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Europe – the tide is turning: Five key arguments in favour of Europe

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At a glance

- Europe has essentially suffered a lost decade, given the persistent underperformance of European equities in the years following the financial crisis, particularly when compared to US equities.
- However, we believe the bloc has now reached a tipping point. The actions taken by authorities in response to the pandemic are setting the stage for a new period of European economic strength and stability. We believe there are five key arguments in favour of Europe:

1. The European Central Bank (ECB) has enacted a series of extraordinary measures designed to support the liquidity and financial health of the Eurozone economy.
2. The European Commission remains engaged in a long-term sustainability drive with a stated aim to ultimately make the European Union carbon neutral by 2050, leading to an ambitious investment plan that could ultimately reach EUR 7 trillion by 2050.
3. France and Germany have joined forces in order to propose a European COVID-19 economic recovery fund, with a funding mechanism which paves the way for potential increased fiscal integration and would enhance the credibility of Europe as a monetary bloc.
4. European banks are being "un-constrained" as they are being freed to use their capital buffers during this crisis, and they will benefit from lower funding costs.
5. The pandemic has caused chaos worldwide but it is now clear that some countries have been more effective than others in combatting the threat. This discrepancy will likely be reflected in the strength of the economic re-start.

Europe's undeterred commitment to the green deal

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"We believe the conditions are now ripe to reconsider European equities, a traditional consensual underweight in global investors' portfolios."

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Europe – The Lost Decade

Europe has essentially suffered a lost decade, given the persistent underperformance of European equities in the years following the financial crisis, particularly when compared to US equities (Fig 1.)

There are 3 key main reasons behind Europe's underperformance since 2009:

- The US market is much more exposed to leading global tech/software/e-commerce and entertainment companies. In addition, the US financial sector has recovered more strongly than the heavily-regulated European banks that have also been impacted by a much lower interest environment in Europe than in the US.
- Under the Trump administration, US corporate profits have been boosted by a drop in the corporate effective tax rate.
- US listed companies have been buying back USD 6.8tr of shares (e.g. approximately 35% of the average market capitalisation) versus USD 0.3tr in Europe (e.g. approx. 4% of the average market capitalisation) since end 2009

However, we believe the bloc has now reached a tipping point. The actions taken by authorities in response to the pandemic are setting the stage for a new period of European economic strength and stability.

European authorities have reacted to the COVID-19 pandemic with a series of proposals that have been designed to mitigate and repair the economic damage. In addition to strengthening the economic health of the Eurozone, these plans would create a wealth of investment opportunities.

Here are five key arguments in favour of investing in Europe:

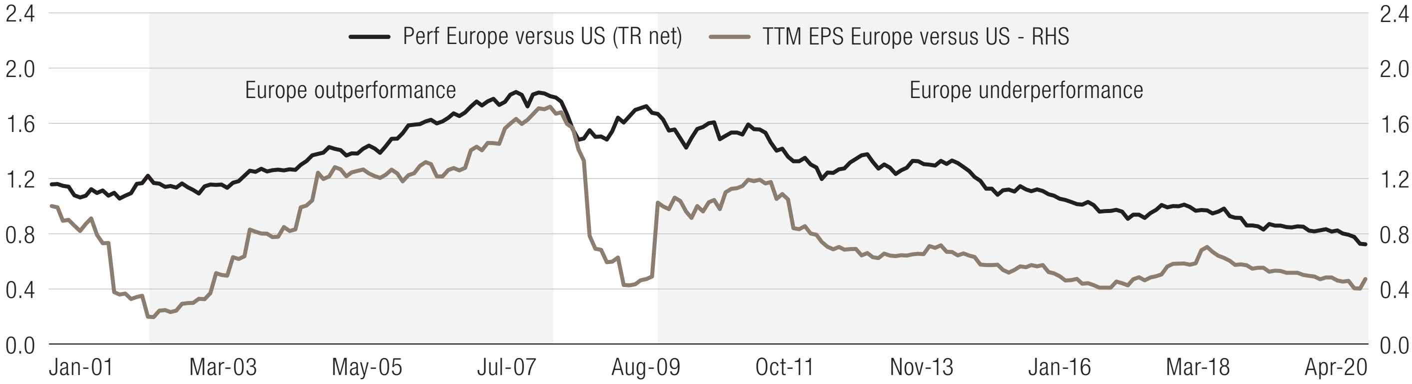
Unprecedented fiscal and monetary measures

