On the Minds of Investors

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What would it take for European stocks to outperform the US?

The outperformance of US stocks relative to European counterparts has been one of the defining characteristics of equity markets in the post-crisis period. This piece highlights how two sectors—technology and financials—have played a key role in driving the divergence between the two regions over the past decade. We then debate the potential catalysts that could trigger a reversal of recent trends.

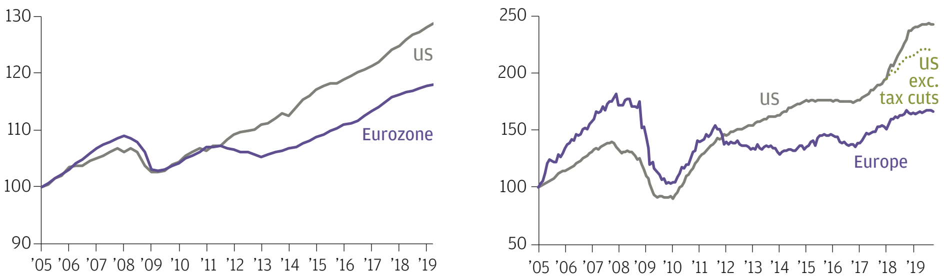
A gulf in growth

For golf fans, contests between the US and Europe evoke many exciting memories. Every two years, the best players from each region engage in a titanic battle over three days to determine which side of the Atlantic will earn the bragging rights. Recent contests have often gone down to the wire, with one magic putt or a lucky bounce of the ball proving to be the difference on the final afternoon.

While the US and Europe have been closely matched on the golf course in recent years, there has been no contest in terms of economic growth. Since the turn of the decade, the euro area has grown at just over half of the pace of the US. Europe's recovery after the global financial crisis has been hampered by a steady stream of political flare ups, most notably the sovereign debt crisis in 2012 and 2013. Mario Draghi's commitment to do "whatever it takes", augmented with wave after wave of central bank support, has succeeded in steering the European economy into calmer waters. Yet the recovery has been much shallower than policymakers would have hoped.

Europe's fragile backdrop has in part contributed to the anaemic earnings generated by many European companies at a time when US corporate earnings have expanded solidly. US corporates have grown earnings per share by 170% since 2010, in comparison to 59% for European companies. Tax cuts have helped to widen this gap further over the past two years, but as **Exhibit 1** shows, a significant gulf was present even prior to the latest sugar rush for US earnings.

EXHIBIT 1: US AND EUROPEAN ECONOMIC AND TRAILING EARNINGS GROWTH



Source: (Left) BEA, Eurostat, Refinitiv Datastream, J.P. Morgan Asset Management. (Right) MSCI, Standard & Poor's, Refinitiv Datastream, J.P. Morgan Asset Management. US and Europe earnings are represented by 12-month trailing earnings per share for the S&P 500 and MSCI Europe ex-UK respectively in local currency. US exc. tax cuts line shows an estimate of US trailing earnings if the 2017 tax cuts had not been implemented based on pre-tax profits. All series are rebased to 100 in January 2005. Past performance is not a reliable indicator of current and future results. Data as of 30 September 2019.

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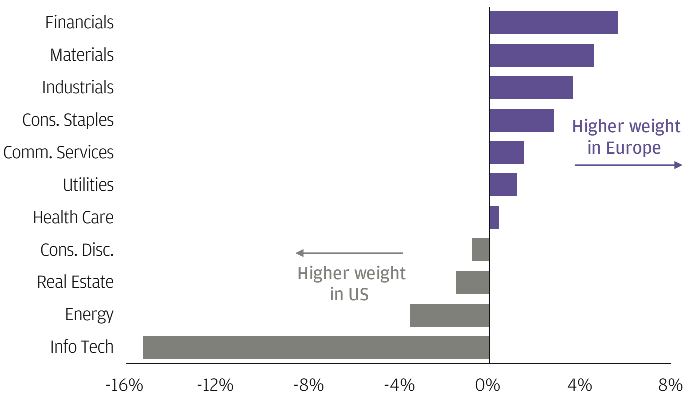
It's not just "the economy, stupid"

Economic growth may be one part of the puzzle, but it's also important to consider how equity indices are exposed to different parts of the global economy. Comparing the average weight of sectors across US and European indices since 2010, we find significant differences. European benchmarks have been heavily tilted towards financials, while the US stock market has provided much higher exposure to technology companies (**Exhibit 2**).

