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News

European Outlook 2023

With a tolerable monetary headwind, pockets of earnings tailwinds and modest valuations it may just be that Europe continues to shine versus its peers.

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12 Dec 2022

The European equity outlook at the beginning of 2022 shone particularly brightly, yet as we know this quickly unravelled in late February with the deplorable Russian invasion of Ukraine. Despite this, Continental European indices in local currency terms have been an outperformer this year, most notably driven by the speed of the fiscal response to the crisis and a weaker euro. With equities having seen a strong bounce from mid-October, investors should be on the lookout for buying opportunities as we head into early 2023.

The global monetary inflection has come thick and fast this year. The European Central Bank will likely take interest rates to a peak of around 2.5% by the end of the first quarter of next year. Central banks have found themselves behind the curve in the face of spiralling inflation, but for all this European rates will remain much lower than those in the US or the UK. Eurozone headline inflation is expected to peak in December at multi-decade highs and slow thereafter, driven by energy price base effects. Full year 2023 headline and core inflation will stay well above ECB 2% target levels, driven by food, services and wages. Therefore the ECB is unlikely to pivot or cut rates too soon given their sole focus on inflation. Whilst rates will probably not fall until 2024, markets will be on a firmer foundation post their peak and this will encourage the idea that the trough is behind us.

Interest rates in Europe had been negative for eight years up until the inflection in July. This has been the land of Goldilocks for growth-biased funds, who surfed the ever lower risk-free rates and subsequent elevation of multiples. Arguably, this party has come to an end, as higher rates simply means higher valuation sensitivity. We are back to the old days of rationalising valuations in grown up ways, without having to rely on excessively low discount rates. This likely means that the more egregiously valued growth stocks will be out of fashion for quite some time, benefitting both Europe's relative performance versus the US and those areas of the European market which enjoy higher rates. Indeed Europe's PE differential versus the US is as great as it has been over the last decade, suggesting that there is ample scope for the gap to close.

With the consensus macro outlook forecasting extremely weak global growth in 2023 and European growth close to zero for the full year, it is likely too early now to be buying non-financial cyclicals. Similarly, Consumer stocks should be largely avoided for some time until the negative real wage gap starts to shrink and the cost of living crisis starts to abate. Therefore we need to be hunting in areas of earnings surprise and resilience, in this context many roads lead to the banking sector. This has been a long term pariah, responsible for a chunk of Europe's decade long underperformance but here and now there is cause for optimism with deposit spreads finally turning profitable and interest margins expanding. The sector's combination of extreme rate sensitivity, surprisingly modest earnings expectations and sector over-capitalisation leaves it a solid bet for 2023.

Elsewhere, stocks with a structural demand underpinning driven by positive thematic trends are the bedrock for the long term. For Europe the Green Deal or net zero beneficiaries are a perfect starting point, whether it's a Schneider in buildings energy efficiency or an RWE in offshore wind these stocks can compound. The Ukrainian war has required Europe to be pragmatic on the energy front, but the long term environmental direction of travel has never been more resolute. Elsewhere, the whole sphere of stocks driven by digitalisation are structurally propelled and this can be within semiconductors, music, gaming or the likes of those who implement digitalisation such as Cap Gemini.

The European energy supply situation will have to remain pragmatically fluid in the next years, but the response has been swift. The rapidity with which gas storage has been filled has been a significant near term positive for European markets abating rationing fears. Russia has fallen from 40% of European gas supply to below 7%, whilst European gas demand has fallen north of 10% and is set to fall further through switching. Germany has already opened its first new LNG terminal at Wilhelmshaven, with more to come. Most would expect that energy prices may well plummet when the Russian invasion of Ukraine ends, but how much might depend on the imponderable of the post-conflict Russian leadership structure. Until then, energy remains a competitive disadvantage for Europe, albeit wholesale gas prices have fallen nearly sixty percent from the August peak. As ever Europe moves closer together during a crisis and as the EU Commission President stated in her State of the Union speech "the Continent has risen in solidarity." For all the doomsayers European Governments have delivered over this tumultuous near three year period and fiscally mitigated the economic downside with unemployment at long-term lows.

The melting pot of war, rates, inflation and near recession will doubtless drive market volatility. Markets can wax between recovery and despair in short periods, whilst fast money positioning can drive dramatic effects. Meanwhile, the one constant is that Europe remains unloved by international investors, with outflows continuing throughout this year. Despite this the environment is favourable for stock pickers, buying the Value beneficiaries of current times and bottom picking some of more GARP like names. With a tolerable monetary headwind, pockets of earnings tailwinds and modest valuations it may just be that Europe continues to shine versus its peers.

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