Asset Class Update: Europe Stocks

Assessment as of: 3/31/2023

Analysts: Jeremy DeGroot, CFA and Kiko Vallarta, CFA

Current View:
Neutral

Change Since Prior:
Neutral

Executive Summary

European equities led the way with a gain of 10.6% in the first quarter. Of the major equity indexes, this was the best return. Europe has been helped by stronger than expected fundamentals and an economy that has been surprisingly resilient to most observers in the face of the Russia-Ukraine war. At the onset of the war, the narrative was certain the European bloc would enter a recession amid soaring energy/commodity prices. So far, Europe has delayed economic calamity and instead posted revenue and earnings growth.

In our base case, we believe European equities are likely to generate mid-single-digit to low double-digit returns annualized returns over our tactical five-year horizon. Like other global markets, Europe faces shorter-term recession risks stemming from tightening central bank policy. While the worst fears from the war have not materialized, it does not mean they have gone away.

Asset Class Returns

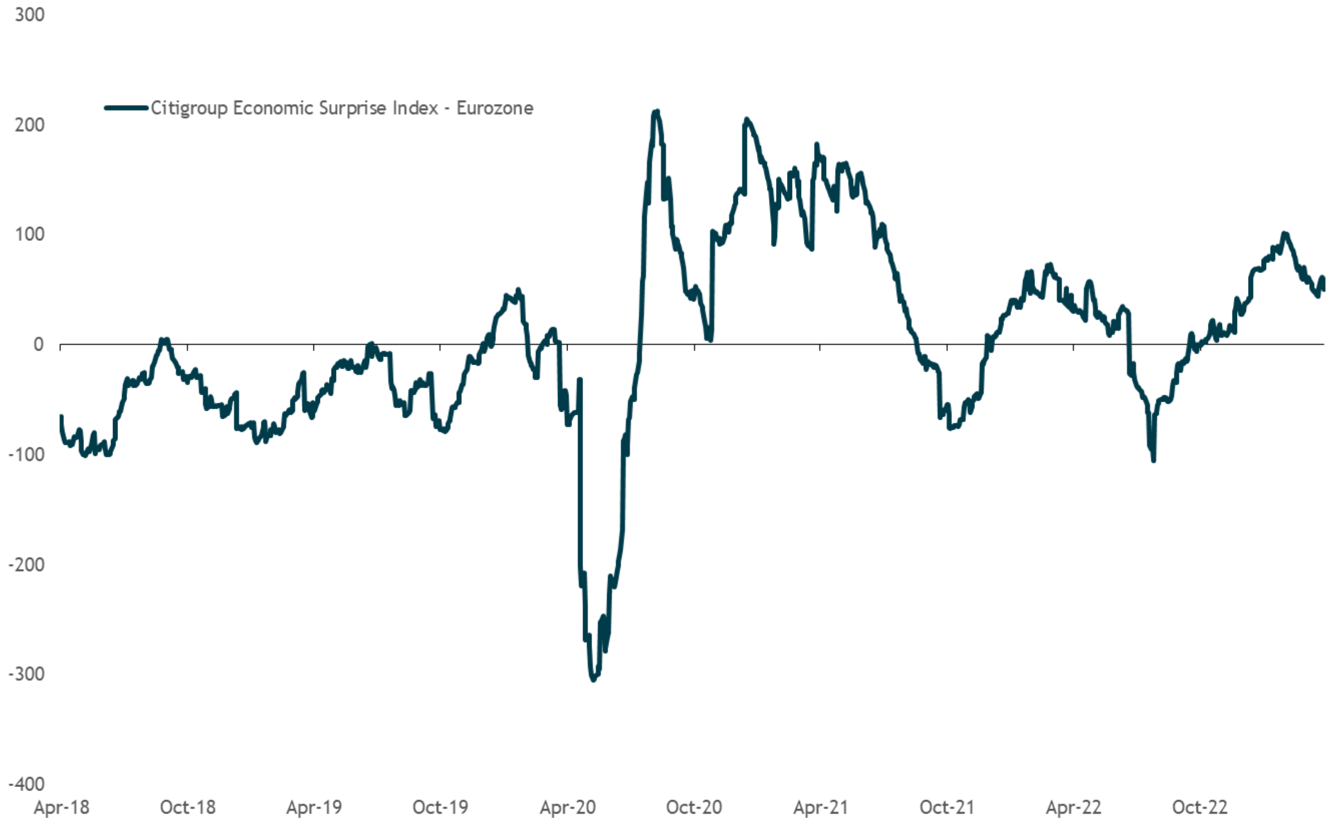
	QTD	YTD	One-Year	Three-Year	Five-Year	10-Year
MSCI EAFE Index	8.47%	8.47%	-1.38%	12.99%	3.52%	5.00%
MSCI World ex USA Index	8.02%	8.02%	-2.74%	13.49%	3.80%	4.91%
MSCI Europe Index	10.56%	10.56%	1.38%	15.00%	4.35%	5.36%

