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Funds and Solutions

SPOTLIGHT - EQUITIES

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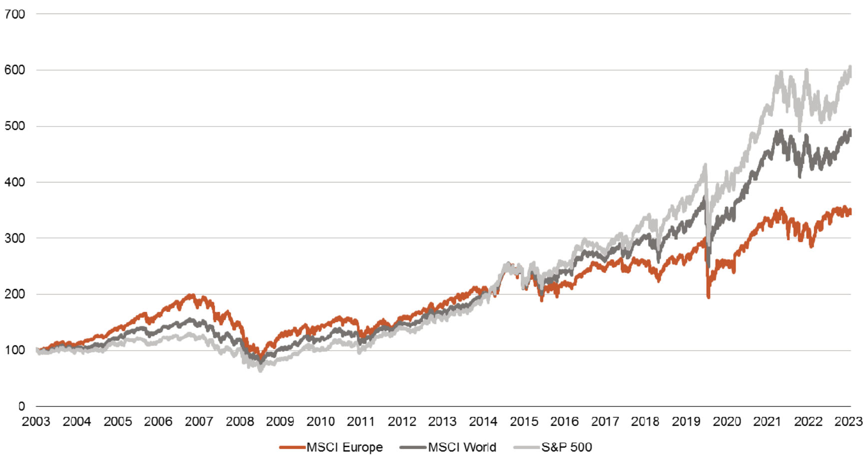
Investing in Europe has become more attractive

Investing in Europe is not fashionable these days. Pessimism around the Old Continent's prospects are commonplace. Stalling growth, high energy prices, an unattractive cost structure and a dearth of innovation are most frequently cited when arguing the case against investing in Europe. While the US is seemingly inventing the future, Europe is thought to be living off its past. It is true that such a view would at least superficially be supported by the performance track record of the European equity market. Indeed, when looking at the past fifteen years, the headline return numbers are not particularly awe enticing. In fact, most global markets and certainly the most considered global benchmarks outperformed the European market significantly. While this is important, it is only part of the story. Also true is that significant subsets of the European market performed excellently over the last two decades and delivered returns that stack up much more favourably in a global comparison. What's more, these subsets, driven by their structural growth, are gaining ground, and are becoming more important for the overall market. Therefore, we believe that contrary to the public perception the European equity market is becoming *more* attractive, not less.

Figure 1: Total Return Indices of different equity benchmarks



Source: Berenberg, Bloomberg, 31.08.2003 – 25.09.2023.

In a new report series, we seek to address this disconnect. We will look at European equity performance over the past couple of decades, explain what has driven the subdued result and highlight which subsets of the market have worked well. Finally, we will argue that although European indices cannot match other markets' growth credentials, a selective approach to investing in Europe would have delivered highly attractive results. We thus make the case for focusing on Europe's strengths. We firmly believe, and seek to demonstrate, that across multiple global industries, Europe occupies positions of enormous comparative advantage. These are industries with significant structural growth tailwinds at their back and thus a promising future ahead.

The following publications are part of the series Berenberg Funds and Solutions:

- Insights
- ► Spotlight
  - Equities
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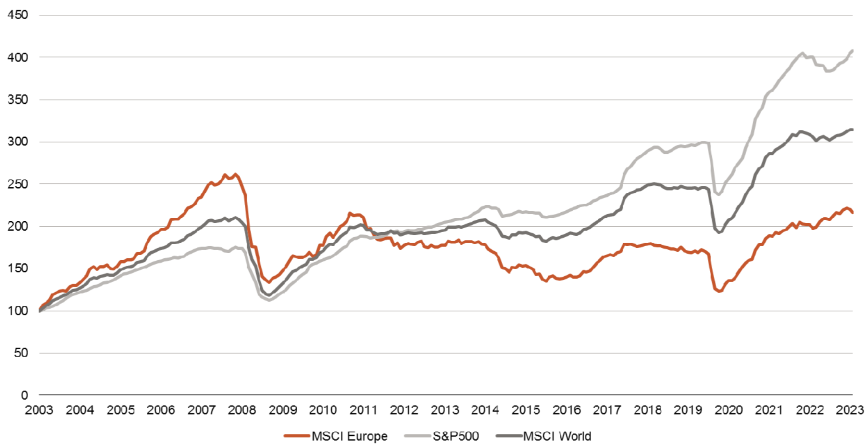
  - Multi Asset
  - Systematic Solutions
  - Overlay
  - ESG

