GLOBAL Insight WEEKLY

Perspectives from the Global Portfolio Advisory Committee March 28, 2024

The metamorphosis of European equities

Frédérique Carrier & Thomas McGarrity, CFA – London

No longer wan and listless, we think European equities are emerging from their chrysalis with newfound potential. We look at how the investment story is transforming and why investors should take a fresh look at the asset class.

We upgraded European equities to Market Weight from Underweight in March. Our bear case scenario was predicated on weakening economic and earnings growth momentum, but this no longer seems to be the case. The economy is showing signs of troughing.

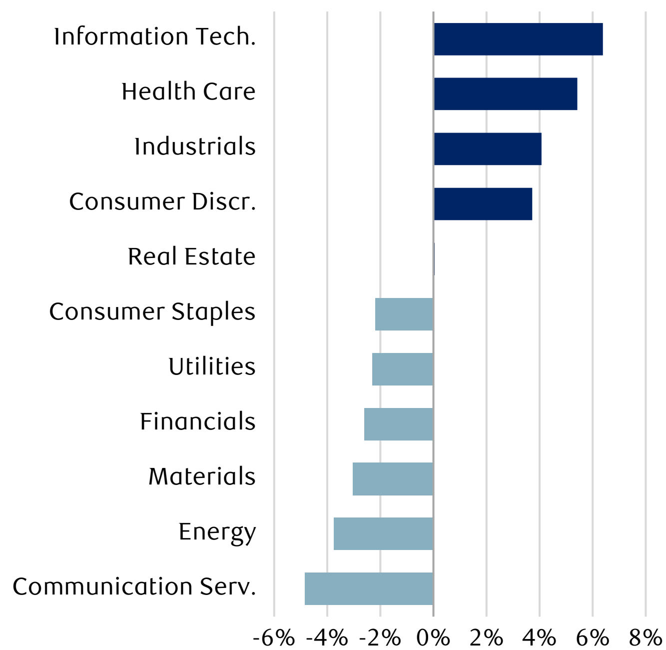
European equities present attractive opportunities, in our view, though misconceptions, anchored in the past, often prevent investors from seeking them out. We discuss the evolution of the European equity market since the global financial crisis and evaluate how to position portfolios advantageously.

A changing face

European equity markets are often thought of as being dominated by “old economy” companies. This was indeed the case 15 years ago when low-growth sectors, such as Financials, Telecommunication Services (now called Communication Services), Utilities, Energy, and Materials, made up a significant portion of the MSCI Europe ex UK Index, which comprises large-cap and midcap companies across 14 European developed markets. With lacklustre earnings growth stemming from poor pricing power and a highly competitive environment, the stocks of many companies in these sectors have been languishing ever since.

Low-growth sectors have been scaled back, while higher-growth sectors have gained

Changes in the sector composition of the MSCI Europe ex UK Index between January 2011 and March 2024



Note: The former Telecommunication Services sector was expanded and renamed Communication Services in 2018.

Source - Bloomberg, MSCI

For perspectives on the week from our regional analysts, please see pages 4–5.

For important disclosures, required non-U.S. analyst disclosures, and authors’ contact information, see page 7.

Priced (in USD) as of 3/27/24 market close (unless otherwise stated). Produced: 3/28/24 16:36 ET; Disseminated: 3/28/24 16:45 ET

But the profile of the European equity market has seen a notable transformation. Those old economy sectors are now no more than a third of the index. Higher-growth-oriented sectors, such as Technology, Health Care, Industrials, and Consumer Discretionary, now represent some 57 percent of the index, a sharp increase from 37 percent in 2011.

Notable changes are also afoot within industries. For instance, some of the formerly clunky and bloated conglomerates in heavy industries have slimmed down, spinning off underperforming operations to enhance capital efficiency, and are focusing on more modern, dynamic businesses and technologies. The Consumer Discretionary sector has also been transformed. It enjoys greater exposure to high-margin luxury goods, having benefited from demand arising from the growing middle class in emerging markets.

The evolution of the index's composition has had several notable consequences. For one, approximately 55 percent of the revenue of index constituents is now generated outside Europe, lessening dependency on what has been an often lacklustre domestic macroeconomic backdrop, while providing exposure to economies with higher growth rates.

Moreover, European companies' profitability, return on equity (ROE), earnings stability, and cash flow profiles have all improved. The ROE—a measure of profitability—of index companies reached 13 percent at the end of 2023, up from a meagre 9.8 percent in 2011.

