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BILBoard June 2024 – Time for equity investors to embark on a European tour?



A study has found that, this summer, Americans wishing to see Taylor Swift's record-breaking Eras Tour might be better off coming to Europe to do so. With US inflation still uncomfortably above target and the Federal Reserve's higher-for-even-longer stance boosting the dollar, in some cases it is cheaper to see her perform in Europe – even taking into account flights and a night of accommodation [1]. This is just one small anecdote as to how the US's enduring economic strength might actually be beginning to have adverse effects. The Federal Reserve cannot start playing its dovish cards because inflation remains sticky, even if the services sector, consumption and the labour market all starting to lose steam. Meanwhile, as the old continent dusts off a mild recession, Eurozone inflation is cooling, giving the ECB leeway to begin cutting

rates in June. We believe this sets the stage for investors to start reconsidering relatively cheap European equities.

The macro backdrop

Europe's old economy is finding its feet again after a mild recession during the second half of last year. Growth sputtered back in Q1 (0.3% versus 0.1% expected), and from here we believe that the worst of the slowdown has passed, absent an unforeseen shock. The upward trend in composite PMIs, a growing services sector, and improved sentiment lead us to expect a tepid recovery throughout the rest of the year. One key factor underpinning this is expected to be a gradual consumption rebound given that European households have yet to make a sizeable dent in their pandemic-era savings, while real wage growth is on the rise.

One element preventing a stronger Eurozone upturn is the worsening downturn in the manufacturing sector, which has spanned 13 consecutive months. Germany, the bloc's traditional growth driver, is hit disproportionately, with manufacturing accounting for around 20% of its GDP (compared to around 15% of the Eurozone's overall economy). As a result, the geo-economic split between northern and southern Europe is less obvious than in the past.

Another factor capping the Eurozone's potential is a host of structural issues, over which much ink has been spilled. Encouragingly, it seems that these issues are again moving up the political agenda, with European leaders keen to rekindle dynamism. For example, Germany is exploring tax cuts to encourage people to work longer hours.

Cooling inflation (latest headline print at 2.4%) keeps a June rate cut on the table, which will give the economy and additional shot in the arm. The pace of cuts thereafter is still up for debate and largely depends on three key factors: wages, sticky services inflation continuing to retreat, and the Fed's policy pathway (too much policy divergence could result in a weak euro, and thus imported inflation).

In the US, some steam is coming out of the economy. Q1 growth undershot expectations, slowing from 3.4% to 1.6% QoQ, versus 2.5% expected. PMIs are retreating (both the ISM Services and Manufacturing readings <50) and consumer sentiment is waning as cracks begin to form in the labour market (the quits rate has fallen to 2.1%, wage growth is slowing, the ratio of open positions to jobseekers has fallen from 2 to 1.32). After two years of pent-up demand, fuelled in part by credit card debt and buy-now-pay-later balances, government stimulus and the run-down of excess savings, the consumption engine is set to slow this year and there is a risk that the pinch that is already being felt by low income households will spread to the middle class amid higher-for-longer rates.

US CPI inflation eased to 3.4% YoY in April, down from 3.5%, but remains quite a way off the 2%

target. Fed Chair Jerome Powell commented, “we’ll need to be patient and let restrictive policy do its work”, leaving the markets with relative uncertainty around the Fed’s policy pathway. Its data-dependent stance could mean markets are very volatile around key economic data releases.

In China, Q1 GDP growth surprised on the upside, coming in at 5.3% versus 4.6% expected. This was largely driven by exports (PMIs suggest this component could remain strong in the months ahead). However, domestic demand remains weak, with consumers becoming increasingly cost-conscious, and the economy continues to flirt with deflation. A major risk presents itself in the form of new US tariffs. As well as a tariff increase from 25% to 100% on EVs, levies will rise from 7.5% to 25% on lithium batteries, from 0% to 25% on critical minerals, from 25% to 50% on solar cells, and from 25% to 50% on semiconductors.

