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Europe better placed than America … and cheaper

European equities | August 2024

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- **In the US, weakening employment poses risks to both consumer expenditure and growth**
- **In China, the consumer is also at risk, as is the property market**
- **The European consumer is more confident despite a tougher business environment and some political uncertainty. However, lower interest rates and inflation are helping**

Consumer and labour markets have not yet deteriorated. The US economy has been powered by easy fiscal policy, pent-up demand and excess savings – but these are dissipating, so the labour market is showing signs of weakness.

United States

For the equity market, the past 12 months have been exceptionally strong and led by the US: the S&P 500 is 25% higher, with the first half of 2024 the strongest since 1900. The consensus sees a 15% uplift to S&P 500 earnings between Q1 and Q4 2024. However, economic momentum is slowing, prompting profit warnings and share price drops from consumer companies: Nike is down 20%, Walgreen 15%.

The S&P 500 may be at an all-time high, but equal-weighted it peaked in March. Nvidia alone has contributed a third of the recent rise and the largest six tech stocks account for three quarters, so the rally has been narrowly based.

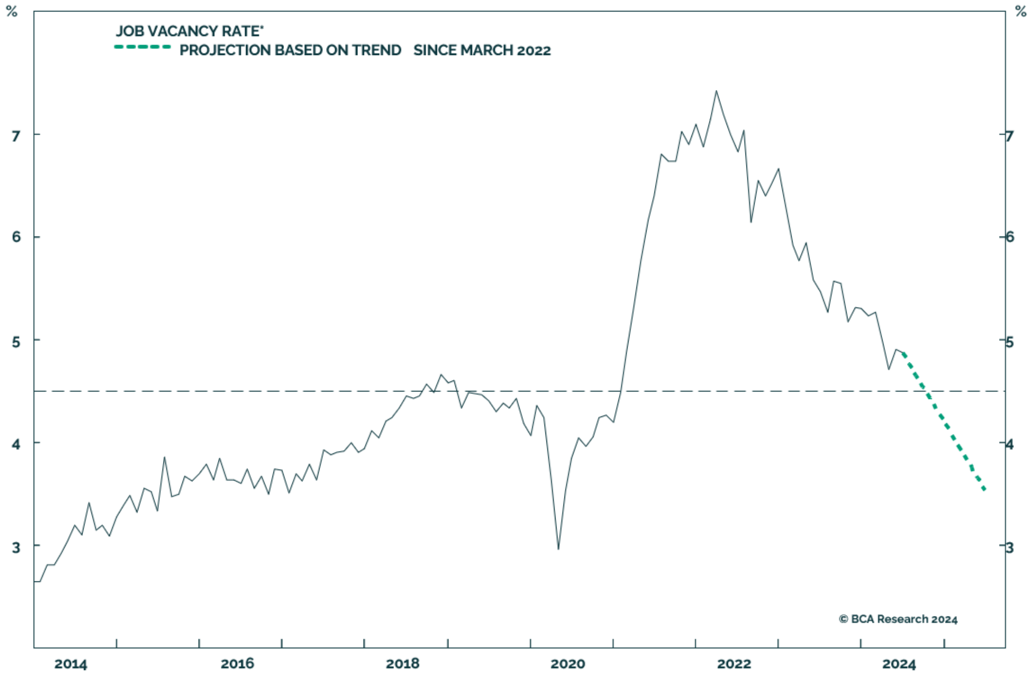
Federal Reserve (Fed) chair Jerome Powell's dovish stance at the end of 2023, as well as easing financial conditions despite four months of disappointingly high inflation, makes it difficult to cut rates. Inflation may at last be easing, but for voters it seems intractable.

The average gap between the first Fed interest rate rise and the beginning of a recession is 29 months[1] – making August 2024 the pinch point. It now seems that the Fed will only start cutting rates once a recession has started.

