

ALLOCATING TO EUROPEAN EQUITIES



One of the key market surprises of 2022 was the resilience of the European economy and equity markets in the face of the surge in energy prices. After Russia's invasion of Ukraine, analysts had expected corporate profits to plunge while the region fell into recession. Many took what happened in the US after the OPEC¹ oil shocks of the 1970s as a model, where stagflation took hold and the ISM² manufacturing activity index fell into the 20s.

THE CASE FOR EUROPEAN EQUITIES

Eurozone purchasing managers' indices (PMIs) did fall, but they dropped to only 46, and the region avoided recession. Several factors supported the economy.

While gas prices rose by relatively more in 2022 than oil prices did during the oil shocks (16x for natural gas versus 4x for oil, see Exhibit 1), the eurozone depends less on gas now than it did on oil then. Oil prices also rose, but no higher than they had been in 2011 and held below the peak in 2008. Companies and households sharply reduced their demand and furthermore, Europe has been more adept than expected in finding other sources of energy (e.g., LNG).

1 Organization of the Petroleum Exporting Countries

2 Institute for Supply Management

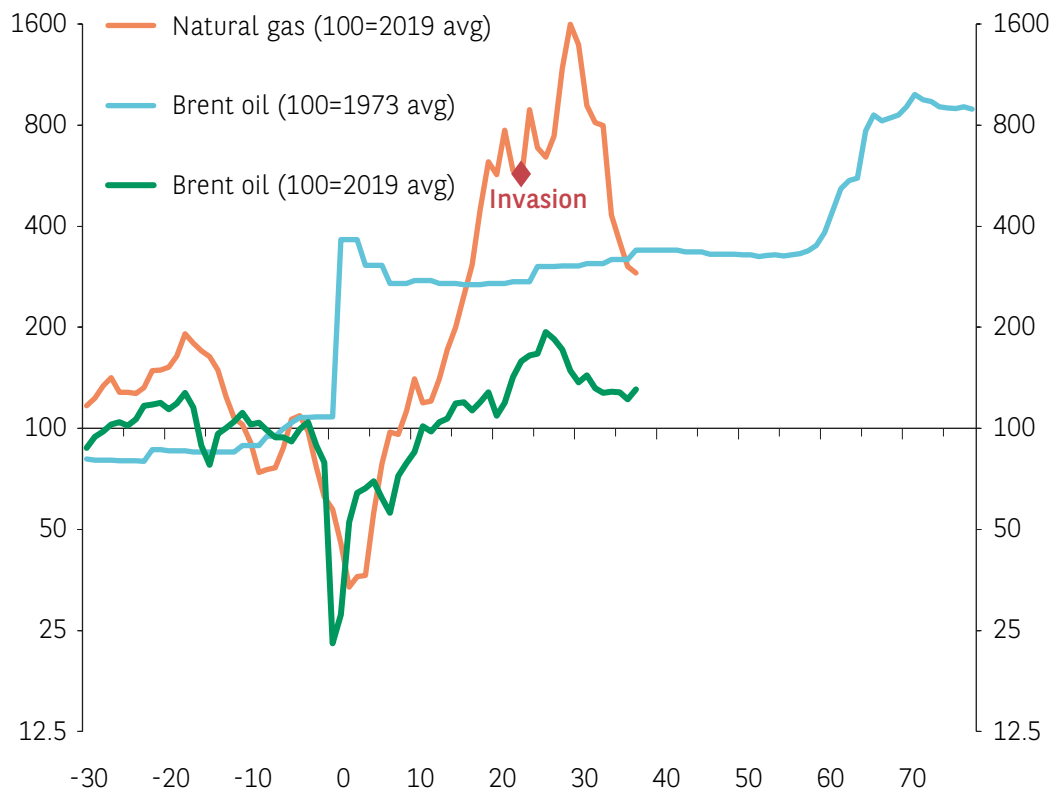


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Exhibit 1: Energy shock on par with OPEC shock in the 1970s

Indexed energy prices, log scale



Data as at 21 March 2023. Sources: Bloomberg, BNP Paribas Asset Management.

Following the pattern set by the response of governments to the Covid pandemic, they offered significant fiscal support to households and businesses. While this raised debt levels yet further, it cushioned the blow to growth.

