Insights
Active Quantitative Equity (AQE)

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Prospects for a Turnaround in European Equity Fortunes

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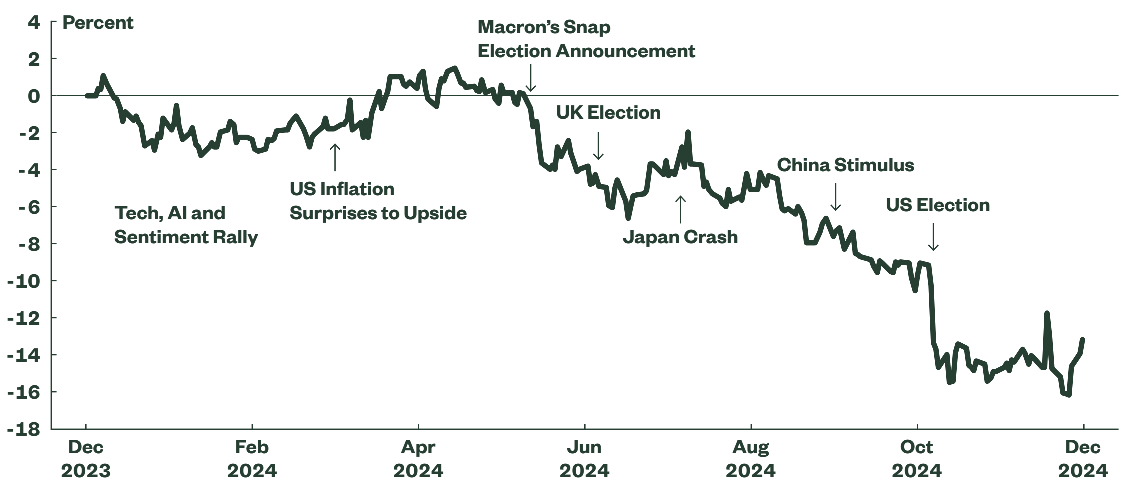
We wrote last month about the incredible strength of the US equity market over the past several years; and probably a disproportionate number of column inches have been focused on this market of late. This month, we turn our attention to a more unloved region for equity investors: Europe. We analyze Europe's underperformance over the past year and identify glimmers of hope for a turnaround in fortunes.

European Equity Underperformance

Over the course of 2024, European equities underperformed other developed markets by 13% in local currency terms.[1] Economic malaise, typified by weak growth, low investments, and high savings rates, created a headwind for corporates and equity markets that was further exacerbated by exogenous shocks, unstable politics, and a few self-inflicted wounds.

Figure 1
MSCI Europe Equity Return Relative to MSCI World in 2024



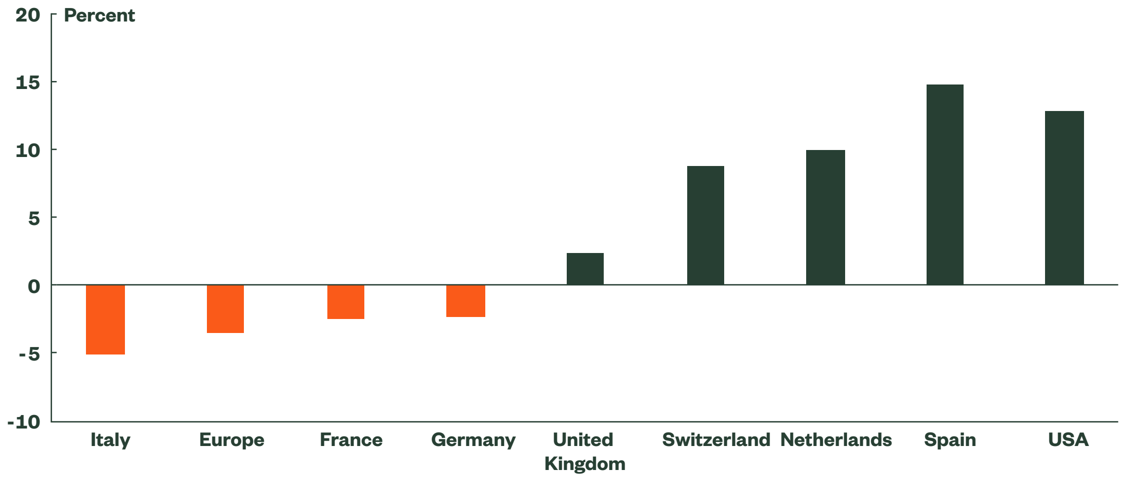
Source: State Street Global Advisors, MSCI, FactSet. As of December 31, 2024. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