***Spotlight** offers insights into the Berenberg product universe and highlights key topics related to current market developments.*

A lack of earnings growth at the heart of Europe's woes

The main culprit for the underperformance of the European market is easily found. A comparison of earnings trends on an index level show Europe woefully lagging her global peers. When benchmarking today's earnings for the MSCI Europe (measured as 12-month forward EPS consensus expectations) against the peak in 2008, one finds that Europe after all those years still has not managed to surpass that level. In other words, Europe has seen negative earnings growth over more than fifteen years. This is underwhelming by itself but particularly striking when contrasted with the significant earnings growth observed for the S&P 500. This picture holds directionally even when excluding the extensive share repurchases seen in the US over that timeframe.

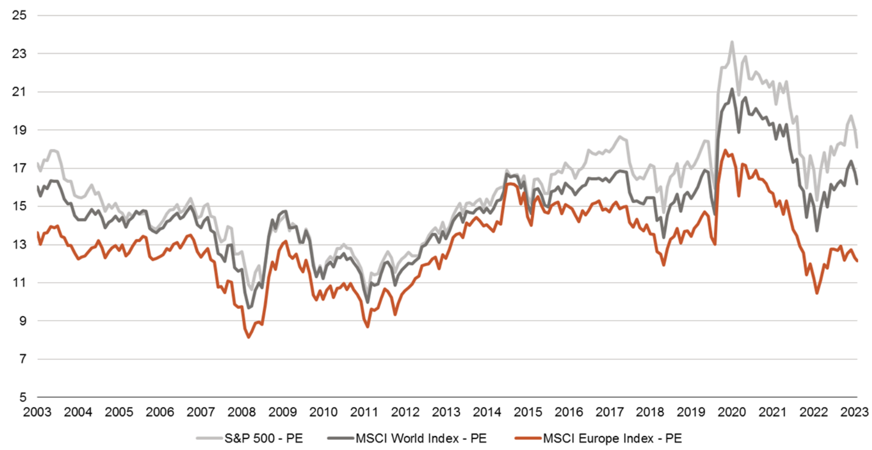
Figure 2: 12M forward consensus EPS on an index level



Source: Berenberg, Bloomberg, 31.08.2003 – 25.09.2023.

A secondary effect explaining European underperformance is found in the differing valuation that investors are willing to ascribe to the European market and global peers. When comparing Europe's 12-month forward Price-Earnings-ratio today with the period leading up to the Global Financial Crisis, valuations are at best on the same level and at worst on a lower level than they were back then. This is markedly different for the MSCI World or the S&P 500. Both have seen a valuation re-rating over those years, providing a tailwind to the index returns.

Figure 3: 12M forward consensus PE ratio on an index level

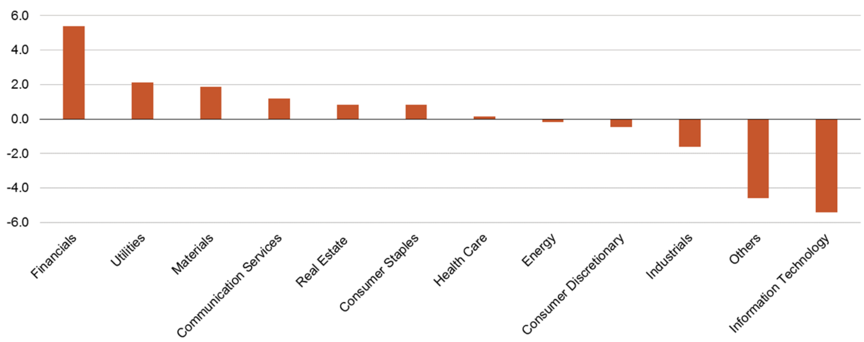


Source: Berenberg, Bloomberg, 31.08.2003 - 25.09.2023.

The wrong sector exposure – playing the wrong game with the wrong team

Europe is often said to be rich of industries which are at best mature and at worst structurally challenged. Europe's sluggish earnings growth over the past fifteen years is indeed a function of the European market over indexing on sectors that experienced significant structural headwinds since the Global Financial Crisis, while under indexing on those sectors which saw the most significant tailwinds. Just before the collapse of Lehmann shuck the world in September 2008, the European market had a comparatively large Financials sector (c. 5pp more than the MSCI World) and thus really bore the brunt of the crisis and its aftermath. As continuously declining interest rates hit any bank's bottom line, Europe's market performance was worn down by its extra-large Financials sector.