Finding its footing

For the remaining 45 percent of revenue generated within Europe, prospects have improved somewhat, in our view. The region narrowly sidestepped a recession in the second half of 2023 despite stomaching three shocks in a row: the pandemic, the sudden energy price surge following Russia's invasion of Ukraine, and a harsh monetary tightening cycle. In fact, economic activity seems to have troughed.

Economic indicators such as the HCOB Eurozone Composite Purchasing Managers' Index have been improving since last October. The European Central Bank's (ECB) recent Bank Lending Survey points to lending conditions becoming much less restrictive. Real wage growth is improving amid falling inflation, and with markets widely expecting the ECB to cut rates in June, we anticipate the region's economy to continue to stabilise in coming months.

We acknowledge that the European economy does not have growth potential as high as that of the U.S., being more highly regulated and with an ageing population. But consensus GDP growth forecasts are no longer being downgraded and are stable at 0.5 percent and 1.4 percent for 2024 and 2025, respectively.

We see downside risk to these forecasts if labour markets were to deteriorate. Conversely, they could prove conservative if the Chinese economy were to improve, as Europe is a large exporter to that market. Moreover, if bank lending picks up as business confidence improves, this could feed into stronger investment growth, another source of upside risk to consensus GDP growth forecasts.

Top 10 companies by weight in the MSCI Europe ex UK Index in 2011 and 2024

January 1, 2011			March 1, 2024		
Company	Sector	Weight	Company	Sector	Weight
Nestlé	Consumer Staples	4.4%	**Novo Nordisk**	Health Care	4.8%
Novartis	Health Care	2.7%	**ASML**	Information Technology	4.7%
Total	Energy	2.4%	**Nestlé**	Consumer Staples	3.3%
Siemens	Industrials	2.2%	**LVMH**	Consumer Discretionary	3.0%
Roche	Health Care	2.2%	**Novartis**	Health Care	2.5%
Telefónica	Telecommunication Services	2.0%	**SAP**	Information Technology	2.4%
Banco Santander	Financials	1.9%	**Roche**	Health Care	2.2%
BASF	Materials	1.6%	**Siemens**	Industrials	1.8%
Sanofi	Health Care	1.4%	**TotalEnergies**	Energy	1.7%
Daimler	Consumer Discretionary	1.3%	**Schneider Electric**	Industrials	1.5%

Note: Some company and sector names have changed since 2011. Total is now TotalEnergies; Daimler is now Mercedes-Benz. The former Telecommunication Services sector was expanded and renamed Communication Services in 2018.

Source - MSCI, Bloomberg

A sheen of opportunity

Overall, as Europe's economy is stabilising, so too are corporate earnings forecasts. After declining for most of the past six months, consensus expectations now call for low-to-mid single-digit growth.

Valuations are not stretched, in our assessment. The MSCI Europe ex UK Index is currently trading on a 12-month forward price-to-earnings (P/E) ratio of 15x, in line with its 10-year average. We note, however, that over the past 12–18 months seven European quality growth leaders with global footprints including Novo Nordisk, the obesity and diabetes drug manufacturer, and ASML, the producer of extreme ultraviolet lithography systems for semiconductor manufacturing, have largely driven stock market performance and seen a notable expansion in valuations. Stripping out these companies leaves the rest of the stock market on a lower valuation.

On a relative basis, European equities trade on a sharp discount to U.S. shares. Adjusting for sector weighting differences, the valuation discount is particularly stark. The Continent's P/E ratio relative to that of the U.S. excluding the Tech sector is at its lowest level since the EU sovereign debt crisis in 2011.

Importantly, a record number of European companies, particularly those with a strong balance sheet and a healthy level of cash, are increasingly buying back their own stock to boost earnings per share growth and improve their valuations. We also note that during recent earnings announcements more and more management teams have been mentioning plans to return capital to shareholders.

Building balance

Given that the tentatively improving macroeconomic backdrop is set against a relatively low-growth environment, we continue to argue for a balanced approach to stock picking. We favour pairing high-quality secular growers, or global leaders listed in Europe, with selective exposure to more cyclically sensitive names, particularly in the Industrials sector.

Long-term, we prefer the Technology sector (particularly mission critical software and semiconductor manufacturing equipment), Health Care, and Industrials names with exposure to the capital expenditure supercycles related to the themes of decarbonisation, deglobalisation (e.g., reshoring), and higher defence spending. The luxury goods segment, within Consumer Discretionary, also benefits from powerful drivers, in our view. By contrast, we have a more cautious view of the Utilities and Consumer Staples sectors.

