Equity Market Review October 2022

A quantitative view on the valuation of the European stock market

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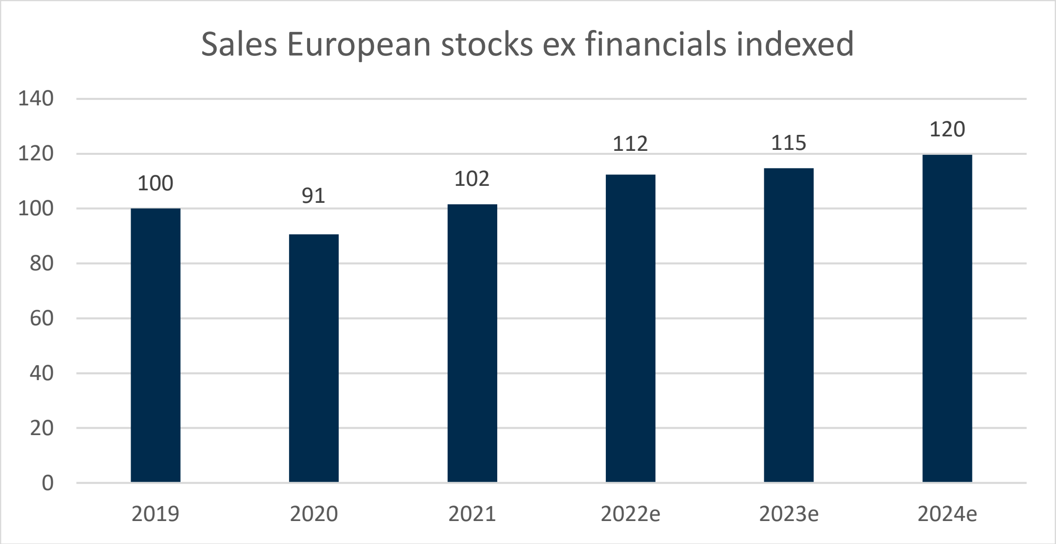
As announced, the European Central Bank has started an interest rate hike path in recent months. Roughly 11 years after the last increase, the ECB raised key interest rates by 0.50% on July 21, marking a historic turning point in its monetary policy. A second increase of 0.75% on September 8, then led to a reference interest rate of 1.25% in total. The main reason for this move was inflation expectations, which were revised upward (7.6% January-August) due to energy, food, and pipeline costs. However, the level is still below the level set by the U.S. Federal Reserve (current Federal Funds rate in the range of 3% to 3.25%). Thus, in both Europe and the U.S., the low interest rate cycle seems to be over.

This situation has led to increased volatility in stock markets, accompanied by expectations of further interest rate hikes. As the financial valuation of companies is largely based on discounting models, their values have been adjusted downwards accordingly. At company level, the expectation of stagnating or negative economic growth weighs heavily. In terms of sales, the major European companies in the Stoxx 600 (around 492 excluding financial companies) recovered from the pandemic year 2020 (fiscal 2021: +12%). However, estimates for the next two years have been revised downward in recent months. Current projections indicate that revenue estimates for 2022 and 2023 are still above those of 2019 (pre-pandemic year), but lower than last June (for 2022: -1% and 2023: -2%).

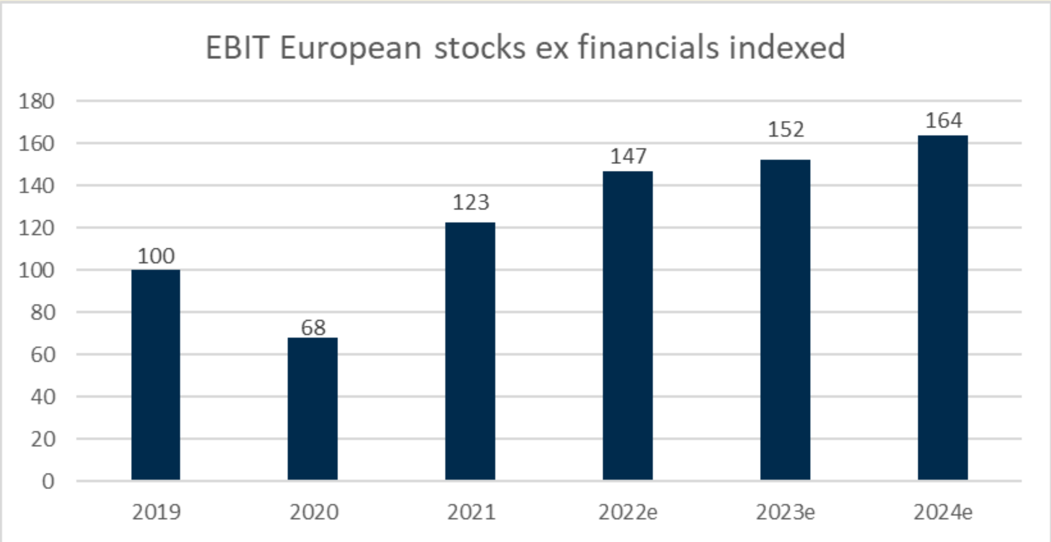
Figure 1: Sales development 2019 to 2024e indexed



