Key Questions

Is the Bounce in European Equities Believable?

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Recent outperformance is causing some to ask if the momentum is sustainable.

Over the past several years, European stocks have trailed their US brethren by a considerable margin. This underperformance trend extended into 2020: European equities lagged US equities by a full ten percentage points from the beginning of the year through mid-May.
In the last six weeks, however, European stocks have jumped ahead of US shares. While not wholly closing the YTD gap, their recent outperformance has prompted some to wonder if the bounce is believable.

Since the end of the last recession (March 2009), European stocks have lagged US equities by a staggering 80%, underperforming in nine of the previous twelve calendar years. During this time, US GDP growth has only marginally exceeded growth in Europe (+3% vs. +2%, annualized). What has fueled the substantial outperformance of US stocks?

Sector differences -– the composition of the major market indexes -– are one reason. Cyclical sectors such as Financials and Industrials have historically held larger weights within European equity indexes. In contrast, growth sectors such as Healthcare and Technology have been featured more prominently within US equity indexes. And in the low growth/low interest rate environment of the past ten-plus years, growth stocks have considerably outshone their value counterparts.

But sectoral differences only tell part of the story. The more significant driver of US outperformance stems from the superior profit growth posted by US companies. Relative to the prior economic peak in 2007, earnings are 86% higher in the US but only 3% higher in Europe.

Not only have US companies generated faster earnings growth, but they have also produced bigger profit margins. For example, net income margins amongst US tech firms equate to 18%, whereas European tech companies post, on average, net margins of roughly 10%.

This vast difference in margins may be explained by higher regulation levels that have undermined European profitability and served as severe structural headwinds. These and other challenges may endure and continue to put European equities at a disadvantage.

That said, we don't believe that the outperformance enjoyed by US equities in the last decade will be as wide in the decade ahead. And sector composition will likely be a factor once again.

The aforementioned growth sectors have grown in prominence within European market indexes, and company-specific opportunities have increased. For instance, European companies are gaining increased recognition for their commitment to sustainability and ESG (environmental, social, and governance) efforts, areas that are attracting new investors and in which Europe is outpacing the US.

While we had been concerned with a lack of cohesion among various EU countries, particularly as they faced pressures caused by the spread of COVID-19, greater coordination and public discussions involving tighter fiscal integration suggests our concerns may have been misplaced. The European Central Bank (ECB) is responding forcefully to address the economic fallout and several key individual member states are openly endorsing financial support between countries in a material way. A more cohesive European Union may produce benefits to owners of European equities.

Such coordination is also apparently yielding broader benefits as evidenced by the decline in new COVID-19 cases throughout much of developed Europe. In contrast, inconsistent guidelines applied from state to state and even county to county in the US have seemingly resulted in contrasting outcomes: COVID cases in the Northeast are falling at the same time that they are rising in the South and in the West.

Looking ahead, based on the outcome of the US presidential election, pro-growth policies (i.e., tax cuts) in the US could be reversed, and both political parties seem intent on reigning in "Big Tech," a risk we profiled a year ago (see Key Questions, June 17, 2019: Who is Makan Delrahim?). And while the bark will likely be larger than the actual bite, operating costs may be on the rise for some US tech firms at the same time that taxes are increased, thereby denting US companies' profit margins.

Moreover, by limiting one's portfolio to US equities, investors stand to potentially miss out on a considerable number of opportunities. Earlier this month, we hosted a conversation with the co-CIO of a leading money manager. (Contact your advisor for a replay of the recording.) During his remarks, he pointed out an interesting statistic: US stocks represent nearly 60% of the market value of the global equity market, yet the US only represents one-fifth of the world's economic output and makes up less than 5% of the world's population. This suggests that the price of US equities might be a bit extended relative to the rest of the world.

Mean reversion is not assured, however. Further, for European stocks to generate sustained outperformance, three conditions are needed in our view: higher interest rates spurred by higher global economic growth, continued evidence that political risks are on the decline, and that value/cyclical stocks will inflect higher.

At the moment, while these variables are showing signs of promise, they are far from robust. Thus, we are maintaining a slight underweight to European equities, although we intend to remain attentive to these trends and others. For while our asset allocation models continue to favor domestic shares, we believe the outperformance that they enjoyed over the past decade may be less pronounced going forward. Hence, we believe that non-US equities deserve a role within a diversified portfolio.

For more information, please contact your Key Private Bank Advisor.

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