



## Macro also matters for equities

### How to Invest in More Volatile Equity Markets?

#### Overview

- The relocation of supply chains and the resurgence of inflation mark the end of an exceptional era: the zero-interest rates period. Although the outlook for equity returns remains promising, the associated risk has durably increased, while the protection traditionally offered by bonds is now more uncertain. On a directional basis, the attractiveness of this asset class has waned.
- However, the significant valuation disparity across sectors offers compelling opportunities, particularly in Europe.
- Since 2010, the Luxury Goods and Technology sectors, driven by globalisation and low interest rates, have seen their profits multiply three to four times. Supported by investor enthusiasm, the valuation multiples of these two sectors have increased twofold over the same period.
- Conversely, several cyclical sectors, such as Banks, Car Manufacturers, Energy, and Natural Resources, are trading at steep discounts. These sectors have been starved of capital due to increased regulatory pressure and a shift in focus toward the energy transition.
- The factors that drove these valuation extremes have shifted dramatically: the reshoring of strategic production and the return of inflation into central banks' policy equation have permanently altered the landscape. The valuation gap is now likely to close.
- Luxury Goods and Technology sector stocks have reverted to the norm, showing greater volatility and flat performance in recent years. In contrast, undervalued cyclical sectors have largely been overlooked by investors, despite exhibiting strong performance, lower risk, and a low correlation with riskier assets.
- Given their characteristics, combining elements of both equities and bonds, stocks from these cyclical sectors represent a compelling choice for an increasingly volatile portfolio allocation.

## Volatility and Inflation: The New Normal for Equity Markets

Equities experienced an exceptional run over the past 15 years, following the global financial crisis. Fuelled by robust global trade and ultra-loose monetary policies, equities delivered annual returns of 8.5% in Europe (four times the rate of inflation) and 14% in the United States. Their volatility was comparable to the bonds market, with central banks providing support whenever disruptions occurred. Such a favourable environment has rarely been seen in history, and certainly not for such an extended period.

Today, although equity markets are expensive, they cannot be considered in a bubble as long as fundamentals, strong corporate margins, resilient global demand, and the absence of private sector imbalances, remain intact. Indexed on nominal growth, stocks are also relatively protected against inflation. Despite entering a cycle of declining interest rates, the outlook for equity returns remains attractive.

However, the risk from holding equities has risen. With higher valuations, particularly in the United States, equities have become inherently riskier. Their volatility has durably increased: COVID-19 was not a one-off incident.

While the shock was unpredictable, the market conditions that arose from it are still prevalent. The pressure from daily volatility is impacting a growing number of investors, and its standardised nature often translates into concentrated flows that weak banking intermediation cannot effectively absorb. Furthermore, the shift to passive investing only amplifies this effect. **As long as these conditions persist, the likelihood of severe market turbulence remains elevated.**

The COVID crisis helps us understand this phenomenon. While the initial shock justified a market correction, the swift response from central banks, through rate cuts and asset purchases, was sufficient to prevent widespread business failures and stabilise the economy. As we wrote at the time, it was an interruption, not a destruction, paving the way for a rapid recovery as the economy reopened.

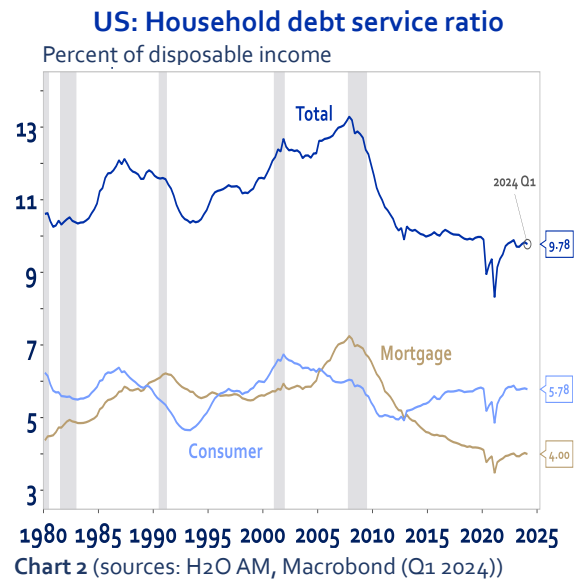
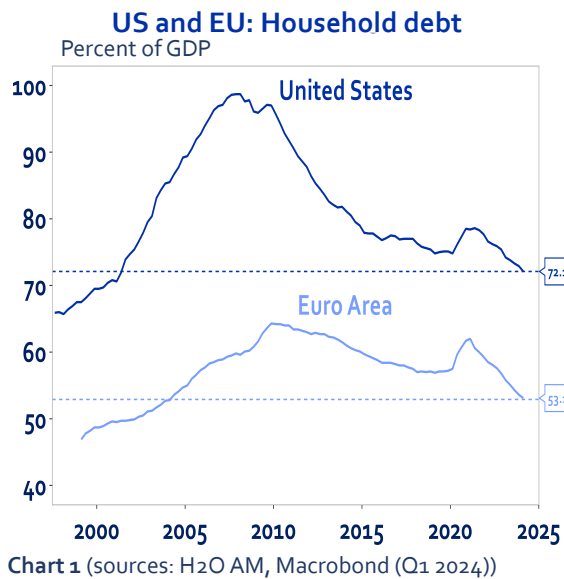
The fundamentals should have reassured investors.

