Europe: Ending on a High?

European markets rebounded from year lows to deliver a strong October and November 2022, with 55% of STOXX 600 stocks trading above their 200-day moving averages.

The semblance of a Q4 rally is occurring despite a challenging backdrop. The European Central Bank (ECB) acknowledged that the Eurozone was likely to be heading for recession. ECB President Christine Lagarde also warned that Eurozone inflation has not peaked and risks are rising even higher than predicted. Unsurprisingly, the ECB raised its key rates by another 75 basis points, with the deposit rate, the refinancing rate and the marginal rate rising to 1.5%, 2.0% and 2.25% respectively.

Better-than-feared 3Q22 results did support recent stock gains, where Financials and Energy saw the best results while Consumer Discretionary and Real Estate disappointed. Operating margin appeared robust with an average of 14.9% versus the 14.6% consensus, driven by the Energy sector's year-on-year (YoY) margin expansion. However, six out of nine sectors actually missed estimates, and without Energy the average margin would have been 12.4%, missing expectations of 12.8%. Given that European earnings have considerably higher exposure to Energy companies than other regions, there has been a disproportionate impact from the sector. And the risk of an earnings downgrade cycle still exists, with the energy crisis keeping macro uncertainty elevated and the potential for reduced currency support, providing risk to consensus 2023 earnings forecasts.

In the near term, Europe will have to swallow the pain of higher prices and reduced energy supply. The more energy-intensive sectors are the most at risk, many of which are already low-margin, making weathering the high energy costs even more challenging. Households also face higher heating and electricity prices, weakening their spending power. And global circumstances remain fluid. China put in motion a relaxation in its stringent zero-Covid policy, and this was a big boost for European exporters – until the Covid case count spiked and the narrative shifted.

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Recent investor sentiment surveys reflect the mixed picture. The November 2022 Bank of America Fund Manager Survey showed a net 95% of participants expect a recession in Europe over the next year, the highest level since 2008. Yet, 53% of investors saw upside for European equities over the coming twelve months (up from 39% in September 2022).

Given the environment, we still see value in taking a diversified approach that encompasses exposure to defensive names, companies providing good shareholder returns, and stocks with inflation-hedge qualities. The STOXX 600 trades on 12.3x 2023e, 30% cheaper than the S&P 500 and at the widest discount since 2005. In addition, dividend yield remains a positive quality for European stocks.

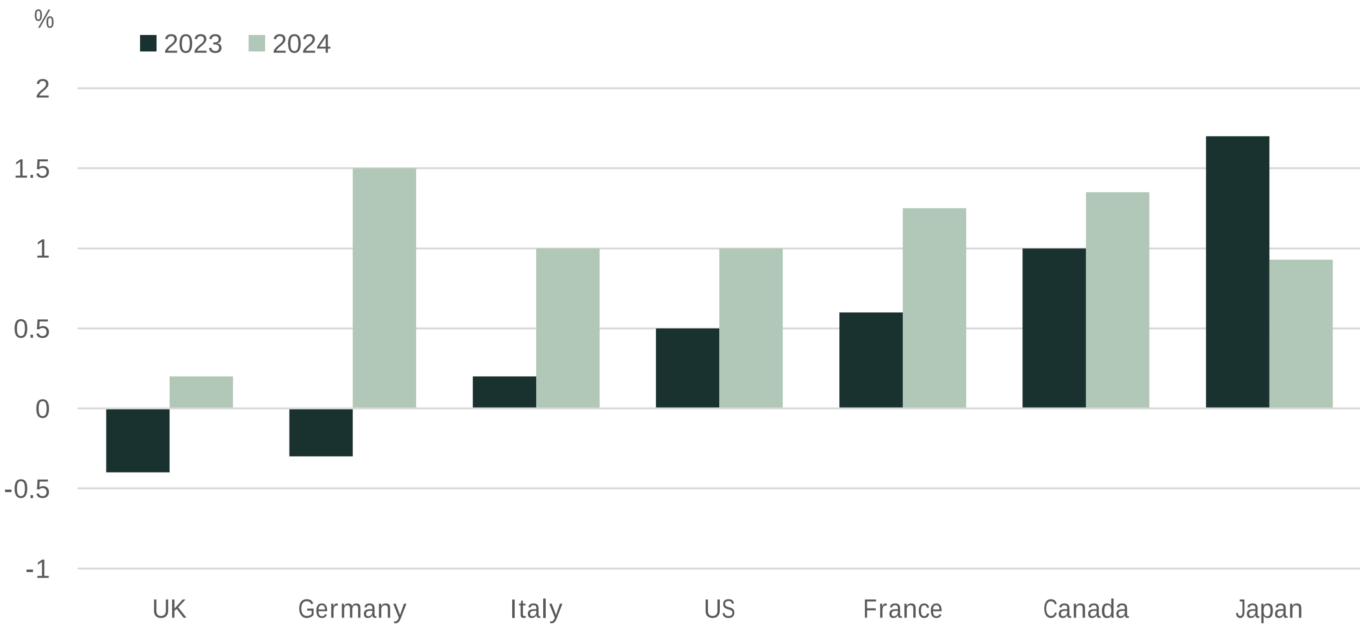
However, it is clear that regional markets have rallied substantially since the October 2022 lows and we would expect some consolidation in this upward price momentum in the near term. This could then offer a better entry point with higher conviction, particularly if we see more momentum in the China reopening story.

