For professional investors only

European growth has dipped, but a US recession is only postponed

European equities | June 2023

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- **Although we've seen banking turmoil and rising rates, the stock market has been resilient due to expectations of cuts before year-end**
- **Despite a technical recession, European equities have outperformed the US by 30% since autumn, reversing a decade of underperformance**
- **Excess savings, strong personal balance sheets and falling energy prices are positives for Europe**

The US Federal Reserve has taken rates from zero to 5%-5.25% over the past 15 months, while the 10-year US Treasury yield rose from 1.5% last year to 4.25%[1]. It has since fallen due to the collapse of Silicon Valley Bank, Signature and First Republic banks.

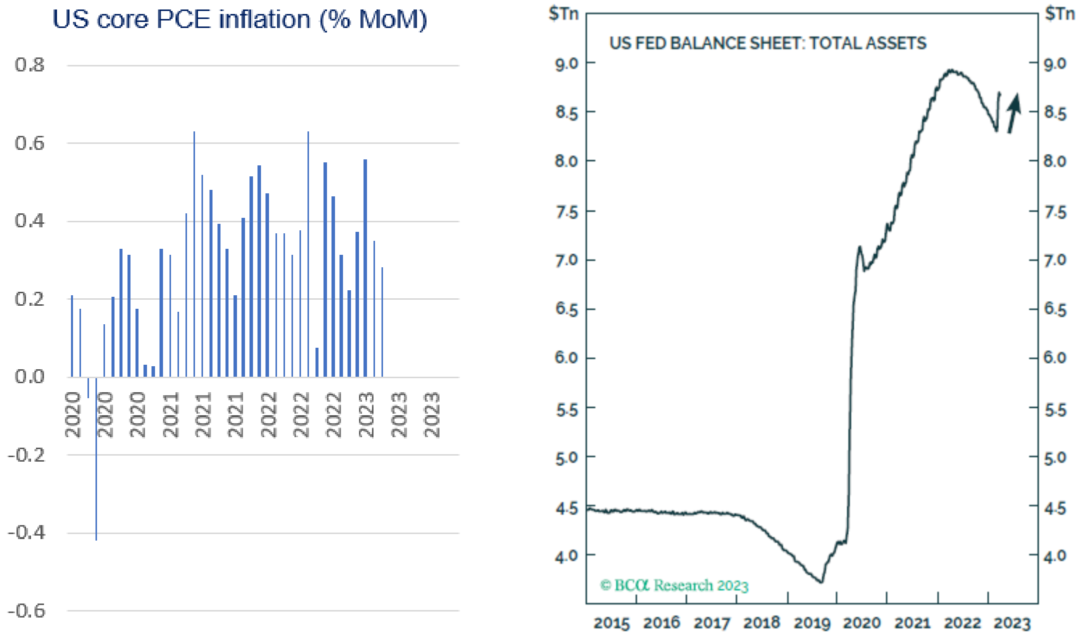
Upset in the banking sector was only the second unexpected event. Rate hikes and high yields had already caused mark-to-market losses on bonds, pushing US depositors from banks to money market funds. The stock market has been resilient – that comes from expectations of rates being cut later this year. But inflation remains stubbornly high: US Core PCE inflation, which represents the prices of goods and services purchased by consumers, may exceed 3.5% at year-end, well above the 2% target. The Fed is not slowing rate hikes, however, preferring to use other levers to maintain banking stability (Figure 1).

There are long lags in both tightening and easing cycles: it takes on average 16 months from when the Fed stops hiking – and 10 months after the first rate cut – before a recession ends. So even if the Fed stops raising rates now the impact will take months to come through.

The next hits from these hikes will likely be on lending, corporate profitability and jobs. Employment follows the profit cycle as companies shed workers to protect profits; rising unemployment flags recession. We are not seeing this yet, even if the jobless rate has been flat since summer 2022.

[1] Bloomberg, as at May 2023

Figure 1: inflation is above target / the Fed is using its balance sheet to deal with bank stress



Source: BCA Research, April 2023

Europe versus the US

Despite slipping into recession – growth was -0.1% in both Q4 2022 and Q1 2023[2] - European equities have outperformed the US by 30% since last autumn[3]. A warm winter, falling energy prices and Chinese re-opening boosted eurozone PMIs and earnings – reversing the underperformance seen since the global financial crisis, which came from a value bias and lack of structural growth. Prices have not cooled in Europe – March headline and core inflation hit 0.9% and 1.2% month-on-month – so interest rate rises will continue.