The European Central Bank (ECB) has enacted a series of extraordinary measures designed to support the liquidity and financial health of the Eurozone economy. This is hardly the first time the ECB has intervened in markets but these latest proposals are unprecedented both in terms of speed and scale.

In March, the ECB launched the Pandemic Emergency Purchase Programme (PEPP). This EUR 750 billion temporary asset purchase programme of both private and public sector securities was increased by a further EUR 600 billion in June, bringing it to a total of EUR 1,350 billion in June. Non-financial commercial paper is now eligible for purchases. The Governing Council has stated that it will remain in place until the COVID-19 crisis has ended, and at least until June 2021.

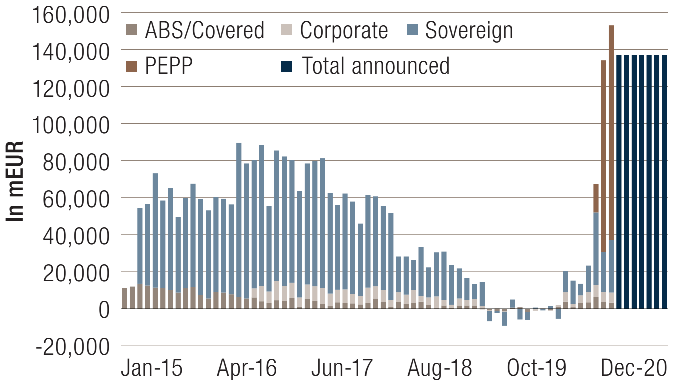
Europe's fiscal stimulus exceeds that of other major economies. Fiscal stimulus measures in Germany, Italy, Spain and France amount to more than 30% of GDP with a combination of discretionary fiscal spending and loan guarantees. In the US, Japan, and the UK it is less than 20% of GDP.

FIG. 1 EUROPE RELATIVE PERFORMANCE TO THE US IN TERMS OF MARKET RETURN AND EARNINGS PER SHARE



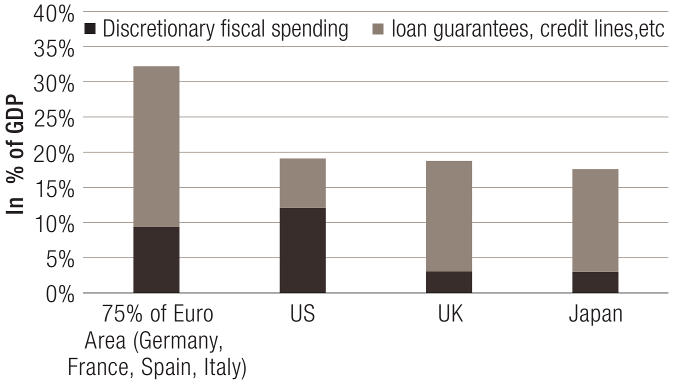
Source: Bloomberg.

FIG. 2 ECB TO PURCHASE OVER EUR 1.1TN IN TOTAL THIS YEAR. PEPP INCREASED TO EUR 1,350 BILLION AND EXTENDED TO JUNE 2021



Source: Federal Reserve, ECB, Bloomberg, Lombard Odier calculations.

FIG. 3 FISCAL STIMULUS IN MAJOR ECONOMIES



Source: IMF, national authorities, Lombard Odier calculations, June 2020.

Ambitious industrial strategy undeterred

The European Commission remains engaged in a long-term sustainability drive with a stated aim to ultimately make the European Union carbon neutral by 2050. Importantly, there have been no clear signs that the pandemic has derailed these plans.

