Outlook on

Europe

JUL 2024

Summary

- European equities should benefit from the recent turn in the interest rate cycle, while modest valuations and a combination of high dividend yields and share buybacks offer further support for the asset class.
- Political risk in Europe has risen after President Macron's surprise decision to call French parliamentary elections, but it should not be overstated.
- Our European Fixed Income team remains positive on the outlook for European bonds despite the risks from inflation and politics. High yield levels are translating into attractive carry (income) for investors.

European Equity

Like a novice ballroom dancer, the European Central Bank (ECB) has typically taken its lead from the Federal Reserve (Fed) on interest rate policy since the bank's birth in 1998. But Christine Lagarde and her Frankfurt-based colleagues upended monetary tradition in early June with a 25 basis points (bps) reduction in the ECB's base rate, unusually before any prior move by the Fed. This action, the ECB's first rate cut in five years, seems likely to pre-empt the first trim in the fed funds rate by many months. As we have discussed in previous updates, ongoing robust US growth, perhaps beginning to falter, has caused investors to slash earlier (unrealistic) expectations of aggressive rate cuts by the Fed. US bond markets are now only pricing in an average of just 1.8 cuts in 2024.

In another break from convention, economic momentum is bottoming out in Europe just as the ECB's rate-cutting cycle has started. Normally, we would expect industrial production and consumer activity to trough several cuts into a rate-cutting cycle. On this occasion, the sharp fall in power prices has done the economic heavy lifting, bringing down inflation and helping to alleviate pressure on industrials and consumers alike.

This combination of a turn in the interest rate cycle and signs that the region's economic activity may pick up from here offers reasons for cautious optimism on the European economy and European stock markets. But with the European football championships currently being played out in Germany, seasoned investors will know all too well that the Continent is skilled at scoring own goals.

Macron's Gamble

On this occasion, it is French politics that is threatening to derail a European recovery. The EU parliamentary elections in early June provided no major change in the overall composition of the European Parliament, even if there was a slight shift to parties on the right, but they did produce some standout results at the country level, most notably in France.

President Macron's shock decision to dissolve the French Parliament and stage parliamentary elections, coming in the wake of a significant defeat of his centrist party by the National Rally party in the EU elections, rattled French equities and French debt and caused a more muted sell-off in wider European markets. Investors worried whether Macron's gamble may backfire and hasten a populist, Eurosceptic, far right-controlled legislature in the EU's second-largest economy.

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Setting aside the political consequences, these turbulent events will have dented global investors' appetite for European stocks in the short term. Frustratingly, this comes at a time when the region was beginning to pique the interest of investors: European equity funds experienced £714m of net inflows from UK investors in June.[1]

While we digest the inconclusive outcome of the second round of the elections on 7 July, we do not believe the vote will be game-changing for the French and broader European economy. The impact of politics on a country's financial markets and its economic trajectory tends to be overblown—after all, the Belgian economy was able to function normally during a period with no national government. In a country with a post-war history of public demonstrations, though, what we may see in France is some disruption and unrest, perhaps spurred by the knowledge that the eyes of the world will be on Paris from late July when the French capital hosts the Summer Olympics. This would potentially slightly dent economic activity for a few weeks but with no likely lasting effects, in our opinion.

Our Reasons for Optimism

Once we pass through the immediate noise of the French elections and the usual dog days of summer, we expect investors to focus on the nascent good news story within Europe. Our cautiously optimistic view on Europe is based on a differentiated rate environment, modest valuations, signs of moderate but improving economic momentum, and generous returns to shareholders through dividends and buybacks.

Diverging Rate Paths

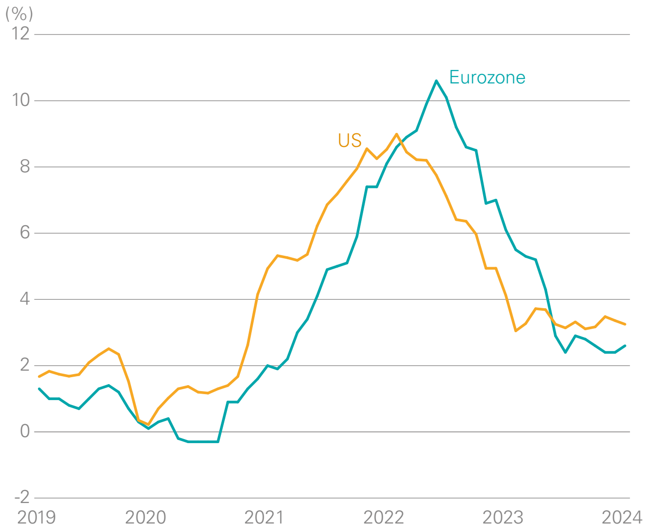
At the start of the year, the market anticipated that the major central banks would broadly start cutting rates around the same time. But these rate-cutting cycles are no longer in sync.