Source: LeanVal Research, 2022 to 2024 are expected or preliminary values (e = expected).

In terms of profitability (EBIT), the recovery from the Corona crisis is also evident (EBIT margin 13% in 2021 versus 8% in 2020). Compared to previous forecasts, operating profit estimates have been revised downwards (2022: -1% and 2023: -3%). The EBIT margin is expected to remain stable in the region of 14% over the next two years.

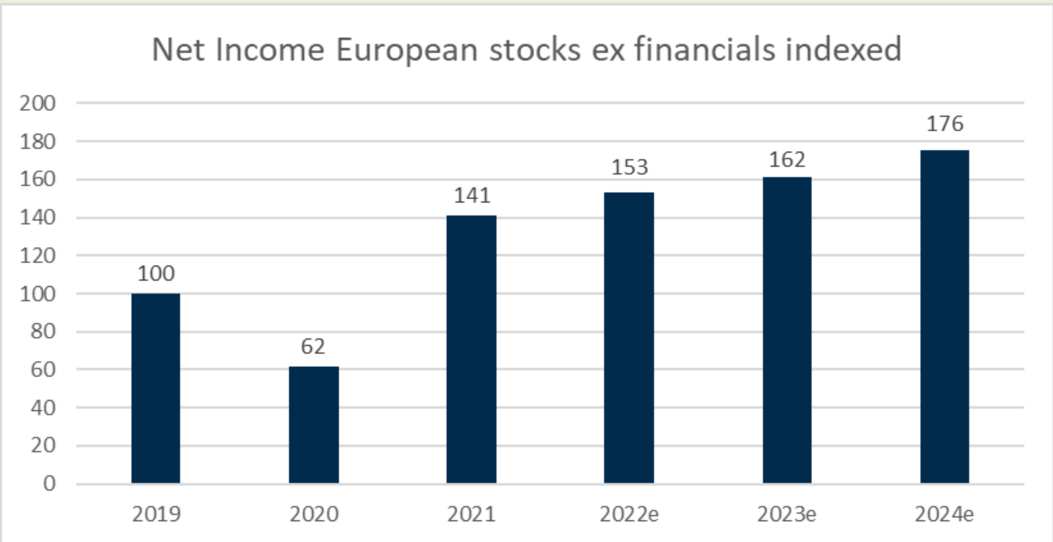
Figure 2: Development of operating profit 2019 to 2024e indexed



Source: LeanVal Research, 2022 to 2024 are expected or preliminary values (e = expected).

The revision of net income showed an upward trend of 3.7% for 2022, while a moderate increase of 0.5% was recorded for 2023.

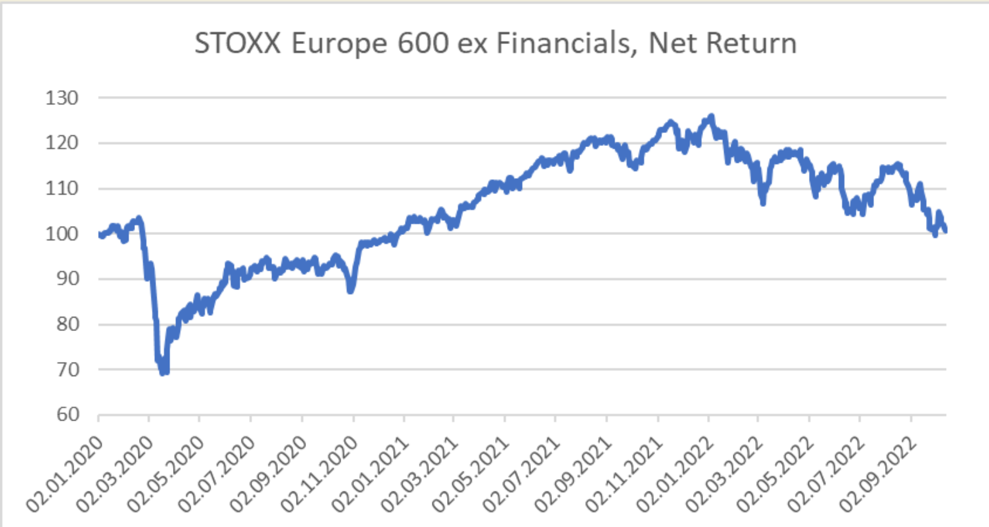
Figure 3: Development of net income 2019 to 2024e indexed