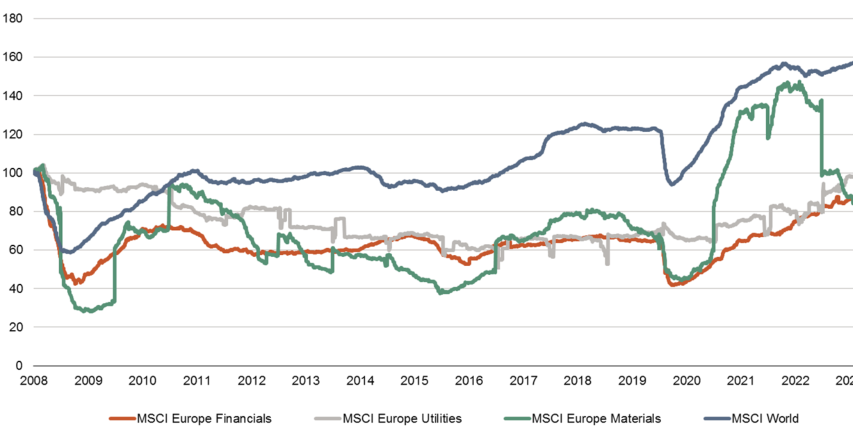
Figure 4: Relative sector weights of the MSCI Europe vs. MSCI World (in pp)



Source: Berenberg, Bloomberg, 28.08.2008.

The other comparatively larger exposures in the European market, i.e., Utilities and Materials, did not fare much better in the post-crisis lower-growth world. While, for instance, the China-induced commodity Supercycle had still benefited Europe's large commodity sector in the runup to the crisis, this was no longer the case thereafter. All three over indexing sectors delivered negative earnings growth over the course of fifteen years, which is significantly worse than what the MSCI World delivered merely on average. To add insult to injury, Europe under indexed exactly on the very sector, Information Technology, which in the years after 2009 delivered a particularly strong earnings growth.

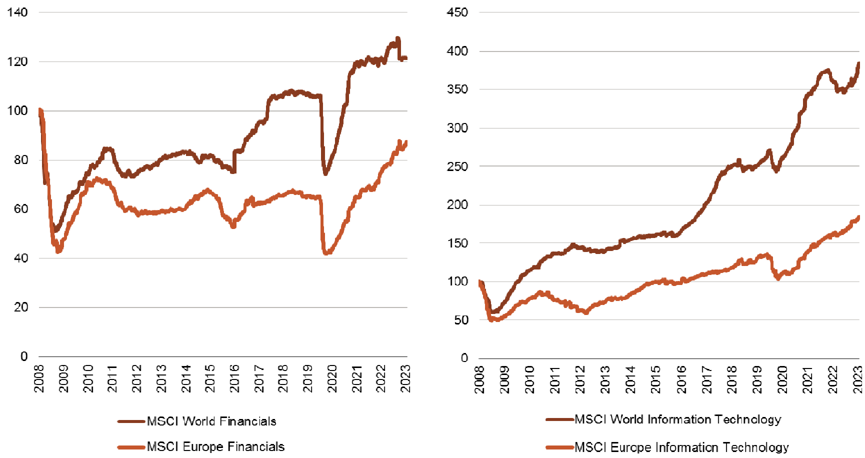
Figure 5: EPS growth indexed to 100 in August 2008



Source: Berenberg, Bloomberg, 28.08.2008 – 20.09.2023

However, the wrong sector exposure is only part of the story. What is more, at least on average the European corporates within both the structurally challenged and highly attractive sectors could not match the earnings growth of their immediate global peers. For instance, European Financials came out of the Global Financial Crisis worse than their global peers. This is particularly striking when considering that the epicentre of the crisis had been the US. Over the ensuing years, European banks had to face a different regulatory environment, greater competition, and a less favourable interest rate environment than their peers across the Atlantic. Another case in point is the Tech sector. While more than a handful of America's Tech firms emerged as global giants, no European Tech company took off in the same way. It was again a more favourable regulatory environment, more readily accessible early-stage financing and most importantly a much more cohesive market that allowed US companies to really play out the network effects to their own advantage.

