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https://blog.en.erste-am.com/charts-dont-tell-the-future-they-tell-stories/

"Charts don't tell the future. They tell stories"

Peter Szopo

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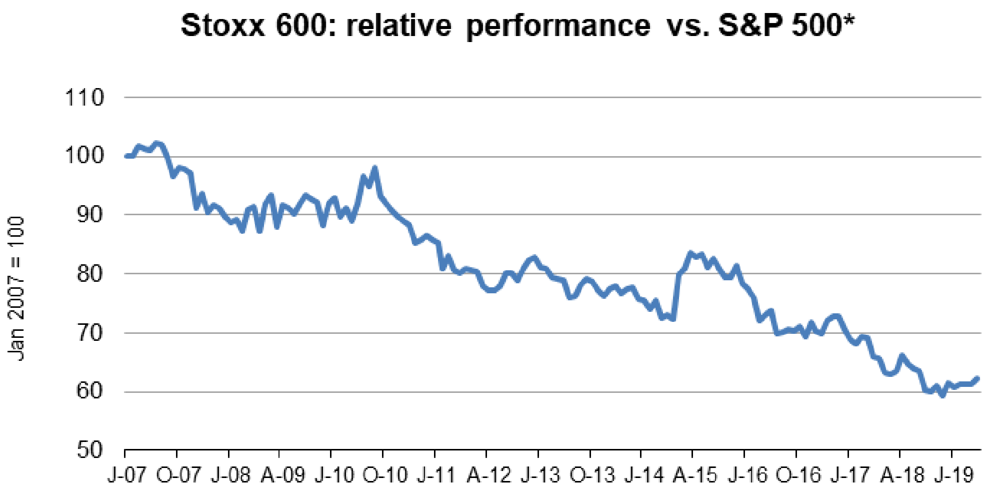
The United States and Europe are home of the two most importantstock markets globally. Together they account for more than 80% of the capitalization of developed markets. Below we present six charts that look at the European and the US stock markets, comparing their performance, sector composition, earnings developments as well as their valuation – mainly with the aim of shedding light on the enduring underperformance of European stocks vis-à-vis the US.

The story, which these charts are telling is that Europe's long-lasting underperformance has been a combination of both structural and cyclical factors. The latter, particularly earnings and valuation trends, could help European stocks to stage a rebound versus their US peers in the course of the year. However, a more pronounced reversal of Europe's relative performance would also require a change in the broader economic backdrop, such as a slowdown in the relentless growth of the tech-sector and a recovery of Europe's troubled banking sector. Whether that will happen in the foreseeable future is anybody's guess because one should not ignore the first sentence of this blog's title (which is paraphrasing a line from the wicked ogre Shrek[1]): charts do not tell us anything about the future.

Europe's dismal performance

The European stock market has underperformed the US market over 30, 20, 10 and 5 years. Since the financial crisis this trend has even accelerated, with the Stoxx 600 losing almost 40% relative to the S&P 500 (in local currency, including dividends) since 2007.

