ODDO BHF

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Laurent Denize
Global Co-CIO ODDO BHF

European Exceptionalism?

> *The question is not to play European "exceptionalism", which could take time to materialise, but to think about European "tacticalism", consisting in starting to close an underweight position (or initiate a position) on Europe.*

Divergence between the US and Europe should continue to shape the narrative in 2025, and in particular the one trend that has persisted in recent quarters and that investors shouldn't resist: US exceptionalism. In terms of absolute performance, in late November the S&P 500 registered its 60th record closing high this year. The relative performance of US equities is even more remarkable. Except for 2017, they have outperformed global equities every year since 2009, and the US now accounts for almost 70% of global indexes. Over the last decade, the MSCI Europe has underperformed the S&P 500 by 7.7%. per year. European earnings have also underperformed for nearly 15 years. As we approach 2025, a large majority of investors and experts believe that the US's impressive dominance will continue. It's hard to argue with this optimism, but it is still worth looking at what could challenge US exceptionalism... and bring Europe back in the game. **And what if 2025 was the start of European exceptionalism?**

How to explain the European underperformance?

European markets have underperformed the US for over a decade, reflecting structural challenges such as low productivity, market fragmentation, and reliance on bank-driven financing. Germany, historically Europe's economic leader, is now struggling with energy crises, Chinese competition, and political inertia. Let us try to summarise today's key issues:

1. **Productivity lag:** Europe invests less in R&D, limiting innovation and growth.
2. **Fragmented markets:** regulatory inconsistencies hinder economies of scale and discourage investment.
3. **Energy and competition:** high energy costs and competition from China weigh heavily on industries like chemicals and EVs.

In fact, Europe has been lagging behind for more than 15 years. Austerity measures since the Global Financial Crisis have hindered its economic growth, leading to lower demand, limited investment, and a deflationary environment. In contrast, the US's more aggressive fiscal policy has fuelled growth, widening the gap between the regions.

What could make Europe great again?

Uncertainty should remain high in 2025. However, Europe is priced for the worst, and economic stimulus expectations are low, leaving room for positive surprises. We see some upside risks at the end of the tunnel:

• **Some macro-economic green lights:** The outlook for real household disposable income remains strong and should support an increase in consumption. Consumers also have a high savings rate. Therefore, as confidence continues to improve, consumers could potentially reduce their savings rate and increase their spending. Credit conditions and bank lending surveys have improved sharply. The labour market is resilient. Economic surprises have also recently turned positive again.

• **Accommodative monetary policy, disinflation, and a weakening euro:** The pace of easing could be faster than expected, as inflation is set to undershoot the ECB target. More ECB cuts could lead to a weakening euro, acting as a relative tailwind for European EPS.

• **Exaggeration of the tariffs risk:** Tariffs are unlikely to have a significantly negative impact on aggregate earnings estimates. We estimate only 6% of European companies' revenue (about 4% if we exclude defence) is generated by goods exported to the US. That impact is overestimated by markets.

• **Low expectations on EPS growth:** We anticipate +3/4% EPS growth for 2025e and 2026e. We think the more important determinant of equity returns in 2025 is whether earnings growth will remain positive. We think it will, and a weaker euro, not yet reflected in the sell-side consensus, should help.

• **Depressed valuations:** European equities do look rather attractive. Europe is trading at a >10% discount to their long-term average. A key fundamental driver of multiple expansion is interest rates. Lower yields are usually supportive of expansion in multiples, and as we will remain in a cutting cycle into 2025, we think this could be supportive of such an expansion. Europe is also trading at a sharp discount to the US, and this remains true on a sector-adjusted basis. The discount is historically wide in all sectors.

• **Positioning:** Long-only and retail investors are long equities but the consensus is clearly bearish on Europe. USD 388bn has flowed into US equities YTD 2024, vs. USD 49bn into Europe. Europe's recent underperformance looks overdone and lots of dry powder is left in money market funds and must be "put back to work". Europe will be on global investors' radar.

• **Fiscal expansion in Germany:** Germany does have the advantage of some fiscal headroom. If the new government has a pro-growth tilt and finds a way past the fiscal debt brake, it could boost public and private investment. Such a scenario might be a tailwind for German domestic stocks and lead to a re-rating.

• **China stimulus:** Massive stimulus in China could be one factor in supports for European companies (particularly in France and Germany) that have Chinese exposure.

• **Ceasefire in Ukraine**: A potential ceasefire between Ukraine and Russia could ease the pressure from energy prices and lead to lower risk premia. This could be a material positive for European assets.

