Document for professional investors only
Written in October 2023

One market hiding another

An unprecedented situation in global equity markets

Juan Sebastian Caicedo, CFA

Quantitative Equities Portfolio Manager

The rise in global equity markets observed in 2023, through until the summer, was chiefly attributable to expanding valuation multiples in the most speculative sectors.

The resulting historic peak in sector concentration is comparable to the periods preceding the bursting of the technologies-media-telecoms (TMT) bubble and the 2008 financial crisis.

Consequently, the gap in growth outlook, between the most volatile and the least volatile sectors, is four times higher than the historic average.

In the context of an economic slowdown, this historically wide valuation and implied growth spreads, in favour of one single sub-segment of the market, offers some genuine relative alternatives.

For investors, opportunities may arise with defensive sectors and value stocks narrowing the gap moving forward.

Introduction

After 2022's the sharp corrections among equity and bond markets, 2023 has been remarkable in terms of the extremely rapid drop in volatility and the accompanying rally among most indices. The way in which the markets have rallied is equally remarkable.

A more-detailed analysis demonstrates that the rise in global indices is entirely due to expanding valuations multiples. Simultaneously, although earnings forecasts are dismissing a recession scenario, they are not increasing either, implying a delay in the economic recovery by more than a year (Fig.1).

Even more importantly, the rally occurred despite the fact that interest rates remain high. This point thus marks a real change in behaviour compared to the prevailing correlation over the past few years, particularly in 2022 (Fig.2).

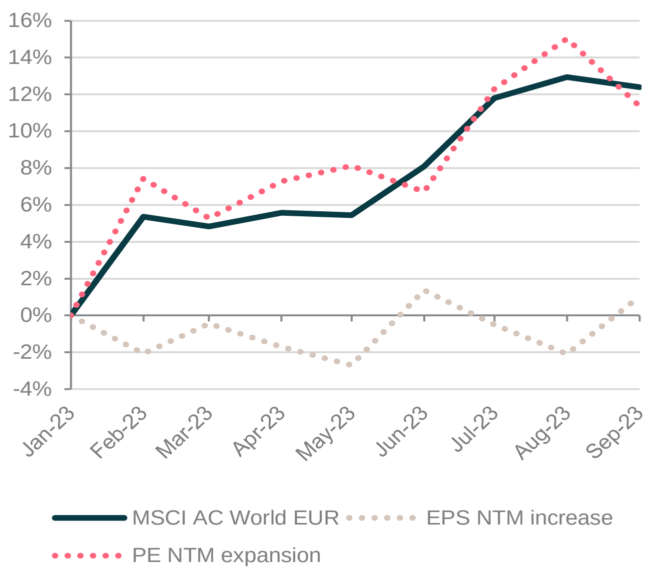

***Fig 1 – YTD performance breakdown of the MSCI AC World (EUR) index**, August 2023 – Source: Ostrum AM, Bloomberg, FactSet*

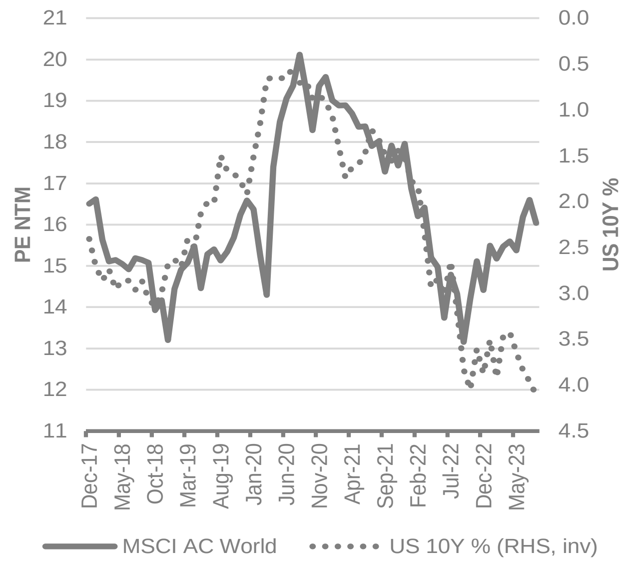

***Fig 2 - Valuation (PE NTM) of the MSCI AC World index vs US 10y rates**, August 2023 - Source: Ostrum AM, Bloomberg, FactSet*

The same index performance breakdown is observable among sector groups.