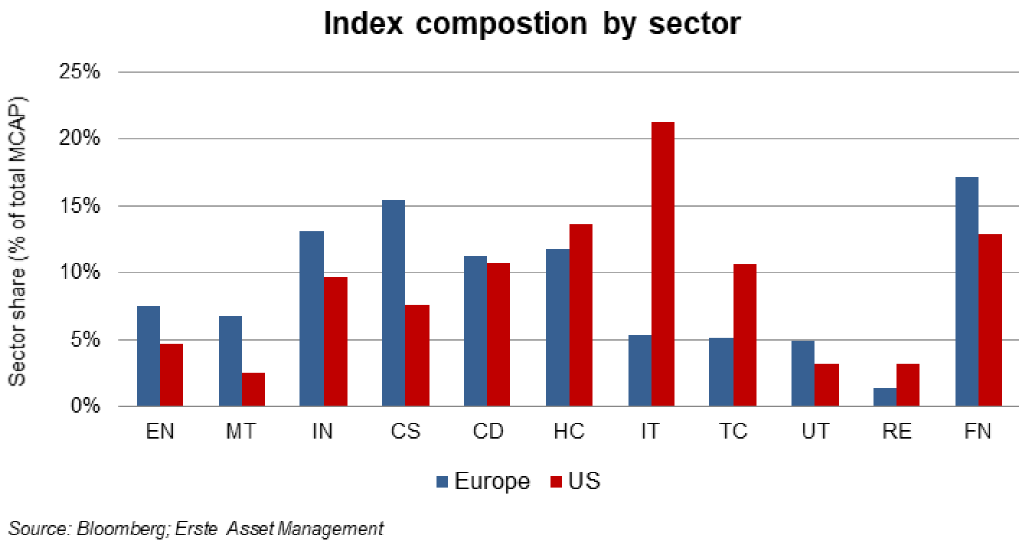


*Source: Bloomberg; Erste Asset Managemment. * Local currency; net return.*

** J-07 = July 2007, 0-07 = October 2007, …*

Sector composition has not helped

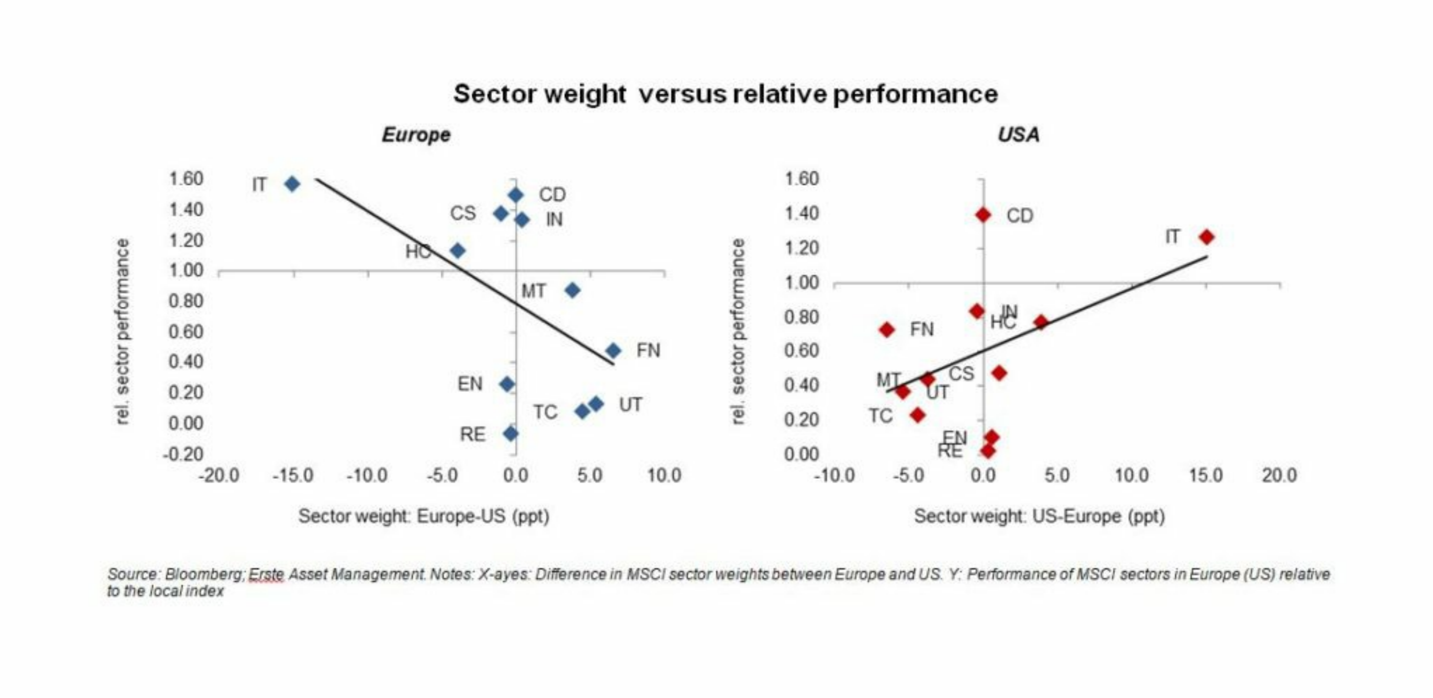
Among the main reasons for Europe's underperformance is the different sector composition of the two markets. In the US, information technology, which has been among the best performing industries over the past decade, is the biggest sector. Its weight of more than 20% is four times higher than the sector's share in the European market. In contrast, in Europe the sector with the highest weight (>17% or 4.3 percentage points higher than in the US) is the financial sector, which has had a mediocre performance over the past decade.