From speaking to international companies, we sense a weakening consumer environment in the US, while industrial surveys are hinting at a slowdown in the US economy, all suggesting higher rates are finally beginning to bite. Yet with annual consumer inflation running at 3.3% and core inflation, which strips out volatile energy and food prices, standing at 3.4%, both higher than in the eurozone, the Fed seems like it will be unable to trim interest rates in the same way as the ECB did (Exhibit 1).

Turning to Europe, victory in the ECB's battle against inflation cannot yet be declared. Annual consumer price inflation remains above the bank's 2% target at 2.5% (based on June's flash number), partly due to services inflation running at a 4.1% annual clip. Core inflation also remains too high for the ECB's tastes at 2.9%. Nevertheless, in making its first downward move on rates, the central bank clearly felt comfortable enough to begin gently taking its foot off the monetary brake.

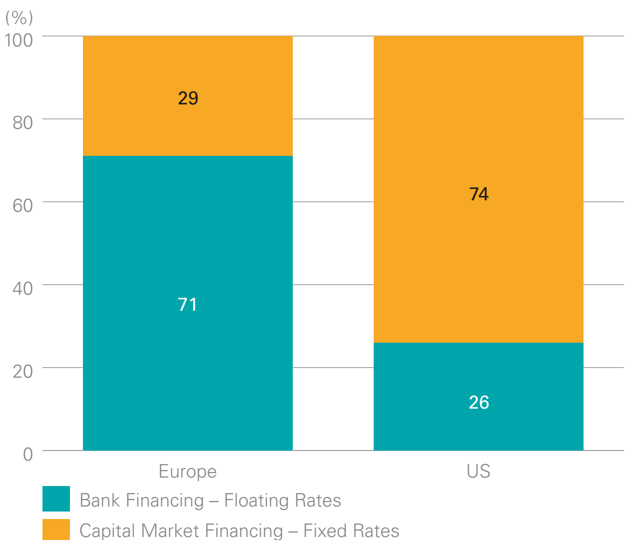
Currently modest levels of activity and easing power prices should support further ECB rate cuts over the second half of 2024, which may lead to an even more pronounced difference in the rate environment versus the US. This could be very supportive for European stocks. European companies are more sensitive to cuts in interest rates than firms globally, as they typically borrow from banks rather than the corporate debt markets (Exhibit 2). Lower rates mean European companies can redirect savings from lower interest charges towards buybacks, dividends, and M&A activity.

Exhibit 1
US Inflation Running Ahead of Eurozone Inflation



As at 31 May 2024
Source: FactSet

Exhibit 2
Floating vs. Fixed Interest Rate Corporate Exposure in Europe and the US



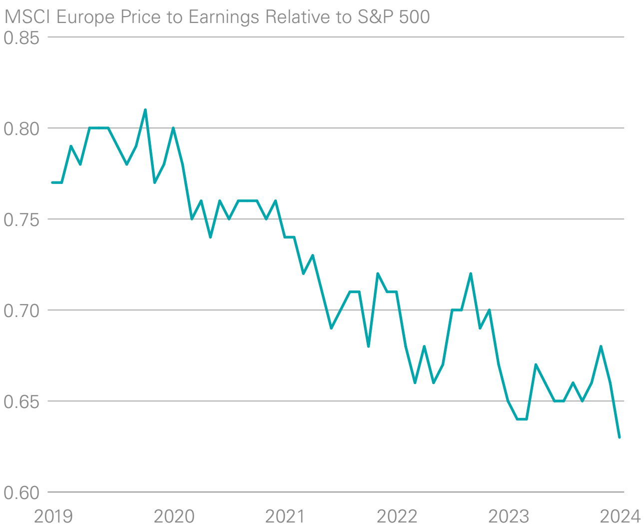
As at 30 September 2023
Source: Deutsche Bank

Valuation Attractions, Broader Performance

European stock market valuations remain attractive relative to their history and global markets, most obviously versus the US market (Exhibit 3). These modest valuations prevail even though European large-cap stocks have kept pace with US equities and outperformed other developed markets over the past three years (Exhibit 4).

