Outlook on

Europe

JAN 2023

Summary

- The stock market revival of recent months seems premature, given the full effects of 2022's aggressive hikes in interest rates have yet to be fully felt.
- We believe forecasts of a shallow recession in the US and Europe are overly optimistic.
- However, the headwinds facing European economies and companies are arguably more priced into stock market valuations than in other developed equity markets, while Europe is likely to exit recession first.
- Easing inflation led to a rebound in European fixed income markets in Q4 2022, ensuring a tough year for investors ended on a brighter note.
- The repricing of European bonds in 2022 means yields are potentially providing attractive entry points—2023 could be an interesting year for the asset class.

European Equity

Readers over a certain age may have childhood memories of the epic animated tussles between Wile E. Coyote and the Road Runner. Without fail, each Looney Tunes cartoon would depict the coyote chasing his nimble nemesis off a cliff, belatedly realising that the ground had vanished from under his feet and plunging to earth.

Overinflated stock markets can sometimes resemble the reckless coyote; share prices can tumble rapidly when investors suddenly grasp there is nothing propping them up. In the turbulent first half of 2022, many investors thought the global economy and stock markets were heading over a cliff. But in a reversal of the classic Looney Tunes comic set piece, when the market looked down, the immediate reality was less bleak than it initially feared. The market had gotten ahead of itself.

The pendulum has since swung too far the other way. Unlike earlier in 2022, when the market was looking too far into the distance, it has taken a very rosy short-term view in recent months. It has interpreted signs of a peak in US inflation, and with it an assumption of less upward pressure on rates, as reasons for optimism. Share prices have rallied significantly: the MSCI Europe Index is up 9.7% (in euro terms) since mid-October's market lows.[1] Complacency has replaced fear, with investors resorting to the muscle memory of buying the dips. This Pavlovian response made sense during the long era of the US Federal Reserve (Fed) put, when abundant liquidity and cheap money provided investors with a safety net, but not in a world where central banks are shrinking their balance sheets and still hiking rates.

By contrast, we retain a cautious stance. Forecasts of a shallow recession in the US and Europe strike us as overly sanguine. Nominal interest rates may be low by historical standards, but we believe it is premature to judge the depth of the looming recession lightly when one considers that central banks have rarely, if ever, raised interest rates by this magnitude and at this pace (Exhibit 1). While economies and borrowers tend to adjust to lower rates, the impact of rate rises from lower levels can prove more of a shock to the system. Put another way, interest payments may hit multiples of the original amounts borrowers were paying earlier in this cycle. This is a highly unusual occurrence with little historical precedent.

LAZARD
ASSET MANAGEMENT

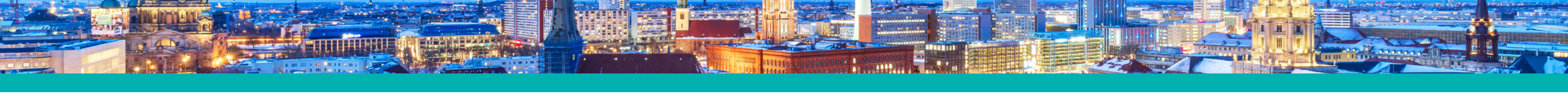
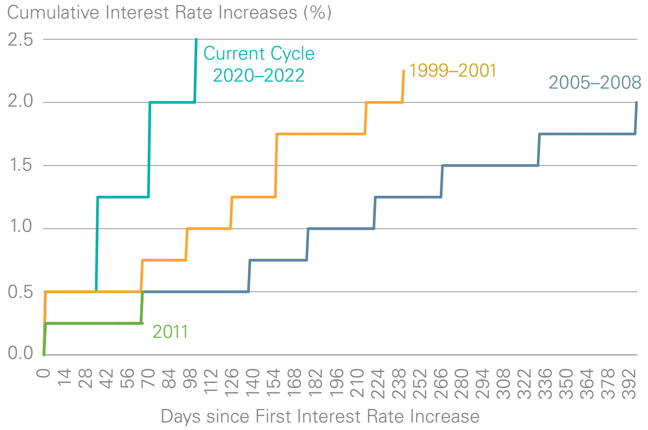
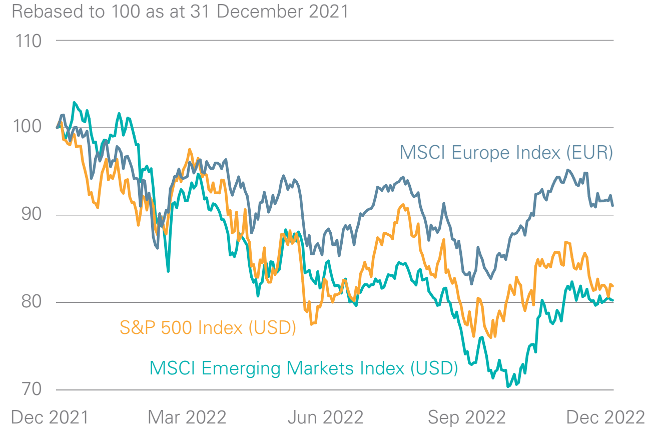


