Europe: Showing New Year Resolve

New Year, new start? Perhaps.

Dragged down by Russia's war in Ukraine, inflation and tightening monetary policy, the STOXX 600 Index ended 2022 lower by 12.8%, its worst performance since 2018.

The outlook for European stock markets in 2023 turns on a connected set of economic and geopolitical drivers, which include inflation, sanctions on Russia, central bank policy, China's reopening, oil prices and currencies.

But 2023 has at least started on a more positive footing. Firstly, Europe has benefited from an unusually mild winter, which has resulted in a sharp fall in gas prices that has lessened the risk of an energy shock. This has been a positive for both corporates and consumers alike.

Next, China's reopening can be viewed as favourable, supporting sectors such as luxury goods, even if it does bring the risk of new inflationary pressures. German stocks have traditionally outperformed European peers when China outperforms the rest of Asia. In that context, investors have turned more positive on the region, reflected in increased fund flows into regional exchange-traded funds.

Anticipation of less aggressive European Central Bank rate hikes, thanks to lower inflation data, has also been supportive. This is despite some more hawkish Governing Council members suggesting that there is still further to go.

This early-year outperformance has seen cyclical names outperform defensive names, with investors looking beyond recession and inflation risks. Last year's winners like Energy, and traditionally defensive areas like Healthcare and Consumer Staples, are languishing at the bottom in terms of returns. Italy's FTSE MIB Index, which closed 2022 at record valuation lows, has led the way in 2023 while the UK has lagged – a sure sign that pro-cyclical value is attracting fund flows.

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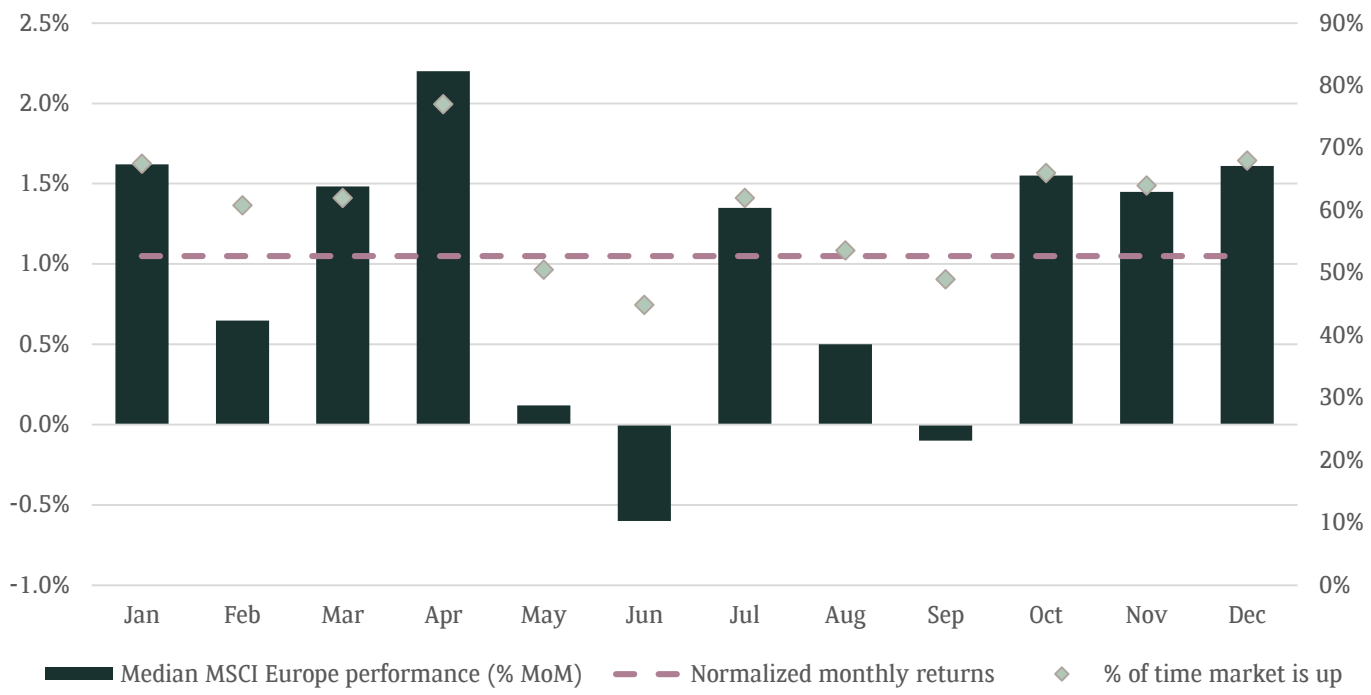
Given the confident start to the year, quarterly earnings are a big focus. Analysts had been more aggressive in revising down European earnings expectations going into the results season than was seen in the US. But that has not stopped us from seeing volatility.