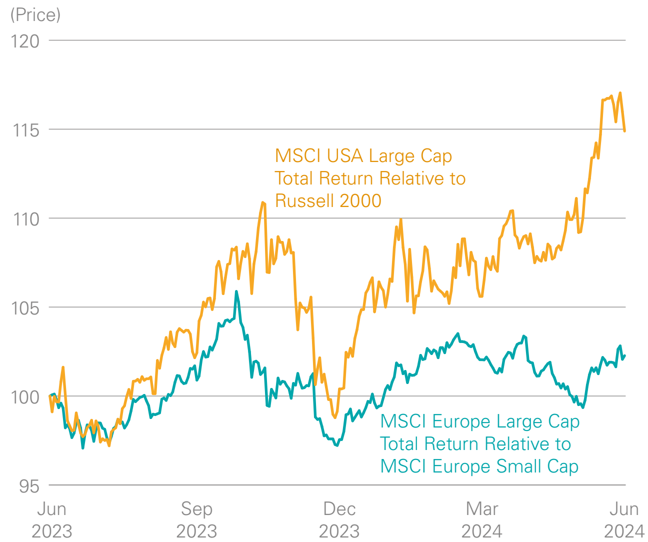
And in contrast to the narrow band of mega-cap growth names that have driven the US market higher in recent quarters, the rally in European stocks has broadened from mega caps and growth to include mid-caps and value (Exhibits 5 and 6).

Exhibit 3
European Stocks Remain Attractively Valued versus US Stocks



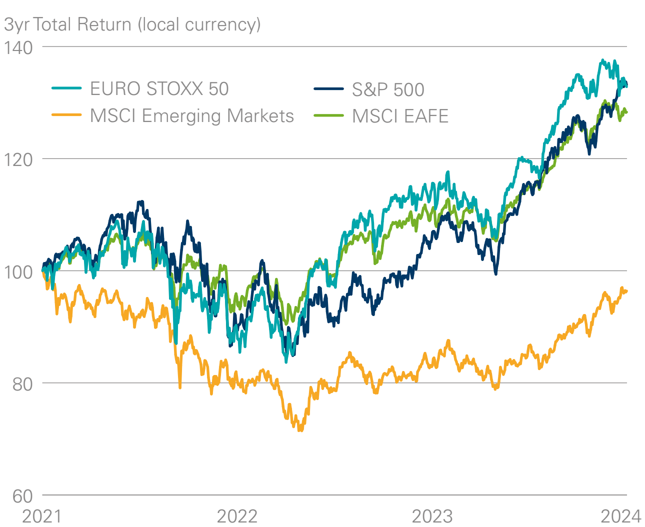
As at 30 June 2024
Source: FactSet

Exhibit 5
Small-Caps vs. Large-Cap Price Performance



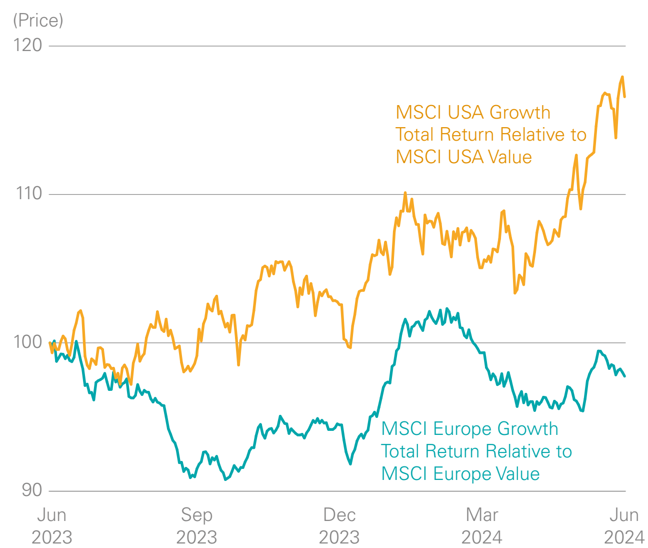
As at 30 June 2024
Source: FactSet

Exhibit 4
European Stock Markets Have Outperformed International Markets Over Three Years



As at 30 June 2024
Source: FactSet

Exhibit 6
Value vs. Growth Price Performance



As at 30 June 2024
Source: FactSet

The Big Payback

As European interest rates start to trend downwards, the yield attractions of European equities should hover into sharper relief. This is especially true on a relative basis, with the MSCI Europe Index yielding 3.5% versus the S&P 500 Index's 1.5% yield. We remain near Europe's highest-ever dividend yield premium compared to the US.