Source: Morningstar Direct. As of 3/31/23.

In the first quarter, the MSCI Europe Index gained 10.6%. A weaker US dollar was a tailwind during the quarter. The euro/USD rate finished the quarter at 1.09—seeing the euro rally over 2% to start the year. The local currency version of the index still outpaced US stocks (up 8.6% versus 7.5% for the S&P 500). The weaker US dollar helped unhedged investors by about two percentage points.

Better than expected economic data tempered the idea that a recession was imminent in 2022. The Eurozone's economic surprise index has been in positive territory since early in the fourth quarter of 2022. Shortly after the onset of the war, market expectations were worrisome but since last summer, the European economy has been resilient and has defied expectations. By early February of this year, Citi's economic surprise index reached its highest level since July 2021.

Europe's Economic Data Hasn't Been as Bad as Expected



Source: Bloomberg LP. Data as of 3/31/2023.

Update

Return Estimates:

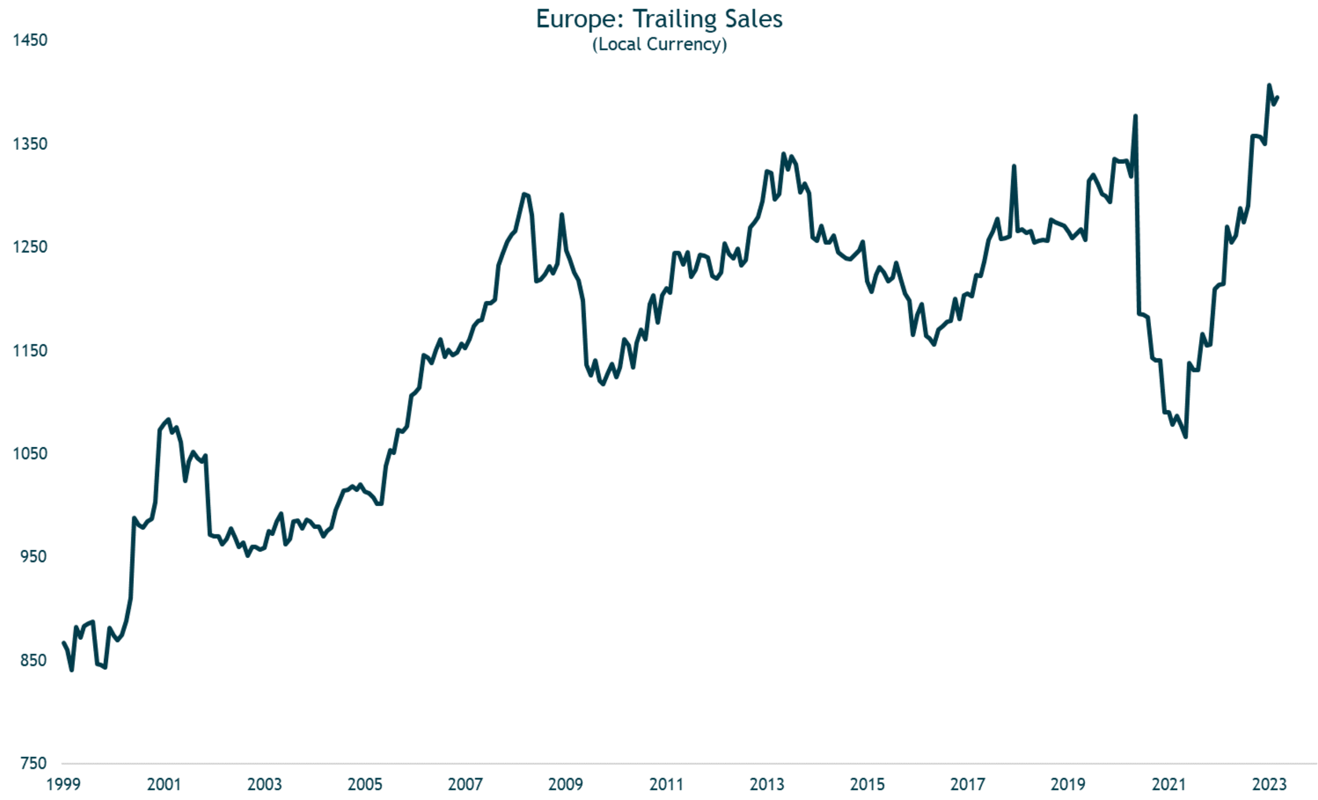
Updated Five-Year Expected Returns for European Stocks					
	Current Level	Downside/Bear	Base Case Lower	Base Case Upper	Upside Bull
European Stocks	1723 LCL	-4.0%	4.2%	11.4%	18.5%

