Investment Insights

Europe: reasons for optimism… and caution

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Europe: reasons for optimism…and caution

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Key takeaways

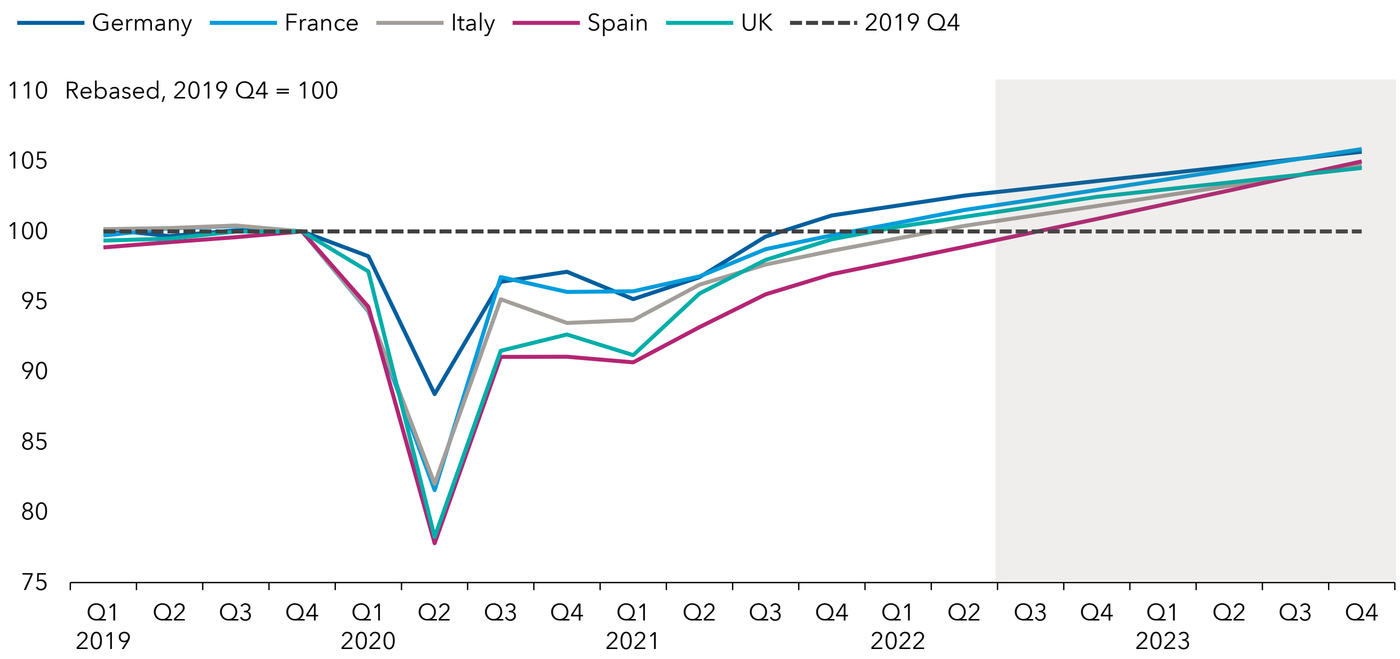
- The economic recovery in Europe is well under way, and equities have recorded strong gains for the year to date.
- However, we may see slower growth ahead.
- Despite the uncertainties that persist, select companies may hold attraction.

In this paper, investment director Martyn Hole explains why the backdrop for Europe looks increasingly positive, but there are risks that warrant caution. He also shares his view on which sectors have the potential to benefit from this environment.

Europe has bounced back so far this year

The European economic recovery is well under way: gross domestic product (GDP) growth in Europe's major economies was stronger than expected over Q2, notably in Italy and Spain. As European economies are opening up, services activity has recovered sharply, boosted by mobility restrictions easing. This is particularly important for economies such as Spain and Italy that are reliant on the tourism/hospitality industry. Manufacturing activity also continues to expand, powering recovery in the eurozone. Capital Group economist Robert Lind believes Europe's major economies could regain their pre-pandemic GDP levels earlier than expected.

