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Investing for a world of change

# What can European equity investors learn from the the 1970s?

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## 2022 has been extraordinarily turbulent in global markets but was Europe one of the most volatile regions?

In many ways, yes. Investors started 2022 feeling reasonably positive towards European equities, but this changed at the end of February when Russia invaded Ukraine. A further turning point was when gas supplies through the Nord Stream pipelines were cut off. Both of these were binary risk-off events that served to increase the upside risks to inflation and the downside risks to growth. Yet, the severity of this broader inflationary backdrop, which we have not experienced since the 1970s, is not a Europe-specific phenomenon and much of it is the culmination of the decade-plus policies of central bank largesse.

Some investors may be surprised to learn that Europe has outperformed the US stock market so far in 2022 in relative terms. On 11x forward earnings, Europe's valuation is severely depressed, but we believe that much of the derating has now taken place. We believe it is now difficult to argue that regional equities, either in absolute terms or relative to other markets (or even relative to interest rates), are expensive.

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The content of this communication is intended for readers with existing knowledge of financial markets.

## Does Europe's relative outperformance take into account the possibility of a recession in 2023?

We have studied drawdown and recessionary periods in Europe and other developed markets from the 1970s onwards, because that is the best way to understand what is going on. There are three distinct features of a proper market correction: first, valuation multiples compress; second, earnings follow after a lag; third, the market bottoms well before the earnings cycle troughs. We expect earnings will, generally speaking, be revised down by another 10-15% and keep declining for another four months after the market correction.

We think that the first valuation phase has now played out across Europe. The second stage, and our more longstanding concern, has been that regional consensus earnings expectations need to be rebased downwards. Consensus estimates currently indicate about 11% growth regionally, while also extrapolating peak margins. We believe this will be difficult and think we are starting to see signs that those earnings estimates are weakening as we move through the Q3 reporting season and into Q4. Indeed, we have seen other global bellwether companies like FedEx issue profit warnings and prove to be the canary in the coal mine, so an earnings rebasing is a critical part of the market bottoming out process.

Regarding Europe's relative outperformance, remember this is a potential stagflationary-driven slowdown/recession. The only precedent we have is the 1970s when multiple compressions caused the majority of equity market drawdowns. In this sense, Europe has been less vulnerable than other markets that came into the downturn on more inflated multiples.

## Is the worst now behind us?

Once earnings and expectations turn more realistic, then we can start becoming a lot more constructive about risk and the opportunity set. If you pay attention to the lessons of the 1970s, or more recent drawdowns such as the COVID pandemic or the Global Financial Crisis (GFC), key uncertainties need to be addressed.

During the pandemic, the issue was vaccine rollouts. In the GFC, it was the bailout of the highly-distressed financial institutions. In the 1970s equity markets moved sideways but they enjoyed three large rallies, which coincided with a peak in the inflation growth rate due to central bank action. We need to reach the 'Fed pivot', to become more constructive on European equities. Having said that, there are always opportunities, and valuations and dispersion are such that stock picking is coming to the fore again, versus the world of 'quantitative easing infinity' when markets were risk on.

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## What sectors look interesting?

We see three distinct opportunities; first, in defensive or value-orientated areas of the market such as energy, which we believe offers us a direct inflation hedge. It contains companies on over 20% free cash-flow yields that are able to operate profitably at US$45/bbl breakeven oil prices, which is substantially below where the spot oil bbl price curve is today.

Second, investors often forget that Europe is home to some globally dominant, durable growth businesses with significant market shares, high gross margins and cross-cycle pricing power. Often, these businesses are the beneficiaries of domestic currency weakness. The drawdown over 2022 has made a lot of these companies much more affordable.

Finally, we are also revisiting European companies positively exposed to medium-term multi-year sustainability megatrends. Renewables is an obvious example, but industrial automation and efficiency is another; we believe that following the invasion of Ukraine, EU policy is accelerating some of these long-term trends because energy security overlaps with climate.

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