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MARKETS INSIGHTS /

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IS THE CYCLICAL ROTATION GOING TO LAST?

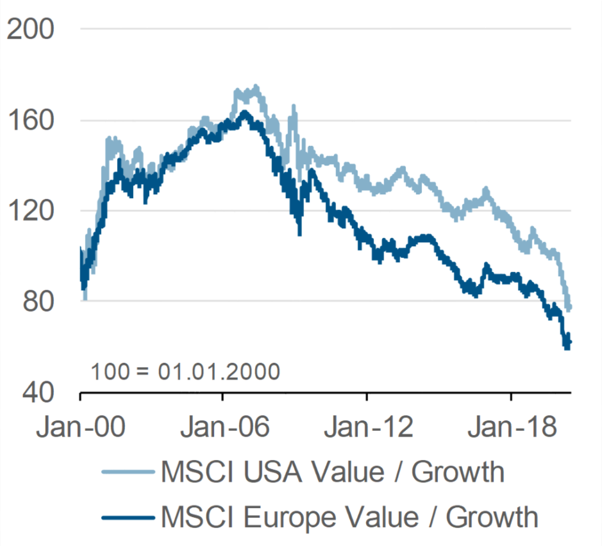
Since May, there has been a spectacular sector rotation in equity markets, in favour of cyclicals and value stocks, to the detriment of defensive and growth stocks. This trend is the result of the reopening of economies without, for the time being, a second coronavirus wave, as well as the bottoming out of global confidence indicators (PMIs). It was also supported by the European Commission's proposal to set up a recovery fund of 750 billion euros, as well as the rise in central banks purchase programs.

In view of these positive elements, introducing a cyclical tilt through positions on solid industrial companies appears attractive. But today, the approach to sector allocation should not be binary in our view. We think it is too early to fully play out this cyclical rotation, as there is no catalyst at the moment to upgrade banks, energy or materials for example, considering the long way before global activity normalizes. In addition, rebounds in these sectors are generally of shorter duration. In this environment, we believe remaining overweight on defensive and growth sectors, such as healthcare and technology, is still appropriate: they are both beneficiaries of the pandemic due to increasing healthcare expenditure and broader use of technology applications to come.

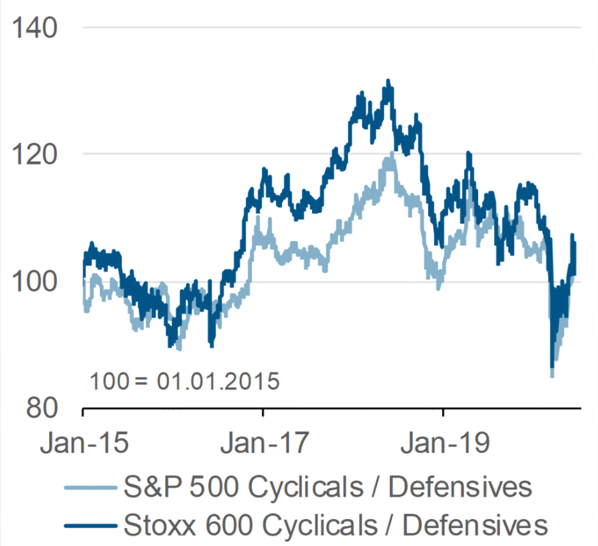
Underperformance of value stocks started after the great financial crisis, and has lasted for more than ten years. Outperformance episodes have been registered several times during this period, albeit brief, usually after an inflection in economic activity.

Structural factors explaining this underperformance during the last ten years are linked in part with financial and economic consequences of the last financial crisis, most of them being still in place today.

Indeed, lower global growth potential is a drag for value and cyclical stocks with limited pricing power. These industries are also facing structural challenges of their own due to new consumer trends or regulations. Regarding energy and material sectors for example, the Chinese transition towards a more services-oriented economy and the lesser contribution of infrastructure investment to growth is weighing on global demand for metals, mining, and energy. Margins have also compressed in the latter sector because of growing energy efficiency, competition from renewable energy, as well as an increase in global production with American shale oil development.



Sources: Refinitiv , Mirabaud Asset Management

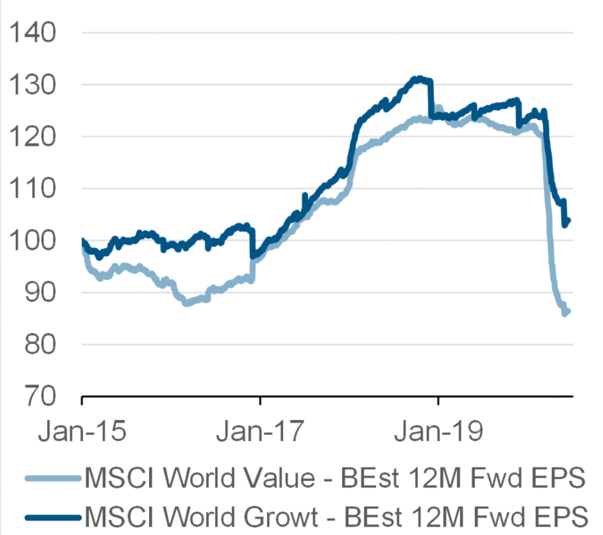


Sources: Refinitiv , Mirabaud Asset Management

On the banking side, the low rates environment since the great financial crisis, combined with new regulatory requirements, is putting pressure on margins, while fierce competition is coming from FinTech companies, disrupting the financial industry.

On the contrary, demographic changes, such as population ageing and the emergence of a middle class in emerging countries, are supporting healthcare and consumer staples, two defensive sectors.

On top of that, the Covid-19 crisis has accelerated the emergence of new consumer trends, supporting growth sectors like gaming, online shopping or media and entertainment. Finally, it is also reinforcing changes in corporate behaviour. For example, the use of home-office is spreading, which will create new cybersecurity needs and boost the software sector. Companies are also accelerating their adoption of robotic and automatized processes.



Sources: Refinitiv, Mirabaud Asset Management

From a valuation perspective, price-earnings ratios are much more attractive for value stocks than for growth stocks, which has been the case for a long time. This divergence is justified, considering better earnings expectations for growth stocks. On the contrary, value sectors are facing structural trends negatively affecting their future profitability. Regarding cyclical stocks, their relative valuation compared to defensive stocks is close to their historical average, and the potential for a further catch-up will be limited.

Sources: Refinitiv, Mirabaud Asset Management

In conclusion, in this environment, a complete shift from defensive into cyclical stocks, or from growth into value stocks seems too early, and of short duration. We believe it is still appropriate to keep a balanced sector allocation between sectors benefiting from the current environment like healthcare and technology, combined with a cyclical tilt on solid and good quality industrial stocks.

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Before joining Mirabaud Asset Management in the beginning of 2019, Marie worked more than nine years as an economist for Covéa Finance. Marie holds two Master Degrees from the Paris-Dauphine University, one in Economy and International Finance and one in Banking and Insurance.

IMPORTANT INFORMATION