Finally, the momentum the region had as it reopened after lingering Covid lockdowns meant demand remained strong even in the face of higher prices. Manufacturing PMIs fell, but services PMIs rose as households turned their spending to travel, leisure and hospitality.

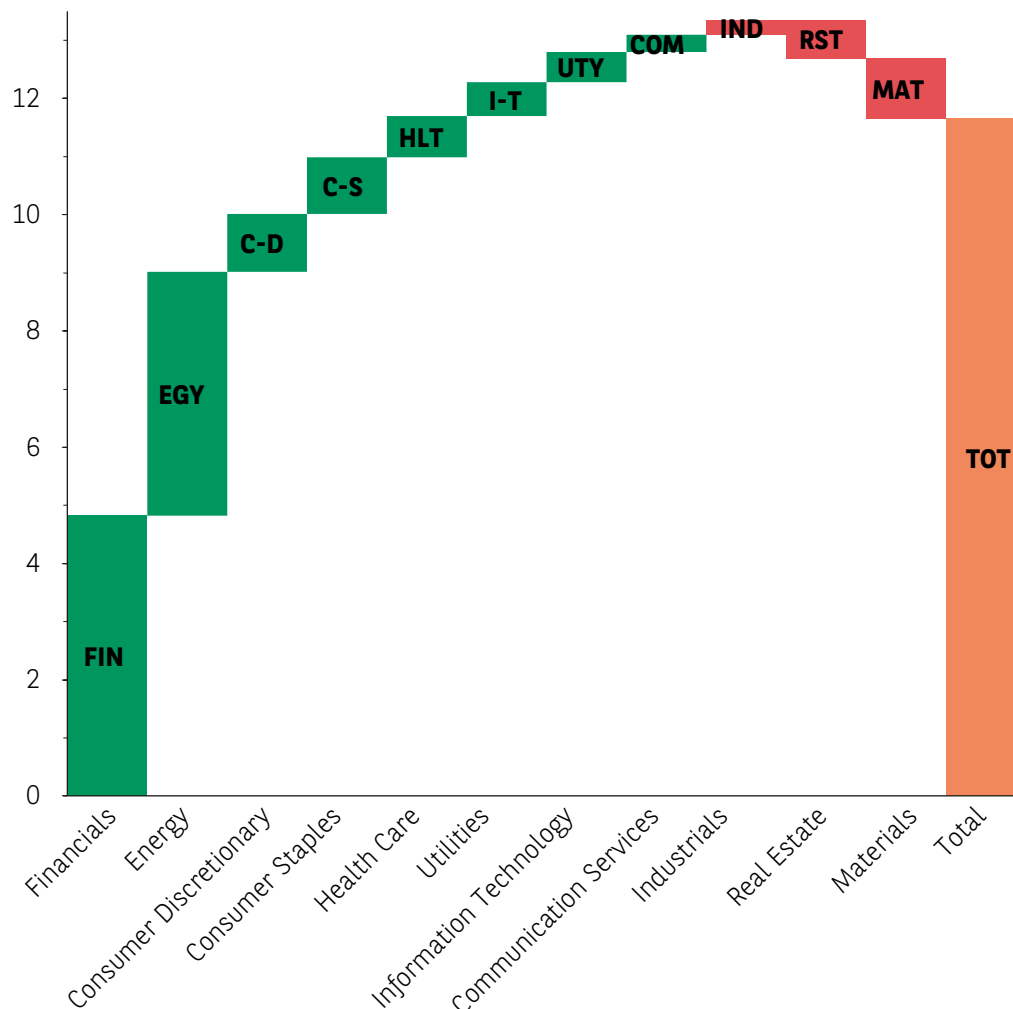
As a result, instead of collapsing, company earnings rose by 6% over 2022. Year-ahead earnings per share (EPS) forecasts increased by 13% over the last year (see Exhibit 2).

FORECASTS RISE TO REASONABLE LEVELS

Not surprisingly, analyst estimates of financial sector earnings have risen as the ECB raises policy rates. Higher energy prices have benefited stocks in the energy sector (at the expense, to some degree, of shares in steel and chemical producers). Even if the gains in other sectors were more modest, it is surprising they were positive at all given how negative sentiment was for most of the year.