Estimated returns are annualized and generated by iMGPFM. This table shows our five-year, annualized asset class return estimates across several broad macroeconomic scenarios we believe are possible. Collectively, the scenarios encompass the range of outcomes we believe are reasonably possible and therefore worth considering in creating our portfolio allocations. We make assumptions for various fundamental and valuation metrics we believe are consistent for each asset class within each macro scenario then incorporate current prices to generate an estimated return. The macroeconomic scenarios and estimated returns can change. When this happens, we will clearly note it and give guidance on new estimates. See disclosure for more information on macro scenarios and fundamental/valuation metrics used in the analysis. S&P 500 Index at 4109. MSCI Europe Index at 1861. MSCI EM Index at 59416, Bloomberg Aggregate yield at 4.40%, BofA ML High Yield Cash Pay Index at 8.2%. Data as of 3/31/2023.

The three tactical assumptions we updated for European stocks are: (1) Five-Year Sales Growth Rate, (2) Net Profit Margin, and (3) Valuation (P/E) Multiple.

Based on historical data and our forward-looking judgement in the context of our five-year base case macro scenario (moderate global growth, moderate inflation, moderate interest rates) we arrived at the following Base Case assumptions for our European equity expected-returns model:

Five-Year Sales Growth Rate: 4%
Sales growth has been strong over the past year—increasing roughly 10%. Topline growth has been stagnant throughout much of the 2010s as the European continent was mired with low inflation and wave after wave of issues. High nominal inflation in Europe has certainly helped nominal revenues. We don't believe double-digit revenue growth will be the year-over-year norm for the foreseeable future, however, slightly higher inflation should provide a boost to revenue growth.



Source: Bloomberg, iM Global Partner. Sales figure in local currency.Data as of 3/31/2023.

Profit Margin: 8%
Profit margins in Europe remain above long-term averages. In fact, margins have yet to collapse in Europe in the same way they have in the US. Instead, profit margins have stabilized in the 10% range. Much like in the US, there is certainly a risk to profitability should wage and other input costs continue to pressure margins—assuming there aren't equivalent increases in prices. Wage growth has picked up in Europe—going from around 2% (and actually sub-2% in the euro area) pre-pandemic to the 5-6% range over the last year.