By ranking sectors according to their beta vs the market, the rally observed since the start of 2023 results mainly from a highly concentrated outperformance by the most volatile sectors (semiconductors, autos, hardware, software), which reflects a strong resurgence of risk appetite in the equity investment universe.

Even more significantly, as reflected by the index in general (MSCI AC World), this outperformance is entirely attributable to expanding valuations among securities in these sectors. Meanwhile, the less-risky sectors have posted almost flat performances, without any real expansion in earnings outlook or valuations (Fig.3).

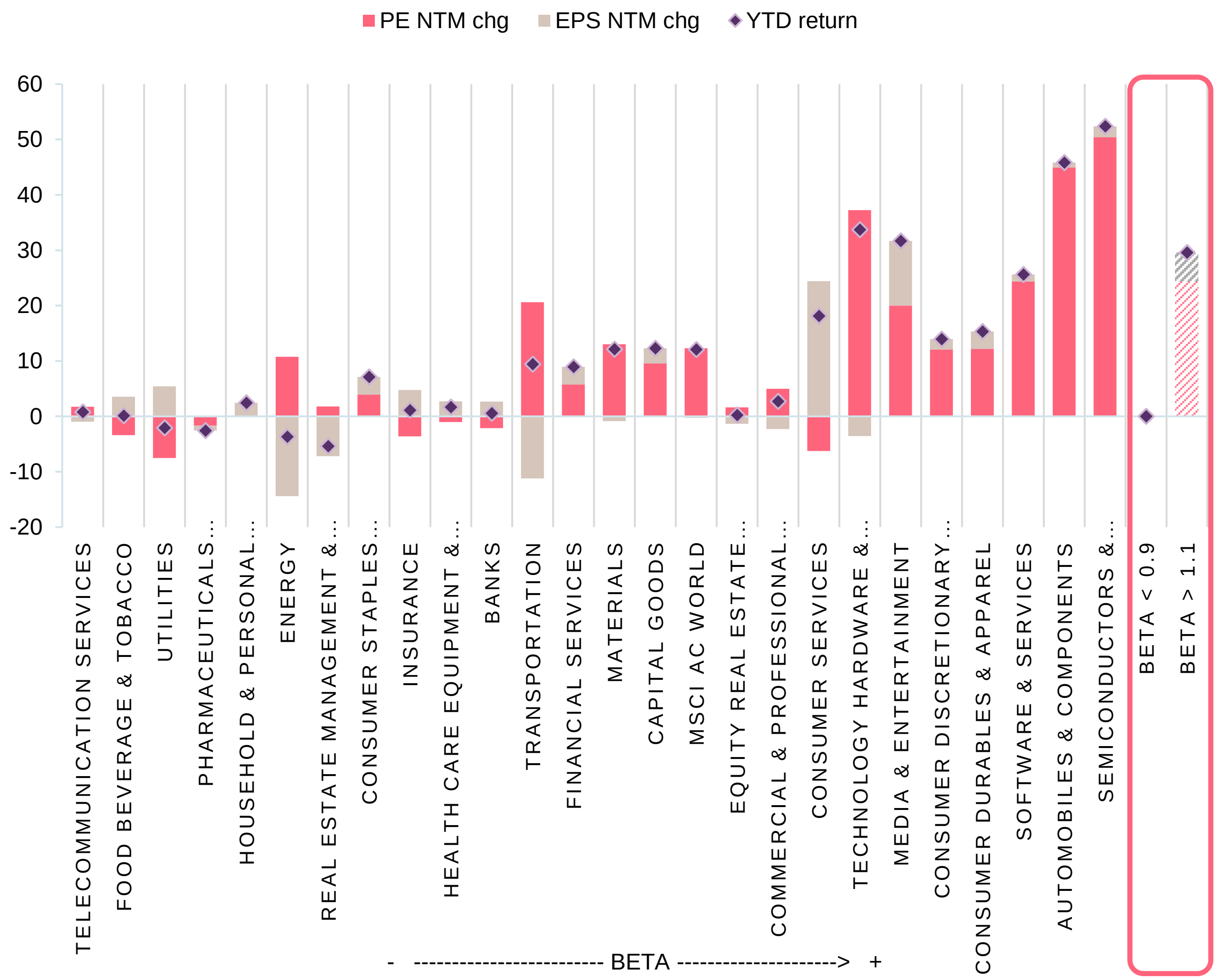

Fig 3 - YTD performance breakdown per sectors (MSCI AC World (EUR)) – classified by growing beta, *June 2023 - Sources : Ostrum AM, Bloomberg, FactSet*

AN ALL-TIME PEAK IN CONCENTRATION….