In addition, many of the problems in US banking are not present in Europe: Europe's banks are stronger than during the GFC, do not face a solvency crisis and are not as exposed to interest rate risk – the rising cost of capital will simply slow economic growth and inflation; European bank bond portfolios are smaller; quantitative easing continues in Europe while the US has started tightening; and debt holdings are 17% of European deposits versus 25% in the US[4], so European banks can suffer more deposit outflow before they have to sell bonds.

Markets-wise, Europe may have outperformed the US for past six months, but the US is still expensive on more than 18x forward price-to-earnings. A risk-free rate of 5% and US 10-year bond yield above the US dividend yield is not helping. Europe offers a better picture on dividends relative to bond yields. The equity risk premium is at a 15-year low, leaving little room for negative shocks; there is not much earnings growth, despite resilient margins.

Industrials have rallied since autumn as we approach the final interest rate hike. Some believe we are at the start of a new cycle, but we doubt that. In equities, sector leadership is defensive

[2] The Guardian, Eurozone sinks into recession as cost of living crisis takes toll, 8 June 2023

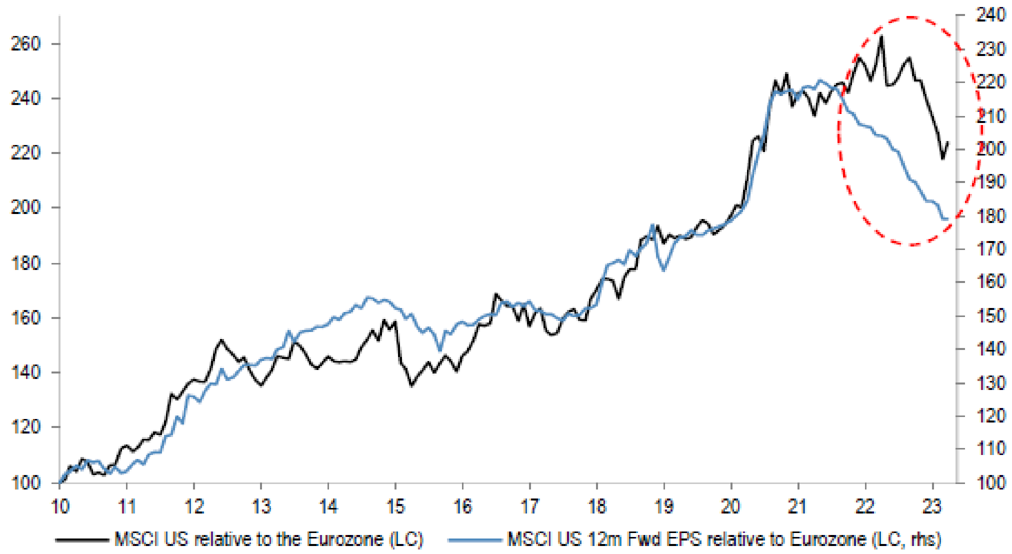
[3] Bloomberg, as at April 2023

[4] European Central Bank Lending Survey, 2023

both before and after a change in the cycle – that means bond proxies such as technology, healthcare and staples. Technology has outperformed and is over-discounting the expected fall in yields.

The price relative of the technology sector is at an all-time high. Sector-neutral, Europe looks cheaper than the US by more than one standard deviation: so the US has underperformed for a reason (Figure 2). The UK still looks exceptionally cheap with the highest dividend yield, a pay-out of 40% and a beta of less than 1 relative to the MSCI World Index[5].

Figure 2: US earnings per share relative to eurozone and relative performance



Source: IBES, April 2023

Value stocks usually underperform growth if bond yields fall. From the lowest point of unemployment to the start of recession is usually no more than six months; we are approaching that.