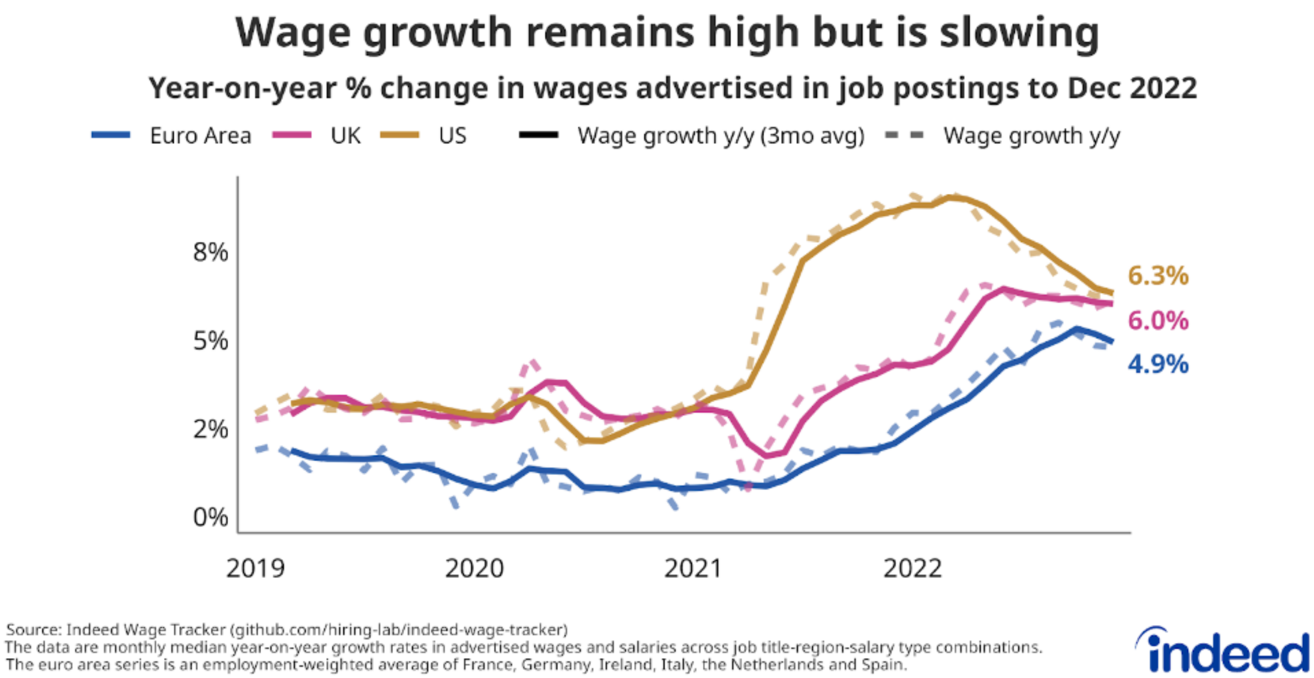