Such wide gaps observed over a short period raise questions over the recurrence of this type of market configuration. The same type of performance breakdown for all sectors since 1996 reveals the extraordinary extent to which valuation expansion has been concentrated within the most speculative sectors this year.

More precisely, grouping sectors by their beta, the performance gap at the end of June 2023, due to expanding price earnings ratios (PE NTM), between the more volatile sectors compared to the least volatile ones was at an all-time high since our observations began. It beat the previous record established during the first half of 2009, as the market rallied out of the 2008 financial crisis. Its cumulative effect is comparable to the entire 2019-2020 period, characterised by the most volatile securities dominating, driven sharply higher by massive liquidity facilities provided by Central Banks in response to the consequences of the pandemic (Fig.4).

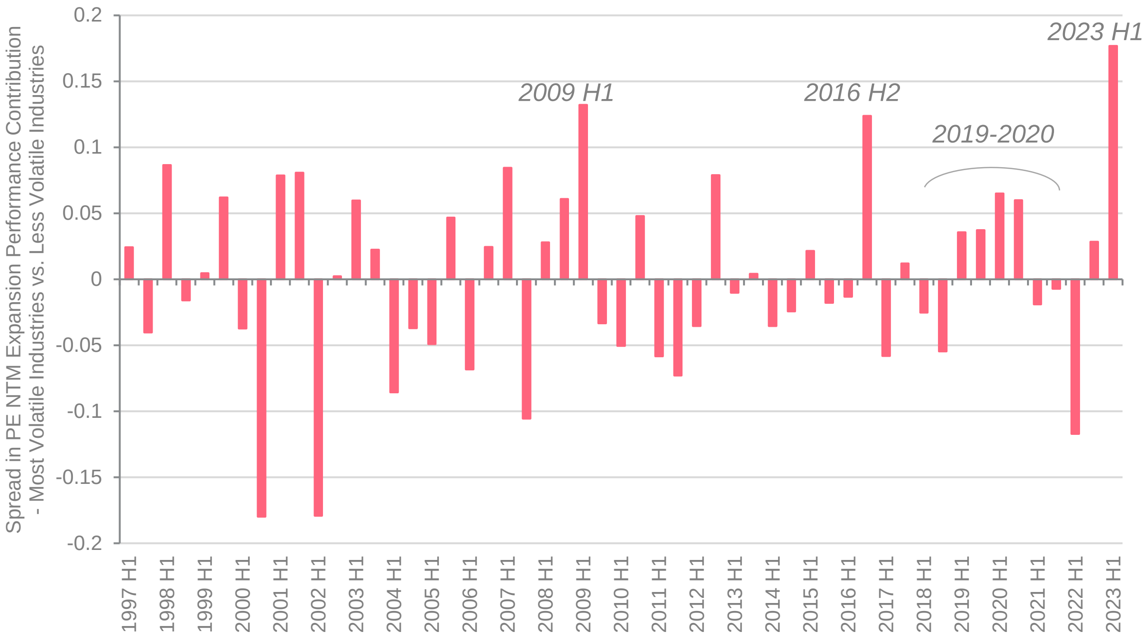

Fig 4 –Performances bi-annual spreads explained by the expansion of valuation multiples (most volatile sectors vs less volatile sectors), *August 2023 - Sources : Ostrum AM, Bloomberg, FactSet*

Behind the concentration peak in the markets towards the most volatile segments, a further more structural outperformance phase by the cyclical/growth segment (tech stocks, industrials, luxury goods) is also observable following the outperformances recorded in 2020 and 2021 (Fig.5). At the end of August 2023, this was the only segment to outperform the MSCI AC World index over one year (+18% vs +5%) and furthermore, the rest of the market returned a negative performance during this period.

After these consecutive phases of very strong outperformance, this segment's relative valuation compared to the rest of the market is currently approaching all-time highs. The level is comparable to those observed during the bubble seen in the late 1990s and early 2000s (Fig.6). This observation is all the more remarkable when comparing the valuation of the riskiest sectors with the least risky, using equity betas.