Investment decisions from our Asset Allocation on 14 May

Equities

In 2024, economic growth is likely to remain weaker in Europe than in the US, as it was the past two years. However, we note several factors that suggest European equities warrant a second look.

The Eurozone is clearly in greater need of a rate cut than the US. The upside of this is that we have more visibility on the ECB’s policy pathway. At the same time, US earnings expectations are very elevated, leaving a wide margin for disappointment, while those in Europe are more manageable. European equities trade at a significant discount to their US equivalents (the S&P 500 is trading at about a 50% premium to the Stoxx 600), while at the same time, 2024 is expected to be a record-breaking year for European dividend payouts. Keep in mind that the European stock market is not the European economy; its companies derive more than 50% of their revenue from outside Europe.

Lastly, we see less event risk in Europe. As of now, relative status quo is the expected outcome of the European elections. In the US, not only is the market really sensitive to every incoming macro datapoint, earnings from bellwethers like Nvidia had the power to send the market in either direction, while the upcoming presidential election is highly polarised and has the potential to become quite toxic.

In light of these developments, we continued to build on a trade that we initiated last month, **further trimming our US equity overweight in favour of Europe.**

We sold the EUR-hedged portion of the US equity portfolio, believing that higher-for-longer could allow the **dollar’s strength to persist for the coming months.** In high-risk profiles, we

moved to further increase our US dollar exposure by switching 3.5% of EUR-hedged US equity exposure into an unhedged equivalent.

The Committee acknowledged the recent rebound in Chinese equities, but perceives it as a bear market rally for now and does not feel comfortable stepping in.

Within our equity portfolio, we made several **sector adjustments**.

While we continue to favour European **Consumer Discretionary**, we moved the US equivalent down to neutral: retail and home building are strong, but US carmakers are warning of a challenging year ahead on the back of rising costs, muted EV demand, and an intensifying price war in the Chinese market.

In turn, we moved **US Communication Services** from neutral to positive. Communications stocks have led returns for S&P 500 sectors this year, but valuations remain depressed. In fact, if you remove the sector's three most expensive companies, its forward multiple becomes the second cheapest of the all the 11 GICS sectors (after real estate).

Energy was brought from positive to neutral (oil stocks have now caught up with rising crude prices) while **Utilities**, a more defensive play, were brought up to positive. Further rate hikes are unlikely which helps this interest-rate-sensitive sector and demand dynamics appear favourable: data centres will drive a 10–15% surge in power demand, while growing electric vehicle usage could also boost electricity demand. Renewables are slightly favoured as they operate with long-term price agreements, while their cost pressures are abating. US utilities saw earnings jump 26.7% in Q1, the second-highest growth rate amongst all sectors.

NEGATIVE	NEUTRAL	POSITIVE
	EUR Communication Services	IT
	Financials	Utilities
	Healthcare	EUR Consumer Discretionary
	Consumer Staples	Real Estate
	Industrials	US Communication Services
	Energy	
	Materials	
	US Consumer Discretionary	

Fixed Income

Our fixed income allocation remains steady, with a preference for European Investment Grade (IG) Corporates and High-Yield.

Though spreads are tight, we are still comfortable holding European Investment Grade corporates, seeing no real catalyst for material spread widening on the horizon. In the US, however, IG spreads offer little risk premium and, as such, in that market, we see Treasuries as more compelling.

In high yield, incremental yield should drive performance, and we see potential for positive

momentum to continue despite very stretched valuations. We emphasise quality in our selection process.

Volatile expectations around central bank policies make us reluctant to further increase duration at this point.

Conclusion

At our latest Asset Allocation, we further trimmed our US equity exposure in favour of Europe, meaning we now have a neutral stance on both regions (give or take, depending on the risk profile). Eurozone inflation is cooling, giving the ECB leeway to signal a June rate cut which could help breathe some more life into the economy. Across the pond, it could feel like a *cruel summer* for many American households and companies, as the Fed delays rate cuts, awaiting more confidence that inflation is sustainable on a path back to 2%. This could start to take a toll on lower income households with debt, and smaller companies with less of a cash buffer.