EN=Energy, MT=Metals, IN=Industry, CS=Consumer staples,, CD= Consumer discretionary, CD=Consumer durables, HC=Health care, IT=Information Technology, UT=Utilities, RE= Real Estate, FN= Financials

Overall, sectors that a decade ago had smaller weights in Europe than in the US outperformed over the past ten years, while sectors accounting for a higher share in Europe – financials as well as utilities and telecoms – underperformed, as is shown in the two charts below: the left chart shows that there was a negative relationship between sector weight and performance in Europe, while the right chart shows the opposite result for the US. Roughly half of Europe's underperformance over this period can be traced to different sector exposures.

Sector weight versus relative performance



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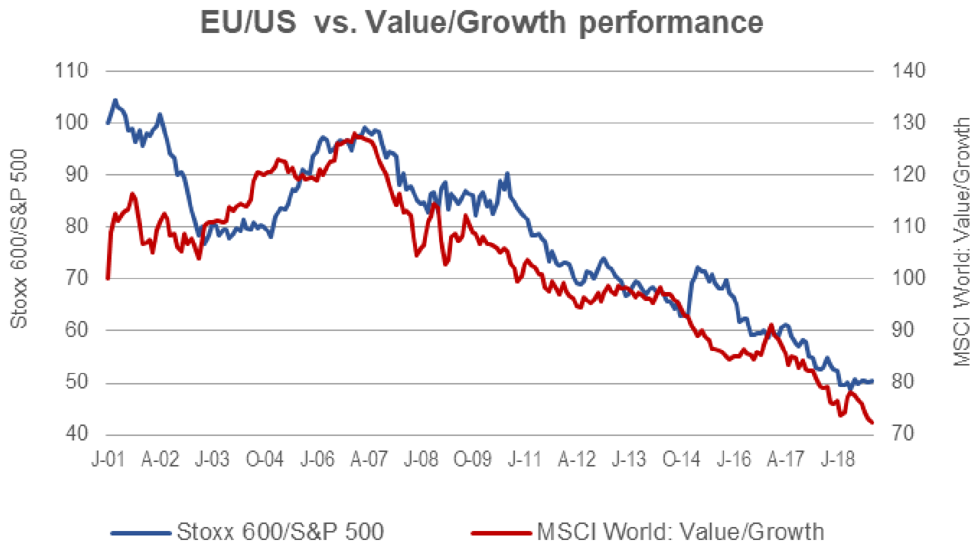
Americans are from Growthland, Europeans are from Valueland

Another difference between the stock markets in the US and in Europe has been the factor exposure of their respective corporate sectors. This is partly related to the sector composition described above but it is also due to company specifics across sectors. The chart below shows that the relative performance between European and US stock markets has been closely related to the value/growth cycle, which has not been very kind to European stocks for more than a decade.