GDP forecasts for Europe's major economies[1]



For illustrative purposes only

With governments protecting household incomes and consumers unable to maintain their usual levels of consumption, saving rates have jumped. This could trigger a release of pent-up consumer demand, benefitting many companies. We are starting to see early evidence of this with retail sales and consumer confidence becoming more buoyant.

Amid the greater optimism about an economic recovery coupled with strong corporate earnings, European equities have recorded strong gains so far in 2021. The MSCI Europe Index has delivered seven straight months of positive returns, rising nearly 20%[2] in euro terms for the year to date.

Past results are not a guarantee of future results.

The M&A market in Europe is buoyant

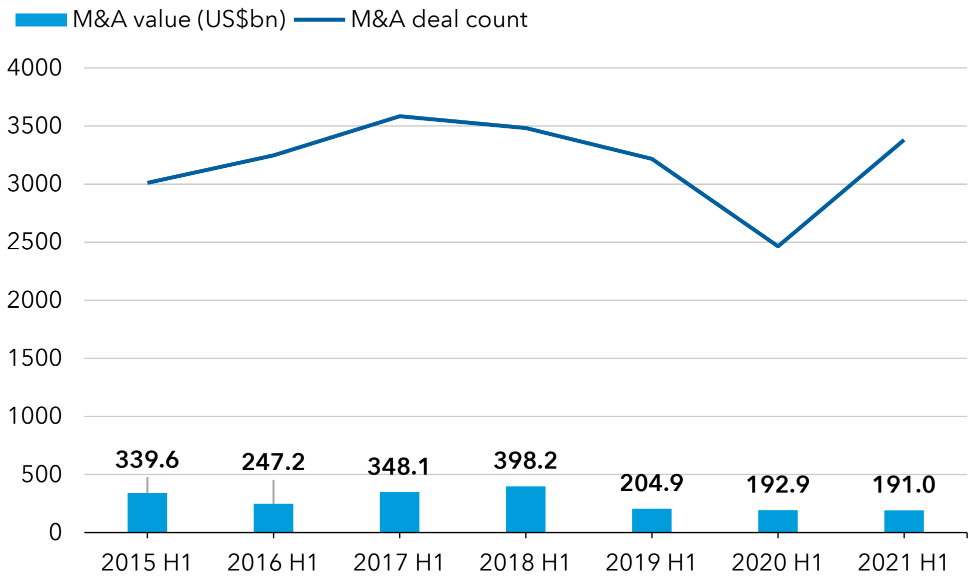
M&A activity has always been affected by global trends and as such, the early days of the COVID-19 pandemic had a considerable impact on the M&A market, driving the number of deals down. Prior to this, European dealmakers were navigating the uncertainty around the UK's withdrawal from the European Union, causing the M&A market to slow in 2019.

As the global economy returns to growth, many companies are seeking to reposition themselves for future growth and investors are looking to put high levels of capital to work. This, coupled with low-cost financing conditions has resulted in a sharp uptick in M&A activity. Global M&A activity hit an all-time high

1. As at August 2021. Sources: Bundesbank, INSEE, ISTAT, INE, CG predictions.
2. As at 30 August 2021. Source: MSCI

in the first six months of 2021[3], with Europe notably recording a significant increase in deal flow. Volumes in Europe have been driven up by deals across a range of industries, while on a country basis the M&A appetite in the UK is strong given much of the Brexit uncertainty has been lifted and a number of UK stocks still appear to be undervalued.

European M&A deal count and value[4]



Highly sought after deals have commanded a premium. For example, Meggitt, the UK aerospace supplier, became the subject of a bidding war after receiving a takeover approach from US competitor TransDigm, and also from Parker Hannifin. Both firms offered a significant premium to buy Meggitt and it would represent the largest-ever takeover by far for either of its would-be acquirers.[5]

We may see slower growth ahead

However, Lind believes there are two key headwinds, which mean growth is likely to moderate during the rest of the year.