The European Green Deal Investment Plan is the investment pillar of the Green Deal and is intended to mobilise at least EUR1 trillion in sustainable investments over the next seven to 10 years, out of EUR7 trillion by 2050. The projects financed under the European Green Deal Investment Plan will contribute to the goals of the Green Deal and to the emergence of new, clean energy and circular economy industries. These include the adoption of the European Industrial Strategy, a plan to decarbonize the industry, and the Biodiversity Strategy for 2030, which aims to protect natural resources.

The investment plan will also have a focus on private investors and the public sector and their role in facilitating sustainable investments.

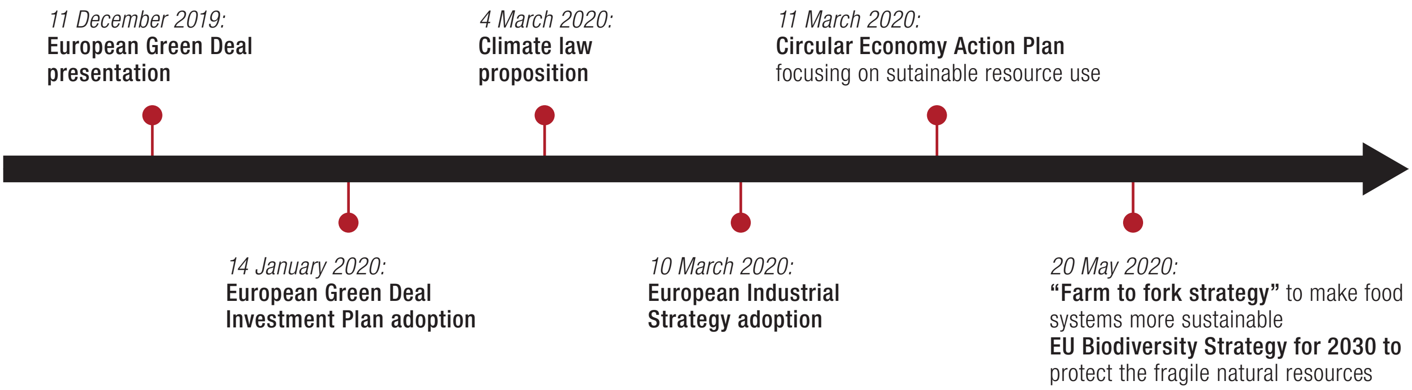
Increased confidence in the euro with debt and fiscal risk sharing on the horizon

France and Germany have joined forces in order to propose a EUR500 billion European COVID-19 economic recovery fund. This plan is now called NextGeneration EU and has been increased to EUR 750 billion, which will be borrowed by the Commission using the EU budget as a guarantee. This plan still need to be approved by EU member states over the summer.

Transfers will be based on need, rather than contributions, to the EU budget and in forms of grants rather than loans which put forward clearly the concept of "solidarity." A recent interview with German Minister of Finance Olaf Scholz suggests even a broader agenda for the future, including the creation of EU taxation capability and some degree of fiscal harmonization according to the World Economic Forum. According to Fitch, raising more money through new taxes earmarked to the EU budget would be an important step towards deeper fiscal integration.