Yet, despite these robust interventions, investors continued to panic under the pressure of risk models and banks' reluctance to shoulder the risk. It was not until the Federal Reserve introduced 'unlimited' support that the market finally stabilised, two weeks later and 15% lower. Once volatility surpasses a critical threshold, even strong economic recovery can no longer halt the mechanical outflow spiral; it necessitates external, unlimited intervention.

Although the crisis has passed, the mechanisms that fuelled the volatility remain in place. This situation is even more pronounced today as inflationary pressures, caused by the massive liquidity injections, **now force central banks to balance their mandates more symmetrically.**

Given the healthy state of private sector balance sheets and the risk of inflation relapse, this recalibration of monetary policy focusing on inflation is likely to persist for several years. Indeed, the private sector shows no signs of imbalances that could destabilise the system: household and corporate debt levels in the U.S. and Europe are at their lowest in two decades (see chart 1). Even with rising interest rates, credit costs remain manageable (see chart 2). While equity and real estate markets may appear expensive, they are far from being speculative bubbles, and the zero-interest rates era has disappeared, for the time being.

On the other hand, inflation has proven strongly detrimental over the past two years. Allowing a second wave to emerge would only amplify the effects: inflation expectations would become firmly anchored, triggering a race to maintain profit margins that would further fuel the price-wage spiral and lead to even higher interest rates. Managing the spillover effects of such situation would become significantly more complex. For central banks, tolerating this risk is simply not an option. As a result, their unconditional support to growth, and by extension, to the markets, can no longer be taken for granted.



With growth and inflation parameters not always aligned, central bank actions are becoming increasingly erratic. The likelihood of a “stop-and-go” approach to monetary policy has risen, making it impossible to provide consistent support for the economy and the markets. The *put* provided by central banks is now a thing of the past (see box below).

**Additionally, the resurgence of inflation introduces uncertainty regarding the protection traditionally provided by bonds.** Their correlation with equities, which is typically negative during periods of low inflation, has now become unstable. This is likely to persist as long as inflation remains a threat. In this environment, the effectiveness of a straightforward asset allocation that combines these two asset classes is questionable.

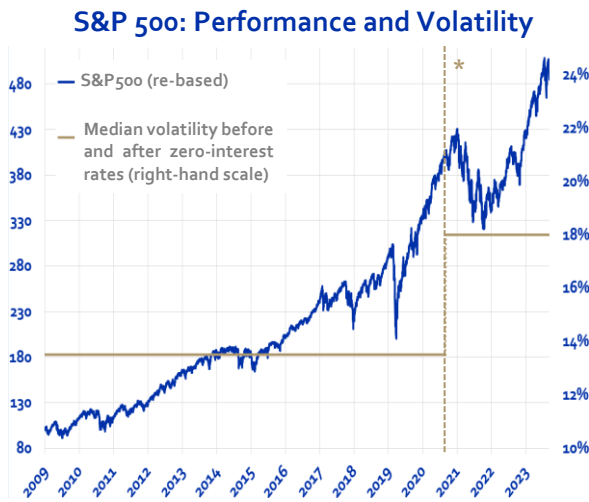
The loss of protections, combined with more costly financing in an already expensive market, leads inevitably to increased volatility. Market corrections will occur frequently, often violently and disconnected from fundamentals, as seen

over the past three years. The volatility associated with COVID is likely to persist (see chart 3). In this context, maintaining a steady asset allocation is increasingly challenging.