UNITED STATES

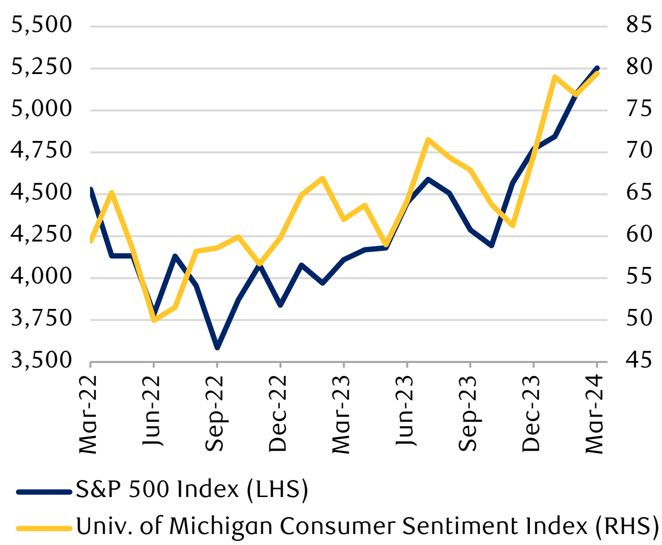
Alan Robinson – Seattle

- **U.S. stocks have traded marginally higher with lower-than-usual volume in the holiday-shortened week, as quarter-end rebalancing prompted traders to lock in some gains.** The S&P 500 posted new highs and marked a fifth straight month of gains, but the Dow Jones Industrial Average and the Nasdaq Composite have failed to follow suit.

- **It was a quiet week for economic data, with new home sales slightly below consensus estimates, and durable goods orders slightly above.** Two consumer-focused measures were released: the Conference Board's Consumer Confidence Survey and the University of Michigan Consumer Sentiment Index. The latter is noteworthy in that it bears a close correlation with the S&P 500 (see chart). This Index's March reading set a new post-pandemic high, adding fuel to the market's bullish sentiment.

- **A strong employment backdrop has been one of the factors underpinning consumer confidence, and recent jobs data, while slowing, has still been surprisingly robust.** Proprietary research from the RBC Capital Markets Digital Intelligence team, however, raises a cautionary flag. The team's nowcasting work shows that job postings data scraped from the websites of 21,000 U.S. companies has taken a sudden downturn. The team believes this implies that the trend of job openings is falling at a faster rate than recent government data which is reported with a multi-week lag.

Stocks appear to move in lockstep with U.S. consumer sentiment



Source - RBC Wealth Management, FactSet; end-of-month data, except for intraday S&P 500 level at 11:05 CT 3/28/24

- **RBC Capital Markets, LLC Head of U.S. Equity Strategy Lori Calvasina raised her year-end target and earnings estimate for the S&P 500.** Calvasina now sees the index ending the year at 5,300, slightly higher than current level but roughly 11% higher than 2023's close. She cites a couple of factors that argue against a more positive view. First, sentiment is becoming too bullish in her view, and she notes the S&P 500 tends to be flat on a three-month forward basis from similarly bullish levels. Second, she sees the risk of a summer air pocket for stocks as is typical in presidential election years. However, she notes lower inflation and interest rates, and higher economic growth may provide further upside for stocks.

CANADA

Sean Killin & Josh Nye – Toronto

- **Canada's economy gained momentum at the start of the year.** The latest figures from Statistics Canada show the economy expanded by 0.6% m/m in January, ahead of the consensus expectation for a 0.4% gain. According to RBC Economics, about half of the increase can be attributed to the return of striking public sector workers, which weighed on the economy late last year (December GDP -0.1%). The flash estimate for February GDP pointed to a solid 0.4% gain, leaving Q1 growth tracking in the 3.5% range (annualized), which would be well ahead of consensus (+1.0%) and the Bank of Canada's (BoC) latest forecast (+0.5%). The BoC has suggested that a slowdown in growth last year shifted the economy from excess demand to excess supply, which policymakers think should help rein in inflation over time. But these latest figures suggest that process may have begun to reverse in early 2024, which should be of some concern to the BoC with inflation still above its 2% target.

- **Canadian lenders are taking action to avoid systemic risks by reining in ultra-long mortgages.** Loose monetary policy during the pandemic recession drove a sizeable increase in residential real estate debt, with looser conditions causing an approximate 40% increase in the value of home loans. As household debt burdens rose, the eventual BoC rate hikes pressured households' ability to service debt—encouraging lenders to increase amortization periods on residential mortgages to avoid delinquencies. With financial markets beginning to price in BoC rate cuts for the rest of the year, and increased regulatory requirements coming into effect in 2025, these ultra-long mortgages are being shortened. According to Bloomberg, Canadian lenders now have about CA$220 billion of mortgages with amortization periods longer than 35 years—down 27% from CA$300 billion at its height in 2023.