Extreme market concentrations often prompt corrections. The rally needs to broaden to sustain its momentum, particularly given mixed news about artificial intelligence (AI). Profit warnings in consumer stocks are not helping. Double-digit earnings growth expectations for the market – +30% for the largest US tech names – are a tall order. Complacency is everywhere: credit, volatility and positioning are stretched. The labour market has not cracked with payroll data showing the US is adding 200,000-300,000 workers a month. Job openings are falling, unemployment rising, and immigration running hot. The participation rate has been rising.

The quits rate and Atlanta Fed wage tracker are falling, but these are lagging indicators. If the Fed waits for them to ease further, we will likely tumble into recession. Headline unemployment has risen from 3.4% in April 2023 to 4.1% now. A further decline in job openings will mean more unemployment.

Figure 1: US job vacancies are falling



Source: US Bureau of Labor Statistics/BCA Research, 2024. *Job openings as a % of labour force.

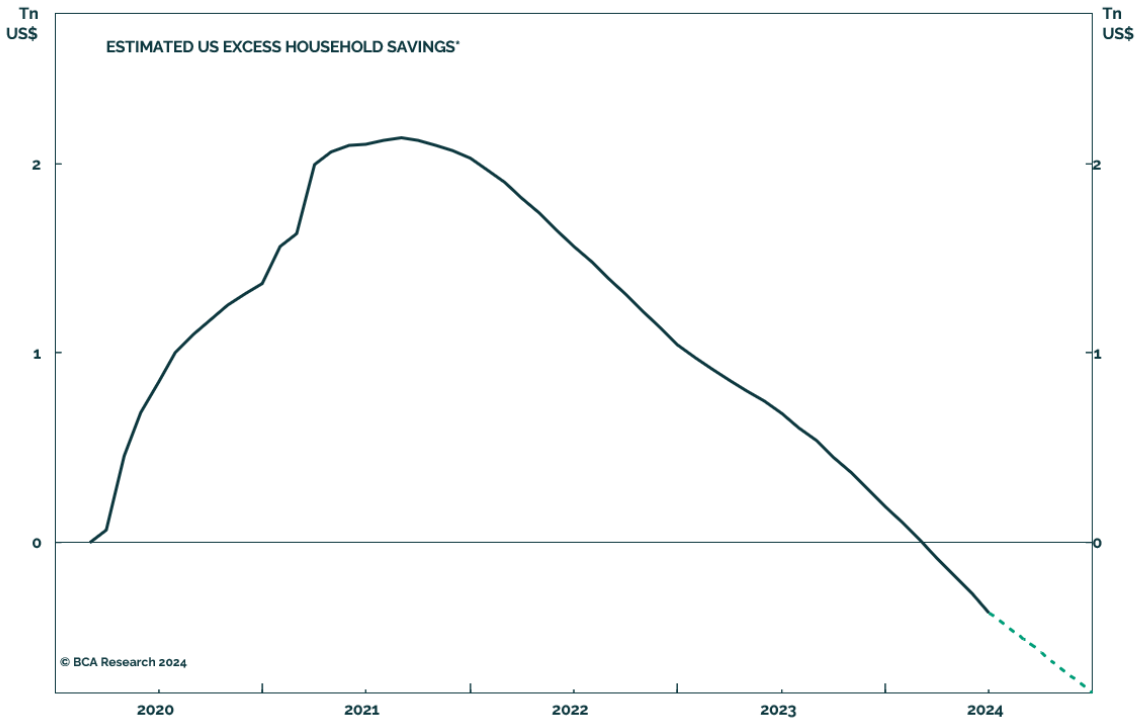
There have only been two occasions since 1945 that US labour demand exceeded supply: the late 1960s and the end of the Covid-19 pandemic. In both cases, explosive inflation followed. The reason that recession has so far not followed is that weak labour demand led to lower wage growth and lower openings. Official openings fell from 7.4% in March 2022 to 4.8% this April, and that trend is continuing (Figure 1). Job openings are now around the 4.5% level that Fed governor Christopher Waller warned would lead to more unemployment. Weakening labour

[1] Columbia Threadneedle Investments' analysis of Bloomberg data

demand can be seen in the data: hirings, quits, wage rates and business surveys. Openings, quits and hiring rates rolled over before recession struck in December 2007, just as they are now.

