachs Global Investment Research

Exhibit 20: ...alongside STOXX Europe 600 Retail
24m fwd P/E relative to market



Source: FactSet, Goldman Sachs Global Investment Research

That said, EPS estimates have yet to come down despite the ongoing hit to real incomes from high and persistent inflation, especially food and energy prices. We note that the consumer is cushioned by large savings and a strong jobs market, but we think the risks to these consumer discretionary stocks remain to the downside. As we show in Exhibit 21 and Exhibit 22 we find that the relative performance of Consumer Discretionary to Energy and the Market is linked to Energy CPI inflation, and the war in Ukraine will continue to put further upward pressure on prices.

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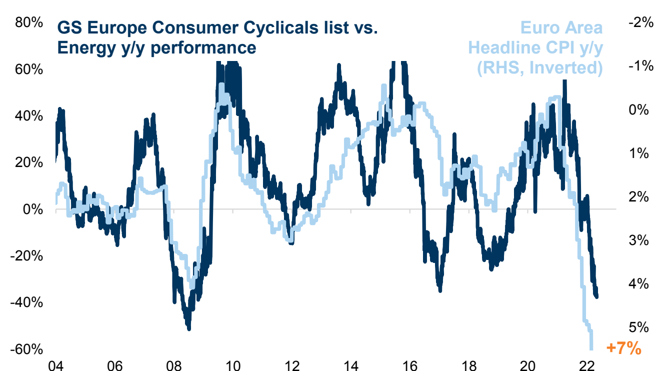
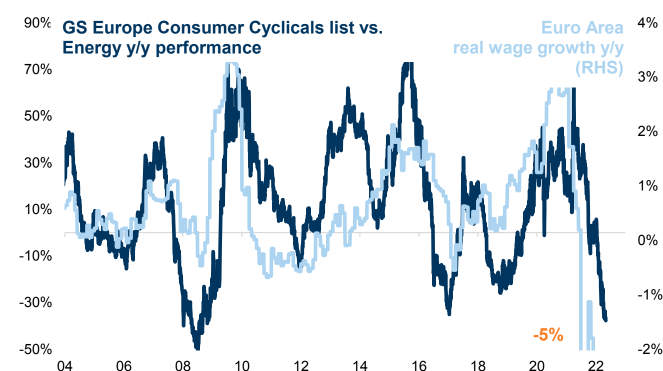
Exhibit 21: Our list of consumer cyclicals tend to underperform energy stocks on higher headline inflation



Source: Datastream, Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 22: Our list of consumer cyclicals tend to underperform the market on lower real wage growth



Source: Datastream, Haver Analytics, Goldman Sachs Global Investment Research

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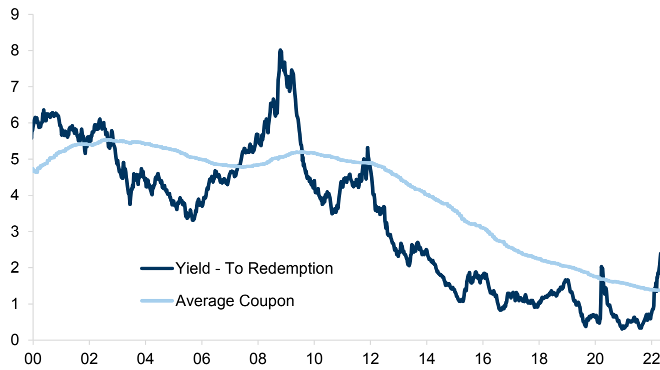
ECB policy – Favour Strong Balance sheet stocks (GSSTSBAL) – a defensive area that has lagged

Strong balance sheet companies have slightly underperformed both the market year-to-date and weak balance sheet names (GSSTWBAL). This is unusual given that economic growth expectations have fallen and borrowing costs risen. The reason is twofold, in our view. First, we haven't yet seen a widening of credit spreads, and second, strong balance sheet stocks tend to be higher-quality/longer-duration than weak balance sheet names and so have de-rated as BYs have risen.

With respect to credit spreads our Credit strategists point out that since February cash market spreads have moved sideways, while synthetic spreads have slightly compressed between EUR HY and IG. They argue three ingredients have been driving this pattern. First, Euro area growth has come in better than expectations, with the PMIs surprising to the upside. Second, despite hawkish messaging, the ECB continues to purchase a large share of EUR IG corporate net supply, thereby supporting the bid for EUR HY through the portfolio rebalancing channel as investors seek carry. Third, from a technical standpoint, the EUR HY primary market supply continues to be very light. But from here they think spreads will widen again as growth slows and as the ECB ends its APP. Our economists expect an end to the APP in June and commencement of the policy rate hiking cycle in July.

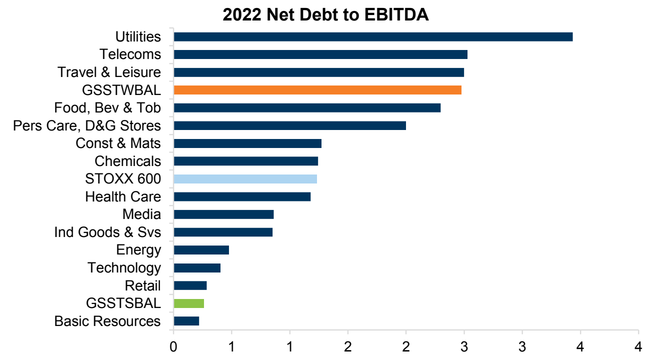
Our basket of companies with weak balance sheets (GSSTWBAL) is screened on Altman-Z scores of balance sheet sustainability, and it is sector neutral to the market ex-financials. This can be paired with our strong balance sheet basket (GSSTSBAL), also sector-neutral to the market. We see weak balance sheet stocks as more vulnerable with spreads widening, and our basket has more leverage than telecoms, but only slightly less than utilities, despite being much less defensive.

