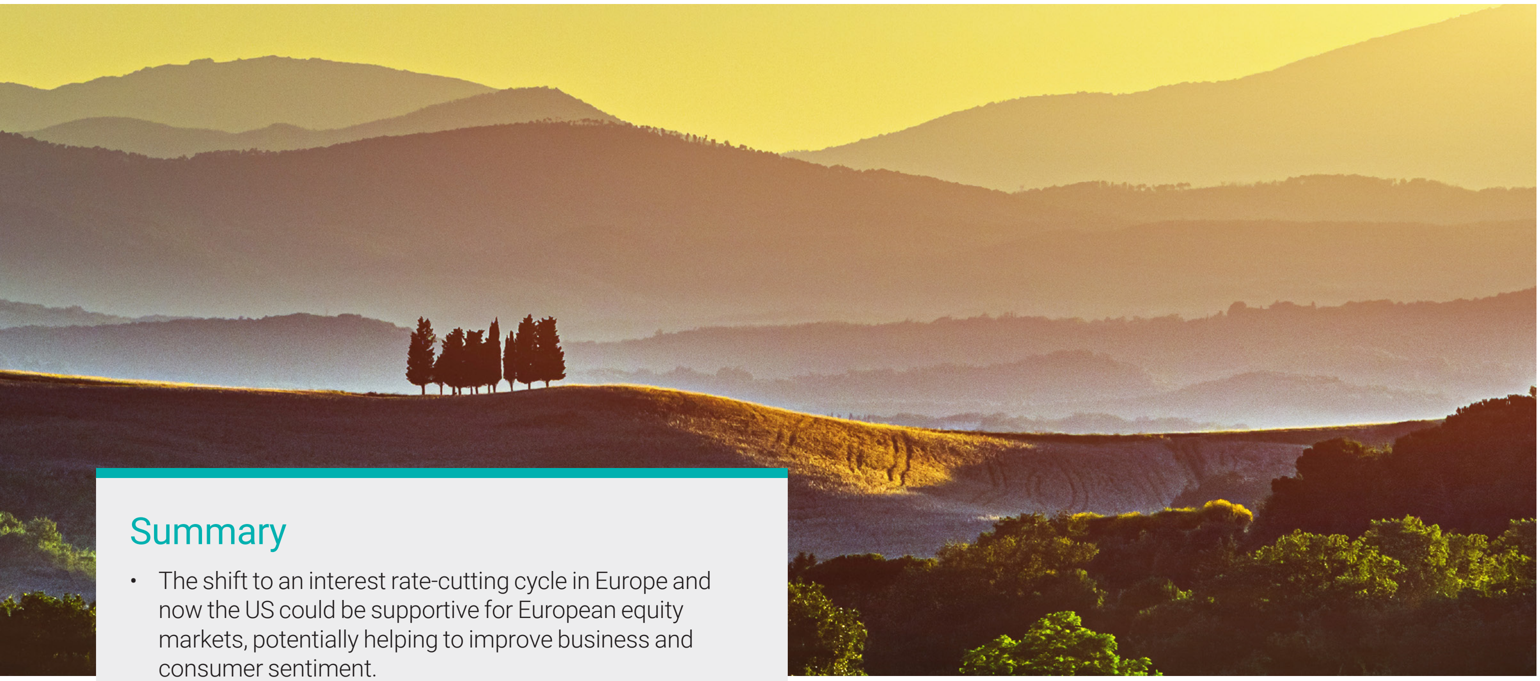
Outlook on

Europe

Oct 2024



Summary

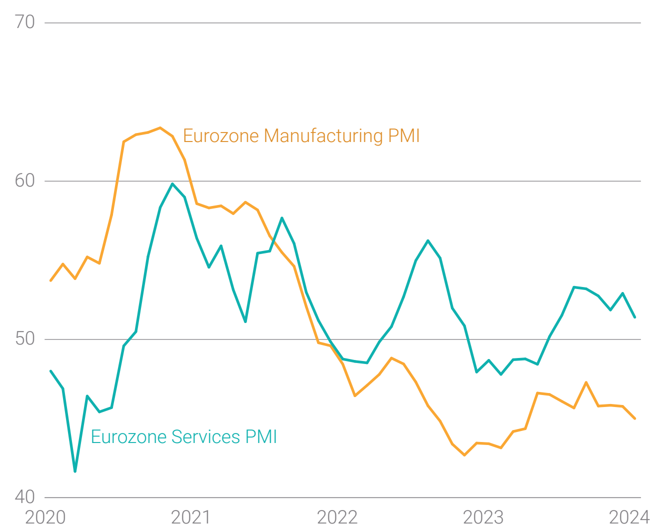
- The shift to an interest rate-cutting cycle in Europe and now the US could be supportive for European equity markets, potentially helping to improve business and consumer sentiment.
- Recent data paints a mixed picture for the European economy, with some signs of a slowdown in momentum and clear weakness in the German economy.
- With rates easing, our European Fixed Income team remains positive on the prospects for European bonds. The team has a preference for Nordic high yield debt, which it believes currently benefits from strong fundamentals and higher spreads.