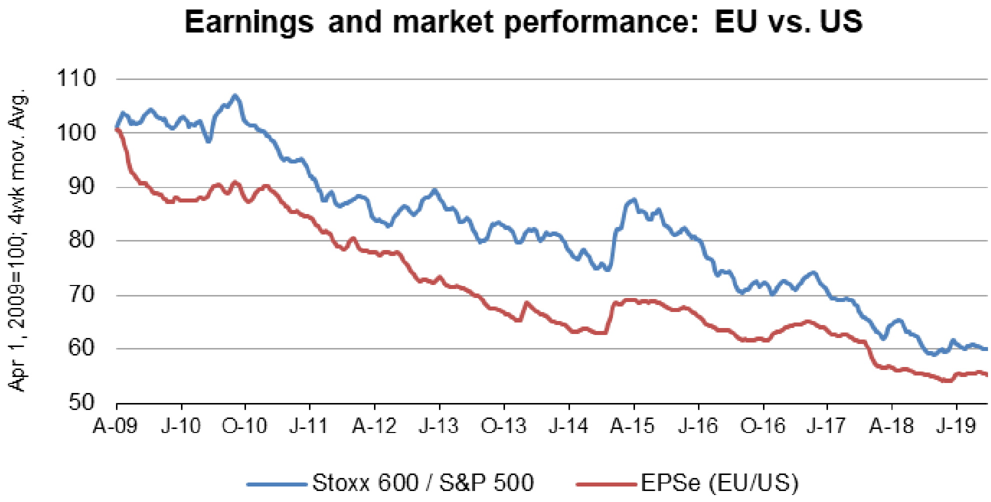


Source: Bloomberg; Erste Asset Management

** J-01 = Jänner 2001, A-02 = April 02, J-03 = Juli 2003 0-04 = Oktober 2004, ...*

Earnings: Europe has been a long-term laggard

Earnings are another key explanation for Europe's lackluster relative performance. The slow European recovery after the financial crisis – compared to the US – held back growth in the corporate sector. Over the period from 2009 to 2018, annual topline growth in Europe was almost three percentage points lower in Europe (1.5% vs. 4.4%). In addition, operating margins in the US showed an upward trend while they moved sideways in Europe. As a result, annual earnings growth in Europe was five percentage points lower than in the US. Unsurprisingly, during most of the period, earnings expectations in Europe were weaker than in the US, which is reflected in the relative index performance (chart below).

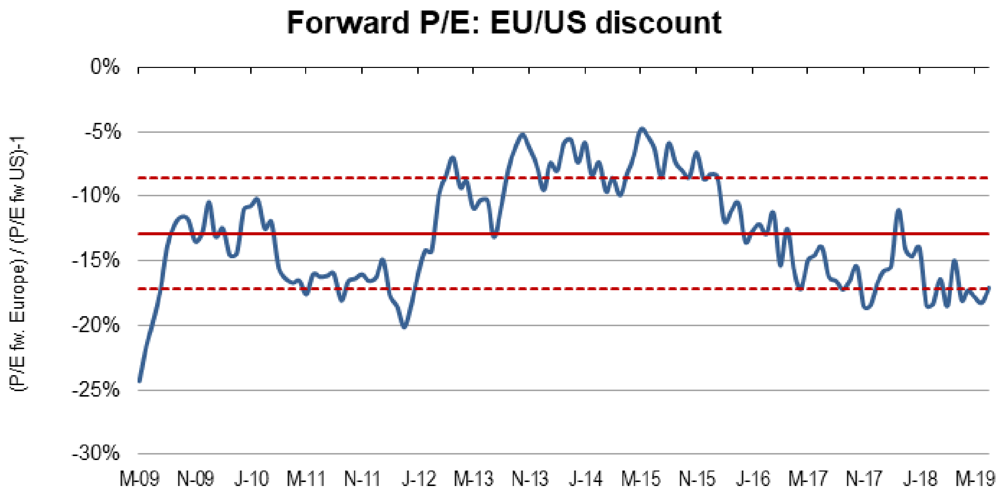


Source: Bloomberg; Erste Asset Management

** A-09 = April 2009, J-10 = Juli 2010, 0-10 = Oktober 2010, J-11 = Jänner 2011 ...*

Valuation: Trading at a discount

Since the mid-2000s (the longest period for which we have forward earnings data) European equities have been, on average, trading at a discount to their US peers. After the financial crisis, the valuation gap moved mostly in a range between -17% and -5%, without a clear trend. Since 3Q18 the discount has been close to the higher end of the range, fueling expectations that mean reversion could trigger at least a temporary rebound of European stocks versus US stocks.[2]



Source: Bloomberg; Erste Asset Management

M-09 = Mai 09, N-09 = November 2009, …

[1] "Well, the stars don't tell the future, Donkey, they tell stories. Skrek" (2001)

[2] It needs to be noted that the valuation gap also reflects differences in the sector composition. One could argue that Europe looks artificially undervalued because 'cheaper' sectors like financials carry a bigger weight. However, adjusting for the sector impact is not without pitfalls and a closer look at sector multiples shows that Europe's undervaluation is a relatively robust fact.

Legal note:

Prognoses are no reliable indicator for future performance.

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Peter Szopo has worked as chief equity strategist at the Erste Asset Management since March 2015. Before he already worked as a consultant for equity fund management at Erste Asset Management for Central and Eastern European equity markets. From November 2009 to April 2013, he was head of the research department at Alfa Bank in Moscow.

After his research work at WIFO (Austrian Institute of Economic Research) from 1978 to 1990, he worked as a securities specialist in various management functions at internationally renowned investment banks. During this time he held the position of Head of Research at such institutions as Creditanstalt Investmentbank, UniCredit Bank Austria, Robert Fleming Securities, and at Bank Sal. Oppenheim.

Along with his analysis activities, he worked from 1997 to 2000 at Eastfund Management as the fund manager for Central and Eastern European equity.