Exhibit 1
The ECB Has Been Aggressively Raising Rates



As at 31 December 2022
Source: FactSet

Exhibit 2
European Equities Could Extend Their Recent Outperformance



As at 31 December 2022
Source: FactSet

Companies and consumers are likely to find 2023 a highly challenging year as the effects of 2022's rate rises begin to bear on their finances. Recent hawkish statements from the Fed and European Central Bank (ECB) lend further support to our view that investor restraint should prevail for now. There is more monetary medicine to come in 2023, despite the global economy having yet to feel the full effects of last year's multiple rate hikes.

Adding to our circumspection, higher interest rates have a nasty habit of delivering unintended consequences and triggering financial accidents, often in the most surprising of places. One example was the 2007 collapse in the US subprime mortgage market. Today, the bank sector is far healthier globally, so banks are unlikely to be the epicentre of the next crisis. Nonetheless, we believe it is prudent to be prepared for the unexpected in a higher interest-rate world.

Europe: First In, First Out?

Turning to Europe specifically, despite the pace of rate hikes in Exhibit 1, we do not believe European interest rates will have to rise as much as in the US. The challenging dynamics of European energy markets and high energy costs facing the region's businesses and consumers are effectively doing the ECB's job of suppressing demand and reducing general price pressures. Mild weather across Europe in October and November meant the rise in energy prices has not been quite as dramatic as feared. But as we outlined in our Q3 2022 outlook, high energy prices may well cause Europe to enter a recession ahead of other regions. However, we also believe the combination of adaptive responses to the energy crisis and policy approaches, combined with the base effect, may help Europe to come out of recession first.

An earlier economic recovery should enable European stock markets to decorrelate further with other developed markets—a process that has been underway since the peak correlations seen during the pandemic. In turn, and buttressed by attractive relative valuations, we believe this should leave European equities looking relatively attractive, suggesting that the outperformance of European markets versus US markets seen in the second half of 2022 (Exhibit 2) could be extended.

Stickier Inflation Ahead

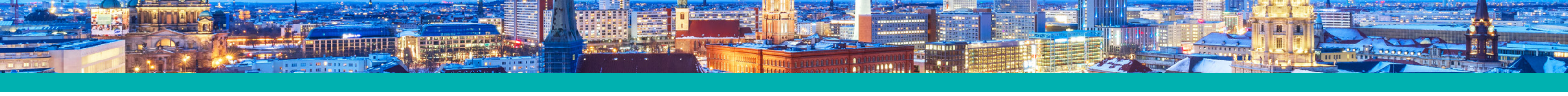
Encouragingly, US and European inflation does indeed seem to have peaked. Furthermore, with lower oil prices, falling transport costs, manufacturing inventories dropping amid a greater availability of components, and an improved supply of semiconductors, there are welcome signs that input prices are starting to roll over. Lower input prices should be reflected in lower output prices as 2023 unfolds. That said, we are now probably in a world of higher and stickier underlying inflation, given widespread wage-rise demands and increased strike activity, as seen in the UK in recent months.

There is also some hope that the ECB will not feel the need to tighten too much. Much attention is placed on the central bank's 2% inflation target. But if the ECB's words are accepted at face value, this target represents an average over time. As Europe experienced lower rates of inflation until recently, there is room for inflation to run at a higher level for a while (although not at multiples of the 2% target).

