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MARKET *view*

January 13th, 2023

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European equities: Stocks of the Old World are back in demand

> *There are numerous reasons to look more positively towards Europe and its financial markets again. One should not write off the Old World too soon.*

Tailwinds are currently driving European stocks. Looking at market performance since the start of the fourth quarter of 2022, equity markets on this side of the Atlantic clearly stand out positively from their US counterparts. The major European indices posted double-digit total returns in the fourth quarter: the DAX 40, for example, was up 14.9%, the French CAC 40 +12.6%, and the Italian FTSE MIB +15.6% in EUR terms. By comparison, the S&P 500 was up a "disappointing" +7.6% and the technology-heavy NASDAQ Composite Index was down -0.8% in USD terms in Q4 2022. As we head into 2023, European stocks continue to outperform.

The relative strength of European markets is no coincidence. In our view, it can be explained by four decisive factors.

Firstly, the situation on the European energy markets has eased in the past weeks and months, at least for now. Natural gas supplies seem secure for this winter. In Germany, for example, according to the Federal Network Agency, natural gas storage levels are once again at an ample 91 percent. Against this backdrop, European natural gas prices have fallen significantly. Currently, they are even slightly below their level at the start of 2022, before Russia's invasion of Ukraine. This does not mean, however, that economic problems are over. Energy prices remain much higher than the long-term average, and higher wholesale prices are now gradually working their way through to consumers. The decline in real household incomes and rising interest rates are slowing demand. Nonetheless, the most serious threats to Europe, for example a "gas shortage", have become less significant. The recent improvement in the very negative sentiment towards Europe is thus boosting European stock markets.

A second factor is the remarkably robust earnings performance in Europe. Currently, 2022 earnings estimates (earnings per share) for the Euro STOXX are almost 13% higher than at the start of last year, when the prospect of yet another crisis seemed far away. In the US, the picture is somewhat different: 2022 earnings estimates for the S&P 500 were lowered by almost 2% during the course of the year (source: I.B.E.S.). Earnings estimates for 2023 show a similar pattern, with a gradual downward revision since mid-last year for US equities (S&P 500). Compared to expectations at the start of 2022, current estimates are 8% lower, with analysts expecting profit margins in the US to fall.

A third factor is the valuation level of European stocks, which makes them attractive again to long-term investors. Indeed, the current price-earnings ratio (P/E ratio) of European equities is currently below the long-term average of the last 20 years. The price-to-book ratio (P/B ratio), which can be a more relevant indicator, especially in times of crisis, is currently around 1.6x and thus, also below the long-term average. In the US, on the other hand, valuations are much more demanding: the P/E ratio for the S&P 500, at just under 17x, is still noticeably above the 20-year average of 15.8x; the P/B ratio, at 3.9x, is also considerably above its long-term average. While the correlation between the valuation of equities and their future returns over short periods of time (e.g. over one year) is low, numerous studies show that equities have significantly higher future returns over five or ten years when valuations are low. For long-term investors, it is thus worthwhile to look to Europe again, despite the lower innovation dynamics in the region.

A fourth factor in favor of European equities is the changing currency landscape. The supply shock resulting from Russia's invasion of Ukraine last February has caused typical safe-haven currencies, such as the US dollar and the Swiss franc, to appreciate sharply. The US economy's lower proximity and vulnerability to the political and economic fallout from the conflict in Europe as well as the Fed's aggressive rate hikes, had provided massive inflows to the US dollar over the past year. We believe these arguments have lost traction. Europeans should survive the winter of 2022/23 without too much upheaval. While markets expect US rate hikes to end in the second quarter of 2023, the rate hike cycle in Europe will probably last longer. Furthermore, taking into account long-term significant fundamental criteria such as current account balances, purchasing power parities and political factors (e.g. reduction of dollar currency reserves in Russia and China), a weakening of the US dollar seems likely.

An improvement in the very negative sentiment towards European equities as a result of the energy crisis easing, the robust earnings announcements in Europe so far, the attractive long-term valuation level of European stocks and a possible appreciation of the euro after the end of the supply shock: there are numerous reasons to look more positively towards Europe and its financial markets again. One should not write off the Old World too soon.

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