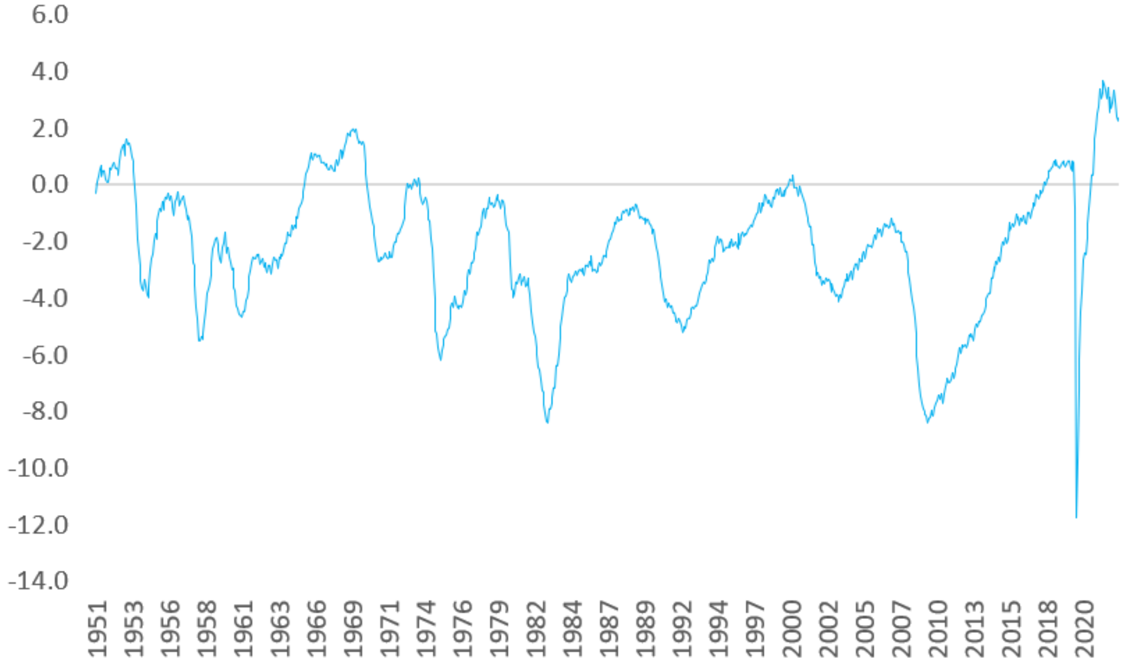
The future

Recent broker emails have titles like "Say hello to Goldilocks". And yes, inflation is falling, unemployment is at lows and central banks are near the end of interest rate rises. But falling inflation could signal that surplus demand from excess pandemic savings, which kept the economy going, is falling. If that changes the supply curve, then unemployment can rise and output fall, creating a market shock.

Job vacancies have been falling for some time, yet unemployment is benign. Previously, unemployment rose when vacancies fell. The difference now is the post-pandemic gap between jobs and workers, between labour demand and supply. This reached a high of almost 4% post-Covid (Figure 3). At full employment, companies compete for workers by offering higher wages. If there is no productivity growth, demand stokes inflation in wages and prices.

[5] Institutional Brokers' Estimate System (IBES), April 2023

Figure 3: the US jobs-workers gap reached a record high in 2022



Source: BCA Research, April 2023. Jobs-workers gap is the difference between labour demand (sum of job openings and civilian employment) and labour supply (civilian labour force) as a percent of the labour supply.

Normally, when demand for labour weakens, vacancies and wage growth fall. Because there has been excess demand for labour, the fall in vacancies has not affected confidence in finding new jobs. GDP, linked to employment growth, has remained positive despite slowing demand. This slowing demand is now lowering inflation: hence the “Goldilocks” headlines.

The problem is when falling demand meets aggregate supply: if demand continues to fall it will impact jobs and output, prompting recession. This is likely to happen as the housing market weakens due to interest rate rises and tighter lending standards – as such excess pandemic savings are dwindling. Tactical strength in US equities may not last; the recession there has been postponed, not cancelled.

In Europe, credit flows have weakened economic growth, as have wages and employment. But with excess savings, strong personal balance sheets, falling energy prices and an easy fiscal position – as the NextGenerationEU plan kicks in – this recession hasn’t proved too deep.

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