JANUARY 2022

Focus —

Captain America

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PRIVATE
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In 2021, the US equity market outperformed the rest of the world by more than 20%. This is the largest relative performance gap since the late 1990s, but it is also the continuation of a trend, as the US has outperformed in 12 of the last 13 years.

This dominance is also true against European markets. Over the past 12 years, the S&P 500 has outperformed the Stoxx 600 index by roughly 315% (almost 13% annualized).

S&P 500 (in USD) vs. Eurostoxx 600 (in USD) performance since 2010

Source: Bloomberg

This performance differential naturally has some consequences on the representation of American and European stocks in global indices. At the time of writing, the weight of the United States in the world's main indices is reaching record levels. For example, the MSCI World Equity Index is made up of nearly two-thirds US stocks, compared to only 15% of European stocks (including the UK and Switzerland). This ultra-domination is also true at the individual stock level: 8 of the 10 largest market capitalizations in the world are American. Moreover, 4 US companies (Apple, Microsoft, Google and Amazon) each have a market capitalization which is greater than the DAX, the German index comprising the 40 largest German companies listed on the Frankfurt stock exchange...

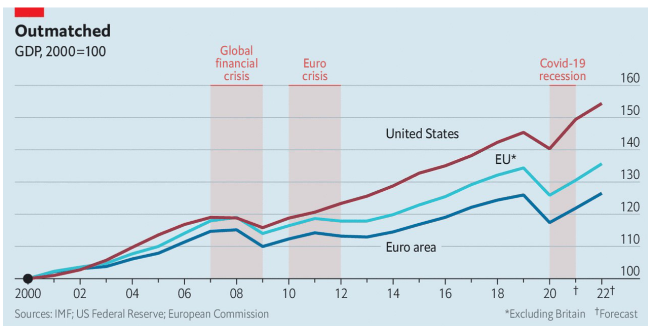
The disparity in performance between the two regions also has consequences on valuations. On a P/E (price/earnings) multiple basis, the European market trades at a record discount relative to its US peers.

P/E of MSCI Europe vs. P/E of MSCI USA

Economic and earnings growth differential

Even if it does not hold true in all cases, there is a long-term correlation between economic growth and the stock market capitalization of a country. Since 2000, US growth has clearly outperformed that of Europe and the Eurozone. There are many reasons for this differential (demographics, productivity, fiscal policy, etc.). But the GDP growth differential alone cannot explain the difference in stock market performance, especially as revenues stemming from the domestic economy are shrinking. The share of FAAMGs (Facebook, Apple, Amazon, Microsoft, Google, etc.) revenues earned outside the US is growing significant. For example, Apple generates more than two thirds of its revenues outside the US. This observation however, is also valid for European companies, which are less and less dependent on revenues generated on the old continent. Around 60% of Stoxx 600 companies revenues come from outside Europe (Asia, US, etc.).

GDP growth differential between the United States, Europe and the Eurozone



Source: The Economist

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Expected earnings per share growth for the next 12 months for the MSCI USA

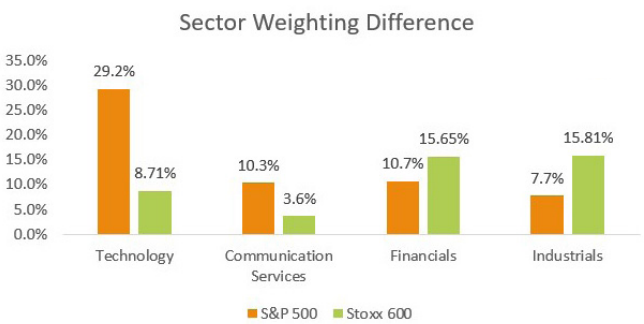
Source: IBES

The importance of sector weightings

Analysts willing to understand the performance differential between the United States and Europe have often looked at the sector allocation of the S&P 500 index and the pan-European Stoxx 600 index.

There are indeed major differences between the two indices. The S&P 500 has a much higher exposure to the technology and communication services sectors. The Stoxx 600, on the other hand, has a much higher allocation to the financial sector (see chart below).

Main differences in sector weights between the S&P 500 and the Stoxx 600



The technology sector tends to trade at higher multiples, a characteristic that has actually strengthened over the past decade. Between 2010 and 2019, a period of sluggish global growth, investors paid a valuation premium for growth stocks. During the pandemic-induced lockdowns (2020-2021), many "growth" stocks (technology, communications) recorded exceptional earnings and were favored by investors.

On the communication side, the US tends to outperform due to a large exposure to high-growth Internet/technology companies, such as Facebook, Disney, Netflix and Google. The European indices, on the other hand, are dominated by traditional telecom services companies (Vodafone, Deutsche Telekom, etc.) with significantly lower growth rates.