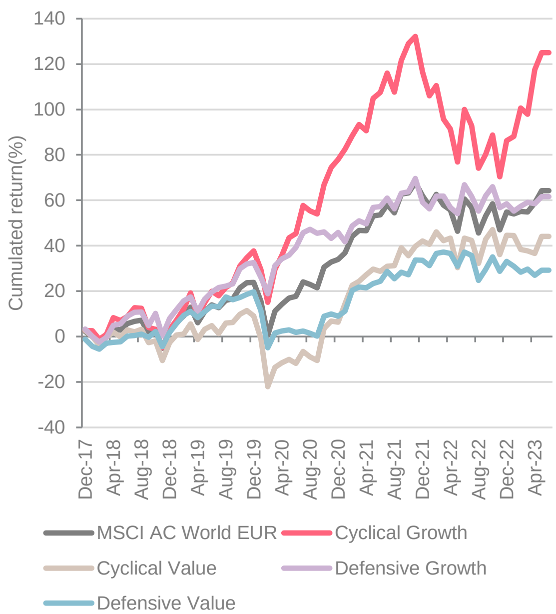

Fig 5 – Cumulated performance since Dec.2017 –MSCI AC World universe, *August 2023 - Source: Ostrum AM, Bloomberg, FactSet*

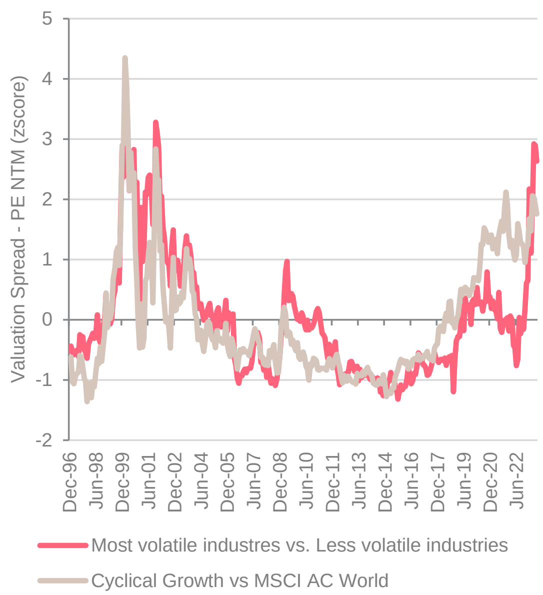

Fig 6 – Valuation spreads (PE NTM), *August 2023 - Source: Ostrum AM, Bloomberg, FactSet*

More specifically, the sectors with betas higher than 1.1 are currently trading at 23.5 times earnings, vs only 15.5 times for sectors with betas lower than 0.9, i.e., a relative spread of over 1.4. In comparison, the average spread has been 1.0, since 1995, and 0.9 since 2009.

… RESULTING IN A HISTORIC PEAK IN IMPLIED GROWTH RATES

The last stage of our analysis therefore logically involves assessing whether these valuation levels are justified from fundamental point of view.

To do so, we calculate the implied earnings growth rates within longer-term valuation multiples. In the case of five-year multiples, a normalisation of spreads would anticipate future growth in the cyclical/growth segment 38% higher than the rest of the market. This would therefore be three times higher than the average observed since 2008, and comparable only to the peak growth gap during the same period.

In the context in which the dynamic that supported global growth and corporate margin expansion over the past two decades is weakening – low interest rates, cheap labour, industrial consolidation, globalisation, tech monopolies – the market appears to be betting on trends remaining on track, or even accelerating, among the few industries which have benefitted most from it so far.

This complacency is also applied to the most volatile sectors, which are now anticipating 10% higher growth than the maximum recorded, compared to less volatile sectors, and four times higher than the historic average (Fig.7).