European Equity

The European economy is in a new phase. The European Central Bank (ECB) is now two interest rate cuts into its current rate-easing cycle, while the annual eurozone inflation rate dipped beneath the central bank's 2% target in September. Europe has moved on from the inflationary and higher-rate environment of the past three years.

While the ECB now appears to be on a clear rate-cutting path, recent data paints a mixed economic picture for the region. The HCOB Eurozone Services Purchasing Managers Index (PMI) figure of 51.4 for September points to a sector still in expansion mode, albeit exhibiting some signs of fading momentum.[1] Meanwhile, the region's manufacturing sector continues to bump along the bottom: the HCOB Eurozone Manufacturing PMI recorded a 45.0 reading, its lowest level in 2024, caused in part by weakness in the German and French manufacturing industries (Exhibit 1).

Exhibit 1
Eurozone Manufacturing and Services Purchasing Manager Indices (PMI) Suggest a Slowdown

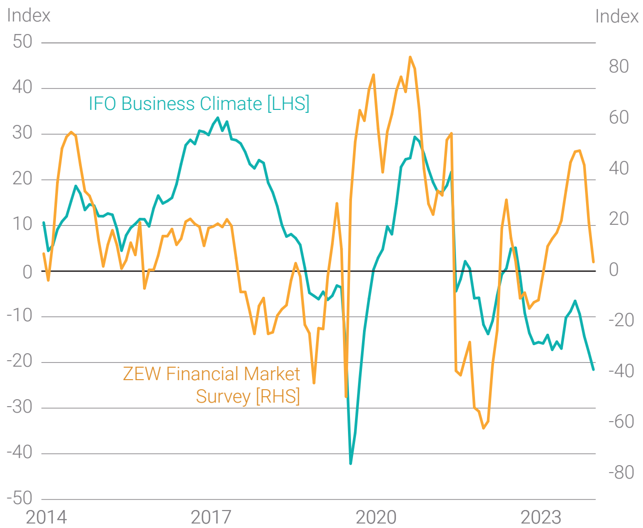


As at 30 September 2024
Source: FactSet

Teutonic Troubles

At the heart of Europe, the German economy is misfiring. Its current malaise is perhaps best symbolized by Volkswagen's announcement in September that it is considering shutting some of its German factories, which would be the first factory closures in the automaker's home market in its 87-year history. Falling business confidence measures suggest the German economy has misplaced its mojo (Exhibit 2). As an export nation, Germany is suffering from ongoing weak global demand, and certain core sectors of the economy are under pressure, including the autos industry. Restrictive fiscal policy and political uncertainty, largely caused by significant gains in state elections in eastern Germany by the far-right AfD party, have added to the headwinds facing Europe's largest economy.

Exhibit 2
German Business Sentiment and Economic Expectations Measures are Rolling Over



As at 30 September 2024
Source: FactSet

But the economic vista across Europe is not entirely gloomy. The annual eurozone inflation rate fell to 1.8% in September and is now below the ECB's 2% target, as noted above. In addition, eurozone consumer confidence has continued its slow but steady recovery since the summer of 2022; GDP growth remains positive, if subdued, at 0.2% quarter-on-quarter for Q2 2024; and the euro area's unemployment rate has ticked down to 6.4%, its lowest ever level.

A Supportive Rate Environment

A mixed economic picture seemingly prevails. However, even if the eurozone economy is only spinning its wheels at present, we believe equity investors can draw some comfort from the recent shift in the interest rate environment.

The ECB made its second cut of this interest rate cycle in September, from 3.75% to 3.50%, and indicated rates are on a "declining path." Coupled with the Federal Reserve's aggressive 50 basis points (bps) cut in US interest rates in September, we believe looser monetary policy could serve as a tailwind for European equity prices over the near term, especially since European companies and consumers are generally more rate-sensitive than many of their global counterparts. The ECB's cuts should have a quicker influence on economic activity than those of the Fed, even if the positive effects will not be felt immediately, given the lagging nature of outcomes from monetary policy changes.

