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European SMID equities continue to offer attractive investment opportunities

While European small and mid-cap stocks (SMID) are up 45% since the 23rd March 2020 lows and up 7% since our recent recommendation on 1st July, they have further to go in absolute and relative terms **– figure 1**.

There are several factors supporting this view:

- The critical assumption is that the European economic outlook is gradually gathering momentum.
- European SMID typically outperform during the 12-months after market lows.
- European SMID has high exposure to both Covid Cyclicals and Value, areas that we favour at a global level.
- The firmer Euro is supportive for the European domestic sectors which SMID are exposed to.
- European SMID companies are only modestly geared.
- European SMID valuations are reasonable, especially in relative terms.
- Ownership levels for all European equities are low, and for European SMID are particularly low.

European economic pickup supports SMID stocks

We have recently raised our GDP growth forecast for Europe for 2021 to +4% - Resilience and Adaptation: Why the Global Economy is Poised for Accelerating Growth. While a rebound in growth was assured after the extraneous pandemic and lockdowns, there have been two important recent drivers that indicate further growth momentum ahead. Firstly, most European governments have done a relatively decent job of containing the virus. While further resurgences are expected, they will likely be regional and not necessitate prolonged widespread lockdowns again. Secondly, the national fiscal responses have been increasingly significant, especially from the locomotives France and Germany, and have now been supplemented by the EU's €750 billion Recovery Fund, which commits €390 billion in grants. In addition, the ECB's responses are supportive, with continued negative rates and €1.35 trillion of bond purchases helping to keep the fiscal costs manageable, and with cheap lending programs helping stressed corporates.

European SMID stocks typically perform well in absolute terms and also outperform large-caps in the early stages of a cyclical upturn. This was seen in both 2001 and 2007**.**

European market recovery supports SMID stocks

European markets have rallied off their lows but are still down 11% so far this year. Further absolute and relative performance is expected to be driven by a mix of factors: decisive policymaking is now driving a relative advantage in the GDP growth pickup, corporate earnings are expected to reflect the GDP growth pickup with an average rise of at least 30% expected in 2021, market valuations are reasonable versus history and versus the US currently, and finally many global investors are still underweight in Europe.

(*) "Covid Cyclicals: Financials, industrials, materials, real estate, consumer discretionary. "Covid Defensives": IT, healthcare, communication services, consumer staples, utilities.

Following the five prior European market corrections in excess of 20%, SMID stocks have outperformed European large-cap stocks by over 11% in the subsequent 12-month period (47% versus 36%) – **figure 2.** In this correction, the initial SMID sell-off was larger than prior corrections and current levels still 15% below February levels.

The European SMID sector has a high exposure to Covid Cyclicals, which we expect to outperform

As "Covid Defensive" sectors like IT and Healthcare drove markets during the second quarter, SMID was held back by its modest exposures in these areas – **figure 3.** However looking forward, as the economic pickup gathers momentum, we expect that Covid Cyclical sectors should attract more buying interest. These "Covid Cyclicals" account for nearly two-thirds of European SMID, with the largest three sectors (industrials, financials and consumer discretionary) accounting for just under 50%.

The European SMID sector has a high exposure to Value, which we expect to outperform

Throughout the second quarter recovery, Growth stocks have performed strongly. As Growth stocks move towards fair value in the coming months, we are expecting increasing rotation into Value.

European markets have a higher Value percentage of total market cap than most other developed markets, and European SMID reflects this too. In addition, while SMID Value has still underperformed versus Growth, its relative performance has been much stronger relative to European large-caps – **figure 4.**

European SMID stocks are typically not impacted by a stronger Euro

As European leaders show more solidarity, the weaker periphery countries are the beneficiaries. This means that the substantial overhang for the Eurozone for almost a decade, potential breakup risk, is much reduced. In addition, the European risk profile is falling, raising inflows into all European assets. For these reasons, we believe that the Euro will keep appreciating to at least $1.20 versus the US dollar - Further momentum behind Euro upside.