Exhibit 23: Companies in Europe have been able to re-finance at very low rates, but this is shifting
iBoxx Euro Corporate



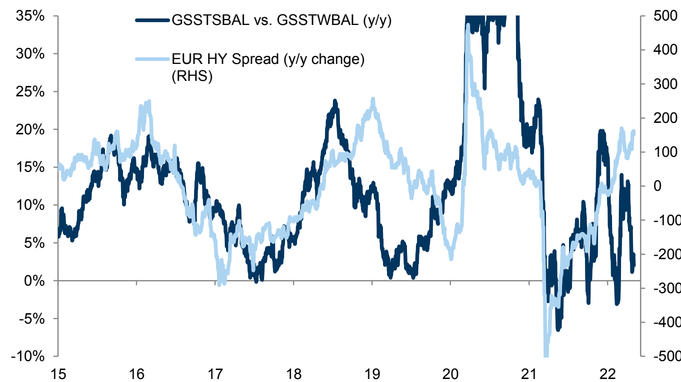
Source: Datastream, Goldman Sachs Global Investment Research

Exhibit 24: Utilities and our Weak Balance Sheet basket are the most levered in Europe
2022E net debt to EBITDA



Source: Factset, STOXX, Goldman Sachs Global Investment Research

Exhibit 25: GSSTSBAL has underperformed even as spreads have started to widen
y/y price relative performance; Strong balance sheet stocks (GSSTSBAL) and Weak balance sheet stocks (GSSTWBAL)



Source: Bloomberg, Goldman Sachs Global Investment Research

Is there value in Tech?

Valuations have fallen considerably, on a 2-year forward basis the P/E for STOXX Technology is down from 28x in mid-2020 to just 19x now. That puts the valuation within the range – albeit at the top end- the sector traded on in the period from 2016-2019. We find that Tech valuation is very tied to US real rates – higher real rates hitting longer duration growth stocks such as tech.

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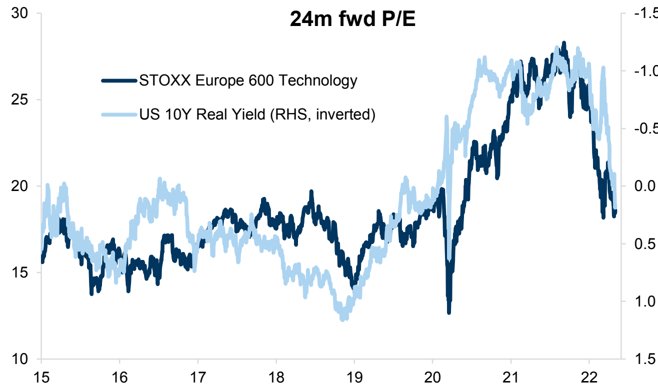
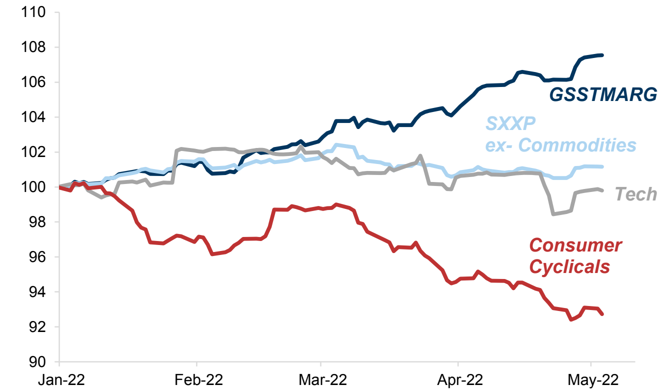
Exhibit 26: Valuations have fallen considerably
24m fwd P/E vs. US 10y real yields



Source: FactSet, Datastream, STOXX, Goldman Sachs Global Investment Research

Exhibit 27: Earnings revisions YTD have been slightly below the market for the sector
2022E Estimates (EUR); GSSTMARG is our Europe High & Stable margins basket



Source: FactSet, STOXX, Goldman Sachs Global Investment Research

Assuming real long rates either stay where they are or go higher from here (at around zero they remain historically low) we think a re-rating upward in Tech is unlikely. Indeed, there is more risk that normalising rates pushes valuation down further. Much depends on whether tech stocks can deliver earnings growth– and there are some tailwinds for the broad technology sector both short term (it's more defensive than other sectors to falling discretionary consumer spend or to rising inflation and commodity costs, and it's also a clear beneficiary from a fall in the Euro) and longer term (more automation to save costs, more government spend on cyber and other forms of security, generally rising Capex all should help tech). While we are overweight Technology we are cognizant that it is reliant on earnings upside rather than valuation. Earnings revisions YTD have been slightly below the market for the sector. But the pace of growth expected is considerably above that of the market with the consensus 2021-23 CAGR of EPS of 16%; only Energy at 31% is expected to be higher.

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Disclosure Appendix

Reg AC

We, Sharon Bell, Peter Oppenheimer, Lilia Peytavin, Guillaume Jaisson and Francesco Graziani, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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