As noted in last quarter's outlook, this latest rate-cutting cycle kicked off in a historically unusual fashion in that the ECB reduced rates before the Fed—we would argue it has been more ahead of the curve than the US central bank on monetary policy. But the ECB moving first has not been the only historical anomaly of late. Normally stock markets perform poorly when confronted with flagging economic activity, which typically coincides with interest rate cuts. This time around European equities have remained resilient and have avoided hitting any air pockets, even as the eurozone economy has showed some signs of stalling and the ECB has been cutting rates.

Looking ahead, the backdrop of falling rates could prove to be a good base for European equity markets to build upon in 2025. In particular a falling cost of capital could provide support for certain cyclical parts of the market, such as chemicals and commodity producers, where we believe valuations have become overly discounted versus the long-term potential of these businesses.

Turning to recent corporate results, earnings have reflected the slowdown in the region. Some defensive sectors, such as consumer staples and utilities, have held up well amid easing economic momentum, while the more cyclical consumer services, autos and commodities sectors have experienced earnings downgrades.

Strategic Spin-offs

Another recent noteworthy market development has been companies divesting non-core assets. French pharmaceutical group Sanofi is reportedly considering bids from private equity firms for its consumer healthcare business and contemplating spinning off the unit if it cannot conclude a deal at a satisfactory valuation.[2] Elsewhere, European companies across the autos, chemicals, and household and personal care products sectors have also expressed a desire to dispose of or spin off peripheral corporate assets. Alongside high levels of share buybacks, we believe these strategic decisions reflect more shareholder-friendly behavior by European corporates and a greater focus on capital allocation by management teams.

Energy Concerns are More Muted

As winter looms large in the northern hemisphere, energy prices inevitably assume a greater significance for the European economy, especially after being buffeted by higher gas prices following the outbreak of the Russia-Ukraine war in February 2022. Two-and-a-half years on, however, natural gas supplies are running at elevated levels while structural demand is lower—European companies reacted to soaring energy prices early in the conflict by making their operations more energy-efficient. A severe winter in Europe that rapidly drains gas reserves would weigh on the region's economy. However, the potential for disruption to energy supplies currently seems low, and worries over soaring input costs have faded, helped in part by an oversupplied oil market. On the latter point, the growing unrest in the Middle East at the time of writing may yet change the dynamics of the oil market, where prices fell below US$70 per barrel in September, their lowest level since December 2021.

Currency Matters

Lastly, given the fortunes of Europe's larger listed companies are more affected by foreign earnings than domestic profits, and with the Fed beginning its rate-cutting cycle with an outsized 50 bps trim, investors may need to keep an eye on the currency markets. This includes watching for any extension of this summer's weakness in the US dollar. The euro/dollar rate is currently near the top end of its short-term range. Further depreciation in the dollar versus the euro could have meaningful negative translation effects for many large European companies.

In conclusion, in a murky outlook, we discern some signs that the European economy is beginning to stutter again after its positive momentum earlier this year. Nonetheless, we believe the dangers to the region's equity markets should not be overstated. Central banks, led for once by the ECB, are getting on the front foot with looser monetary policy. Furthermore, valuations for European stocks remain modest versus their history and their international peers, while companies are engaging in more shareholder-friendly behavior, from spin-offs and share buybacks to healthy dividend payments. For these reasons, we believe European equities continue to offer attractive investment opportunities.

European Fixed Income

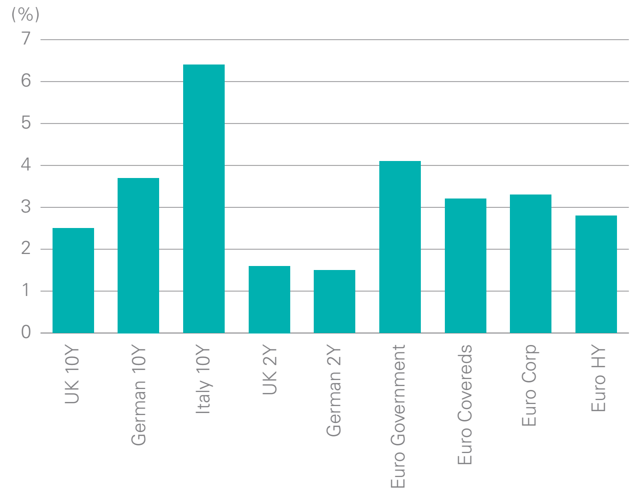
The macro environment was favorable for European fixed income over the third quarter (Exhibit 3). European government bond yields fell during the period due to ongoing disinflation and rate cuts. As yields at the short end of the curve have dropped significantly more than at the long end, sovereign yield curves are almost flat again, at least when looking at the 2-year and 10-year maturities. In Germany, the spread between 2-year and 10-year Bunds was above zero for the first time since November 2022.