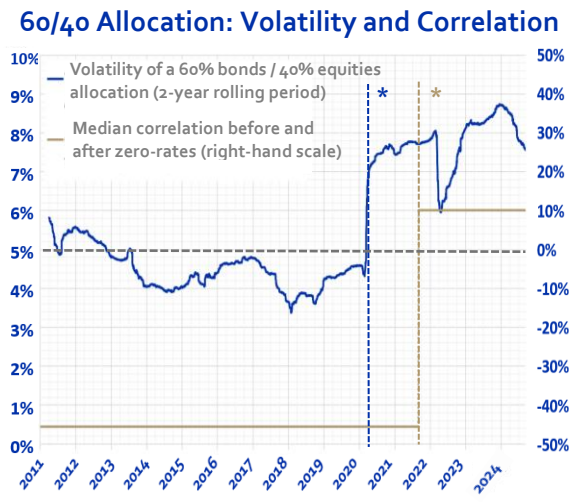
Many investors sensitive to daily volatility find themselves forced to exit the market during major downturns, only to reinvest sporadically once stability returns, often at higher prices than when they sold. Even those with a lower sensitivity to volatility are noticing an increase in the overall volatility of their allocations. Unless there is an unlikely shift toward greater tolerance for volatility, the proportion of equities in investment portfolios is expected to decline (see chart 4).

**Directionally, the equity asset class has returned to a more normalised state. The years 2010-2020 were the exception rather than the rule. We are back to the classic characteristics of equities: they ought to generate strong returns, but with increased volatility and less consistent protection from bonds.**

***“The loss of protections, combined with more costly financing in an already expensive market, leads inevitably to increased volatility”***



**Chart 3** (sources: H2O AM, Bloomberg (H1 2024))  
 \*Interest rate normalisation and quantitative tightening announcement (Jackson Hole)



**Chart 4** (sources: H2O AM, Bloomberg (H1 2024))  
 \*Covid shock, with persisting volatility  
 \*End of zero-interest rates

### Central Banks' Put

Refers to the common belief that central banks will intervene and deploy the tools at their disposal to **safeguard the market when asset prices fall too rapidly**, thereby preventing a downward spiral that could harm market participants and, ultimately, the economy at large. This concept is commonly associated with i) the intervention of the Federal Reserve during the global financial crisis (2008-09), ii) that of the European Central Bank during the eurozone sovereign debt crisis (2012), or iii) more recently that of all central banks during the COVID crisis (2020-21).

The term "put" refers to **put option contracts** that provide the holder the right, but not the obligation, to sell the underlying security at a predetermined price, thereby offering protection in the event of a market decline.

And while this protection tacitly offered to investors has not disappeared, it is no longer guaranteed due to the return of inflation at the core of central banks' risk management considerations.

## Capitalising on Europe's extraordinary sectoral dispersion

While the direction of equity markets is less clear and holding stocks has become more costly in terms of risk, heterodox monetary policies implemented over the past decade have nonetheless revealed attractive sectoral opportunities. Dispersion has never been as high as it is in Europe, where the valuation ratio between the most and the least expensive sectors exceeds 6, compared with 2 to 3 under normal circumstances (see chart 5). With the end of zero-rates, this dispersion is expected to narrow, presenting opportunities that can already be capitalised on. But to do so, we must understand the origins of such value disparity.

### A. Accommodative monetary policies

On the winning side, zero-interest rates and globalisation favoured the development of global players who dominated the market. The United States led this zero-rate environment, benefiting quickly from it due to direct financing and minimal bank intermediation. Access to free capital in an attractive market allowed them to conquer new sectors: electric vehicles with Tesla, new media with Facebook and Netflix, artificial intelligence with Nvidia, to name just the main ones. Thanks to zero-interest rates, leaders, both new and established, were able to protect their position through acquisitions of competitors or low-risk R&D investments since they were financed at 0%, thus driving U.S. innovation. Europe, with highly intermediated financing channels and a suboptimal capital market, had little chance in this landscape.