Asset Class	DEFENSIVE			LOW			MEDIUM			HIGH		
	Strategic Weight	Bonds: 100%		Strategic Weight	Equities: 15% - 45%		Strategic Weight	Equities: 25% - 75%		Strategic Weight	Equities: 40% - 100%	
		Previous	New		Change	Previous		New	Change		Previous	New
Equities												
Fixed Income	100.0%	97.0%	97.0%	⇒ 0.0%	65.0%	63.5%	63.5%	⇒ 0.0%	42.0%	44.0%	44.0%	⇒ 0.0%
Cash & cash equivalents	0.0%	0.5%	0.5%	⇒ 0.0%	0.0%	1.5%	1.5%	⇒ 0.0%	0.0%	0.0%	0.0%	⇒ 0.0%
Other	0.0%	2.5%	2.5%	⇒ 0.0%	5.0%	5.0%	5.0%	⇒ 0.0%	8.0%	5.0%	5.0%	⇒ 0.0%
Equities												
USA					12.0%	13.5%	12.0%	↓ -1.5%	20.0%	23.5%	21.0%	↓ -2.5%
Europe					12.0%	10.5%	12.0%	↑ 1.5%	20.0%	17.5%	20.0%	↑ 2.5%
Japan					3.0%	3.0%	3.0%	⇒ 0.0%	5.0%	5.0%	5.0%	⇒ 0.0%
China					1.0%	0.5%	0.5%	⇒ 0.0%	2.0%	1.0%	1.0%	⇒ 0.0%
Emerging Markets Ex-China					2.0%	2.5%	2.5%	⇒ 0.0%	3.0%	3.0%	3.0%	⇒ 0.0%
Fixed Income												
Government Bonds - Developed	50.0%	39.0%	39.0%	⇒ 0.0%	30.0%	26.0%	26.0%	⇒ 0.0%	20.0%	19.5%	19.5%	⇒ 0.0%
Emerging Market Debt	7.0%	4.0%	4.0%	⇒ 0.0%	5.0%	3.0%	3.0%	⇒ 0.0%	3.0%	2.0%	2.0%	⇒ 0.0%
Corporate - Investment Grade	33.0%	41.0%	41.0%	⇒ 0.0%	23.0%	25.5%	25.5%	⇒ 0.0%	14.0%	16.5%	16.5%	⇒ 0.0%
Corporate - High Yield	10.0%	13.0%	13.0%	⇒ 0.0%	7.0%	9.0%	9.0%	⇒ 0.0%	5.0%	6.0%	6.0%	⇒ 0.0%
Other												
Gold					5.0%	2.5%	2.5%	⇒ 0.0%	8.0%	2.5%	2.5%	⇒ 0.0%
Total Return	0.0%	2.5%	2.5%	⇒ 0.0%	0.0%	2.5%	2.5%	⇒ 0.0%	0.0%	2.5%	2.5%	⇒ 0.0%
Currency Exposure												
EUR	100.0%	98.0%	98.0%	⇒ 0.0%	77.0%	79.5%	79.5%	⇒ 0.0%	62.0%	71.0%	71.0%	⇒ 0.0%
Other FX	0.0%	0.0%	0.0%	⇒ 0.0%	6.0%	4.5%	4.5%	⇒ 0.0%	10.0%	6.5%	6.5%	⇒ 0.0%
USD	0.0%	2.0%	2.0%	⇒ 0.0%	12.0%	13.5%	13.5%	⇒ 0.0%	20.0%	20.0%	20.0%	⇒ 0.0%
Gold (in USD)	0.0%	0.0%	0.0%	⇒ 0.0%	5.0%	2.5%	2.5%	⇒ 0.0%	8.0%	2.5%	2.5%	⇒ 0.0%

[1] Despite the tour playing on both sides of the Atlantic, the European leg of the Eras Tour has drawn five times as many Americans than the Paris Olympics this summer.

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