The fact that the ECB's easing of monetary policy is seemingly not being driven by the need to protect the European economy from an impending recession was also constructive for corporate bonds. (Exhibit 4). Company balance sheets largely remain solid, in our opinion, and most quarterly results have not shown any signs of weakness.

Even if a eurozone recession cannot be completely ruled out, we see no signs that one is imminent, in part because of consumer strength. A combination of low inflation and rising real wages should underpin consumer confidence.

Turning to the UK, despite other positive indicators (encouraging PMI survey readings and solid GDP growth), consumer confidence has rolled over recently. We believe the Bank of England will slowly but steadily continue to relax monetary conditions over the rest of the year, which should help to stimulate consumption.

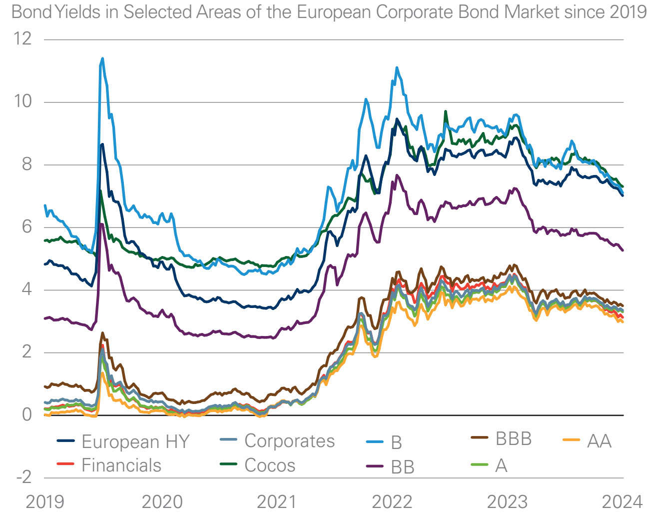
Exhibit 3
Q3 2024 European Fixed Income Performance



As at 30 September 2024
Source: LSEG Datastream

Exhibit 4
European Corporate Bond Yields are Falling but Remain Elevated

Bond Yields in Selected Areas of the European Corporate Bond Market since 2019



As at 30 September 2024
Source: LSEG Datastream

Slow and Steady

With a eurozone recession in the near term being unlikely, in our view, and the ECB wishing to keep its options open and ensure inflation is under control, we believe eurozone interest rates will also only fall slowly over time.

Lower rates should have a stimulative effect on the economy, albeit probably with a lag of a couple of months. Although we do not anticipate significant growth for the eurozone, we believe it should be solid. The IMF estimates the eurozone economy will expand by 0.9% in 2024 and 1.5% in 2025, which we regard as credible.

On the negative side, the outcome of various elections globally and fears of a further shift to the far-right pose concerns. A resurgence of inflation cannot be ruled out either, whether due to wage pressures or structural factors, such as worsening demographics and climate change costs.

Nordic Appeal

Despite the forementioned risks, our outlook on the European bond markets, both investment grade and high yield, remains positive. We believe corporate bonds should be beneficiaries of a robust, if unspectacular, short-term economic performance by Europe, as risk premia will not rise should economic momentum be sustained.

In general, Euro high yield continues to look a little overvalued, in our opinion, although we believe selected issuers and bonds still offer good value: active management will be key. We consider Nordic bonds to be an interesting niche. In our view, they currently offer considerable value and performance potential, based on their strong fundamentals and higher spreads.

In summary, there remains a risk that inflation will return. Although this is not our base case scenario, this would likely create volatility in bond prices. More positively, we believe the European fixed income asset class should be boosted by further interest rate cuts to come.

This content represents the views of the author(s), and its conclusions may vary from those held elsewhere within Lazard Asset Management. Lazard is committed to giving our investment professionals the autonomy to develop their own investment views, which are informed by a robust exchange of ideas throughout the firm.

Notes

1 Source for economic data is FactSet unless otherwise stated. Data as of 3 October 2024.

2 https://www.reuters.com/business/healthcare-pharmaceuticals/sanofi-gets-two-bids-valuing-its-consumer-health-unit-about-17-billion-bloomberg-2024-09-24/

Important Information

Published on 14 October 2024.