### B. Globalisation

The old continent benefited more from globalisation. The rapid expansion of global trade gave rise to a new class of consumers who, having accumulated wealth quickly, now seek social recognition. With limited price sensitivity, these consumers assert their status through the display of branded goods, a trend the Luxury Goods sector capitalised on by increasing its sales volumes. Other sectors with strong brand identities, such as Technology and

Sportswear, also seized this opportunity to increase their margins.

Exclusivity, it seems, knows no price, and it has driven margins to unprecedented levels. Since 2010, profits in the Technology sector have quadrupled, while those in the Luxury Goods sector have more than tripled. In contrast, profits in most other sectors have barely kept pace with inflation.

Investors, many of whom also benefited from globalisation and the era of cheap capital, fuelled this trend by continuously injecting funds into these sectors. Since 2010, the valuation of Technology stocks has surged nearly eightfold, while Luxury Goods stocks have increased sixfold, double the rate of profit growth. By the time central banks signalled the end of zero-interest rates in 2021 due to rising inflation, these two sectors were trading at more than 40 times their annual earnings (see chart 6).

### C. Regulation

Conversely, some sectors have reaped little benefit from zero-interest rates and have been negatively impacted by the financial repression following the 2008 global financial crisis.

Banks are the most prominent example. Having been at the centre of the crisis, they have since been subject to stringent regulatory constraints, including greater transparency, sector consolidation, and more than a doubling of equity capital requirements. While these measures greatly strengthened the system's resilience, they also placed significant pressure on profits, a situation exacerbated by the prolonged era of zero-interest rates. Between 2010 and 2021, bank profits declined by 40%.

Like other sectors, banks also felt the impact of regulatory pressure on the liability side as they prompted investors to shift towards less volatile assets. Indexing the measure of risk on volatility made them more sensitive to daily market fluctuations. Standardisation across the financial industry led to uniform investor

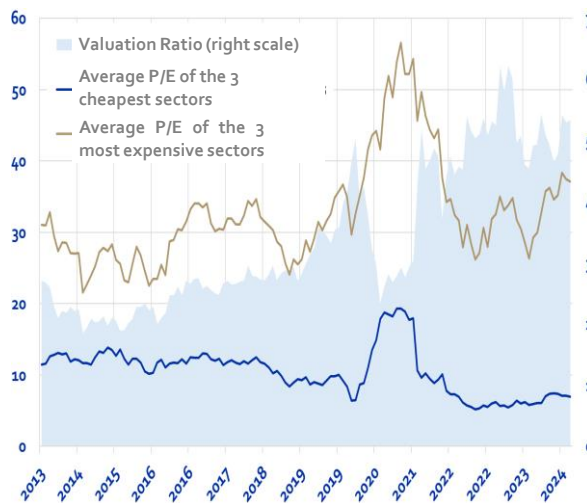
**Sectoral breakdown of the European market\***



**Chart 5** (sources: H2O AM, Bloomberg (H1 2024))

\*Calculation method: The ratio of the average P/E of the most expensive sectors to the average P/E of the least expensive sectors. A company's P/E (Price Earnings) ratio corresponds to the market value of the share divided by its EPS (Earnings Per Share).

**Sectoral dispersion in Europe**



**Chart 6** (sources: H2O AM, Bloomberg (H1 2024))

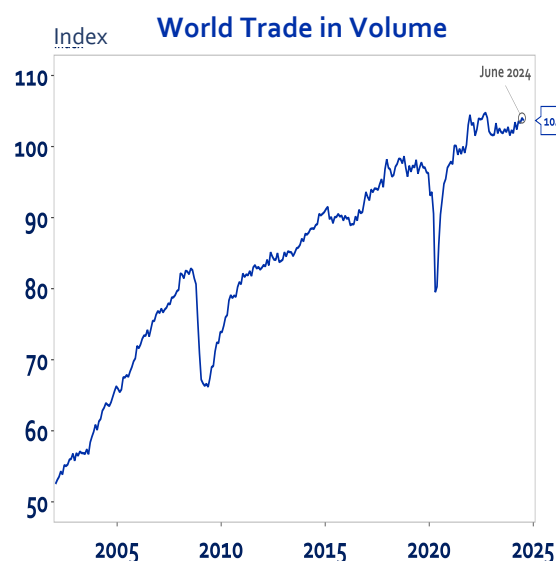
behaviour, frequently resulting in capital flow concentrations and liquidity gaps (see [H2O AM's note on market mechanisation](#)). As a result, the most cyclical sectors, naturally more volatile, have faced a shortage of capital. Investors have gradually reduced, or even eliminated, exposure to Banks, Automakers, Natural Resources, and Energy, as these sectors are considered too 'costly' for their risk models.