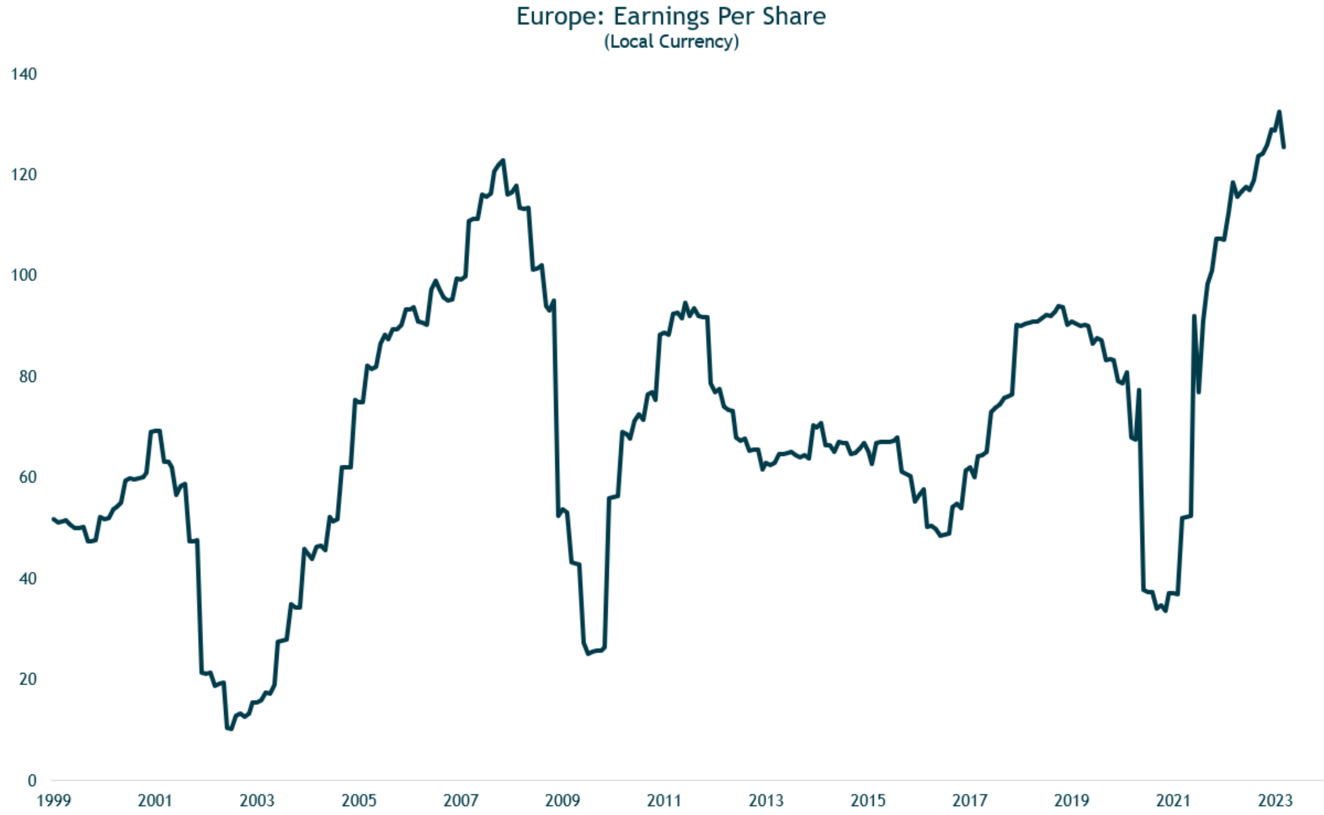