Exhibit 2: Contribution to change in MSCI Europe next-twelve-month earnings per share forecasts

Since Feb 2022 to date, local currency terms



Data as at 21 March 2023. Sources: FactSet, BNP Paribas Asset Management.

While forecasts have risen, they are far from predicting unreasonably high growth rates. Year-on-year forecast earnings growth in 2023 is just 2%, though this is partly a function of lower energy prices offsetting expected gains for financials.

Another support for earnings gains has been depreciating currencies, which boosted the euro value of export earnings. This tailwind may turn into a headwind if currencies recover versus the US dollar, though this would also have the benefit of reducing imported inflation and hence pressure on the ECB to raise rates.

MORE BALANCED INDICES

The comparatively low weight of the technology sector in European indices has been another positive factor as higher discount rates have not depressed tech valuations as much as they have in the US.

The European growth index is more diversified, with industrials, healthcare, consumer staples and consumer discretionary having similar weights. The larger share of financials in the European value index means higher interest rates are not entirely negative for index performance (see Exhibit 3).

Exhibit 3: Sector weights in MSCI Growth and Value indices

Sector	Growth		Value		World
	Europe	US	Europe	US	
Energy	0.5	1.1	11.4	8.3	1.4
Materials	4.8	0.9	9.4	4.6	2.6
Industrials	20.3	6.7	9.4	10.5	10.8
Consumer Discretionary	16.2	15.6	6.4	5.3	15.5
Consumer Staples	17.7	2.5	7.9	10.9	6.2
Health Care	19.6	10.8	11.2	17.6	12.7
Financials	4.1	3.5	28.7	17.0	5.8
Technology	12.6	45.5	2.6	12.1	34.3
Communication Services	3.1	12.5	3.9	3.5	9.6
Utilities	0.8	0.04	7.9	5.7	0.3
Real Estate	0.3	1.0	1.3	4.5	1.0
	100.0	100.0	100.0	100.0	

Data as at 28 February 2023. Sources: MSCI.

The recent banking crisis has shown European bank regulation is effective and the region withstood contagion from the collapse of two US banks or the acquisition of Credit Suisse.

Poor sentiment has been reflected in the allocations by institutional investors: they are underweight Europe. In the short to medium term, fund flows could turn positive as investors reassess the outlook and rebalance portfolios.

We believe that investors should therefore consider adding to their European equity allocation across the market capitalisation spectrum to funds with high-conviction, fundamental stock-picking capabilities.

PERFORMANCE SHOULD HOLD UP

The performance of European equities so far this year has been good thanks to the decline in energy prices to below-invasion levels and the re-opening of China.

Europe benefits from China's abandonment of its zero-Covid policies in two ways. Consumption should rebound, which will benefit European exporters, and supply chains should improve, reducing imported inflation. There should also be a spillover from higher Chinese growth to emerging markets more broadly, to which Europe has a higher exposure.

A key structural driver for additional gains is the region's commitment to the energy transition. Significant investments will be made to enable the conversion of Europe's economy to renewable energy and there is a welcoming government, corporate and societal environment for this push. Europe leads the world in the low carbon transition with many companies significantly reducing emissions; as carbon begins to be priced more widely, there is potential for a multi-year competitive advantage.

Despite recent declines in gas prices and some success in substitution, many older fossil fuel power businesses have faced significant margin pressure. This provides an opportunity for longer-term investors to take positions in non-fossil fuel competitors who will have increased pricing power and reinforced industry leadership over time.

Higher policy rates will likely weigh on valuations, but for the time being, these are a function of strong economic growth. Inflation boosts corporate revenues.

Thanks to improving supply chains and normalising demand after the post-lockdown surge, inflationary pressures are decreasing anyway. On the other hand, there is still a risk of a wage-price spiral as salary gains enable additional demand, which could give a renewed boost to inflation.

Central banks may need to induce recessions to bring inflation back down to their targets, but we do not believe such a significant slowdown in growth will be necessary. Europe should in any event prove resilient to a slowdown in global growth given the comparatively defensive, value orientation of the index.

Most valuation metrics are broadly neutral, some slightly below historical averages (price-earnings ratios, enterprise value-sales ratios), and some slightly above (price-book, price-cash earnings, dividend yield). Given that valuations are not extreme, earnings will be the principal driver of future performance.



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VIEWPOINT



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