EUROPE

Thomas McGarrity, CFA – London

- **Some green shoots are appearing in the eurozone economy, after many months of stagnation in the wake of the energy crisis.** The European Commission's Economic Sentiment Indicator (ESI) inched up to 96.3 in March from 95.5 the previous month. The improvement was broad-based, with both manufacturing and services businesses, as well as consumers, all showing marginal improvements in confidence.

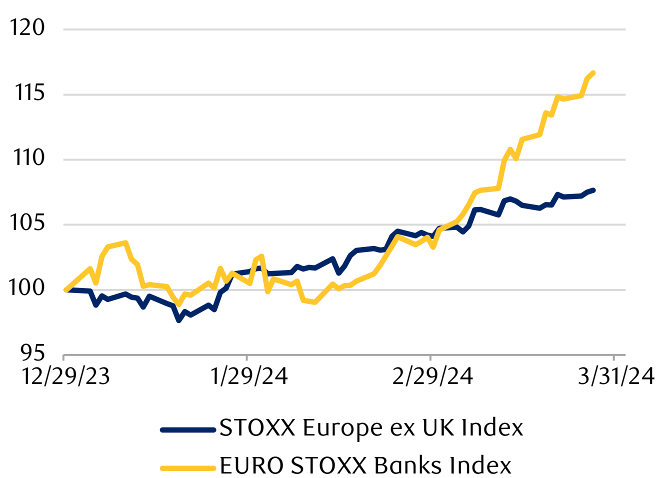
- **The rising business sentiment appears to indicate that firms are gradually becoming more optimistic about the months ahead**, although business activity is muted. Manufacturing businesses point to stronger order books and low inventories boding well for the second half of the year. Service businesses also expect services inflation to moderate given subdued current conditions.

- **The readings are consistent with an imminent end to stagnation and a modest pick-up in growth over the rest of the year, in our view.** The European Central Bank should be relieved that services inflation is not picking up. We feel confident in our call for June to mark the beginning of an interest rate cutting cycle.

- **The improving macroeconomic picture for the region has supported the European banking sector**, which has outperformed year to date. The EURO STOXX Banks Index is up almost 17% through March 27, more than double the STOXX Europe ex UK Index's rise of roughly 8%. Although European banks' net interest margins may peak with interest rates, improving business and consumer sentiment could support growth in loan demand, while a better economic environment should help keep loan loss provisions relatively constrained. Moreover, returns to shareholders from European banks remain elevated, through both high dividend yields and share buybacks.

- **The valuation of the banking sector has edged up**, with the EURO STOXX Banks Index now trading at 0.9x price to tangible book value. While this is a premium to its 10-year median of 0.75x, we would argue that it is justified given the higher returns on equity and balance sheet strength. We believe select European banks with the highest shareholder distribution yields over the next three years represent an area of opportunity.

An improving regional macro outlook has been a tailwind for European banks in 2024



Source - Bloomberg; data normalized to 1/1/24 = 100

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- **Asia Pacific equity markets have traded mixed during the week.** Australia led the region, while Japan lagged. After hitting a fresh high last week Friday, Japan's TOPIX Index lost steam during the week as investors began to book some profits ahead of the quarter-end rebalancing.

- **The yen fell this week to the lowest level against the U.S. dollar since 1990.** The weakness came despite the Bank of Japan raising interest rates for the first time in 17 years. We think traders believe current monetary policy in Japan remains too loose, especially when the Federal Reserve is holding interest rates at a two-decade high. The currency's slide prompted Japanese officials to warn traders who are trading against the yen. Masato Kanda, vice minister of finance for international affairs for the Japanese Ministry of Finance, pledged to take action against excessive swings in the market. Finance Minister Shunichi Suzuki said the government will take bold measures against excessive moves. We cannot rule out government intervention in the currency market if the yen continues its decline.

- **Toyota Motor Corporation (7203 JP), the largest automobile manufacturer in the world, is facing growing competition in China and a list of safety issues.** In February, global sales declined 12%, the first drop in 13 months, while production declined 12.1%, the second consecutive monthly decline. We think the data suggests Toyota may struggle to exceed last year's record sales.