Chart published December 8, 2022

Falling profitability in Europe was not the driving factor behind their fundamental underperformance over the past decade. While profit margins did not break out higher as they did in the US, European companies remained profitable. Earnings were lackluster largely due to a lack of sales growth, as shown above.



Source: Bloomberg, iM Global Partner. Data as of 3/31/2023.

With profit margins historically high in Europe, either (1) strong sales growth and a moderate fall in profit margins or (2) moderate sales growth and steady profit margins are needed to keep earnings positive from current levels. So far the latter has been taking place. Our current base case assumptions of 4% sales growth and an 8% profit margin imply flat earnings growth over the next five years. The compression of margins that are currently two percentage points above average has a significant impact on earnings.

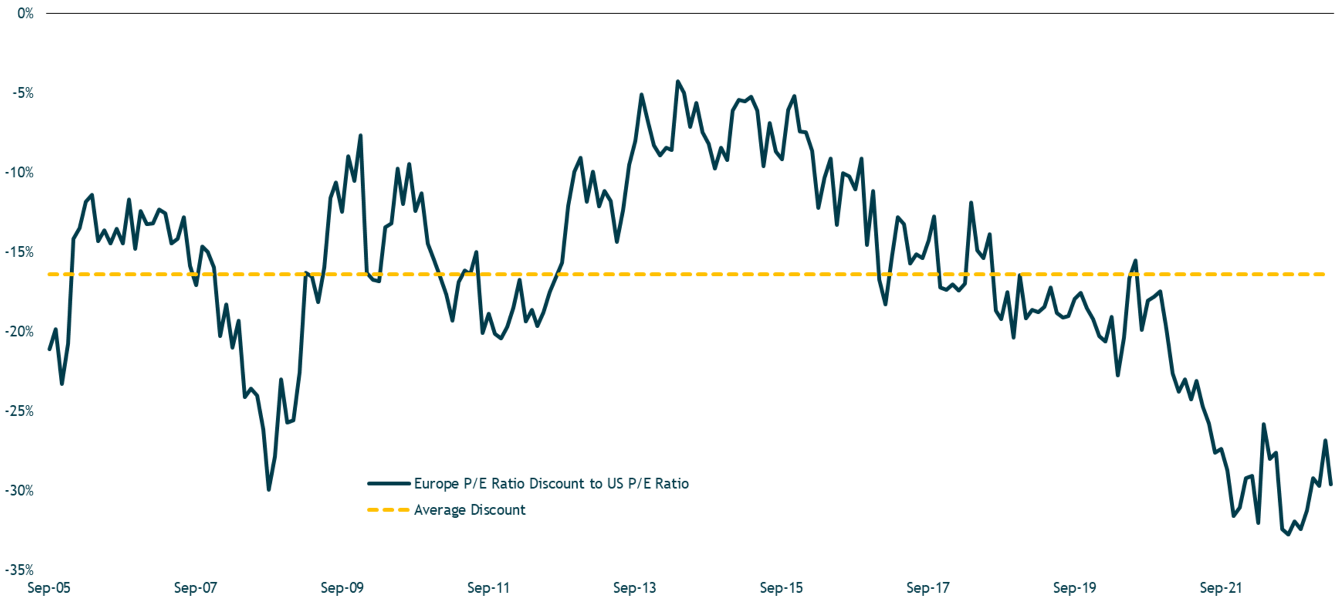
P/E Valuation Multiple: 17x

Based on NDR data, the 50-plus year average Europe P/E multiple is a little more 15x. Looking at both the post-1980s and post-2000s periods, the average P/E multiple has been higher than the full history average. This leads us to believe that 17x is fair multiple.

Our Europe base case P/E assumption of 17x is a 23% discount to the Upper Base P/E ratio of 22x for US equities and an 11% discount to the 19x in the US Lower Base case. It implies roughly a 17% discount to the midpoint of the two P/E multiples in the US base scenarios.

The chart below shows Europe's P/E discount to the US P/E multiple since 2005. Europe's valuation discount to the US is currently historically wide at over 30%.

European Equities Trade at a Historically Wide Discount to US Equities



Source: Bloomberg LP, iM Global Partner. Data as of 3/31/2023.

Putting together 4% revenue growth with 8% margins results in very modest earnings growth over the next five-years (again, due to margin compression of about two percentage points). However, assuming the current trailing P/E multiple expands from 14.8x to 17x adds to forecasted returns. On top of possible multiple expansion, European equities pay a much higher dividend yield than most global markets. The current dividend yield is over 3%, which is approximately the region's long-term average. In such a scenario, the estimated five-year return for European equities is 7.9% annualized.

Key Factors in Our Assessment

We are estimating what the normalized earnings power of a broad basket of European stocks likely is looking over five or so years and what is a reasonable multiple to pay for it, given the asset's quality, consistency and growth prospects. We learn from history where and when we believe it has relevance. The assessment of normalized earnings power of an asset and what is a fair multiple to pay is a function of both quantitative and qualitative analyses, such as current fiscal and monetary conditions, where we are in the business cycle, unemployment levels, debt levels, trade and fiscal deficits, demographics, currency, bond yields, flows for both stocks and bonds, market sentiment etc.