1. **The rapid spread of the Delta coronavirus variant could undermine the recovery, particularly through the autumn, though governments appear reluctant to re-impose tight lockdowns.**

   There have been divergent experiences in Europe's largest countries through the summer. Spain's latest upsurge in cases has encouraged a marked acceleration in vaccinations. In France, authorities have responded by tightening some restrictions again to compensate for slower progress in vaccinations. So far, Italy and Germany have experienced lower case rates as governments have been cautious in loosening restrictions. They have sustained their vaccination programmes though there has been a slowdown recently.

   In the UK, infection rates have risen and the pace of vaccinations has dropped markedly. While the government has continued to ease restrictions, there are signs that people are still cautious in their behaviour and this has

3. As at July 2021. Source: EY
4. As at 30 June 2021. Source: Bloomberg Mergers and Acquisitions
5. TransDigm has since confirmed it would not proceed with a firm offer for Meggitt.

undermined economic growth somewhat over the summer. The UK's experiment suggests that, if there is another wave of infections through the autumn, there are downside risks to economic growth either in response to tighter government restrictions or because of a persistent change in behaviour by consumers/companies.

2. **There are increasing concerns that growth in the US and China might have peaked already. The European economy may find it hard to escape this gravitational pull from its largest trading partners.**

   The trajectory of the virus and vaccinations in the US are no longer developing in a way that is consistent with the forecast of a return to normalcy in the domestic economy by year-end 2021. We are beginning to see some reopening measures being reversed in certain parts of the country, and while the steps taken may be minor, the direction of travel has clearly changed. This suggests that the return to equilibrium – where the supply and demand for goods, services, and labour is more in balance – will likely be delayed, and the "distortions" – primarily higher inflation – more likely to persist.

   In China, recent macro data has been weak with growth retreating more quickly then expected as the Delta variant and floods disrupted business operations. With an industrial slowdown already happening, and the likelihood of the consumer sector being hit further on the back of the COVID Delta wave, it is probable that China's economy will weaken in the second half of this year.

Substantial monetary and fiscal policy support should help underpin growth in the major European economies

If the Delta variant impacts growth in Europe, a combined fiscal and monetary approach will remain crucial for the continued recovery of the eurozone economy. Since the start of the pandemic, we have seen huge fiscal expansions from governments in Germany, France, Italy and the UK - a profound change in approach compared to the global financial crisis (GFC). Monetary policy continues to be very accommodative with the European Central Bank (ECB) maintaining the pace of asset purchases to support the eurozone economy until it becomes sustainable.

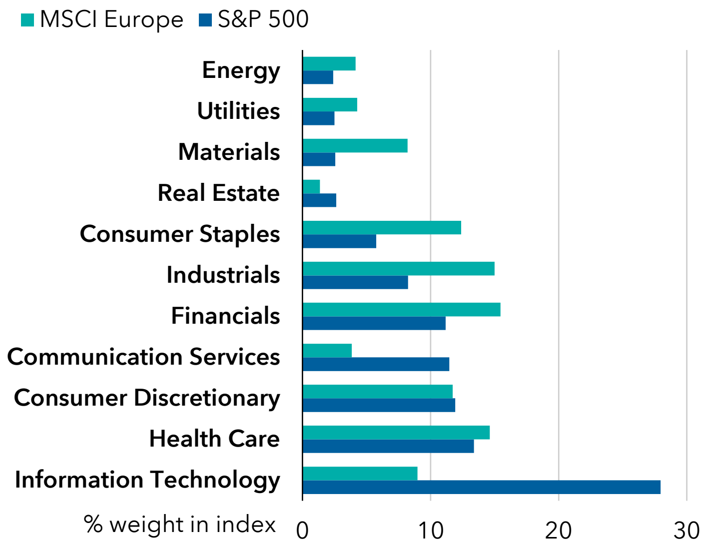
The recent spike in inflation has caused concern that we could see further upward pressure on both headline and core inflation over the next three to six months. ECB officials have said they will look through temporarily higher inflation but the key policy debate is how much the expected recovery and inflation upturn justifies higher nominal/real interest rates.