EXHIBIT 2: RELATIVE SECTOR WEIGHTS IN US AND EUROPEAN STOCK MARKETS

Average sector weights in US and European stock markets, 2010-2019



Source: MSCI, Standard & Poor's, Refinitiv Datastream, J.P. Morgan Asset Management. US and European stock markets are represented by S&P 500 and MSCI Europe ex-UK respectively. Averages shown are from 2010-2019, with the exception of real estate. Real estate stocks were only separated from the financials sector in 2016, so the real estate average shown is from September 2016 to September 2019. Past performance is not a reliable indicator of current and future results. Data as of 30 September 2019.

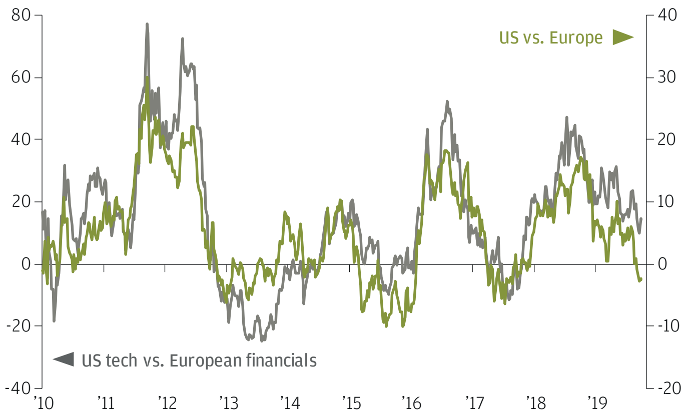
Drilling down deeper, however, may take some investors by surprise. While US tech stocks, for example, are often thought to be synonymous with the "FAANGs" (Facebook, Apple, Amazon, Netflix and Alphabet's Google), only one of these five mega-cap companies now resides in the tech sector, with the others split across communication services and the consumer discretionary sectors. Approximately three-quarters of tech stocks are divided relatively evenly across four sub-sectors by market capitalisation: systems software, tech hardware, data services and semiconductors.

In Europe, although "financials" is a term often used to refer to bank stocks specifically, European banks currently make up less than 60% of the financials sector, with insurance companies and other financial services firms, such as asset managers and stock exchanges, comprising the remainder.

The skews in sector composition have resulted in the historical performance of US vs. European stocks being closely linked to the performance of US tech and European financials. Over the past 10 years, the correlation between the relative one-year rolling returns of these two sectors and the two regions as a whole has been close to 0.9. As **Exhibit 3** shows, it has been very rare to find periods where US tech outperforms European financials and the US does not outperform Europe. Since 2010, US stocks have outperformed Europe by over 120%, with US tech and European financials accounting for close to half of this gap. From 2017 to date, when US tech stocks have soared and European financials have sagged, these two sectors alone have driven over three-quarters of the US market's overall outperformance.

EXHIBIT 3: ROLLING PERFORMANCE OF US TECH VS. EUROPEAN FINANCIALS, AND US VS. EUROPE

%, 12-month rolling relative performance



Source: MSCI, Standard & Poor's, Refinitiv Datastream, J.P. Morgan Asset Management. US and European markets are represented by the S&P 500 index and MSCI Europe ex-UK index respectively. US tech and European financials use the sector components of these same indexes. Total returns are shown in local currency. Past performance is not a reliable indicator of current and future results. Data as of 30 September 2019.

Catalysts for a European revival?