The increased use of buybacks by European management teams is also bolstering cash returns to investors. Nowhere is this more than apparent than in the banking sector, where Europe's mega-cap banks have aggressively been returning capital to shareholders.

In conjunction, these outsized dividends and buybacks are providing a powerful reason to own European shares. Combined with the potential for capital gains, this creates a potent alternative to cash.

Opportunities in AI, Industrials, and Banks

Finally, turning to specific opportunities, we are currently drawn to artificial intelligence (AI)-related plays, industrials, and banks.

Europe is often regarded as a relative backwater in AI. That may be true in terms of the numbers of pure-play AI firms versus the US, but the region is home to leaders in the semiconductor capital equipment industry, which should benefit from the AI boom.

In industrials, we find value in companies with sustainable cash flows and like their reliability in compounding returns over time. As for the banks, as touched on above, they are returning significant amounts of capital to shareholders without constraining their operations.

In summary, with the path of European and US rates diverging in Europe's favor, signs that economic activity has bottomed out and may now be beginning to climb, companies returning large amounts of capital to their shareholders through dividends and buybacks, and valuations remaining modest, we see enough reasons to believe European stock markets can continue to progress over the second half of 2024.

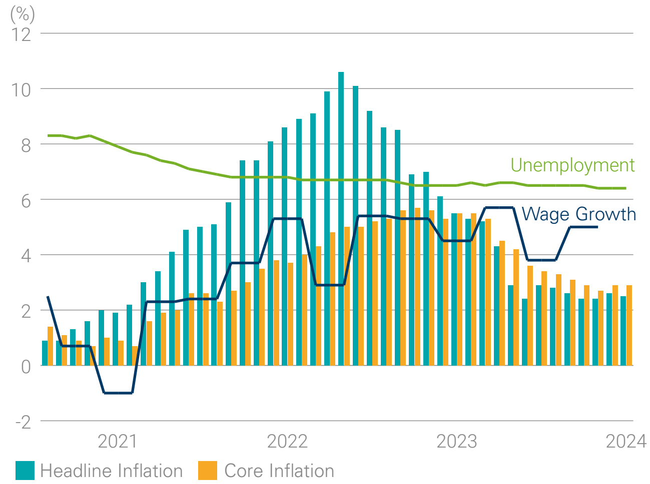
European Fixed Income

The second quarter was eventful on both macroeconomic and political fronts.

After a prolonged period of stagnation, the eurozone economy has experienced a recovery, recording 0.3% GDP growth in the first quarter. However, inflation, which edged up slightly in May (Exhibit 7) before easing to 2.5% in June (based on the flash number), presented an unwelcome surprise, while strong wage growth (above the inflation rate) stirred fears that increasing wage costs may eventually be passed on to consumers: are fresh inflationary pressures on the horizon?

Amid numerous uncertainties regarding a potential resurgence in inflation, the ECB's 25 bps rate cut in June was consistent with market expectations. However, the central bank also indicated that price pressures remain elevated. Its projections for both growth and inflation in the euro area have risen. As a result, the ECB will adhere to its data-dependent approach and is prepared to maintain a relatively restrictive policy stance, if necessary. Consequently, we believe there is a strong likelihood that the ECB will pause further interest rate cuts and wait cautiously to assess whether the disinflation trend continues. In our view, it would require a significant surprise in GDP and inflation data for the next interest rate cut to occur as early as mid-July.

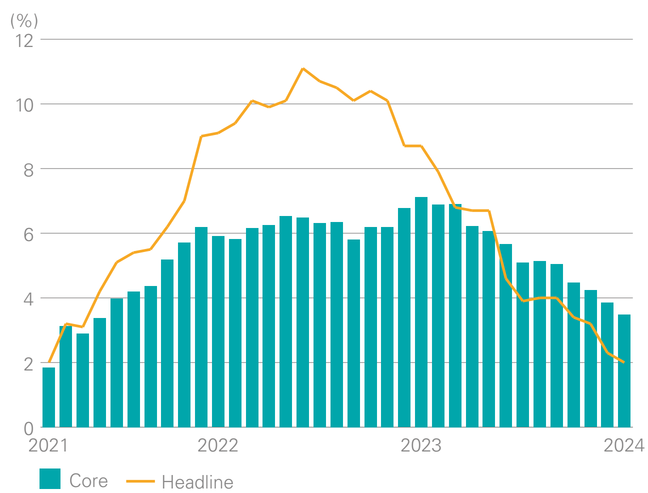
Exhibit 7
Eurozone Headline and Core Inflation, Unemployment Rate, and Wage Growth



