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Trade Concerns Create Opportunities in European Equities

- On the surface, European equities seem to be destined for an unexciting future, but that impression may be unfounded.
- When viewed through the lens of both value and quality, European equities in general now appear more attractive than their US counterparts.

European equities have struggled over the past few years as political uncertainty, low growth, stagnating earnings, global trade tensions, and stumbling economies have banded together to build a wall of worry around the region. Over the past two years, euro-based investors have achieved a relatively paltry 2% return and had quite a volatile ride along the way (see Figure 1). As a result of both local and global concerns, an increasingly bearish consensus of investors considers the US, rather than Europe, as the region to be best positioned to ride out any economic weakness.

On the face of it, European equities look destined for an unexciting future. But those expectations may need to be adjusted.

Figure 1
**Net Total Returns for
Regional and Global
Equity Indices**



Source: Bloomberg Finance L.P., MSCI, State Street Global Advisors, as of 19 August 2019.
Past performance is not a reliable indicator of future performance.
Index returns reflect capital gains and losses, income, and the reinvestment of dividends.

Trade Tensions Spread Beyond the US and China

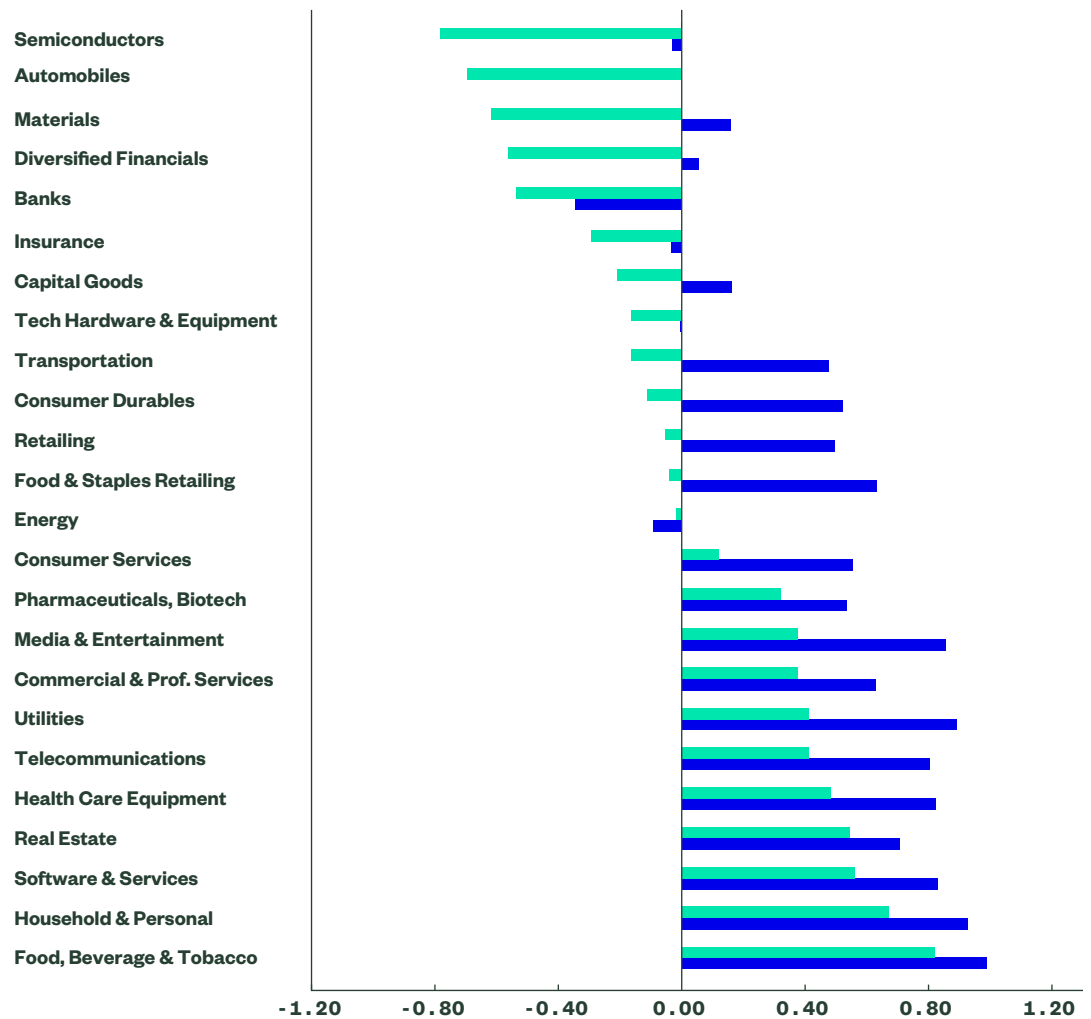
A great deal of attention has been directed at US-China tariff imposition, negotiation and retaliation. The lasting effect of this dispute will not be limited to the US and China, however. Its consequences inevitably will be felt more broadly around the world, particularly if the current stand-off is prolonged or continues on to a messy ending.