Instability in the eurozone powerhouse economies of Germany and France undoubtedly added to the negative market view. Germany's economy has been a consistent drag on European growth in recent years, whilst the snap French election called by President Emmanuel Macron created uncertainty and led to a further sell-off in the equity market. The latest leg-down in relative performance came after the United States election in November, which resulted in a strong rally by US equities and negative returns for Europe through the end of the year.

Talk of tariffs from the US has been a headwind for Europe, particularly post-election, but the extent of the recent weakness goes beyond the direct effects. A sweeping 10% tariff on all imports into the US would in aggregated knock around 1-2% off revenues for European companies.[2] But the extent of the weakness in earnings far exceeds that level, most notably in some of the larger countries.

Figure 2

Changes in Rolling 12m Earnings Forecasts During 2024



Source: State Street Global Advisors, MSCI, FactSet. As of December 31, 2024.

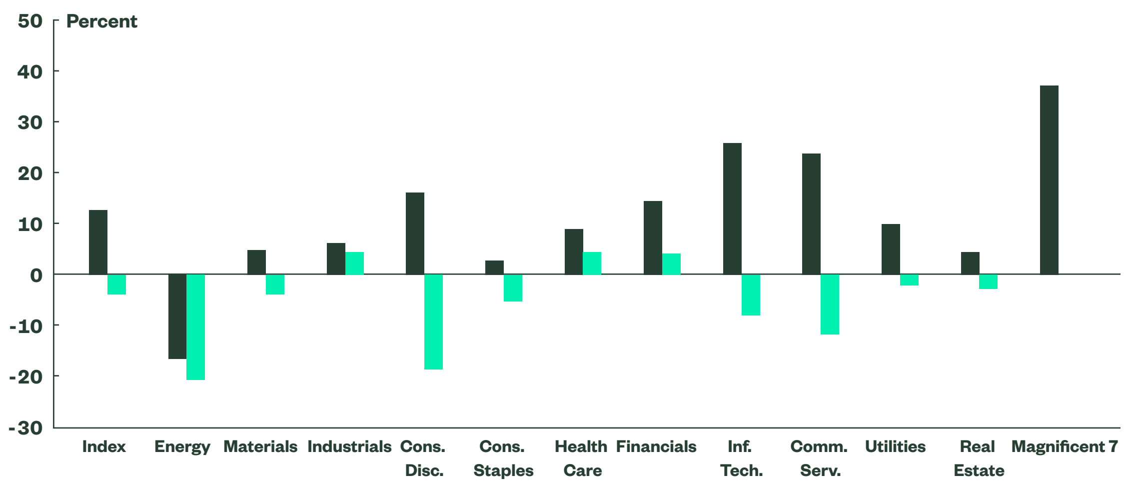
The headlines in the USA have been grabbed by mega-cap technology companies, and the "Magnificent Seven", but the comparative weakness in Europe is not isolated to this segment. In many sectors of the economy, European company earnings have been lagging.