In order to identify a potential catalyst for a European resurgence at the index level, we first tackle the outlook for tech vs. financials. A reversal of recent trends could be driven from either side of this equation.

Starting with US tech, this part of the market has been on a seemingly unstoppable march higher since the start of 2013. While many investors often point to extortionate valuations within the sector, it is notable that at an aggregate level, the gap in valuations between tech and the broader index has only opened up materially since the start of last year. This suggests that much of the outperformance in prior years was driven by a stronger earnings outlook (**Exhibit 4**).

EXHIBIT 4: RELATIVE PERFORMANCE OF US TECH, AND VALUATIONS OF US TECH AND THE S&P 500

Index level, S&P 500 tech vs. S&P 500

x, 12-month forward price-to-earnings ratios

Source: Standard & Poor's, Refinitiv Datastream, J.P. Morgan Asset Management. For the left chart, the index level is rebased to 100 at the start of 2010. Past performance is not a reliable indicator of current and future results. Data as of 30 September 2019.

With stock market valuations increasingly being called into question as we move later into the economic cycle, tech companies will need to continue to generate outsized profits if their higher multiples are to be justified. The prospect of increased regulation poses another risk particularly in a scenario where the Democrats win the 2020 US election, although investors must be careful to distinguish between regulation that impacts the tech sector specifically compared to regulation that is more targeted towards some of the mega-cap FAANG stocks that are now bucketed in different parts of the market.

The battle for tech supremacy between the US and China is another key consideration. China's desire to become more self-sufficient in areas such as semiconductors poses a threat to demand for US products, although US companies retain a stronghold in many areas including cloud computing. While Chinese pressure on US tech may help European stocks to close the gap, further escalation in the trade dispute would also threaten European bourses given the European economy's high exposure to global trade.

The potential for US tax cuts to be repealed, either partially or in full, following the 2020 election is another risk for US stocks. All else being equal, the S&P 500 priced at 17x 12-month forward earnings based on a corporate tax rate of 21% would be equivalent to a price-to-earnings (P/E) ratio of over 20x at a corporate tax rate of 35%. Relatively low effective tax rates for the US tech sector prior to the 2017 tax cuts meant that tech companies were not the biggest winners. Yet the implications of a repeal to the tax cuts cannot simply be viewed as a mirror image, especially given that the outcome would also depend on the treatment of profits generated overseas under an amended tax code.

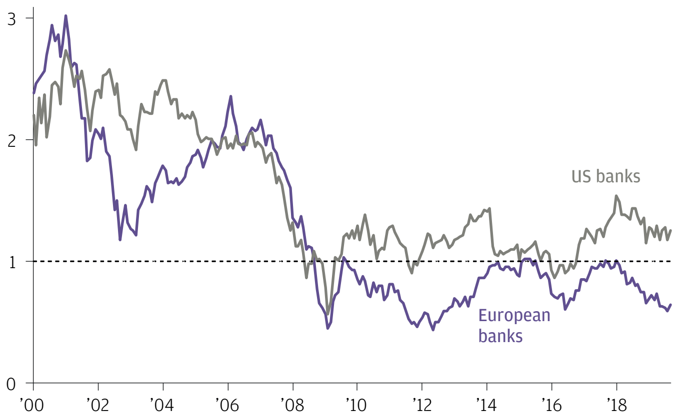
Turning to Europe, pressure on financials is coming from several angles, although the negative interest rate environment is often the first explanation offered for the decline in the sector. While the precise link between bank profitability and the level of interest rates remains up for debate, it is clear that a decline in net interest margins over recent years has coincided with a period of low or negative rates across the continent.

The European Central Bank (ECB) has recognised that there are unintended consequences from its highly accommodative policy stance, and has tried to offset these by introducing a "tiering" strategy whereby negative interest rates are only charged on a portion of a bank's reserves. While tiering can help to dampen the impact of negative rates on bank profitability, it does not serve to boost the outlook materially. With the ECB running out of ammo, attention is shifting to whether fiscal policy may be able to revitalise the eurozone growth outlook. A substantial fiscal package would certainly help to boost the growth outlook and support cyclical sectors, such as banks. Policymakers appear to be moving very tentatively in this direction, but northern member states in particular remain reluctant, and any expectations of a co-ordinated euro-area wide fiscal package in the near-term can be described as "optimistic" at best.