Despite these uncertainties, valuations should insulate European equity markets from any growth disappointment

The European stock market has lagged the US over the last 13 years. One reason for this is that post the global financial crisis, the US economy recovered more quickly, supported by monetary policy and quantitative easing. In contrast, Europe took a more conservative approach of fiscal discipline, resulting in diverging economic paths.

Secondly, the index composition of the S&P 500 is materially different to MSCI Europe. MSCI Europe has greater weightings towards energy, materials, utilities and financials sectors compared to the S&P 500 where the information technology and communication services sectors have a higher weighting. Over the last decade, technology giants such as Alphabet, Apple, Amazon, Facebook and Microsoft have driven US and global equity returns, underpinned by strong earnings growth. Cyclical sectors such as energy, materials, industrials and financials, which dominate the European index have underperformed over the same period and experienced lower earnings growth, causing the relative earnings growth and return differential.

Difference in index composition between US and European equities[6]



European equities are currently trading at 16.0x based on 12-month forward price-to-earnings ratios compared to 21.3x for US equities.[7] US companies led the earnings recovery reflecting the strong economic rebound, but we are now starting to see earnings per share estimates increasing strongly in the EU and the UK, driven by financials and materials. Measures of equity risk premium show that European equities remain relatively undervalued and are also less vulnerable to rising interest rates compared to the US. As earnings recover, European markets – especially the UK – could outperform significantly.

Notably, Germany and the UK appear relatively 'cheap' while France is the most expensive major European market. Still, given their greater weighting in cyclical/value stocks, the persistence of this valuation discount in Germany and the UK will depend on whether we see a resumption of the 'reflation' narrative that supported returns in the first half of 2021. If investors become more optimistic about 'reflation' (perhaps in response to policy stimulus in the major global economies or in Europe) then we could see a narrowing of implied equity risk premiums in the 'cheaper' value-oriented markets. Alternatively, if investors become more worried about the recovery, the 'reflation' narrative would weaken further, potentially undermining returns in Germany and the UK but boosting returns in more 'expensive' growth-oriented markets like France.

Against this backdrop, there are opportunities to be found

Despite the uncertain backdrop, we believe it is possible to find a large range of interesting longer-term investment opportunities among Europe-listed equities. The slowdown in the economy and corporate earnings is likely to be mild and

6. As at 31 August 2021. Source: Factset
7. As at 31 August 2021. Source: Refinitiv Eikon

the major European economies and markets should continue to benefit from the loosening of mobility restrictions.

In particular, select companies in the sectors listed below have been resilient against the backdrop of the pandemic and have continued to adapt and navigate the changing economic and market environment.

- **Online and bricks-and-mortar betting and gaming companies** may continue to benefit from online gaming, the reopening of betting shops on the local high street and a summer of sporting events.
- **Online retailers** such as Ocado may also continue to do well in a post-COVID world. The shift to online grocery shopping looks set to continue given retail sub-sectors remain highly underpenetrated in Europe.
- **Luxury goods:** Pent-up demand has the potential to provide a substantial boost to companies in that sector. European firms such as LVMH, Richemont and Kering dominate the luxury market, and Chinese consumers are driving much of the growth. Although recent news regarding China's wealth redistribution initiatives have caused shares to decline, our analyst believes certain companies in the sector remain long-term buying opportunities.
- **Industrials:** Aerospace and defence companies are beneficiaries as international travel resumes and the production of aircraft ramps up again for Boeing and Airbus.
- **Utilities:** as many countries in Europe are boosting clean energy as part of their post pandemic economic stimulus funding, the fundamentals of Europe's largest clean energy companies remain strong.

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