In order to get a more informed view into investors' minds and how they are reacting to trade tensions, we identified the key escalation dates in the trade war over the past year and a half, from an early US presidential tweet announcing that "trade wars are good, and easy to win" through to the threat of an additional 10% tariff on a range of Chinese goods in August 2019.

To isolate the effects of trade concerns on equity investors, we drilled down to view the three-day periods after each escalation of US-China tension. During these periods of increased trade stress, we found that on average equity market returns were slightly negative (-0.3%); however, there was considerable disparity between regions and sectors. Europe, for example, continued its laggard status and underperformed the world by a further 0.3%, led by weakness in the cyclical, global manufacturing industries that are likely to be most sensitive to trade. The US market continued its outperformance over the rest of the world during the escalation periods (see Figure 2).

Figure 2
Average Three-Day Returns Around Trade War Escalation Dates

■ US
■ Europe



Source: Bloomberg Finance L.P., MSCI, State Street Global Advisors, as of 19 August 2019. Calculated as equal weighted excess returns of stocks within MSCI Europe and MSCI US industry groups, compounded over three days and averaged over all the trade escalation dates. Past performance is not a reliable indicator of future performance. Sectors shown are as of the date indicated and are subject to change. This information should not be considered a recommendation to invest in a particular sector. It is not known whether the sectors shown will be profitable in the future.

Formerly Cyclical, Now Defensive

In the three-day escalation periods, outperformance was seen in many traditionally defensive sectors, such as food & beverage, household goods and utilities. Among the weaker performers were not only industries directly targeted by trade threats such as autos, but also traditionally cyclical companies, including firms in the financials, capital goods and materials sectors.

Some traditionally cyclical sectors, however, including software, media and consumer services, outperformed in these periods. With higher growth profiles and business models less directly targeted by the trade conflicts, investors seem to have judged these firms as better able to traverse economic uncertainty than the manufacturing sector. These historically cyclical sectors have been behaving in a more defensive way than would ordinarily be expected. These “newly defensive” sectors are less well represented in the European market than they are in the US, which has likely adversely affected European equity performance relative to rest of the world. At the same time, however, we believe this situation may actually give rise to opportunities in European equities over the longer term.

Opportunities in Europe

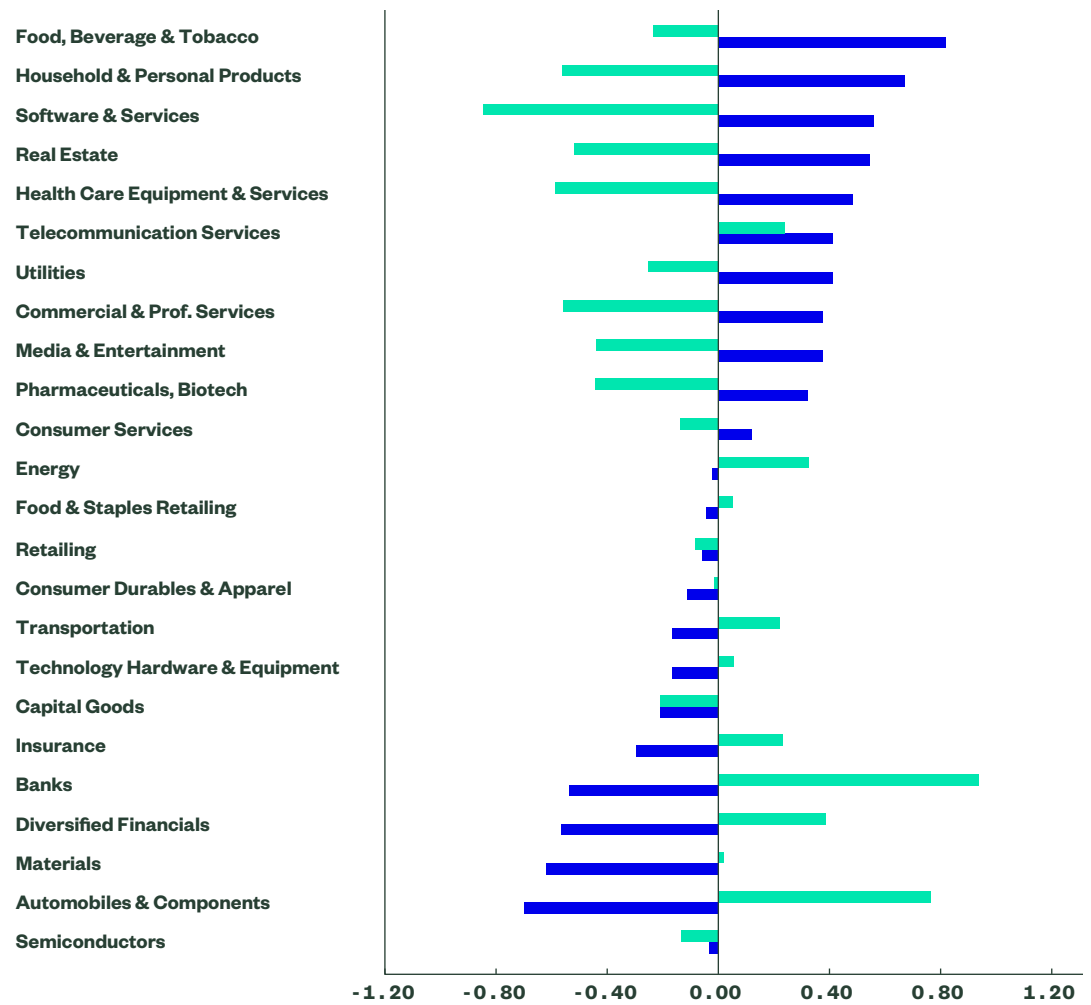
The rotation we’ve witnessed within equity markets toward trade-defensive sectors has led to increasingly stretched valuations within these sectors. Our value rankings on many of the sectors that have performed well during the trade tensions are far worse than the value rankings of the cyclical sectors that have underperformed. This is particularly true in the US, where the less-trade-sensitive sectors are more expensive than the world as a whole (see Figure 3, next page). This disparity in sector valuation,¹ combined with measures of company and earnings quality,² makes European equities look particularly attractive.