Falling Inventories Are a Challenge for Late-Cycle Sectors

Another challenge of the current economic environment has been the remarkably high inventory levels, as noted above. Unusually, many industrial companies have had exceptionally large order books with longer-than-normal turnaround times. This has been an outcome of supply chain failures and customers being unable to source goods as and when needed, leading them to overorder. This situation should correct over the next 12 months, which will be good for corporate cash flows as inventories are cleared. However, the normalisation of order books may serve as a hit to medium-term growth, a factor that does not seem to have been fully discounted by the equity market in relative valuations of these mostly late-cycle companies.

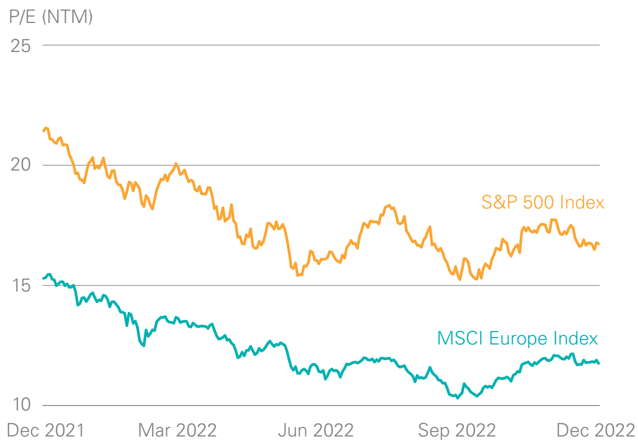
By contrast, we believe some early-cycle companies offer upside potential in the year ahead. Many have already experienced severe margin contractions because of high input prices (e.g., oil and power), and their valuations already discount much of this pain. They should benefit from both falling input prices and a bottoming out of demand.



Europe’s Problems Are Being Priced In

Having painted a gloomy picture of the challenges facing consumers, companies, and economies in 2023, we would stress that these headwinds are arguably more fully priced in within European stock markets than in most other equity markets. The region’s stock market valuations have already contracted by over 20% and remain at a sizeable discount to US equity ratings (Exhibit 3).

Exhibit 3
European Equities Are Attractively Valued versus US Stocks



As at 31 December 2022
Source: FactSet

Finding Opportunities

Despite the gloom, we are finding opportunities within specific industries that are less affected by the current economic environment. For example, the aerospace industry currently enjoys large order books. Its airline customers are rebuilding fleets to become more fuel-efficient after downsizing during the pandemic. Elsewhere, financials are benefitting from a return to a rising yield environment, a tailwind they have not felt for many years. In addition, we now see value emerging in certain cyclical industrials and consumer-facing parts of the market that have already experienced a significant downturn.

European consumer stocks should also gain from China’s reopening after the relaxation of its zero-COVID policies. In comparison to a global economy likely to be in recession, the Chinese economy could rebound strongly this year if it can throw off its COVID-19 shackles. This would be a welcome boost for global trade. Since companies within the MSCI Europe Index derive 7% of their revenues from China, versus 3% for S&P 500 Index constituents, Europe’s popular consumer brands are particularly well placed to profit from a more upbeat Chinese consumer. Finally, we are drawn to areas benefitting from structural growth drivers, such as music streaming.

At some point, geopolitical volatility may create a major buying opportunity within Europe. This might arise out of the conflict in Ukraine, depending on what President Putin plans to do to reverse Russia’s flagging fortunes in the war. Or it may be weather-related. It has been a benign European winter thus far, but an extended period of low temperatures across the continent may start to see gas stocks depleted at a faster-than-expected rate, sending energy prices even higher and hurting business and consumer confidence. We will remain alert to any such buying windows.

Policy Co-ordination and Superior ESG Support European Exposure

Lastly, we would point to two ongoing developments that add to the long-term secular appeal of European equities. First, the EU’s effective policy coordination over energy supplies and its united front against Russia’s aggression has challenged traditional criticisms that the region is politically dysfunctional. European political leadership now looks far more coherent.

Second, as companies and stock markets in the rest of the world catch up with Europe in terms of ESG-related disclosures and data availability, the generally superior ESG characteristics of the region’s companies should become even more apparent as straight comparisons become easier. This should serve as a positive differentiator for European stocks.