Figure 3

Changes in Rolling 12m Earnings Forecasts During 2024 by Sector

USA

Europe



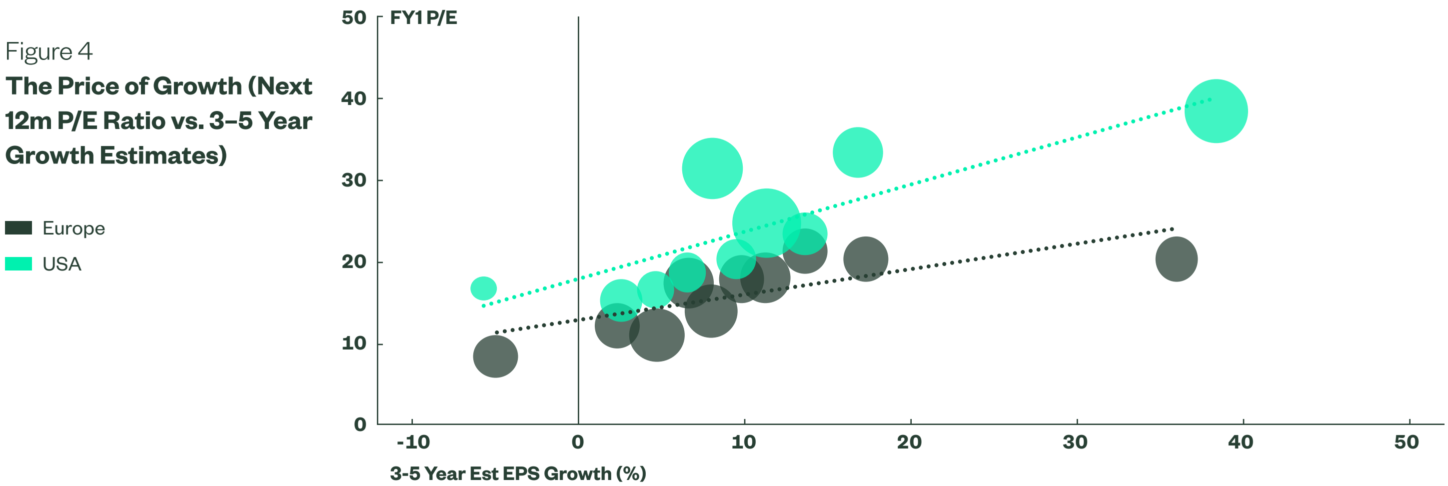
Source: State Street Global Advisors, MSCI, FactSet. As of December 31, 2024.

Taking all this into account, institutional investors have largely voted with their feet and reallocated away from Europe. As a result, valuations for European companies are significantly cheaper than their US counterparts, with MSCI Europe in aggregate trading at 13 times next years' earnings compared to 22 times for US stocks.[3]

Accounting for lower longer-term growth expectations in Europe still shows the significant discount at which European stocks can be purchased. As illustrated in Figure 4, in areas of the European market where there are high growth expectations three-to-five years out from now, the current price-to-earnings ratio is substantially lower than for similar US companies. In every one of the growth deciles, US stocks trade at a higher price.

In the chart below, the size of the bubble indicates the proportion of index weight in each of the growth deciles. In the US, the largest growth cohort is also the second largest by market cap and heavily concentrated in the Information Technology sector. Europe is more evenly spread by market cap, as well as by composition within the highest growth decile, with higher weights in Industrials and Financial Services than IT, which is suggestive of lower concentration risk.

Figure 4
The Price of Growth (Next 12m P/E Ratio vs. 3–5 Year Growth Estimates)



Source: State Street Global Advisors, MSCI, FactSet. As of December 31, 2024.

The difference in the slopes of the two lines probably reflects a combination of a fundamental misvaluation of US vs European earnings, as well as some level of uncertainty over the ability of European companies to achieve those growth estimates. If investors' confidence in future European growth forecasts is lower, they will apply a higher discount rate to those forecasts reducing current valuations.

The Bottom Line

Given the headwinds European equity markets have faced over the past few years, it is likely there is some level of peak pessimism baked into investors' psyches, as reflected by the low valuations commanded even for companies with robust growth prospects. For Europe (in aggregate) to recover, there probably needs to be a shift in fundamentals, such as improving earnings, and more stability in economic policy and politics to create a shift in investors' preferences.

Until that time, we believe there are still good returns that investors can make in Europe, through being selective and focusing on alpha rather than purely the beta. In a time of low earnings and low confidence in earnings growth, higher quality companies that have more stable earnings profiles could be rewarded, as could companies where we are seeing a tangible uptick in operating performance and investor sentiment. Valuations, as always, are important but likely need a catalyst to see a rerating. We deploy a diversified set of Quality, Sentiment, Valuation and Catalyst signals in the quantitative returns forecasting (alpha) model we use for our Active and Enhanced strategies. These signals have been proven to capture long-term drivers of return both for European companies as well as those around the world.

Endnotes

1 Source: State Street Global Advisors, MSCI, as of 31 December 2024.

2 Source: State Street Global Advisors, Citi Estimates, as of 31 December 2024.

3 Source: State Street Global Advisors, FactSet as of 31 December 2024.

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* Pensions & Investments Research Center, as of December 31, 2023.
†This figure is presented as of December 31, 2024 and includes ETF AUM of $1,577.74 billion USD of which approximately $82.19 billion USD in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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