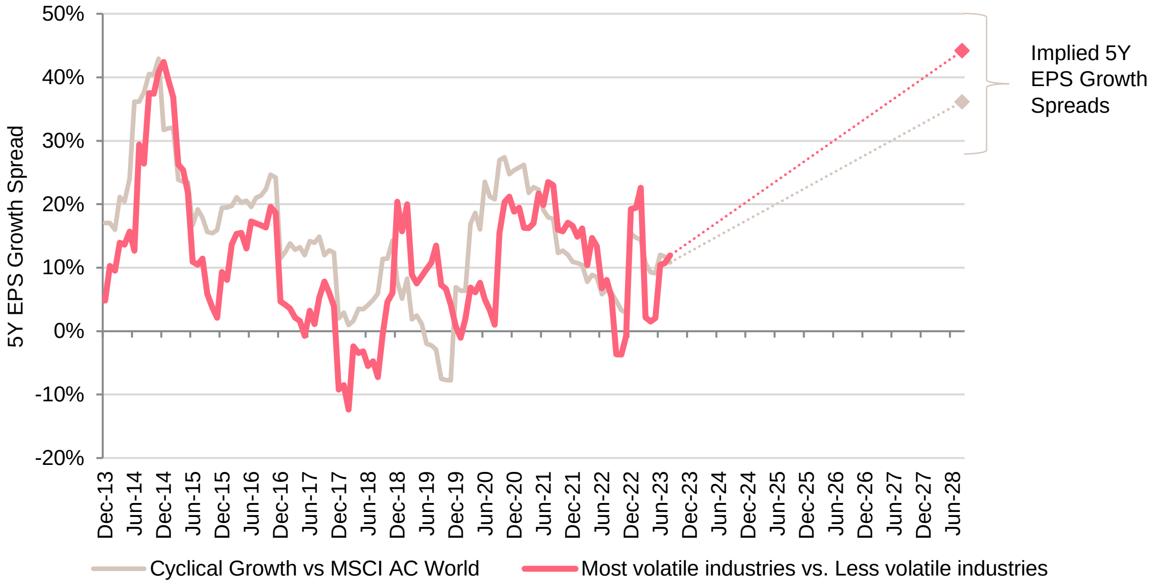

Fig 7 – Realised and anticipated growth spreads–MSCI AC World universe, *August 2023 - Sources : Ostrum AM, Bloomberg, FactSet*

Over the past three years, momentum has remained continuous among all asset classes, where any brutal short-term change in conditions (COVID, geopolitical crises, the rise in generative artificial intelligence) has been offset by governments implementing extraordinary monetary and fiscal measures. The debate still rages around the conditions which will enable the launch of a fresh economic cycle. Nevertheless, excessive concentration and dispersion in the markets reflects a system which is struggling to find balance and infers exceptional relative growth rates. Historically, such extreme disparities have coincided with the start of a new regime, which enables the gaps to close. For investors, although heightened vigilance is required in this type of market, long-term investment opportunities may arise.

Investors have to regularly confront their own views and the market's. The target is always moving, and the market ultimately only acts like a weighing machine over the long term, to paraphrase Benjamin Graham[1], finding equilibrium by converging towards its fundamentals. Today, equilibrium will involve the return to normal of the excessive concentration and positioning, which has built up over the past few years, and which has left no margin for error in growth trajectories.

While questioning the health of the global economy gives rise to *directional* bets in the equity markets, we believe that the historic levels of valuation and implied growth gaps, favouring one single sub-segment of the market, offer real *relative* alternatives. For investors, these alternatives involve mean-reversion for defensive sectors and the most neglected such as Value stocks.

---

[1] Benjamin Graham, 20th century American economist, entrepreneur and investor, recognised as one of the founding fathers of value investing.

Additional notes

Ostrum Asset Management

Asset management company regulated by AMF under n° GP-18000014 – Limited company with a share capital of 50 938 997 €. Trade register n°525 192 753 Paris – VAT: FR 93 525 192 753 – Registered Office: 43, avenue Pierre Mendès-France, 75013 Paris – www.ostrum.com
This document is intended for professional, in accordance with MIFID. It may not be used for any purpose other than that for which it was conceived and may not be copied, distributed or communicated to third parties, in part or in whole, without the prior written authorization of Ostrum Asset Management.
None of the information contained in this document should be interpreted as having any contractual value. This document is produced purely for the purposes of providing indicative information. This document consists of a presentation created and prepared by Ostrum Asset Management based on sources it considers to be reliable.
Ostrum Asset Management reserves the right to modify the information presented in this document at any time without notice, which under no circumstances constitutes a commitment from Ostrum Asset Management.
The analyses and opinions referenced herein represent the subjective views of the author(s) as referenced, are as of the date shown and are subject to change without prior notice. There can be no assurance that developments will transpire as may be forecasted in this material.
This simulation was carried out for indicative purposes, on the basis of hypothetical investments, and does not constitute a contractual agreement from the part of Ostrum Asset Management.
Ostrum Asset Management will not be held responsible for any decision taken or not taken on the basis of the information contained in this document, nor in the use that a third party might make of the information. Figures mentioned refer to previous years. Past performance does not guarantee future results. Any reference to a ranking, a rating or an award provides no guarantee for future performance and is not constant over time. Reference to a ranking and/or an award does not indicate the future performance of the UCITS/AIF or the fund manager.
Under Ostrum Asset Management's social responsibility policy, and in accordance with the treaties signed by the French government, the funds directly managed by Ostrum Asset Management do not invest in any company that manufactures, sells or stocks anti-personnel mines and cluster bombs.