Economic dirigisme further prolonged this trend. The governments' push to direct capital towards socially responsible investments (SRI) disproportionately penalised many cyclical stocks, often viewed as incompatible with environmental goals. Technology and Luxury Goods sectors benefited from this situation by crowding out these capital-starved sectors.

Both dirigisme and regulation weighed heavily on valuations. By 2021, the most undervalued sectors, almost all cyclical, were trading at half the valuations they exhibited in 2010 (see chart 8).

However, the landscape has profoundly changed. In 2017, a strategic shift toward relocation began, driven by the Trump administration. By 2020, the COVID crisis accelerated this trend, fuelled by concerns over

security and medical supply autonomy. Since then, global trade has slowed (see chart 7). In response to the crisis, regulators eased their repressive policies and began relaxing certain constraints, particularly on banks, to facilitate monetary transmission. A year later, in August 2021, the U.S. Federal Reserve acknowledged the persistence of inflation and initiated a cycle of interest rate hikes, which would soon be followed everywhere.



**Chart 7** (sources: H2O AM, Macrobond (June 2024))

Performance (dividends included) of the most & least expensive EU sectors after the zero-interest rate period

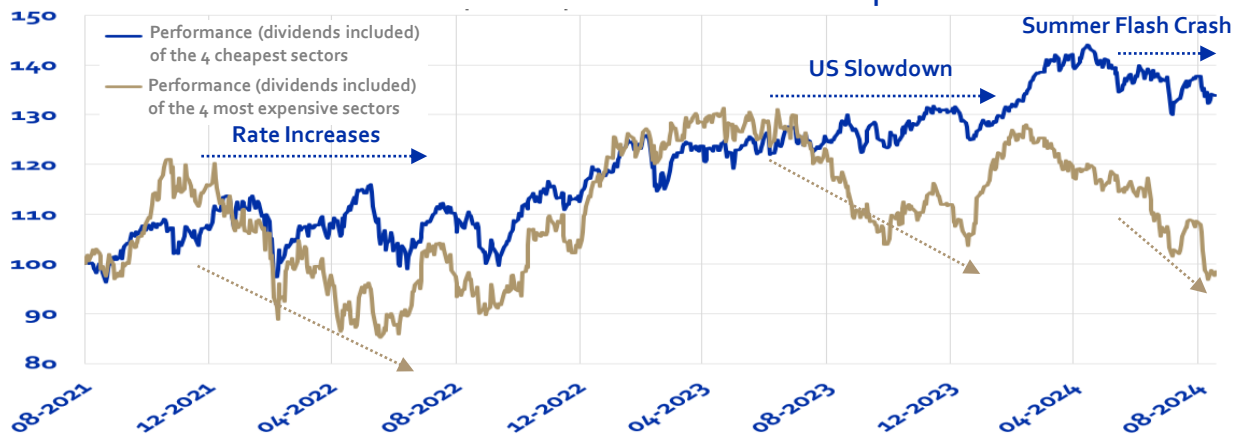


Chart 8 (sources: H2O AM, Bloomberg (Aug 2024))

The three drivers of this significant valuation gap, globalisation, regulation, and ultra-accommodative monetary policy have reversed. The deck has been reshuffled, and sector valuations are now poised to converge.

Luxury Goods and Technology, which thrived on high margins and the capacity to export cheaply, were major beneficiaries of globalisation. However, the rise of production relocation and the associated protectionism are now curbing their growth prospects. In Asia, luxury goods sales have stagnated, while local competitors are steadily replacing global technology firms. Initially, the market remained confident, but this sentiment crumbled with the emergence of inflation and the first rate hikes. After years of steady growth, uncertainty arose, making it impossible to sustain the previous trend. A self-reinforcing cycle of volatility and forced selloffs was triggered as investors, constrained by their risk models, were compelled to look for the exit. Despite rising profits, valuations fell sharply. In a market increasingly mechanised due to regulation, even a slight shift in earnings momentum is enough to derail the narrative. As a result, performance stagnated (see chart 8).

