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European equities – still time to get on board?

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The performance of European equities in the year to date has been disappointing. While in the USA stock exchanges are going from strength to strength, European share prices have been stagnating. In fact, a long-term analysis even shows that an European equity index has not posted any significant gains in the past 20 years, net of dividends. US equity investors, on the other hand, have earned more than 160 percent over the same period, or 5 percent per year, again net of dividend returns.

In the following, we take an in-depth look at the development. The euro equity index has remained within a bandwidth of 600 and 1,400 for almost 20 years. At the moment, we are close to the upper limit (see fig. 1).

Fig. 1, Source: Thomson Reuters Datastream
Note: Past performance is not indicative of future development.

This prompts two crucial questions:

- Was that it, and will we therefore be going through a setback in the coming weeks? Or will we see a breakout from this range?
- Why was that possible in the USA as early as in 2012, but we still have not seen it in Europe?

The first (two-pronged) question is difficult to answer. However, we can respond to the second one on the basis of company earnings, profitability, and the composition of the index.

Earnings development in the USA and Europe (euro region):

A long-term analysis of earnings and valuations in the USA and Europe teases out interesting insights as to why US equities have outperformed their European peers in recent years.

Fig. 2, Source: Thomson Reuters Datastream
Note: Past performance is not indicative of future development.

Greece and the euro crisis were dampening the European stock exchanges

Up until the financial crisis in 2009, earnings were going more or less in sync in the USA and the Eurozone (slightly more cyclically in Europe, but still in line with the trend). While the first recovery from 2009 in the wake of the financial crisis was unfolding in synchronicity between the USA and the Eurozone, Europe had to face another crisis in 2011 – the euro crisis featuring Greece. It left clear marks on the earnings scenarios of European companies (especially among banks). The discrepancy in the earnings development in the USA and the euro region is reflected in fig. 2. Whereas US earnings increased clearly from 2011 to 2015, company earnings declined in Europe. Only from 2016 onwards did the two curves re-join a parallel pattern. On aggregate, US company earnings have almost tripled within the past 20 years (i.e. +5.4 percent p.a.), while in Europe the increase was (only) and average +3.6 percent per year. The share price increases in the USA have largely been driven by earnings. While earnings in Europe have picked up as well, valuations have decreased significantly, which has caused share prices to stagnate.

Europe currently commands fair valuations, while US valuations are above average

20 years ago, the current PE ratio amounted to 22.7x in the USA. In Europe, it was even slightly higher than that at 23.6x. Now, US valuations are at 1998 levels. In Europe, they have fallen to 17.5x. This is not the least due to the banking sector, which was traded at a PE of about 18x 20 years ago and which is at 12x today. Another example is the automotive sector, which todays is traded at 7.5x as compared to 18x in 1998. Another erstwhile heavyweight, the telecoms sector was traded at a PE of 32x back then; at 16x, it is currently at half that level. Overall, this new valuation level means that Europe is now on par with the average value of the past 40 years, whereas the USA is 20 percent above the long-term average. Profitability is the reason why we have seen a revaluation in Europe but not in the USA.

Europe with relative upside potential

"Europe is cheaper than the USA, which means that European shares hold relative upside potential and should be catching up." We hear this statement frequently, but it is completely wrong! Do not get fooled by such misjudgements. US shares are expensive because their quality in terms of profitability is higher. Higher profitability justifies high valuations. As fig. 3 illustrates, US companies are as profitable again as they were prior to the financial crisis in 2008/09. European companies, on the other hand, have failed to recover by the same degree.

Whoever claims that European shares are holding upward potential relative to the USA really means that Europe's profitability is adjusting to that seen in the USA. This is not unlikely as the period of 2003 to 2007 shows, but we cannot see such development at the moment.

Fig. 3, Source: Thomson Reuters Datastream
Note: Past performance is not indicative of future development.

Europe has more cyclicals, the USA more technology

Another difference between the USA and Europe is the composition: Europe is clearly higher weighted in value shares than the USA. There are more cyclical companies in the index than in the USA. This would actually be advantageous in a strong economic environment. However, in recent years, many value shares have underperformed the index by a wide margin. Investors have preferred technology shares for a while now, i.e. the so-called FANG shares (named after facebook, Amazon, Netflix, and Google). These companies are underrepresented in Europe. As long as investors focus on technology, the European market will find it hard to outperform its US peer.

"Shall I (still) buy European shares?"

Generally speaking, it is difficult to pinpoint the "right" moment to buy and sell on the stock exchange. After six years of bull market, it is legitimate to wonder whether boats have been missed. To paraphrase Warren Buffet, the best time to buy shares is when one has money to invest, ideally in regular intervals like on the basis of a fund savings plan.

But there are parameters that can be used for decision-making and that do suggest buying:

- European equities are fairly valued
- Earnings are on the rise

As long as earnings are rising, further share prices increases are very likely given that European equities are fairly valued. Why, then, have share prices not increased in 2018 if earnings are up? That is a justified question that is not easy to answer. Investors are currently avoiding cyclical equities – that is a fact. This means that a majority of investors expect a significantly weaker economy and thus falling earnings. This may be the case, but not necessarily! An alternative explanation for the weakness of value shares is that in times of strongly disruptive changes many companies are being shunned (Tesla vs. traditional automotive sector, Amazon vs. traditional retailers, Netflix vs. network operators etc.).

Whether it pays off to invest in European equities instead of their US counterparts depends on whether technology shares remain among investors' favourites; and on whether the economy will be experiencing a noticeable downturn in the coming months or whether it will pick up particularly in Europe. As pointed out earlier, Europe is value-heavy and thus more sensitive to the economic cycle.

Investors keeping or opening positions in European equities operate on the following premises:

- There is a rotation from technology shares to cyclicals
- The economy is about to pick up in the coming months
- There will be no euro crisis (specifically, a crisis in Italy will be averted)
- The profitability gap to the USA can be reduced

If you cannot get on board with these premises, you are better off betting on a broadly diversified portfolio. If at least two of the aforementioned premises were to materialise, European equities could be outperforming their US peers.

Legal note:

Prognoses are no reliable indicator for future performance.

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