The powerful monetary medicine dispensed last year by the major central banks, including the ECB, has few historical precedents. And the impact of this severe tightening is still unfolding, suggesting the recent buoyancy in global stock markets is unwarranted. Certainly, the European economy will face another challenging year in 2023, after a tumultuous 2022. But the difficulties ahead are beginning to be priced in, with European valuations at modest levels that compare favourably to the US stock market. Complemented by our opinion that the region will likely emerge from recession first, encouraged by peaking inflation and bolstered by our view that the current rate-hiking cycle in Europe will be less severe than elsewhere, we believe European equities offer relative attractions that should come to the fore as the year progresses.

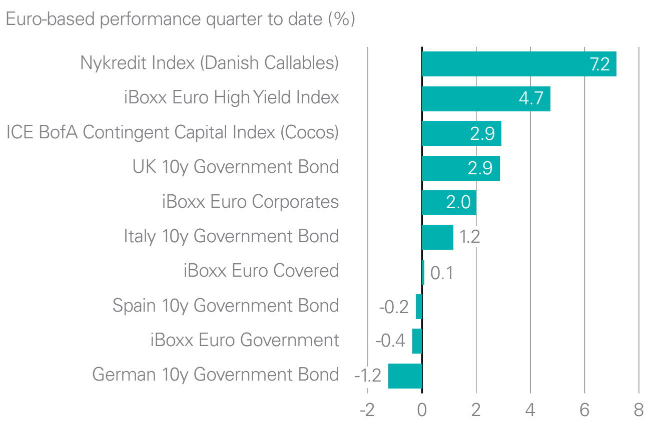
European Fixed Income

Inflation and rate hikes ensured a disappointing year for fixed income returns in 2022. As noted above, though, relief came from the inflation figures at the end of the year, giving rise to hopes that rates have peaked. This positive inflation surprise helped fixed income markets to recover some ground in the fourth quarter (Exhibit 4).

But despite having fallen slightly, inflation remains far above the major central banks’ 2% target. Furthermore, even though all three of the central bank heavyweights—the Fed, the ECB, and the Bank of England—trimmed their rate hikes to 50 basis points in December, we believe inflation will remain high in 2023, which will call for additional central bank action; investors expect the ECB base rate to peak around 3.25%.

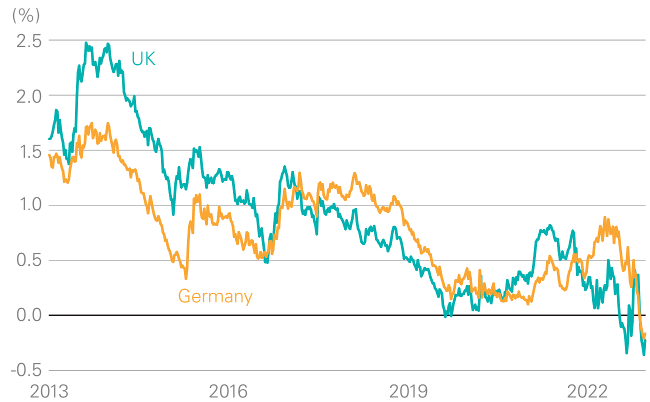
Looking ahead, European fixed income markets are focused on the prospect of a significant economic downturn. The risk of recession remains high, even if economic data has held up better than expected. And we can see these market fears of a downturn in the inversion of the UK and German government bond yield curves (Exhibit 5).

Exhibit 4
European Fixed Income Bounces Back in Q4 2022



As at 19 December 2022
Source: Refinitive Datastream

Exhibit 5
German and UK Yield Curves Have Inverted



As at 19 December 2022
Shows yield differential between 10-year bonds and 2-year bonds.
Source: Refinitiv Datastream

Europe may not have slipped into recession so far, but it faces a unique challenge due to the energy crisis. Until the beginning of December, mild weather across the continent helped to build up gas storage levels and led to lower energy prices, which in turn underpinned economic data. But the winter is not over, and inflation remains high.

On a brighter note, while last year was clearly tough for European fixed income investors, this difficult market environment has created opportunities. The repricing and higher yields of bonds are potentially providing attractive entry points; valuations appear cheap. Therefore, 2023 could be an interesting year for the asset class.

The caveat is the high risk of recession, which will likely be a significant factor for European bond markets to digest in the coming 12 months. The fourth quarter's recovery in bond markets was welcome, but it remains unclear if this represented a turning point or simply offered short-term respite. Carefully considered asset allocation will be critical in the months ahead.

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Notes

1 Source: FactSet. As at 31 December 2022.