Figure 6: EPS growth indexed to 100 in August 2008

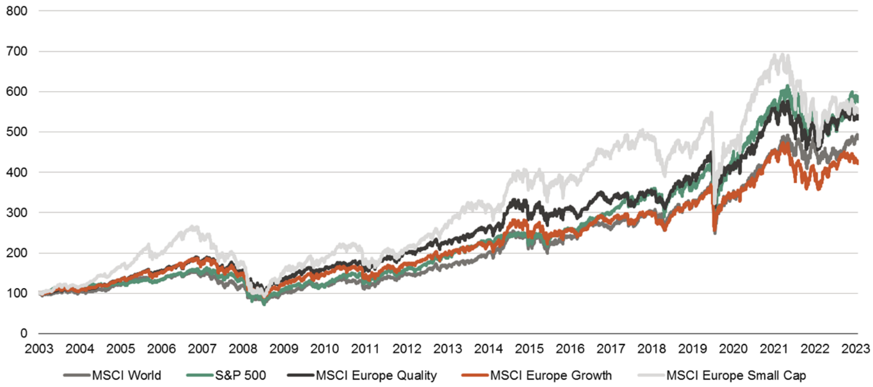


Source: Berenberg, Bloomberg, 28.08.2008 - 20.09.2023

European investment returns to write home about

Despite this unfavourable analysis, it would be unwise to ignore the fact that over the past couple of decades it was possible to achieve highly attractive returns from investing in Europe. A more selective investment approach, focused on sub-segments of the European market could have yielded investment returns that stack up a lot better versus global peers. If one, for instance, considers proxies of those subsets, i.e., the MSCI Europe Quality, Growth and Small Cap Index, the performance track record looks much better and two of them can even get close to matching the performance of the S&P 500.

Figure 7: Total Return Indices

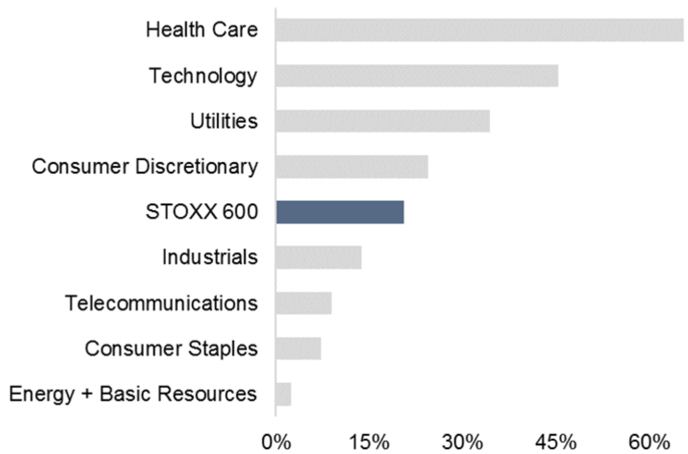


Source: Berenberg, Bloomberg, 31.08.2003 - 20.09.2023.

Europe's strengths and where to find them

The strong performance of these subsets of the European equity market speaks to inherent strengths of the European continent. Of course, we cannot claim that Europe possesses tech giants of the kind one finds in the US. However, amidst areas of weakness, the Old Continent does possess many world-leading companies that are benefitting from strong structural tailwinds. These companies invest in the growth opportunities provided by the market as well as the competitive positions to harness those opportunities. Key is to focus on those few privileged companies, while weeding out the rest. Sectors already provide a useful classification here. As a recent analysis from Goldman Sachs Research demonstrates, there exist stark differences between sectors' investment levels. While Health Care and Tech companies in Europe invest very large proportions of their cash flows into growth and R&D, Energy and Basic Resources companies invest hardly any cash. As we believe, over the longer term, such investments are going to be key drivers of profit growth and business success, we tend to focus on these sectors. The exception proves the rule, which in this case is the Utilities sector. The high investment rate in this sector is mainly driven by renewables. However, we believe there are only few renewables businesses with really attractive competitive positions and are thus sceptical as to how high the returns will be on those investments.