Quality is an investment theme that tends to perform well in periods of economic stress, and helps to cushion the drawdown in the event of negative shocks. Choosing higher quality stocks, bought at cheap valuations, can help to create the margin of safety that contributes to attractive long-term investment opportunities.

It is at this intersection of cheap *and* high quality cheap securities where Europe becomes a more attractive equity investment location than the US. By comparing combined value and quality scores derived from our proprietary measures, we can see that European stocks look better in nine out of the eleven sectors (see Figure 4). In particular, European stocks look much better than their US counterparts in the defensive utilities sector, as well as the cyclical industrials and financials sectors. A significant valuation discount in Europe relative to the expensive, defensive, US consumer staples sector also stands out.

Figure 3
**Trade Sensitivity and
 Relative Value in US
 Equity Markets**

■ Trade Sensitivity
 ■ US Value Rating



Source: Bloomberg Finance L.P., MSCI, State Street, as of 19 August 2019. Value rating is according to State Street Global Advisors' proprietary valuation scores. A positive score on the value rating represents cheaper securities on average; a negative score indicates securities that are more expensive on average. A positive trade sensitivity score represents industry groups that outperform when trade tensions escalate. Sectors shown are as of the date indicated and are subject to change. This information should not be considered a recommendation to invest in a particular sector. It is not known whether the sectors shown will be profitable in the future.

Figure 4
**Combined Value and
 Quality Scores by Sector,
 Based on State Street
 Active Quantitative
 Equity's Proprietary Model
 Europe versus US**

Exposure	Sector	Europe	US	Europe — US
Cyclical	Energy	-9.5	-4.3	-5.2
Cyclical	Materials	10.7	10.8	-0.1
Cyclical	Industrials	11.8	2.5	9.3
Cyclical	Consumer Discretionary	16.2	8.6	7.6
Cyclical	Financials	16.6	6.8	9.7
Cyclical	Information Technology	-11.7	-16.4	4.7
Defensive	Consumer Staples	14.4	0.4	14.0
Defensive	Healthcare	-31.3	-34.2	2.9
Defensive	Communications Services	1.0	-5.6	6.6
Defensive	Utilities	13.1	-6.8	19.9
Defensive	Real Estate	-3.5	-10.8	7.4

Source: State Street Global Advisors, Bloomberg Finance L.P. MSCI, as of 19 August 2019. For ease of comparison, scores are reported as rankings out of 100 minus 50. Characteristics are as of the date indicated, are subject to change, and should not be relied upon as current thereafter.

The Bottom Line

The current trade tensions may have far-reaching consequences for equity markets around the globe. These may certainly present challenges to equity investors — but they may also create opportunities.

Our analysis suggests that, in light of escalating trade tensions, investors have sought out certain historically cyclical sectors — including software, media, and consumer services — for the defensive characteristics they have exhibited in this environment. This has driven up valuations, particularly in North America, where many of these firms are located.

Long-term equity investors may find more abundant opportunities in Europe, where valuations are lower. As always, careful consideration of quality measures can help investors to identify genuine bargains (and to avoid stocks that are cheap for a reason). We believe that continuing to focus on time-tested investment themes that focus on fundamental attributes is the best path toward uncovering the opportunities — and avoiding the pitfalls — presented by escalating trade tensions.

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Endnotes

- 1 Value investing involves choosing stocks that exhibit solid fundamentals (e.g., dividends, earnings and sales) that tend to trade at lower prices than their peers.
- 2 Quality indicators include a range of measures that go to a company's capital productivity and balance-sheet health, among other attributes.

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