Source: LeanVal Research, 2022 to 2024 are expected or preliminary values (e = expected).

In view of the uncertain situation regarding economic growth and events related to the Ukraine crisis, the Stoxx Europe 600 (excluding financials) has recently lost ground. A comparison with the pre-pandemic level (January 2020) shows a significant price decline in recent months.

Figure 4: Performance of the Stoxx Europe 600 excluding financials indexed



Source: Stoxx

The estimates of the financial ratios (relative valuation) for the companies included in the index show a clear downward trend, which is a clear signal of the economic expectations in the coming quarters. Comparing the estimates of 2021 with those of 2023, there is a decline in the price-to-book ratio (P/B) and even more clearly in the price/earnings ratio (P/E) as well as the ratio of enterprise value to operating income (EV/EBIT).

Figure 5: Comparison of valuation multiples estimates for fiscal 2021 vs. 2023

Benchmark	base year	Adj. P/B	Adj. P/E	EV/EBIT
Stoxx Europe 600 NR	2023	3.8	17.3	12.7
	2021	5.5	26.8	18.0

Source: LeanVal Research

The following table provides an overview of the performance and estimates of the different sectors. The energy sector shows a remarkable performance of around 53% in the reference period, but with reduced multiples in the 2023 estimate compared to those of 2021 (i.e. lower P/E, EV/EBIT). The consumer staples sector achieved an overall performance of just under 6% with slightly lower estimates. The worst performing sector was real estate (-27%), with one of the lowest P/B ratios for 2023. Technology followed as the second biggest loser with declines of -25% and an improvement in attractiveness, e.g. P/E ratio.

Figure 6: Valuation multiples of the sub-indices based on earnings expectations

Industry	Performance (Today / HistoMonth)	base year	Adj. P/B	Adj. P/E	EV/EBIT
EU Consumer Cyclical	-16.8%	2023	4.7	19.2	15.2
		2021	6.8	28.4	20.6
EU Energy	53.3%	2023	1.3	7.6	5.6
		2021	1.4	13.0	10.5
EU Financial Services	-4.7%	2023	1.0	9.6	1.2
		2021	2.2	15.9	2.9
EU Healthcare	-1.2%	2023	6.6	21.8	17.5
		2021	8.0	33.2	24.1
EU Real Estate	-26.6%	2023	0.7	12.9	20.6
		2021	1.2	19.2	21.4
EU Industrials	-15.3%	2023	3.4	17.8	14.8
		2021	6.0	26.2	19.1
EU Technology	-25.0%	2023	7.9	25.5	18.6
		2021	11.1	50.8	36.7
EU Basic Materials	-10.0%	2023	2.6	15.0	11.4
		2021	3.7	21.1	16.6
EU Consumer Defensive	5.9%	2023	4.5	20.7	17.9
		2021	5.5	28.1	22.2
EU Communication Services	-10.9%	2023	3.1	17.5	3.2
		2021	5.1	25.6	2.9
EU Utilities	2.0%	2023	2.4	16.8	16.7
		2021	2.4	23.3	21.2