As at 30 June 2024
Source: LSEG DataStream

This past quarter brought some positive news from the UK. The UK economy grew more robustly than expected in Q1, with a 0.7% increase in GDP, while the disinflation trend continues. However, core inflation remains uncomfortably high at 3.5%, (Exhibit 8) prompting the Bank of England (BoE) to diverge from the ECB by not cutting interest rates. We assume that UK core inflation will ease somewhat in the coming months, which may give the BoE room to cut interest rates now the general election has passed.

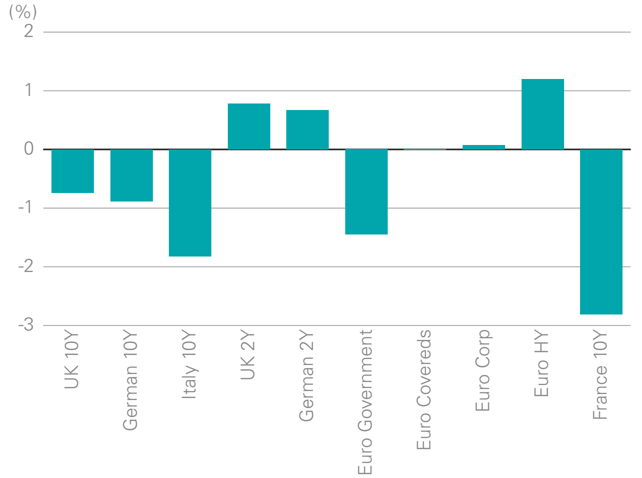
Exhibit 8
UK Headline and Core Inflation



As at 30 June 2024
Source: LSEG DataStream

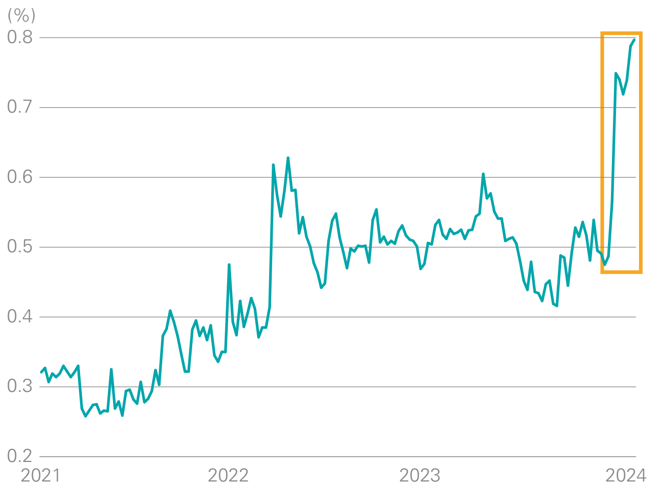
European government bond prices fell over the second quarter (Exhibit 9). While the disinflation trend in Europe is evident, strong wage growth has sparked concerns that inflation rates could rise again. Although some relief was provided by the ECB's rate cut, upward inflation and GDP projections from the central bank, coupled with the rightward shift in the European parliamentary elections and President Macron's surprise decision to call French parliamentary elections, put bonds under pressure. Government bond yields rose, particularly in France. Meanwhile, demand for perceived safe-haven debt grew, leading to a small drop in German Bund yields. The yield spread between France and German government debt widened significantly (Exhibit 10).