Earnings have been far from stellar. As of 10 February 2023, only 58% of the STOXX 600 have beaten earnings expectations and 35% have missed. Banks have been the standout, with Consumer Discretionary particularly heavily hit. The worst of a profit recession may have been avoided but negative share price reactions have been significant on disappointing results. Some companies posted double-digit declines on earnings misses. Forward guidance has been key, and stock prices tended to hold up when companies signalled the outlook had not deteriorated dramatically.

One issue that gets highlighted by analysts is that fixed income in Europe is finally starting to offer a viable alternative for multi-asset fund managers, particularly as the equity risk premium in Europe has fallen to cycle lows. Nonetheless, European equities still look attractive from an earnings growth, shareholder returns and valuation perspective. Given that payout ratios remain low, there is also room to raise dividends across the region. This is important because over the longer term, dividend income in Europe typically provides two-thirds of total equity returns through the cycle.

With valuation multiples still looking attractive relative to the US, and the market in a seasonably favourable period (see chart 1), we believe the market can start to look beyond looming earnings risk. Our view on Continental Europe has been raised to positive.

CHART 1: SEASONALITY OF MSCI EUROPE PERFORMANCE – MEDIAN SINCE 1970



Source: Organisation for Economic Co-operation and Development, Bloomberg, as of 28 November 2022
Past performance is not indicative of current or future performance.

UK: A Winter of Discontent

The UK's FTSE 100 index eked out a gain for 2022 and outperformed major equity markets for the first time in a decade, aided by the record decline in the pound and buoyant commodity prices.

The benchmark finished 2022 up 0.9% at a time when the more domestic-focused FTSE 250 lost 19.5%, its biggest annual loss since 2008. In US dollar terms, the FTSE 100 lost 10%, still beating the MSCI All-Country World Index by nine percentage points — the most since 1996.

Differentiating stocks exposed to the domestic growth story with those with high overseas exposure is important when it comes to the UK, given that the domestic economy is facing one of the most challenging macroeconomic backdrops amongst advanced economies.

On the surface, the UK still faces many challenges. A range of strikes has disrupted daily life, from public transport to health services, in the biggest wave of industrial unrest since the 1980s. Inflation is still running at 10.5%. The British Chambers of Commerce suggests the economy has entered a five-quarter recession, with growth returning gradually in late-2024. The International Monetary Fund expects the UK to be the only G7 economy in recession in 2023. In relation to the energy crisis, help only started for households in October 2022 and will be scaled back in April 2023, meaning higher bills to come. Concerns remain that the situation will not improve by next winter.

The Bank of England also delivered its 10th consecutive interest-rate increase, raising rates by 50 basis points to 4%, alongside forecasts underscoring the risk that inflation becomes more persistent in the UK economy. A major retailer's cautious profit outlook highlighted the challenges within the UK market.

Yet, expectations were already low going into 2023, and so far the worst-case scenarios have not played out. The consumer demand is holding up post-Christmas. Inflation may be peaking. European gas prices have fallen more than 20%. Mortgage rates have already come down from their November 2022 high. Such has been the recent turnaround in the outlook, a 2023 recession is no longer guaranteed – or at least the very least could be shallower than expected.

Even though the FTSE 100 recently reached an all-time high, the UK has lagged most of its pro-cyclical peers this year. 2022's stable performance was supported by a convergence of drivers that played to the FTSE 100's unique composition. Elevated interest rates have supported banks' profitability, while rising metals prices have driven returns in commodity names. And with more than 70% of revenue coming from outside of the UK, pound weakness has been supportive. But some of these underlying fundamental supports evident last year are now faltering or running out of steam.

Nonetheless, the market still offers yield and valuation attractions – important elements in a rockier macro environment. The FTSE 100 has a dividend yield of 3.6%, higher than the 10-year gilt yield of 3.4%. Our current preference is for UK names with international exposure, the exception being domestic-focused banks that benefit from the rising rate cycle.

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