Higher unemployment would hit consumption and increase savings. The US savings rate is now half what it was before the pandemic, with bank deposits back to pre-pandemic levels. The poorest have less than they did in 2019 (Figure 2).

Figure 2: US household savings are down



Source: Data revisions and pandemic-era excess savings, H. Abdelrahman and L. Oliveira, Federal Reserve Bank of San Francisco, 8 November 2023 / BCA Research 2024

Credit card and auto loan delinquency rates are at 2010 levels, when unemployment was 10%. Banks have tightened lending standards; interest rates on consumer loans and credit cards are at a record (21.6% for the latter). If unemployment increases, consumers and businesses will rein in spending. In spite of the AI hype, capital expenditure remains depressed and commercial construction spending is at a 12-year low.

Monetary policy will tighten even as the Fed cuts rates because what borrowers actually pay is more important than official rates. The average mortgage rate is 300bps less than what is paid on new mortgages. Commercial property loans are souring while the bank credit impulse is rolling over. All of this is occurring while US government deficit is 7% of GDP[2] – a Donald Trump election victory would unleash even more borrowing. At the start of year, investors were betting on growth accelerating and the Fed cutting. But Fed credibility is being tested. Last summer, when it was hawkish and rates rose to 5%, the market fell 10%. That changed when Powell

[2] US Treasury, as at June 2024

turned dovish. Since then, Fed futures and stock prices have moved in opposite directions. Bullish expectations on earnings had better be right or the market will retrace. We are still waiting for the first cut, yet the market is at an all-time high.

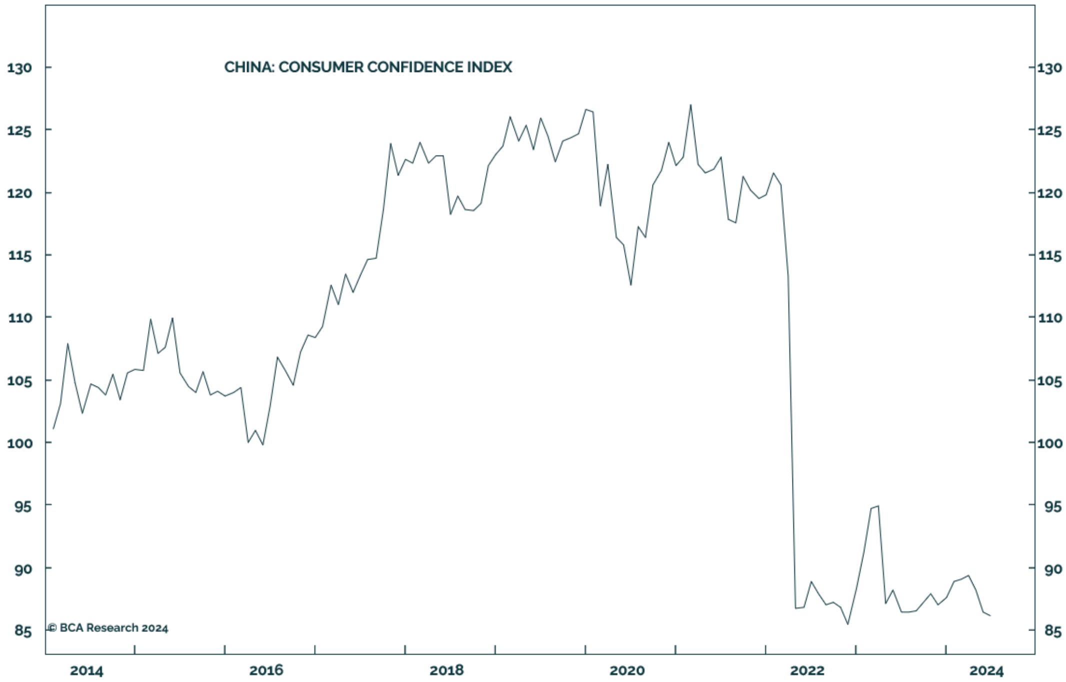
With the economic surprise indicators negative, unless the Fed stimulates, we may hit an air pocket in the second half of 2024. After rising from October to May, the Eurozone Composite PMI is falling. US data has been disappointing: retail sales, investment intentions and housing starts turning down. Some of this will be interpreted as a soft landing and not a recession. Global equities correlate with the US dollar; now equities are holding up despite the strong dollar.