As part of assessing the normalized earnings power we utilize insights from our conversations with expert stock pickers. We assess how the drivers of profitability might be changing versus history and what it may mean for profits looking out five years and beyond. We try not to fall into the false-precision trap of relying on one expected-return number, knowing markets are multivariate and nearly impossible to quantify in one number, especially with equities which inherently have a wide range of outcomes. We focus on the long term because that's how we believe we can more consistently add value. We believe markets are largely efficient in pricing news and events but are susceptible to overreacting, on both the upside and downside. As long-term investors, we can add value by keeping a very high bar before deviating from our strategic allocations, which are based upon a 10-plus-year view, weighing both longer-term risks and opportunities.

Our European equity assumptions are based on local currency earnings in order to remove the impact of currency translation effects. Historically, when Europe's currency has been extremely cheap (such as in the early 2000s), Europe has outperformed US equities in dollar terms over subsequent years (after factoring in the currency translation effects). We think currencies are extremely difficult to value with confidence, and they can be out of sync with longer-term valuation metrics such as purchasing-power parity (PPP) for very long periods, so they lend significant uncertainty to our analysis. At present, both the euro and pound appear to be undervalued versus the US dollar, and we expect dollar depreciation versus developed market currencies to add some additional return for US dollar-based (unhedged) investors.

Jeremy DeGroot, CFA®

Managing Director – CIO Asset Management US

Kiko Vallarta, CFA®

SVP - Portfolio Management, Co-Head Equity Strategies

Estimated Returns Disclosure

Scenario Definitions:

Downside*: The economy falls into a deep recession for any of various reasons, such as deleveraging/deflation, unexpected systemic shock, geopolitical conflict, Fed or fiscal policy error, etc. At the end of our five-year tactical horizon, S&P 500 earnings are below their normalized trend and valuation multiples are below-average reflecting investor risk aversion. Inflation, 10-year Treasury nominal and real yields are below the Fed's long-term targets.*

Base*: Consistent with long-term economic and market history, reflecting economic and earnings growth cycles that are interspersed with recessions around an upward sloping normalized growth trendline. Inflation is moderately higher than the Fed's 2% target level (i.e., around 3%) and 10-year Treasury real yields are slightly positive. For equity markets, we bookend our Base Case with Lower-end and Upper-end estimates:*

- *In our Base Lower scenario, we assume nominal economic growth is higher than the average due to moderately higher inflation. We assume some additional profit margin compression and moderately lower valuations compared to the Base Upper scenario.*
- *In our Base Upper scenario, we assume nominal economic growth is higher than average due to both moderately higher inflation and strong real growth. As such, we assume S&P 500 profit margins remain elevated (although below their all-time highs) and valuation multiples are also elevated versus historical averages.*

Upside: This is the "Goldilocks" scenario for stocks. S&P 500 earnings end the period well above their Base Case trendline, driven by both higher sales growth and high profit margins. Valuation multiples are well above average and higher than the Base Upper assumption. Inflation is under control, around or slightly higher than the Fed's 2% long-term target. The fed funds rate is around the Fed's estimate of "neutral," the yield curve is positively sloped, and 10-year Treasury real yields are modestly positive.

What the Table Shows: Our five-year, annualized asset class return estimates under several broad economic scenarios. Collectively, the scenarios we use encompass the range of outcomes we believe are reasonably possible and therefore worth considering in creating our portfolio allocations.

Why We Use Scenarios: Considering how each asset class might react under a consistent set of scenarios allows us to calibrate our return expectations across asset classes. We believe this helps us make better asset allocation decisions.

These Scenarios Can Change: As the overall economic environment changes it will at some point necessitate changes to the scenarios we consider. Therefore, there could be times when we are reassessing scenarios and temporarily suspend providing updates for one or more scenarios. When this happens, we will clearly note it and give guidance on when we expect to complete this process.

Any projections provided regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. Investing involves risk, including the potential loss of principal, and investors should be guided accordingly.