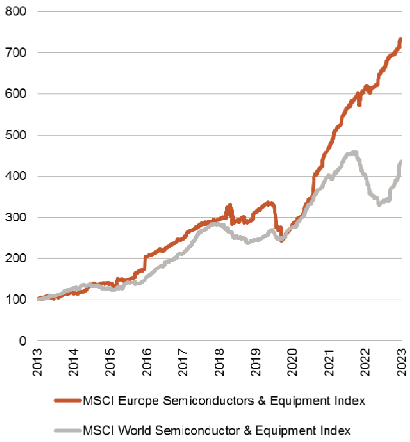
Figure 8: Last 5-year growth investment ratio (Growth capex + R&D / CFO)

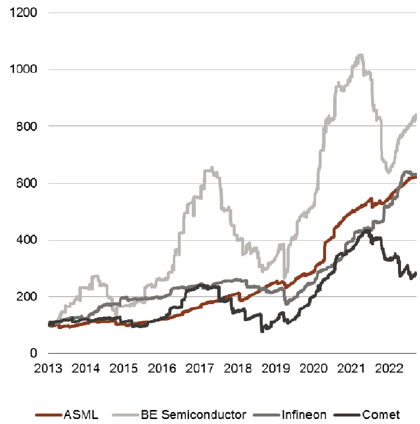


Source: Goldman Sachs research, FactSet.

Within the semiconductor industry, one encounters a different picture. Here investments will continue to yield very attractive returns. This year's most prominent conversation topic, Artificial Intelligence, provides us with a case in point. While US capabilities in this field received most of the limelight in this regard, there are many European semiconductor companies that are inexorably tied to the rise of AI, without which none of the optimistic forecasts that were recently making the rounds would be achievable. As it happens, many of the most critical aspects of the industry's value chain are housed in Europe. Staying true to Europe's long tradition around equipment manufacturing excellence, it is semiconductor equipment from Holland and Germany, which has emerged as the lynchpins of the entire industry. The following two exhibits demonstrate that this pocket of European excellence delivered strong earnings growth. A significant share of that was, of course, driven by the Dutch giant ASML, however as we can see, there are other smaller companies that also benefit from strong structural growth.

Figure 9: EPS growth indexed to 100 in August 2008





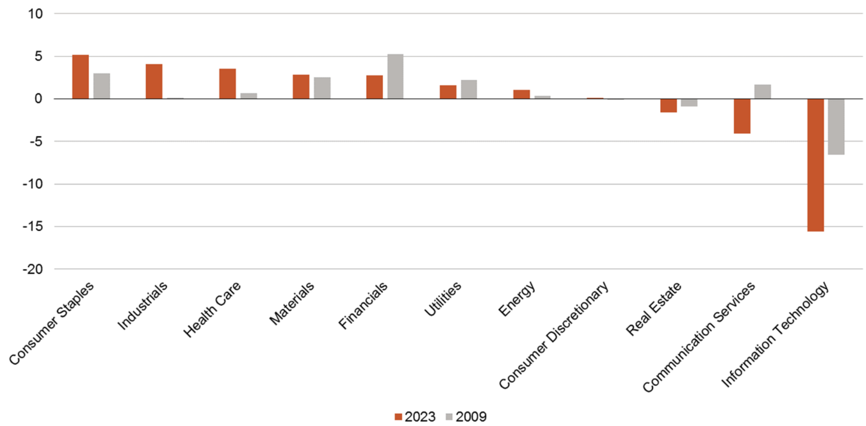
Source: Berenberg, Bloomberg, 20.09.2023.

Europe's strengths go far beyond the semiconductor industry. In the Luxury industry Europe is firmly established in the global lead with brands built over generations and a heritage that is near impossible to surmount. However, these companies are also innovative, think ahead and stay ahead. Similar tales can be told about European Industrials, Health Care companies and of course Europe's rich tapestry of Small Cap companies. They are laden with innovative prowess and an entrepreneurial spirit, offering investors attractive investment opportunities. These are tales that will be told in subsequent editions. Here we merely want to emphasize that one should not ignore these strengths, but instead we advocate an investment approach that focuses on them.

Final thought - Europe is getting stronger

Even as we continue to make the case for an active and selective investment approach that focuses on few pockets of strength, we want to counter the pessimists by arguing that investing in Europe is today *more*, not less attractive than it was 15 years ago. The compounding effect of Europe's strength has done its work, and will continue to do so, increasing the importance and index weights of those structurally attractive sectors, while more challenged industries have shrunk in size. Europe today has its largest overweight in Staples, Industrials and Healthcare. These are sectors, where European corporates do possess strong competitive positions and that benefit from the structural tailwinds. The Financials sector overweight versus the global benchmark has also been reduced in size. Only Europe's Tech underweight has actually been increased by the significant growth seen in the US. However, this also means that Europe today is also a lot less concentrated than other markets, which comes with its own advantages.

Figure 10: Sector exposures MSCI Europe vs. MSCI World (in pp)



Source: Berenberg, Bloomberg, 20.09.2023.

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IMPORTANT NOTES

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