China

China improved this year because of exports, up 7.6% year-on-year in May. Domestic demand is being held back as house prices, starts and sales are declining. Housing is unlikely to improve because of high prices relative to rents, while a declining population creates an overhang. The People's Bank of China offering RMB500 billion for state companies to buy apartments from developers is just 4% of developers' financing needs. Deflation, meanwhile, is pushing up real rates: producer price inflation is at -1.4% and consumer price inflation close to zero. The authorities focus on industrial policy, subsidising production and pushing electric vehicle exports, and think they will not need to do more to hit its 5% GDP growth target.

The Chinese consumer remains the big uncertainty. Confidence crashed in 2022 and remains in the doldrums (Figure 3). Nominal retail sales are only growing 2%-3% per annum. But Chinese households have accumulated savings, so there could be short-term relief, though it will take a concerted effort to lift the economy out of its funk.

Figure 3: Chinese consumer confidence is low and struggling



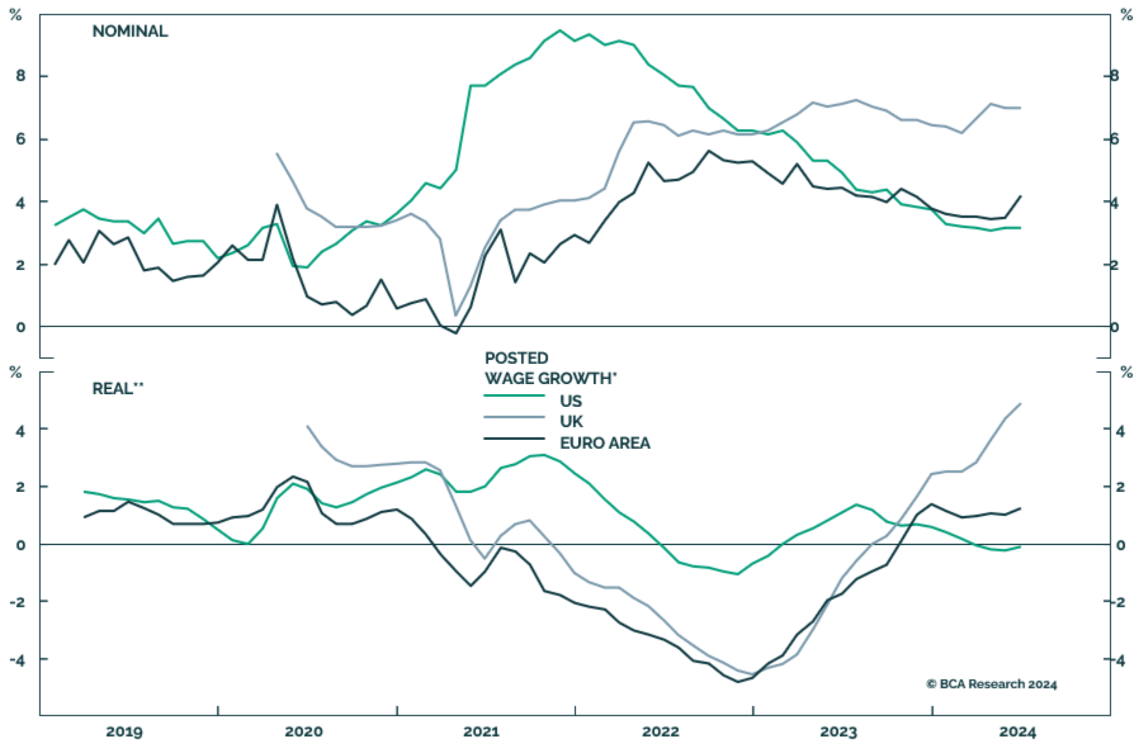
Source: National Bureau of Statistics of China, July 2024

Europe

While the US grew strongly in 2023, the eurozone actually contracted. Consumer confidence is increasing but business confidence remains low. PMIs for manufacturing and services have disappointed.