Market views and positioning

Equities: We recommend a slight bias in defensives over cyclicals, driven by a moderate global growth slowdown and lower bond yields in the coming months. Some bright spots we see in Europe are aerospace (demand significantly exceeds supply), capital goods (the nascent electrification theme), real estate (exposure to lower yields), pharma (overdone regulatory risks, low leverage, strong cashflows and attractive valuations), and software (attractive long-term drivers from digitalisation and AI, the most defensive part of tech). Small and mid-caps also remain an area for selective outperformance, particularly in the US. We continue to see many small & mid-cap stocks as undervalued and an area of significant potential upside from an earnings and valuation perspective. On the flip side, we remain cautious on semiconductors (due to a challenging market backdrop, normalisation of demand in China, digestion of recent capacity additions), energy (high risk of EPS revisions), automotive (oversupply, competitivity, pricing pressure, low earnings clarity), and financials.

Rates: We see a trading range for much of 2025 with a bias to buy duration on any selloffs. Europe is a better place to be long duration, with the US 10Y yield having recently inched lower. We see a recovery in term premia in both Europe and the US. On Europe, we prefer peripherals and believe it is too early to reposition on France.

Credit: We are overall positive on credit for 2025. Credit is likely to remain a total yield, rather than a spread story at current tight levels. We prefer Europe to the US for both investment grade and high yield. We are sticking to a strong conviction for short duration.

Forex: The USD is on track to close out 2024 on a high note after a year of evolving narratives. We expect the USD the remain strong a bit longer, in the 1.00/1.05 range.

US exceptionalism and European "tacticalism"

US exceptionalism remains the playbook for the next few months, and we expect US stocks to continue their broad-based rally. However, it doesn't come cheap. At the opposite end, we see moderate downside for European assets, as cheap valuations, low expectations on EPS growth, depressed positioning, a weaker euro, peace in Ukraine, and an already "priced for worst" status may improve the asymmetry for Europe, once tariffs and domestic melodrama (France, Germany, etc.) are digested. Additionally, the wild card is if German Q1 elections offer some potential for the relaxation of the debt rule. Put simply, Europe will continue to face significant challenges in the next few months (quarters?) but also presents potential for investors. Structural reforms, fiscal flexibility, and innovation could unlock long-term growth, thereby narrowing the economic gap with the US.

To that extent, Europe can no longer be ignored. New-Year holidays are a perfect time to think about repositioning, at least tactically on Europe (due to green leadership, defense, Germany, mid-caps, short-duration credit, etc.). The question is not to play European "exceptionalism", which could take time to materialise, but to think about European "tacticalism", consisting in starting to close an underweight position (or initiate a position) on Europe.

READ THE PRESENTATION

OUR CURRENT CONVICTIONS FOR EACH ASSET CLASS

Equities	OVERALL EQUITIES			1		
	Large cap Eurozone		-1			←
	Mid cap Eurozone			1		←
	Small cap Eurozone			1		←
	UK			1		
	USA			1		
	Emerging markets		-1			←
	Japan			1		
	China			1		
Currencies	USD/€ (Direction of the USD)		-1			
	YEN/€ (Direction of the YEN)			1		
	GBP/€ (Direction of the GBP)		-1			
	CHF / € (Direction of the CHF)			1		
Commodities	Gold		-1			
	Crude oil		-1			
Government bonds	OVERALL GOVERNMENT BONDS			1		
	Core Europe			1		
	Semi Core Europe		-1			
	Peripheral Europe			1		
	USA			1		
Corporate bonds	OVERALL CORPORATE BONDS			1		
	Investment grade Europe				2	
	Investment grade short duration				2	
	High yield credit short duration				2	
	High yield Europe		-1			←
	High Yield USA		-1			←
	Emerging markets		-1			←
Money Market	Developed markets	2				

Source: ODDO BHF AM, data as of 22/11/2024

← → Changes vs previous Global Investment Committee meeting

Past performance is not a reliable indicator of future returns and is subject to fluctuation over time. Performance may rise or fall for investments with foreign currency exposure due to exchange rate fluctuations. Emerging markets may be subject to more political, economic or structural challenges than developed markets, which may result in a higher risk

ODDO BHF Asset Management SAS (France)
A portfolio management firm certified by the French Financial Markets Authority (AMF) under n° GP 99011.
Established in the form of a simplified joint-stock company with authorised capital of €21,500,000.
Entered into the Paris Register of Trade and Companies under number 340 902 857.
12. boulevard de la Madeleine - 75440 Paris Cedex 09, France - Tel. : 33 (0)1 44 51 85 00
am.oddo-bhf.com