Source: LeanVal Research

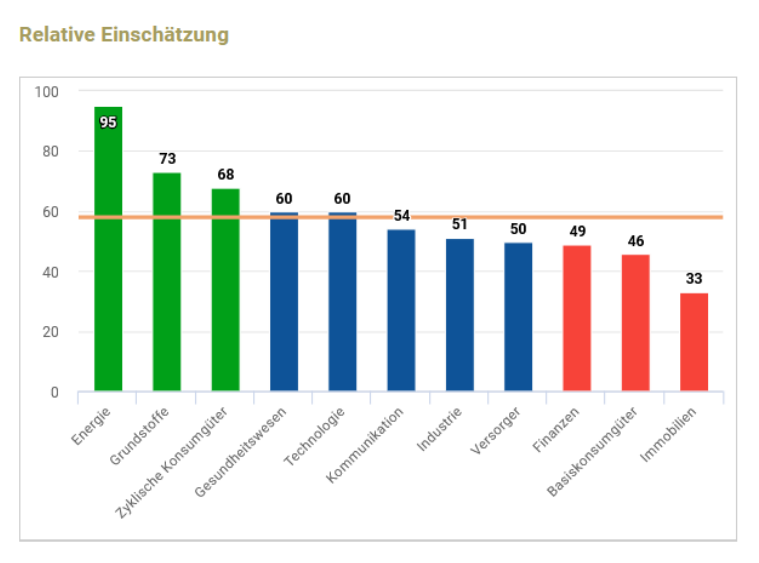
Valuations on the stock markets will continue to be influenced by inflation growth data in the coming months. This will be an important indicator for interest rate decisions of the European Central Bank and thus potentially weigh on the stock markets. The absolute valuation methods discount the future value based on a discount rate linked to the reference interest rate of the central banks. On an annual basis, the increase in material and energy costs could reduce the profitability of European companies in 2022 and thus slow down the post-pandemic recovery (an example is the profit warning of Kion Group). Another negative factor could be short-term debt-based sales. For example, higher consumer credit costs could mean lower end-user demand for certain goods (e.g., consumer goods, cars, or real estate). However, lower corporate valuations could lead to extraordinary mergers and acquisitions, reviving the stock market. The low cost of financing in recent years has generated a significant amount of liquidity on the balance sheet of many publicly traded companies that could be used for financing. This is consistent with what has been stated recently by the management of several European corporations.

The war in Ukraine and trade tensions with China (including the Taiwan conflict) remain issues that need to be further addressed in the short term. Employment and wage dynamics within the Eurozone also need to be considered. For example, the aforementioned inflation rate is well above the Eurozone's wage growth (+4.4% in Q2 2022), which could further impact corporate profitability. Negative economic expectations for the Eurozone are also one of the reasons for the unfavorable exchange rate of the Euro against the US-Dollar.

In this scenario, passive investment instruments could be very risky. By replicating the performance of the benchmark indices, they could lead to short/medium-term lows (drawdowns) driven both by short positions of professional investors and by the emotional behavior of less experienced traders. A selective approach could avoid costly portfolio mistakes. The stocks to keep an eye on at the moment tend to be found in more defensive sectors according to value investing criteria. High-dividend stocks are good investment ideas as long as they are analyzed while weighing the possibility of a dividend cut. In this sense, the pharmaceutical sector, for example, is one of those that guarantee a stable and growing dividend over time.

Based on LeanVal Research's multifactor model, the sectors energy (Energie), basic materials (Grundstoffe) and consumer cyclical (Zyklische Konsumgüter) currently appear to be of interest.

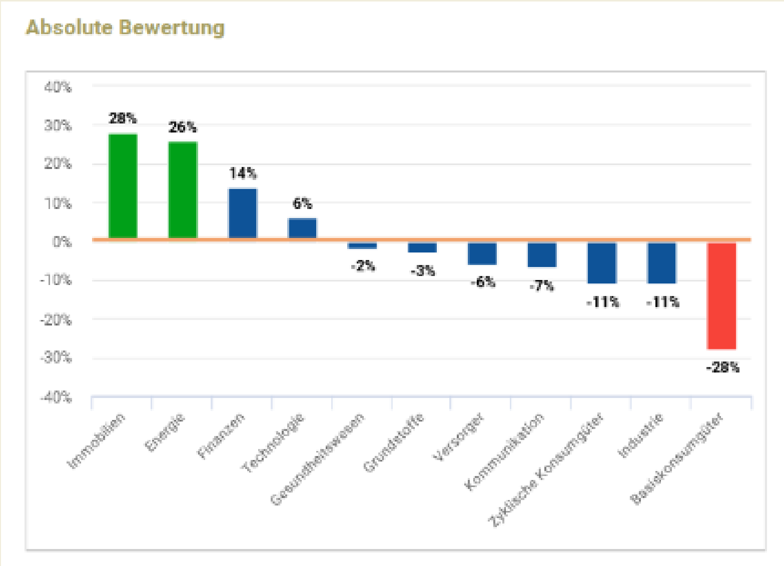
Figure 7: Relative attractiveness based on the multifactor approach (October 2022)



Source: LeanVal Research

Based on absolute valuation, the energy sector appears equally attractive. Here, however, the real estate sector (Immobilien) is taking the lead because of falling share prices. Interest rate hikes clearly have a negative impact on the real estate sector. This applies both to real estate valuations and to lending (e.g. due to higher mortgage costs). With an improvement in the macroeconomic environment and a faster recovery, the sector could become interesting.