Europe suffered a worse energy shock than the US from the Ukraine war: inflation rocketed causing real incomes to crash. But natural gas prices are down 90% from the highs of mid-2022, and with the European Central Bank remaining restrictive in nominal and real yield terms, inflation has come under control and real wages have begun to recover (Figure 4). Unlike in the US, European households still have post-pandemic savings (equivalent to 12.5% of GDP), which will help consumption. Car registrations remain a quarter below 2019 levels, so sentiment indicators like the ZEW and Ifo surveys are positive. But the European Commission's Economic Sentiment Index is slowing and June's manufacturing PMI was negative. Falling vacancies, meanwhile, are a sign that the positive labour market might not last. Capex intentions are weak. According to the International Monetary Fund[3], Europe's fiscal thrust will move from -0.4% in 2023 to -1% in 2024.

Figure 4: European wages are recovering



Source: BCA Research, 2024

In France, both the left and right wing want to increase spending. Whatever political outcome ultimately materialises (parliament is hung and a government has yet to be formed) the bond

[3] IMF, The Global Economy in a Sticky Spot, July 2024

market will test these plans. Consumer loans in Italy and Spain will reset higher, while Germany is tightening fiscal policy by 1% this year.

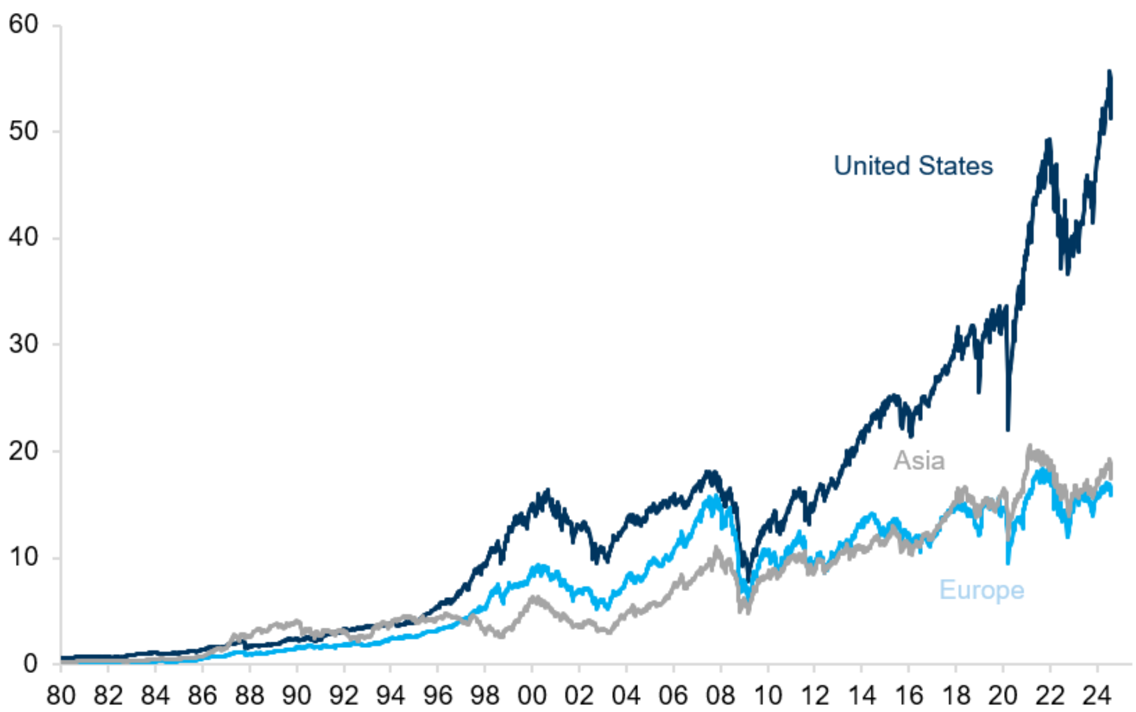
Banks performed well when interest rates rose, outperforming by 140% since the 2020 nadir. Even now they look cheap, but rates are at a peak. Their core Tier 1 capital has stabilised at 16%, twice the level of the global financial crisis (GFC), and returns on equity are back to pre-GFC levels.