Exhibit 9
European Fixed Income Performance – Q2 2024



As at 30 June 2024
Source: LSEG DataStream

Exhibit 10
Spread between 10-Year French and German Government Bonds



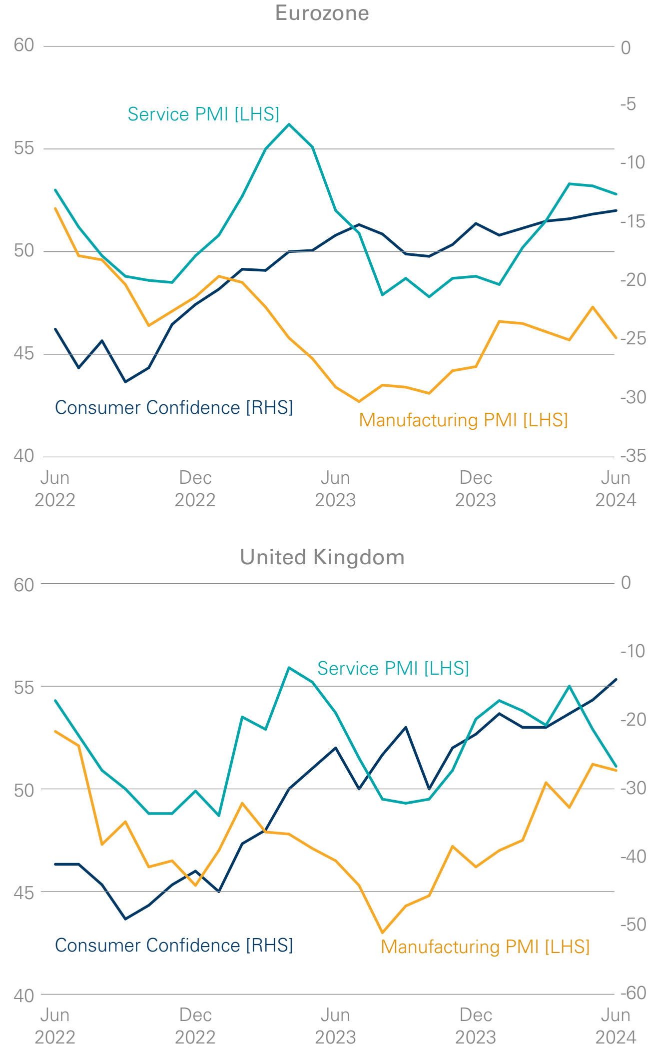
As at 30 June 2024
Source: LSEG DataStream

In the corporate bond sector, risk premia decreased over the course of the quarter. This was driven by the economic recovery in the eurozone, evidenced by improved sentiment indicators and modest GDP growth. Financial bonds performed particularly well, buoyed by a robust earnings season for the sector. However, the EU election results led to yield increases, especially for French financial bonds. European high-yield bonds weathered the EU parliamentary elections fallout well, ending the quarter on an upbeat note.

Looking ahead, we believe the outlook on Europe remains mixed.

On the positive side, economic momentum is picking up. Both the eurozone and the UK economies are growing again, with sentiment indicators also generally showing increasing optimism (Exhibit 11). Moreover, eurozone consumers have more money in their pockets due to growth in real wages. Consumer demand therefore remains solid and well supported.

Exhibit 11
Eurozone and UK Purchasing Managers' Index (PMI) and Consumer Confidence Surveys



As at 30 June 2024
Source: LSEG DataStream

On the negative side, the outcomes of various national elections, including the inconclusive French parliamentary elections, and fears of a further shift to the right pose significant concerns. In the US, a President Biden victory —now a lower probability after his stumbling performance in the first presidential debate—would almost certainly be better for the global economy and, by extension, Europe, given President Trump's stated intention to impose high tariffs on imports if he wins a second term. In addition, a Trump victory would pose a geopolitical risk—would he maintain America's support for Ukraine?

Uncertainty surrounding inflation adds to the mixed outlook. There are dual implications from high wage growth. On one hand, it boosts consumer confidence, but on the other, it may stoke inflationary pressure. In addition, commodity prices have also risen considerably, which could add to price pressures.

What does this mean for European fixed income? Our outlook on the European bond markets remains positive despite the risks from inflation and politics. High yields translate into an attractive carry (income) for investors. Meanwhile, improving economic data and continued solid corporate results suggest a recession seems unlikely.

Corporate bonds are among the beneficiaries of the brightening economic outlook. Risk premia should not rise if the economy improves further. Drilling down, we still believe Euro high yield looks a little expensive, on average, although select issuers and bonds offer value. Elsewhere, Nordic high yield offers considerable value and performance potential, in our opinion, based on strong fundamentals and higher spreads. We also like the European investment grade segment as we believe it offers adequate yield levels.

In conclusion, European fixed income could receive a boost from further interest rate cuts later this year. However, there is still a risk that inflation will return, which would create some turbulence. Nevertheless, the latter is not our base case scenario.

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Notes

1. Source: Calastone Fund Flow Index – 3 July 2024

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