UK: The More Things Change, the More They Stay the Same

The Liz Truss premiership lasted just 44 days. The fallout from her ill-judged mini-budget meant former Chancellor Rishi Sunak became the latest Prime Minister to take on the UK's range of challenges.

The UK is the only G7 economy that has not recovered to its pre-pandemic size after suffering from a decade of lower productivity and near-stagnant income growth, and is predicted to be the worst performer in 2023 and 2024 (see Chart 1). Inflation remains an issue, with consumer prices rising to 11.1% YoY, a 41-year high and above the Bank of England forecast of a 10.9% peak.

CHART 1. UK PREDICTED TO BE WORST PERFORMER IN G7 (CHANGE IN GDP YOY)



Source: OECD, Bloomberg, as of 28 November 2022

Such is the concern about inflation, the central bank pushed through its largest interest rate increase in 33 years, bringing the benchmark lending rate to a 14-year high of 3%.

Added to that, a recession has already begun according to the Bank of England, and is forecast to last for eight quarters, potentially the longest recession on record.

Faced with this backdrop, Jeremy Hunt, the latest Chancellor, got to work with the government's new economic policy. Tax hikes were at the forefront of the Autumn Budget Statement, with the oil and gas sector facing an expanded windfall tax of 35%, up from 25% and was extended to 2028 from 2026. Corporation tax will also rise to 25% from 19% from April 2023, while the surcharge on bank profits will fall to 3% from 8%.

Some companies seem to be navigating the current environment better than others. A UK retailer stated trading was in line with its forecasts. A budget airline raised its full-year passenger goal and said bookings looked strong as far ahead as next summer. A supermarket chain also maintained its full-year profit outlook. At the same time, however, an online furniture retailer went into administration, with a retailer acquiring the brand. A clothing retailer also warned that it may not be able to repay a GBP5 million loan.

Consumption has not yet collapsed, though trading down is becoming more apparent, with consumers now faced with the perfect storm of a rise in mortgage rates, a cost-of-living crisis and potential tax rises. The FIFA World Cup has provided a much-needed distraction and spending support for supermarkets, while shorter days and cooler temperatures of a British autumn has limited some of the earnings upside for the hospitality sector.

And when the traditionally lean month of January comes around, Christmas credit card statements will coincide with higher heating bills. Also, the milder weather may well help reduce the energy cost impact on consumers, but it is less helpful for retailers trying to offload seasonal clothing. This could result in even more aggressive discounting to reduce inventory (an online retailer is sitting on more than GBP1 billion of unsold stock), which will squeeze margins.

But from an equity market performance perspective, the UK continues to show resilience in the face of domestic headwinds. It remains one of the best-performing markets year-to-date in both local currency and dollar terms, and trades on only 9.6x 2023e price-earnings ratio (P/E). Its bias towards overseas-focused defensive and commodity names is playing well in the current environment. UK equities remain favoured over Continental Europe.

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