Investment Themes & Strategy

For European equities, winter won't last forever

Stefan Hofrichter | 08/01/2019

Summary

While Europe faces its own share of political uncertainty, many of its headwinds are similar to those faced by capital markets around the world – not specific to Europe. In fact, with trade wars hurting the US and China, and with the Fed in danger of overreaching, European equities may be in a strong relative position.

Key takeaways

- Thanks to Brexit, Italian politics and EU Parliamentary elections, political uncertainty is on the cards for Europe in 2019 – and the markets don't like uncertainty
- If European equities can weather the region's political storms – which won't be without challenge – they could emerge in a strong position, particularly compared with US stocks
- Some of the biggest market headwinds aren't Europe-specific, including trade wars (which could hurt the US more than Europe) and monetary policy (the Fed may be at bigger risk of overplaying its hand than the ECB)
- Valuations are attractive for European equities, both compared with their long-term average and compared with US stocks: CAPE is around 18 in Europe vs about 30 in the US

US equity investors got a head start on a chilly winter season in early December 2018, with major indices experiencing steep drops and surging volatility that continued into the New Year. But European investors have been feeling the freeze even longer, with stock prices in Europe heading downhill beginning in May 2018.

In fact, European equities have had a tough time since this decade began. According to MSCI, European stocks have underperformed global stocks by almost 30% in local currency terms since 2010, and underperformed the US equity market by more than 35% in US dollar terms.

So what is causing Europe so much trouble? Political uncertainty seems to be a major factor. On close examination, however, Europe appears to be less susceptible to some of the global headwinds that are currently worrying the markets. If European equities can weather the region's political storms – which won't be without challenge – they could emerge in a strong position, particularly compared with US stocks.

European political uncertainty looms large in 2019

Even a quick glance at the political calendar for the coming year could make one sceptical that Europe's market troubles will end anytime soon. Political uncertainty is the order of the day for 2019 – and the markets don't like uncertainty.

For example, no one knows how the Brexit saga will unfold, with multiple outcomes still possible. At the time of this writing, it was unclear whether the UK Parliament would accept the proposed withdrawal agreement with the EU, followed by a transition period until the end of 2020. Alternatively, the UK could crash out of the European Union in a disorderly way at the end of March 2019 in a "no-deal" Brexit.

Overall, the European political landscape has become much more fragmented since the global financial crisis and European debt crisis. This political uncertainty is translating into economic uncertainty, which is dragging down growth.

- Around the region, anti-EU populists have steadily gained ground in their efforts to oppose the requirements of EU membership, with the government of Italy – the euro-zone's third-largest economy – essentially only paying lip service to the EU's budgetary constraints.
- French President Emanuel Macron – one of the most outspokenly pro-European political leaders – is facing strong domestic political opposition.
- If populist forces win further support in Europe's May 2019 Parliamentary elections, governing the region will likely become more difficult, which could further slow economic growth.

Today's biggest market headwinds come from outside Europe

Yet although Europe has its share of regional political troubles, some of the biggest headwinds battering the markets are global in nature – not specific to Europe – and in some respects, Europe is in a stronger position to weather them.

For example, trade-war concerns have been providing investors everywhere with major headaches, yet trade wars are likely to affect China and other (Asian) emerging markets more than Europe. The US is particularly sensitive to trade-war fallout, with tariff retaliation and general uncertainty potentially acting as a bigger drag on US markets than European ones.

Moreover, although cyclical data grew particularly weak in Europe at the beginning of 2018, macroeconomic indicators are also weakening outside of Europe – particularly in the US. We expect this to continue in 2019 as the effects of the 2018 US fiscal stimulus fade, and as a reflection of tighter monetary policy, especially in the US.

Monetary policy is another point of distinction between the EU and US, as their central banks are on somewhat divergent paths. If the US Federal Reserve continues hiking the federal funds target rate closer to what economists believe to be the 3% "neutral rate" – a rate that neither stimulates nor restrains economic growth – we believe the risks to a US economic "hard landing" could increase. The Fed has also been trimming its bond holdings at an annualised rate of around USD 450 billion. The European Central Bank, on the other hand, is still far away from raising rates for the first time in years, and is unlikely to trim its balance sheet size anytime soon. All told, the Fed may be at bigger risk of overplaying its hand than the ECB, potentially dampening growth prospects in the US – which could make Europe more attractive.

Valuations are attractive for European equities

From a longer-term perspective, there is an additional compelling argument in favour of European equities. Based on our preferred equity valuation measure – the cyclically adjusted price-to-earnings-ratio (CAPE) – equities in Europe were more attractively priced than those in the US as at late December 2018, according to Bloomberg:

- Europe's CAPE was around 18, cheaper than its long-term average of approximately 20.
- The United States' CAPE was about 30, a significant premium over its long-term average of around 16.5.

These rather high US equity valuations can hardly be explained by the superior growth rates of the US technology industry. In fact, the tech-heavy Nasdaq stockmarket is trading at a CAPE of 34 – a small discount, not a premium, to its long-term average. In addition, European earnings are still below their long-term trend growth rate, while in the US they are at the trend.

All in all, European equities could benefit if valuations and earnings were to return to their long-term averages – particularly if, as we believe will be the case, US equities face valuation headwinds in the coming years. If investors can gain more clarity on Europe's political situation – and if they take an active, selective approach to investing – they may be able to unlock the potential value hiding in European stocks.

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