Natixis Investment Managers

This material has been provided for information purposes only to investment service providers or other Professional Clients, Qualified or Institutional Investors and, when required by local regulation, only at their written request. This material must not be used with Retail Investors.
To obtain a summary of investor rights in the official language of your jurisdiction, please consult the legal documentation section of the website (im.natixis.com/intl/intl-fund-documents)
In the E.U.: Provided by Natixis Investment Managers International or one of its branch offices listed below. Natixis Investment Managers International is a portfolio management company authorized by the Autorité des Marchés Financiers (French Financial Markets Authority - AMF) under no. GP 90-009, and a public limited company (société anonyme) registered in the Paris Trade and Companies Register under no. 329 450 738. Registered office: 43 avenue Pierre Mendès France, 75013 Paris. Italy: Natixis Investment Managers International Succursale Italiana, Registered office: Via San Clemente 1, 20122 Milan, Italy. Netherlands: Natixis Investment Managers International, Nederlands (Registration number 000050438298). Registered office: Stadsplateau 7, 3521AZ Utrecht, the Netherlands. Spain: Natixis Investment Managers International S.A., Sucursal en España, Serrano n°90, 6th Floor, 28006 Madrid, Spain. Sweden: Natixis Investment Managers International, Nordics Filial (Registration number 516412-8372- Swedish Companies Registration Office). Registered office: Kungsgatan 48 5tr, Stockholm 111 35, Sweden. Or,provided by Natixis Investment Managers S.A. or one of its branch offices listed below. Natixis Investment Managers S.A. is a Luxembourg management company that is authorized by the Commission de Surveillance du Secteur Financier and is incorporated under Luxembourg laws and registered under n. B 115843. Registered office of Natixis Investment Managers S.A.: 2, rue Jean Monnet, L-2180 Luxembourg, Grand Duchy of Luxembourg. Germany: Natixis Investment Managers S.A., Zweigniederlassung Deutschland (Registration number: HRB 88541). Registered office: Senckenberganlage 21, 60325 Frankfurt am Main. Belgium: Natixis Investment Managers S.A., Belgian Branch, Gare Maritime, Rue Picard 7, Bte 100, 1000 Bruxelles, Belgium.
In Switzerland: Provided for information purposes only by Natixis Investment Managers, Switzerland Sàrl, Rue du Vieux Collège 10, 1204 Geneva, Switzerland or its representative office in Zurich, Schweizergasse 6, 8001 Zürich.
In the British Isles: Provided by Natixis Investment Managers UK Limited which is authorised and regulated by the UK Financial Conduct Authority (register no. 190258) - registered office: Natixis Investment Managers UK Limited, One Carter Lane, London, EC4V 5ER. When permitted, the distribution of this material is intended to be made to persons as described as follows: in the United Kingdom: this material is intended to be communicated to and/or directed at investment professionals and professional investors only; in Ireland: this material is intended to be communicated to and/or directed at professional investors only; in Guernsey: this material is intended to be communicated to and/or directed at only financial services providers which hold a license from the Guernsey Financial Services Commission; in Jersey: this material is intended to be communicated to and/or directed at professional investors only; in the Isle of Man: this material is intended to be communicated to and/or directed at only financial services providers which hold a license from the Isle of Man Financial Services Authority or insurers authorised under section 8 of the Insurance Act 2008.
In the DIFC: Provided in and from the DIFC financial district by Natixis Investment Managers Middle East (DIFC Branch) which is regulated by the DFSA. Related financial products or services are only available to persons who have sufficient financial experience and understanding to participate in financial markets within the DIFC, and qualify as Professional Clients or Market Counterparties as defined by the DFSA. No other Person should act upon this material. Registered office: Unit L10-02, Level 10 ,ICD Brookfield Place, DIFC, PO Box 506752, Dubai, United Arab Emirates
In Japan: Provided by Natixis Investment Managers Japan Co., Ltd. Registration No.: Director-General of the Kanto Local Financial Bureau (kinsho) No.425. Content of Business: The Company conducts investment management business, investment advisory and agency business and Type II Financial Instruments Business as a Financial Instruments Business Operator.

www.ostrum.com

Ostrum
ASSET MANAGEMENT

An affiliate of: NATIXIS INVESTMENT MANAGERS