As **figure 5** shows, SMID companies typically outperform large-cap companies during periods of Euro strength. This is because of SMID's significant domestic exposure, versus large-cap companies that are much more export orientated and consequently could face some headwinds from Euro strength.

European SMID companies are generally not overly geared financially

Given the suddenness of the Covid-induced recession, balance sheet and cash flow strength is particularly important (long-term focus on strong company balance sheets). While SMID certainly includes some weak companies, Government support programs are helping. On average, the sector gearing looks only modest. The huge volume of corporate bond issuance over recent weeks does not show a disproportionate proportion of stressed SMID companies looking to raising capital.

European SMID stocks are inexpensive and expected to re-rate versus large-cap

Valuations for European markets are broadly not expected to fall in the coming months, as the earnings rebound looks assured, political risks are low, and interest rates are low. In addition, the current and prospective multiples for European SMID are in line with European large-caps, and over time, we expect the historic European SMID premium rating to reassert **– figure 6.**

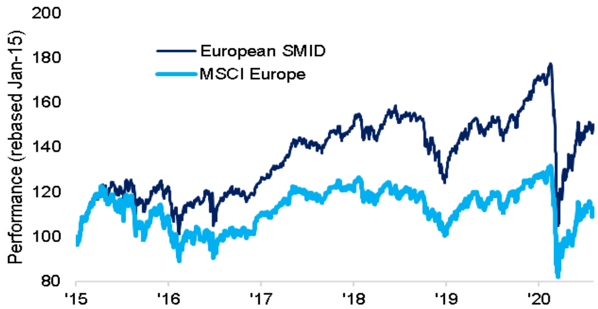
European SMID has high weighting in our preferred countries

Scandinavia and Germany have done relatively well in containing the virus, and are also the countries most able to raise government spending to support their recoveries. Their stock markets have led the SMID rebound – **figure 3.**

Our favoured SMID country remains Germany. Germany's combined fiscal packages at 9.6% of GDP are supporting domestic companies and keeping rises in unemployment relatively contained. The latest German ZEW domestic expectations survey data shows a sharp rebound in forward looking forward expectations. Such a move has historically boded well for domestic companies and indicates likely further upside potential in German small-caps – **figure 7.**

Our preferred German SMID sector is industrials, which trades at an average multiple of 21x. The sector should also be a key beneficiary of the re-opening of the economy and benefit from a sharp pick-up in manufacturing activity as production is ramped up to meet demand.

Figure 1:SMID performance versus large-cap



Source: Bloomberg as of August14th 2020

Figure 2: SMID outperforms large cap following prior bottoms

	Forward 12M Performance	
Prior Bottoms	Large	SMID
12/03/2003	52%	63%
09/03/2009	60%	79%
23/11/2011	22%	31%
12/02/2016	22%	26%
27/12/2018	27%	38%
Average	**36%**	**47%**
Performance since March 23rd low		
23/03/2020	*35%*	*45%*