Given significant question marks over European bank profitability, price-to-book (P/B) ratios for the sector have failed to sustainably break through 1.0x since the global financial crisis. US counterparts have fared somewhat better, helped by a faster pace of recapitalisation and more aggressive underwriting of troubled assets, and less of the dilution of private shareholders that has dragged on European profits. **Exhibit 5** highlights the gap between US and European bank P/Bs that has opened up since the crisis.

EXHIBIT 5: BANK PRICE-TO-BOOK RATIOS

x, multiple



Source: MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. MSCI USA and MSCI Europe ex-UK bank sector indexes are used to represent the different regions. Past performance is not a reliable indicator of current and future results. Data as of 30 September 2019.

European financials are now trading close to two standard deviations cheaper than the broad region in 12-month forward P/E terms. This gap, which was last seen in the aftermath of the global financial crisis in 2009, suggests that prices currently reflect significant doom and gloom.

Given extremely high levels of competition, consolidation across the banking sector would likely be the most impactful way to improve the outlook. The European Banking Federation highlights that the number of banks across the European Union has declined by over 2,000 since 2009, but this still leaves over 6,000 organisations vying for business. Spain, Scandinavia and the Benelux are among the success stories on the consolidation front, but the combination of heterogeneous banking practices across different European nations and a lack of a unified European legal and tax structure make cross-border mergers particularly challenging. Frustratingly slow progress towards the completion of a fully integrated European Capital Markets Union has acted as a further headwind towards cross-border collaboration. Conversely, significant consolidation in sub-sectors of financials, most notably insurance, may in part explain why these sub-sectors have delivered strong returns over the past few years, yet they are not large enough to have driven an improvement in the financials sector as a whole.

All is not lost...

Even if the outlook for the banking sector looks murky, it's not all doom and gloom for investors in European stocks. While financials remain a significant part of European indices, sector exposures have become more balanced in recent years, particularly within concentrated mega/large cap indices such as the Euro Stoxx 50, where the exposure to banks has halved since 2008.

European stocks have traded at an average discount to the US market of approximately 10% since the mid-1990s. At a current discount of just over 15%, the undervaluation of the European market as a whole relative to the US bears is not extreme but does warrant attention. Flow data suggests that investors have shunned the market in recent years, with hefty outflows from European equity funds at an industry level since the start of 2018. Yet while political headlines have weighed on investor sentiment, many industry-leading businesses exist beneath the surface, often with little exposure to their domestic country's economy.

European indices also exhibit a stronger relationship to global growth, suggesting that if we were to see signs of stabilisation in the economic cycle, European companies stand to benefit disproportionately. Finally, for investors outside of Europe, currency impacts will also play a role. European stocks may warrant particular attention from US investors with a long-term horizon, given that the US dollar stands at relatively elevated levels compared to long-run fair value estimates.

Conclusions

For investors hoping for a turnaround in the prospects for the European market at an aggregate level, the outlook for the European financials sector vs. US tech should be a key consideration.

Valuations in the European financials sector already reflect much doom and gloom, although a near-term catalyst for a significant re-rating is hard to identify. Meanwhile, much of the outperformance of US tech has been driven by strong earnings, but for valuations to be maintained, companies will have to continue to demonstrate their ability to grow profits at a faster pace than the broad market at a time when changes to the US tax code pose a risk to US stocks.

Beneath the surface in Europe, industry-leading businesses risk being ignored by investors who are steering away from the market as a whole. In the absence of a pick-up in European growth momentum, investors may favour a selective approach to the European market. This includes a focus on screening for “quality”—those companies with strong balance sheets, stable earnings and robust return on equity—given their more resilient nature in periods of below-trend economic growth.

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