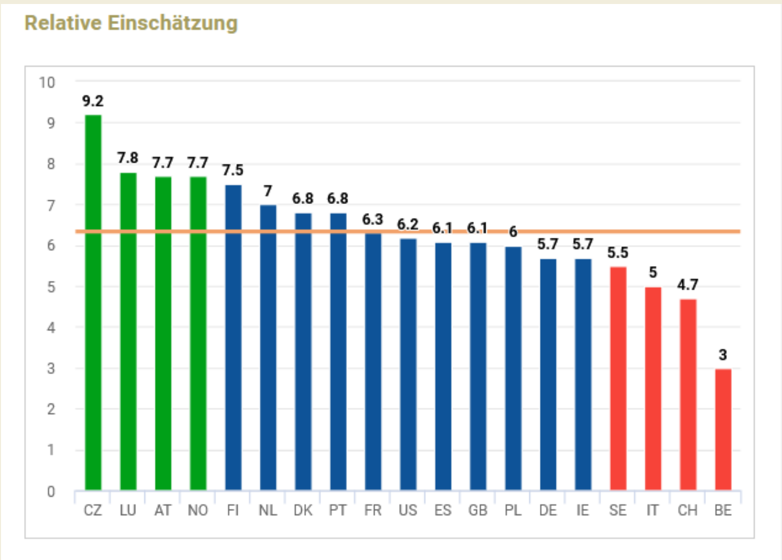
Figure 8: Absolute attractiveness based on the multifactor approach (October 2022)



Source: LeanVal Research

At the beginning of the fourth quarter, the Czech Republic, Luxembourg, Austria, and Norway were still among the most attractive countries with high market depth, according to LeanVal Score. Most countries have a score close to the average. At the bottom of the list are Sweden, Switzerland, Italy, and Belgium.

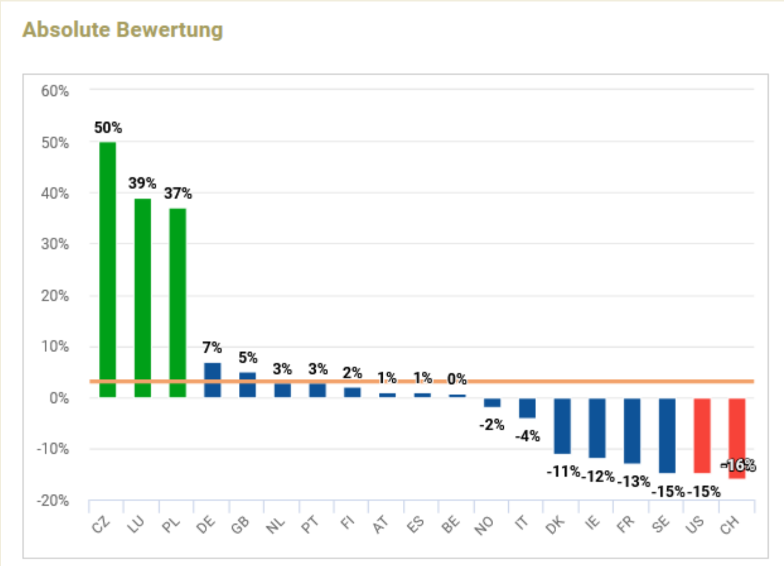
Figure 9: Relative attractiveness of countries (October 2022)



Source: LeanVal Research

In absolute terms, only the Czech Republic, Luxembourg, and Poland stand out with positive ratings. However, these countries tend to play a less significant role in terms of market capitalization and the number of companies. Some eleven countries have below-average ratings. Switzerland, the United States of America, and Sweden appear less attractive.

Figure 10: Absolute attractiveness of countries (October 2022)



Source: LeanVal Research

In conclusion, the stock markets are currently characterized by high volatility caused by the Ukraine war, high inflation rates, and a possible recession. The multifactor approach could benefit from this environment as a conservative alternative to passive investment strategies.

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Sell	Potential < -15%

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