- **BYD Co. (1211 HK), one of the world's largest electric vehicle manufacturers, reported 2023 results in line with the profit alert issued on Jan. 29.** Q4 2023 revenue was up 15% y/y while earnings were up 19% y/y, resulting in an 81% increase in 2023 earnings. The dividend payout ratio rose to 38% in 2023 from 20% in 2022. Management is guiding for 20% volume growth and steady profit for 2024, but it was more cautious on profit per vehicle, reflecting intense industry competition.

MARKET
Scorecard

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	5,248.49	3.0%	10.0%	32.0%	15.5%
Dow Industrials (DJIA)	39,760.08	2.0%	5.5%	22.6%	14.1%
Nasdaq	16,399.52	1.9%	9.2%	39.3%	15.7%
Russell 2000	2,114.35	2.9%	4.3%	20.6%	1.8%
S&P/TSX Comp	22,107.08	3.5%	5.5%	12.6%	0.5%
FTSE All-Share	4,325.93	3.9%	2.2%	6.3%	3.9%
STOXX Europe 600	511.75	3.5%	6.8%	15.1%	12.8%
EURO STOXX 50	5,081.74	4.2%	12.4%	22.0%	31.4%
Hang Seng	16,392.84	-0.7%	-3.8%	-16.2%	-23.4%
Shanghai Comp	2,993.14	-0.7%	0.6%	-7.9%	-6.8%
Nikkei 225	40,762.73	4.1%	21.8%	48.4%	44.8%
India Sensex	72,996.31	0.7%	1.0%	26.6%	27.3%
Singapore Straits Times	3,251.71	3.5%	0.4%	0.4%	-4.7%
Brazil Ibovespa	127,690.62	-1.0%	-4.8%	28.1%	7.2%
Mexican Bolsa IPC	57,369.01	3.5%	0.0%	8.5%	3.5%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	4.188%	-6.2	30.9	65.9	171.5
Canada 10-Yr	3.439%	-5.1	32.9	54.4	89.3
UK 10-Yr	3.932%	-19.2	39.5	56.6	223.7
Germany 10-Yr	2.292%	-11.9	26.8	6.5	170.5
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	4.86%	0.7%	-1.0%	1.9%	-2.4%
U.S. Investment-Grade Corp	5.34%	0.8%	-0.8%	5.0%	-0.4%
U.S. High-Yield Corp	7.70%	1.0%	1.3%	12.8%	8.2%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	2,194.84	7.4%	6.4%	12.2%	12.1%
Silver (spot $/oz)	24.64	8.6%	3.5%	6.7%	-3.5%
Copper ($/metric ton)	8,748.47	4.1%	3.4%	-2.3%	-14.6%
Oil (WTI spot/bbl)	81.62	4.3%	13.9%	12.1%	-29.3%
Oil (Brent spot/bbl)	86.32	3.2%	12.0%	10.5%	-28.5%
Natural Gas ($/mmBtu)	1.71	-7.8%	-31.8%	-17.9%	-69.2%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	104.2970	0.1%	2.9%	1.4%	5.6%
CAD/USD	0.7368	0.0%	-2.4%	0.7%	-8.1%
USD/CAD	1.3572	-0.1%	2.5%	-0.7%	8.8%
EUR/USD	1.0828	0.2%	-1.9%	0.3%	-1.4%
GBP/USD	1.2640	0.1%	-0.7%	2.9%	-4.1%
AUD/USD	0.6534	0.6%	-4.1%	-1.8%	-13.1%
USD/JPY	151.3200	0.9%	7.3%	15.0%	24.0%
EUR/JPY	163.7400	1.0%	5.2%	15.3%	22.2%
EUR/GBP	0.8567	0.1%	-1.2%	-2.5%	2.8%
EUR/CHF	0.9787	2.4%	5.4%	-1.0%	-4.2%
USD/SGD	1.3475	0.1%	2.1%	1.2%	-0.8%
USD/CNY	7.2260	0.5%	1.8%	5.0%	13.5%
USD/MXN	16.5441	-3.0%	-2.5%	-9.8%	-17.4%
USD/BRL	4.9882	0.4%	2.7%	-4.1%	5.2%

Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Tuesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing.

Examples of how to interpret currency data: CAD/USD 0.73 means 1 Canadian dollar will buy 0.73 U.S. dollar. CAD/USD -2.4% return means the Canadian dollar fell 2.4% vs. the U.S. dollar year to date. USD/JPY 151.32 means 1 U.S. dollar will buy 151.32 yen. USD/JPY 7.3% return means the U.S. dollar rose 7.3% vs. the yen year to date.

Source - Bloomberg; data as of 3/27/24

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As of December 31, 2023

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Sell [Underperform]	46	3.17	6	13.04

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