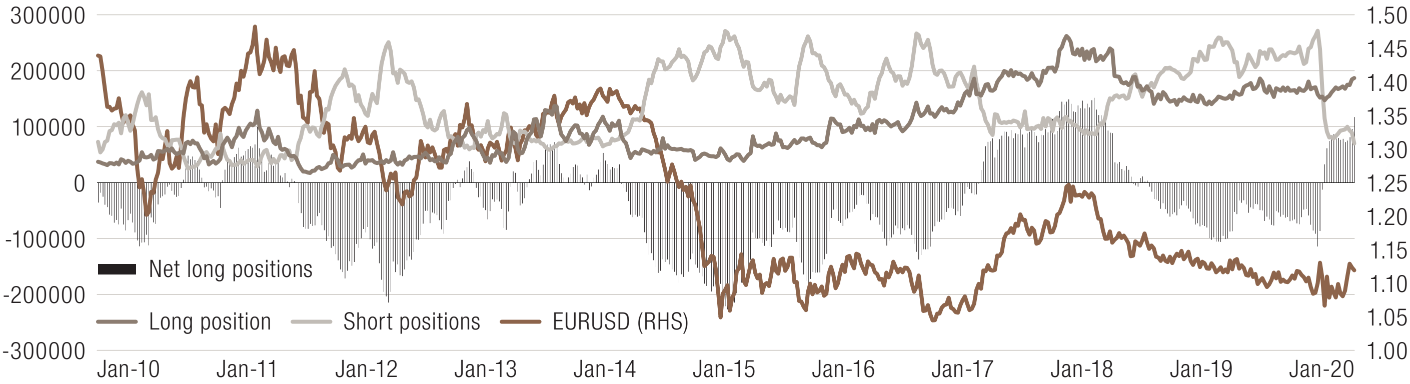
In early June, at the European Parliament's Economic and Monetary Affairs Committee, ECB President Christine Lagarde emphasised that the largest supranational issuance in euro ever announced that is associated with the proposal could also have a positive impact on the international role of the euro.

FIG. 4 EUROPE, UNDETERRED COMMITMENT TO THE GREEN DEAL



Source: European commission, LOIM analysis.

FIG. 5 INCREASED CONFIDENCE IN EURO



Source: Commitments of Traders, June 2020.

It is our view that this has the potential to create a more homogenous Europe and improve its credibility as a monetary bloc. As mentioned by Fitch, if the fund evolved into a permanent structure with some fiscal risk-sharing that enhanced the capacity for counter-cyclical policy and central debt issuance, this would help to strengthen the single currency. The announcement has had a positive effect on markets and increased confidence in the euro. This changing mood is reflected in a massive reduction in short positions, an increase in long positions, and a resulting net positive positioning that we have not seen in a while (Fig. 5)

European banks being "un-constrained"

While the 2008 financial crisis stemmed from the banking sector, it is a different situation this time around and this latest crisis instead requires banks to be part of the solution. European authorities have recognised this and banks are being freed to use their capital buffers during this crisis.

The ECB will allow banks to operate temporarily below the level of capital defined by the Pillar 2 Guidance (P2G), the capital conservation buffer (CCB) and the liquidity coverage ratio (LCR) in order to support the economy. Banks will also be allowed to partially use capital instruments that do not qualify as Common Equity Tier 1 (CET1) capital to meet the Pillar 2 Requirements (P2R). This measure was actually supposed to come into effect in January 2021 but was moved ahead of schedule to the crisis. A series of measures also allows banks to postpone margin call requirement for unlisted derivatives and to postpone updates of VARs calculation, reducing implicitly the impact of the crisis on their capital requirements.

In addition, the interest rate on all targeted longer-term refinancing operations (TLTRO III) was recently reduced by 25 basis points, which is expected to boost liquidity and lower funding costs.

Unlike other crises, corporate credit demand is now increasing as companies face liquidity issues from COVID-19. However, with states' guarantees and lower funding costs, this should help the European banks system to sail through this crisis at a time when their US peers face net margin pressures due to falling US interest rates.