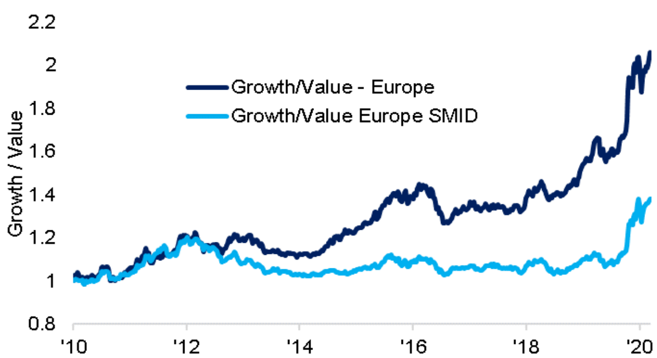
Source: Bloomberg as of August14th 2020

Figure 3: SMID country and sector breakdowns

Country	$ Market Cap (million)	# Companies	Performance since March 23rd	Performance YTD	PE Ratio (x)	Net Debt / EBITDA (x)	Sector	Covid Cyc / Def	$ Market Cap (million)	Performance since March 23rd	Performance YTD	PE Ratio (x)	Net Debt / EBITDA (x)
Belgium	57,653	34	23%	-17%	46.3	1.4	Cons Discretionary	C.Cyclical	306,206	69%	-9%	36.1	3.5
Britain	382,124	226	46%	-18%	34.1	3.1	Energy	C.Cyclical	38,454	50%	-41%	11.9	3.0
Denmark	70,966	29	58%	9%	69.2	2.0	Industrials	C.Cyclical	491,707	46%	-15%	35.7	2.5
France	374,219	113	34%	-17%	37.8	2.5	Materials	C.Cyclical	147,436	42%	-10%	26.3	2.6
Germany	368,397	131	54%	-5%	44.9	1.6	Financials	C.Cyclical	270,427	41%	-14%	23.2	1.8
Italy	119,647	76	33%	-15%	24.2	3.1	Real Estate	C.Cyclical	191,643	22%	-23%	31.3	7.6
Netherlands	117,876	44	46%	-7%	38.3	2.7	Comm Services	C.Defensive	158,342	38%	-10%	29.9	2.1
Norway	31,250	37	75%	-11%	39.9	4.6	Cons Staples	C.Defensive	113,835	27%	-6%	25.1	3.0
Spain	99,355	55	24%	-22%	30.3	4.0	Health Care	C.Defensive	270,087	49%	9%	76.5	0.3
Sweden	153,497	103	76%	11%	30.6	3.3	IT	C.Defensive	240,140	62%	3%	54.8	0.3
Switzerland	366,743	104	41%	-4%	38.4	1.3	Utilities	C.Defensive	87,961	41%	15%	49.2	4.6
EUROPE	2,316,238	1055	47%	-10%	37.3	2.6	EUROPE		2,316,238	47%	-10%	37.3	2.6

Source: Bloomberg as of August14th 2020

Figure 4: Growth/Value performance in large-cap and SMID

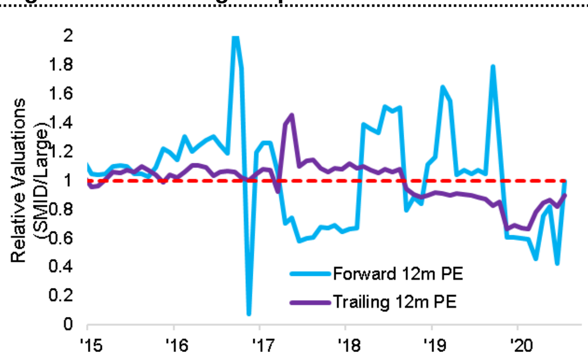


Source: Bloomberg as of August14th 2020

Figure 5: Europe SMID/Large versus the Euro

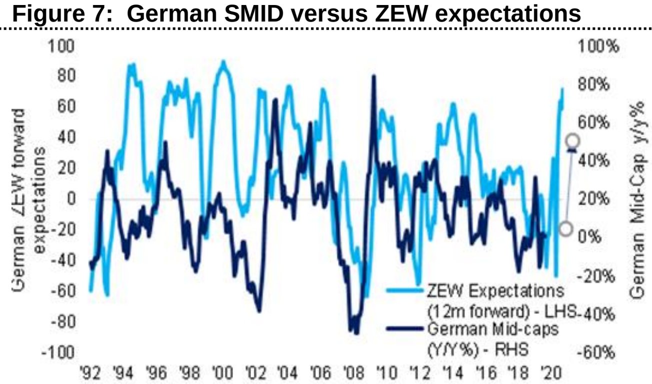
Source: Bloomberg as of August14th 2020

Figure 6: SMID/Large-cap relative valuations



Source: Bloomberg as of August14th 2020

Figure 7: German SMID versus ZEW expectations



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