For 20 years until the pandemic, US 10-year bond yields and long-duration assets were correlated. Inflation at the end of the pandemic undermined this. We believe that if the Fed cuts rates too late, this relationship is likely to reappear, which would be good for our quality investment style. Growth stocks are outperforming value and the same is true for large cap versus small. Earnings for the S&P 500 ex the Magnificent 7 remain negative. Growth stocks continue to produce better earnings growth than value. It may be time for software to do better relative to IT hardware after the AI frenzy – more capacity will enter in semiconductors.

Europe has underperformed the US over 12 months, but French politics could make us more positive on Europe. Debt, however, remains high: France has debt-to-GDP of 112%, Italy 137%, Greece 162%. France's public sector deficit will be 5% in 2024 and 2025.

The market cap of the US has diverged from other markets (Figure 5). The US roared due to the government lavishing money on consumers and favoured industries, global capital chasing US tech companies and AI. The US dollar's share of global financial transactions remains close to 90%.

Figure 5: A US disconnect



Source: Datastream/Worldscope, June 2024

Since 2007, eurozone equities have underperformed the US by 71% in common currency terms. European equities have often underperformed the US but enjoyed short bursts of outperformance, as in the late 1980s and from 2002-07. Europe has too many small firms with low productivity: whereas 59% of US firms have more than 250 employees, it is 48% in France, 43% in Germany and 24% in Italy. Europe's retiree numbers are set to explode, squeezing the cost of labour.

The EU has reduced fragmentation between markets, but laws, customs, cultures and languages still create friction. Europe's capital markets lack the depth and liquidity of the US, while the dollar dominates capital flows (60% versus 20% for the euro). Europe invested $4.8 trillion less than the US over the past three decades. "America innovates, China replicates, Europe regulates" sums up the cultural differences.

Cyclical factors can help Europe. Capex is focused closer to home (and outside China). Tax cuts and subsidies (the Inflation Reduction Act in the US with $360 billion, and €270 billion from Europe's Green Deal Industrial Plan) will help, as Europe is weighted to industrials, materials and energy.

United Kingdom

The clearer political picture in the UK and lower inflation – so lower interest rates – should help the UK. Headline inflation has fallen to 2%[4], but core at 3.5% remains a long way off target. Services inflation remains at 5.7%, driving high wage growth and higher costs. UK unemployment has risen from 3.7% in July 2022 to 4.4%. The Bank of England expects inflation below 3% over the next two years[5], so wage growth may moderate. Services PMI is above 50, with manufacturing PMI picking up and household and business confidence improving, helping retail sales. Lower yields and higher mortgage approvals should improve housing sentiment. Rising wages have reduced household debt as a proportion of disposable income: 124% now compared with 155% during the GFC.

Expectations of seven interest rate cuts this year have faded, replaced with optimism that GDP and earnings will grow. A deterioration in economic surprises will not help. We need earnings and GDP growth if there is not to be a pull back, given the equity risk premium is low.

Conclusion

The bears are capitulating. Morgan Stanley has upgraded equities, with an S&P 500 target of 5,400 in June 2025, below today. If JP Morgan upgrades its year-end forecast of 4200, there will be no investment bank left with a bearish view on recession – but this may not be a positive sign.

[4] As at June 2024

[5] Bank of England, Monetary Policy Report, June 2024

All market data is Bloomberg as at July 2024 unless otherwise stated

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