The financial sector, which is over-represented in Europe, has been suffering for many years from extremely low or negative interest rates that have weighed on banks' interest margins heavily. Higher earnings volatility and a much lower return on capital than for technology and communications companies have weighed on valuation multiples.

However, it is interesting to note that US financial stocks have outperformed their European counterparts since the great financial crisis of 2008. Among the reasons, the various European crises (sovereign debt in 2011, Greece's economic downfall in 2014, Brexit) that have weighed on multiples but also an even more dovish monetary policy than in the US. The performance gap between the financial stocks of the two continents is particularly visible when looking at the 2011-2018 period, as the market value of US banks increased fourfold compared to only 1.3 times for their European peers.

Cultural differences

The contrasts between the U.S. and the EU go beyond the financial aspect as some cultural factors also contribute to the performance disparity.

First, social policies in Europe (universal health care, free education, subsidized daycare, pension systems, etc.) are significantly more advantageous than in the United States. Because they are less "protected", American households have an incentive to save for the long term and invest in the equity markets through vehicles such as the 401k. According to a Federal Reserve survey, 50 percent of U.S. adults own stocks, with an average of $40,000 in stocks per household. From a tax perspective, U.S. households are encouraged to hold their stocks for the long term, while the tax treatment in Europe for individual shareholders is not particularly attractive.

In addition, finance and investment are much more deeply rooted in American culture than in Europe. From a very young age, Americans are educated on the stock market. The United States is home to some of the best schools specializing in finance as well as the most renowned investment banks.

The over-representation of high-growth sectors in the U.S. index is also due to the culture of entrepreneurship and innovation that prevails in the United States. Uncle Sam welcomes the best talent, attracts capital from all over the world, and rewards boldness and success. The venture capital boom of the last few years has disproportionately benefited U.S. companies, and the large number of IPOs taking place in the so-called "growth" sector are highly prized by both domestic and international investors.

Finally, it is worth remembering that the United States benefits from economies of scale that are difficult to replicate on our continent: a federal state, a single language and very similar regulations in the various states allow companies to reach critical size and an established customer base more quickly and efficiently than in Europe.

Can a trend reversal occur?

European stocks have not always underperformed U.S. stocks. In fact, they outperformed from 2000 to 2007, as well as in 2009, 2012 and 2017. This outperformance often occurred during phases of accelerating global growth. This is a somewhat expected pattern, as Europe has a higher proportion of companies that are sensitive to the economic cycle (energy, financials, manufacturing and automotive). Due to their higher operating leverage (high proportion of fixed costs), the profits of EU companies are more sensitive to macroeconomic conditions. Therefore, if global growth continues to accelerate, European stocks have the potential to outperform U.S. stocks.

Other factors that could contribute to European equity outperformance:

- A change in monetary policy by the ECB. A sharp slowdown in bond purchases by the European Central Bank would create the conditions for a steepening of the European bond yield curve, which would benefit European banks and thus the Stoxx 600 Index;
- In general, European equities have a higher (positive) sensitivity to inflation and interest rates than U.S. equities;
- A marked improvement in the Covid-19 pandemic. Europe has been more affected than the rest of the world by restrictions (lockdowns, border closures, etc.). The end of the pandemic should benefit Europe more than the rest of the world;
- A moderation of supply bottleneck issues. Semiconductor shortages have impacted automotive production lines, an important sector in terms of weight for the Stoxx 600;
- Aggressive fiscal stimulus policies. GDP growth generated by the European Economic Recovery Fund is expected to materialize in the coming years, benefiting sectors such as financial services and industrials, where the Stoxx 600 has the highest exposure;
- Potential for earnings growth to catch up. While U.S. companies are reporting record numbers, aggregate earnings in the Stoxx 600 index have yet to return to pre-covid levels. The basis of comparison for Europe is therefore much easier than for U.S. companies.

It should be kept in mind that a large part of the exceptional outperformance of the U.S. stock market comes from a very limited number of stocks - including the famous FAAMNGs. In a scenario where these stocks correct sharply or even stagnate, the European indices could de facto catch up with the U.S. stock market.

To conclude, we do have a favorable short-term view on European equities (overweight) even if our long-term outlook continues to favor U.S. stocks due to their long-term earnings growth, which is higher than that of their European counterparts.

For further information

Banque Syz SA
Quai des Bergues 1
CH-1201 Geneva
Tel +41 58 799 10 00
Fax +41 58 799 20 00
syzgroup.com

Charles-Henry Monchau, Chief Investment Officer
charles-henry.monchau@syzgroup.com