Conversely, the most heavily discounted cyclical sectors, Banks, Carmakers, Energy, and Natural Resources, are benefiting from the new environment. Despite their exposure to rising interest rates and global trade, their performance over the past three years has been notably positive (see chart 8). After a decade of

market pressure, these sectors have been forced to adapt. Carmakers have cut costs and reduced debt, building substantial reserves that have improved solvency and lowered interest rate risk. The Energy sector has followed a similar path. Banks have significantly reduced their leverage, by more than half on a like-for-like basis, consolidated in fragmented markets, and streamlined their least profitable franchises. In these industries, larger players have absorbed smaller, less profitable ones or merged to share costs and diversify, as seen with Stellantis in 2021 in the Automotive sector. **Better positioned, these sectors are now less vulnerable to relocation and the shift back to monetary orthodoxy.**

On the liability side, investors had largely disengaged from these sectors during the previous decade, thus significantly reducing the risk of large outflows today. The short-term volatility of undervalued cyclical sectors remains high due to lower liquidity, but over much shorter periods and with less correlation to the overall market. Moreover, their undervaluation has led companies to opt for share buybacks, introducing a stable investor into the system and thereby reducing the risk of sustained correction. Central banks' put, beneficial to markets and zero-rate winners, is now replaced by the put of undervalued firms leveraging depreciated valuations to lower their cost of capital and enhance return on equity, akin to banks repurchasing their shares at over 40% discount to underlying asset value.

Consequently, undervalued sectors are better shielded from economic cycles. Restructuring efforts enabled them to withstand the sharp interest rate hikes in 2022 and recession fears in late 2023. More recently, the share buyback programs and minimal exposure by volatility-sensitive investors mitigated the risk of these sectors during the Nasdaq 'flash crash' last July-August. While daily volatility remains elevated for undervalued cyclical sectors, their overall risk has significantly decreased (see chart 8).

With modest earnings growth prospects, high returns, lower risk, and a price tag representing only a few years' earnings, undervalued cyclical sectors are now more comparable to bonds than equities. They should be treated as such.

**The economic environment tells us that this is likely to remain the case for the years ahead. Geopolitical risk, climate change, the strategic war between the United States and China, and the shortage of skilled labour are all sources of inflation that will prevent a return to zero-interest rates for a long time.**

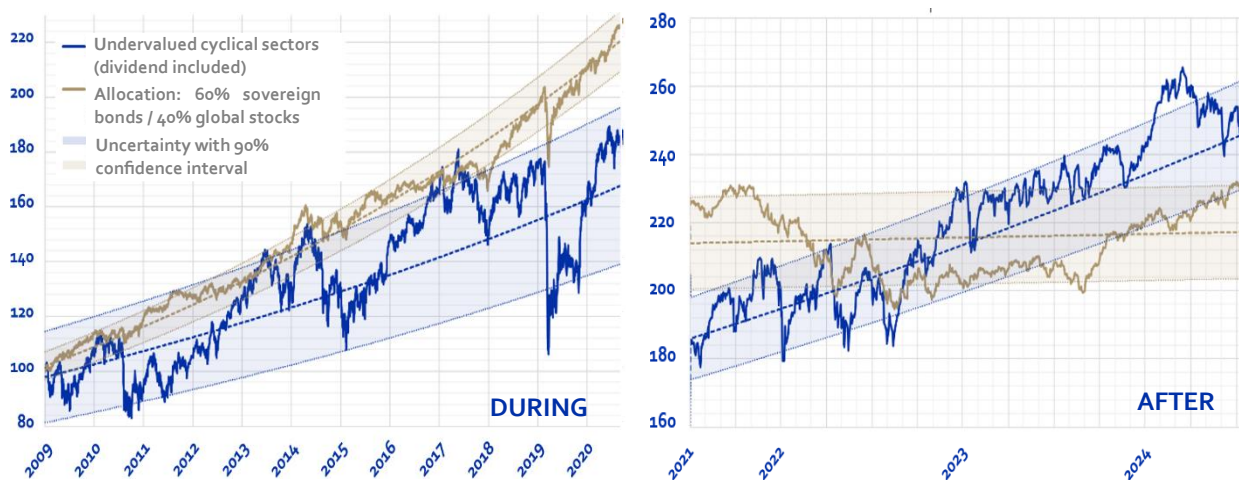
Politicians across the spectrum and in various countries have stated their strong commitment to push for reindustrialisation and production reshoring. As a result, global trade is unlikely to rebound anytime soon. Finally, the financial

system has become healthier, and excess regulation is now starting to show some unintended negative effects. It is therefore unlikely that authorities will revert to their previous repressive stance. The uniqueness of the 2010-2020 era is now behind us.