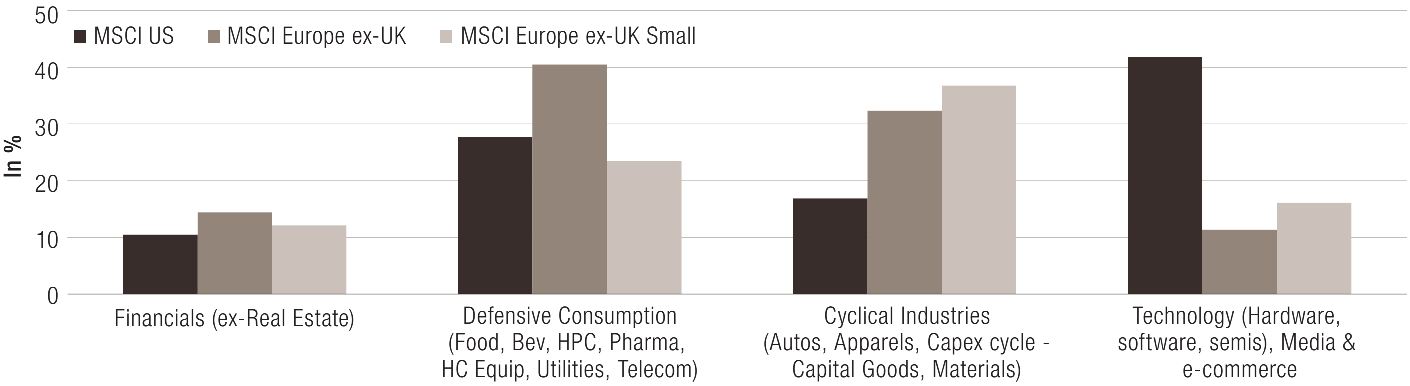
Health situation under control, favouring a more solid cyclical upturn in Europe

The pandemic has caused chaos worldwide but it is now clear that some countries have been more effective than others in combatting the threat. This discrepancy will likely be reflected in the strength of the economic re-start as lockdown measures are being unwound.

Europe is in the process of opening back up, and new weekly cases of COVID have been in decline since April for the majority of member states. Comparatively, new weekly cases in the US are on the rise in a number of states and the world's largest economy is on the brink of a second wave with some states reverting on their initial objective to re-open their economies. These dynamics create much more volatile economic conditions in the US compared to Europe where the upturn in the economic cycle could therefore be more pronounced.

This is very relevant from a market perspective. European equities are the most exposed to a cyclical recovery. We estimate that 30% of the European Equities are in sectors the most exposed to a cyclical recovery. This exposure is even greater when looking at the smaller companies (MSCI Europe ex-UK Small index) with close to 37%. In addition these sectors are also important beneficiaries of the EU recovery measures.

FIG. 6 CYCLICAL EXPOSURE ACROSS US AND EUROPEAN EQUITIES



Source: Bloomberg, MSCI, LOIM Analysis.

Conclusion

We believe the conditions are right to drive investors back to Europe after a lost decade. A potential change of leadership in the US with an unwinding of certain corporate-friendly measures combined with an uncontrolled health situation could further emphasise the relative attraction of European equities. Global investors require a much higher risk premium to invest in European large cap (Fig 7) and European small cap (Fig. 8) than for the US counterparts. These higher risk premiums have never realigned themselves to the US since the European sovereign crisis. This is particularly true for European small cap. In addition, investors in the US are willing to pay a lower risk premium on small cap versus large caps, which has been exactly the opposite case in Europe since mid-2014. There is therefore a double case for small cap in Europe: a re-rating of Europe versus the US combined with a re-rating of small cap versus large caps.

We believe the conditions are now ripe to reconsider European equities, a traditional consensual underweight in global investors' portfolios.

FIG. 7 EQUITY RISK PREMIUM EUROPE VERSUS US LARGE CAP

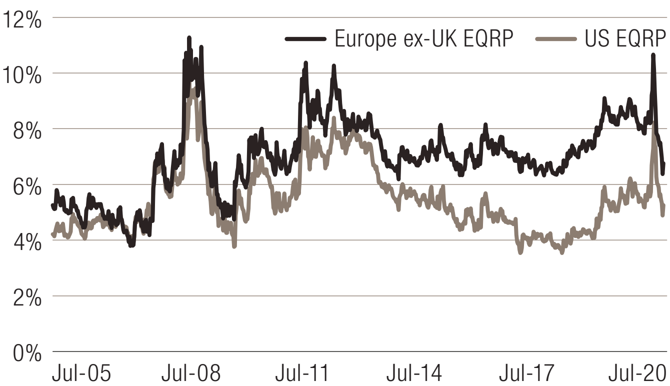


FIG. 8 EQUITY RISK PREMIUM EUROPE VERSUS US SMALL CAP

Source: LOIM calculation based on market PEs, risk free rates (10 years) and rolling average inflation rates.

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