While the winners of the zero-interest rate period have now adjusted, deeply discounted cyclical sectors remain cheaper than ever. Equity investors are deterred by these sectors' weak earnings prospects, while bondholders lack access to these securities, instead opting for more expensive, hybrid instruments (i.e., Convertible bonds, Additional Tier 1, and CoCos) which are not necessarily less risky<sup>1</sup>. Meanwhile, these sectors offer yields more than 7 percentage points higher than money market returns, with reasonable risk and low correlation to the broader market.

Combining equities and bonds has become riskier due to the instability of their correlation. A straightforward allocation to undervalued cyclical sectors would therefore allow us to rediscover the attributes that once made them valuable (see charts 9 and 10). This will continue to hold true as long as the market continues to overlook these background dynamics, whether through inertia or neglect.

**Undervalued cyclical sectors vs. traditional asset allocation during/after zero-rates**



Charts 9 & 10 (sources: H2O AM, Bloomberg (Aug 2024))

<sup>1</sup> The bankruptcy of Credit Suisse in March 2023 sets a useful precedent. In an unprecedented move, holders of hybrid debt instruments saw their claims, which were senior to equity, completely wiped out, while shareholders had their shares bought by the acquirer UBS.

Edited in London, October 2024

## Disclaimer:

This document is distributed for information purposes only and does not constitute advice, an offer or an invitation by or on behalf of H2O AM to buy or sell securities, related financial instruments or other products, or to engage in any trading strategy in any jurisdiction. This document is intended for professional clients within the meaning of the MiFID Directive. It may not be used for any purpose other than that for which it is intended and may not be reproduced, disseminated or communicated to third parties in whole or in part without the prior written consent of H2O Asset Management.

This document has been designed and produced by H2O Asset Management from sources it considers reliable. H2O Asset Management shall not be held responsible for any decision taken or not taken on the basis of the information contained in this document, nor for the use that a third party may make of it. The analyses and opinions contained in this document represent the views of the author(s) referenced at the date indicated and are subject to change without notice. There is no guarantee that future developments will correspond to those anticipated in this document.

Before investing in any product, an investor should fully understand the risks, including any market risk associated with the issuer, the financial merits and suitability of such products and consult with his or her own legal, tax, financial and accounting advisors before making an investment decision. An investor should fully understand the characteristics of the transaction and, in the absence of any provision to the contrary, be financially capable of bearing the loss of his or her investment and be willing to accept such risk. The investor should be aware that the value of an investment and the income derived from it may go down as well as up and that past performance is not a guide to future performance. Any investment in a described product is subject to prior reading and understanding of the product documentation, in particular that which describes in detail the rights and duties of investors and the risks inherent in an investment in that product.

The legal and regulatory documentation of the funds managed by H2O AM is available free of charge on the website [h2o-am.com](http://h2o-am.com). The H2O Asset Management Group comprises the following entities:

H2O Asset Management L.L.P. which is an investment management company authorised and regulated by the Financial Conduct Authority ("FCA") and registered with the registration number 529105. H2O Asset Management L.L.P. is registered with the English Companies Registry under number OC356207. The FCA register can be found at <http://www.fca.org.uk/>. Company name and registered office: H2O Asset Management L.L.P. 33 Cavendish Square, London W1G 0PW, United Kingdom. Company Number: OC356207.

H2O Asset Management Europe is an asset management company authorised and regulated by the Autorité des Marchés Financiers under the n° GP-19000011. The AMF register can be consulted at <https://www.amf-france.org>. Company name and registered office: H2O AM Europe, 39 avenue Pierre 1er de Serbie, 75008 Paris, France. Company Number: RCS Paris n° 843 082 538.

H2O Monaco SAM which is authorised and regulated by the Commission de Contrôle des Activités Financières (CCAF SAF 2017-04). Company name and registered office: H2O Monaco SAM, 24 bd Princesse Charlotte 98000 Monaco. Company Number: (RCI) 17S07498.

We are committed to respecting the confidentiality of the personal data - H2O AM Data protection and Privacy policy is available [here](#)