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# European reform must wait as the US continues to advance

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**Paul Doyle**
Head of Large Cap European Equities

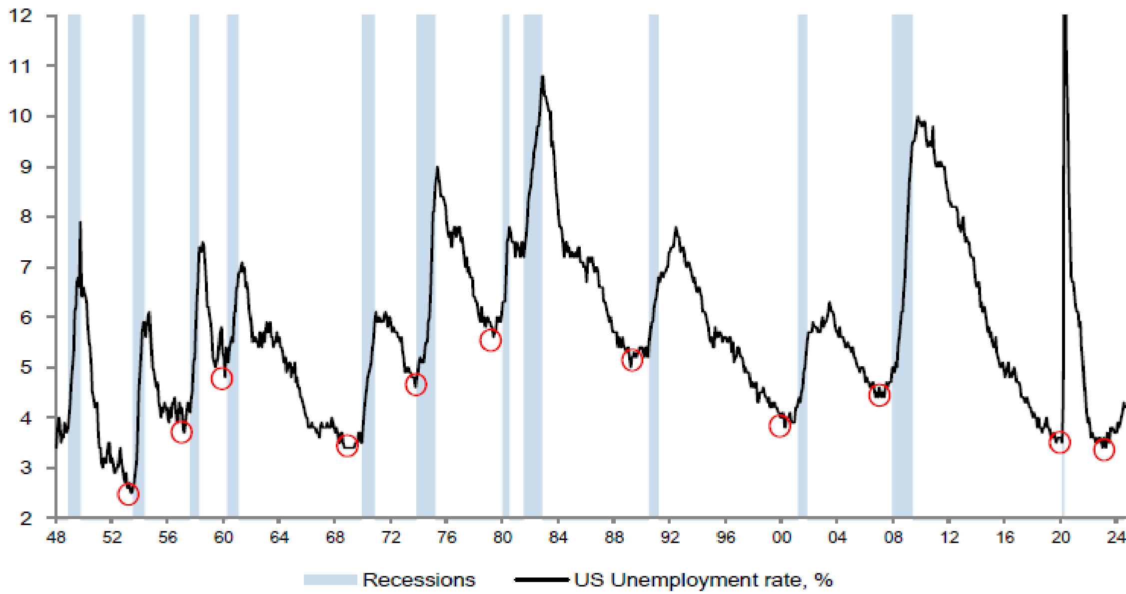
- **Europe, struggling with competitiveness, needs to cut interest rates faster – but even that may not be enough**
- **Against a tricky backdrop, stock picking is key – to find the gems in Europe and dodge the mantraps**
- **The S&P 500 is expensive compared with Europe and elsewhere, but the consensus optimistically expects its earnings to grow 14% next year**
- **China's stimulus is on a declining path and unlikely to achieve the desired growth – it needs people to spend not save**

## The United States

Dramatic US rate cuts with strong payrolls, alongside Chinese monetary and fiscal reflation, have silenced the bears. But labour demand continues to slow: labour force growth slowed to 0.4% in August from 1.9% a year earlier. New entrants and re-entrants to the labour market make up 40% of the increase in unemployment; the rest is from job losses. This means the number of people unemployed after losing their jobs is now beyond that which triggered previous recessions (Figure 1). Job openings have fallen to 4.6% from the 2022 peak of 7.4%. The number who work part time because they cannot work full time is increasing.

Excess pandemic savings boosted US consumption, but these are now depleted. It is unlikely that consumers will increase borrowing when credit card and auto loan delinquencies are back to where they were in 2010, when unemployment was close to 10%. Banks have tightened credit standards. Unlike in 2007, there is no overhang of single-family homes in the US. But house prices are 22% higher than before the pandemic. Mortgage applications are at rock bottom. The number of residential units started fell 1.9% in the latest month, down 10% since year-end. This is worrying for construction employment: the outlook for commercial construction is questionable, with real estate prices down 8.9% year-on-year – the worst since the global financial crisis (GFC) (Figure 2).

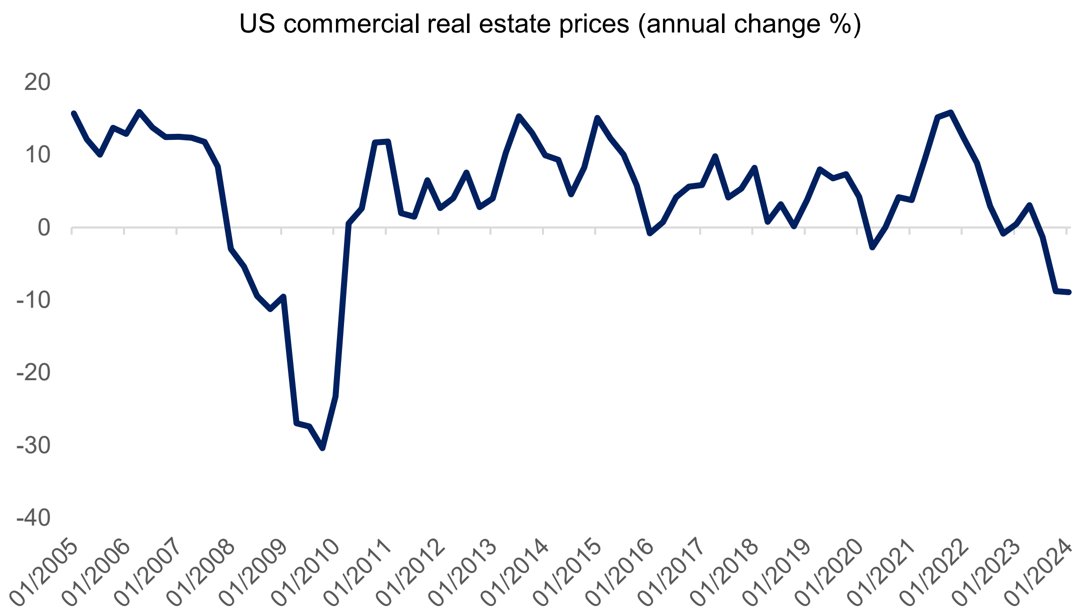
Figure 1: Inflation is surprising to the upside




Source: Bloomberg Finance LP, as at October 2024

ISM manufacturing new orders fell to 44.6 in August, orders-to-inventories to 0.89. New orders in the S&P Global US manufacturing PMI hit a low of 42.7 in September, indicating that weaker European industrial activity may follow. The ISM manufacturing index correlates with capital expenditure intentions, which have been sustained by the CHIPS and Science Act and Inflation Reduction Act subsidies. These may not last.

Figure 2: Commercial real estate prices are tumbling




Source: International Monetary Fund, as at October 2024

There has been a huge increase in government hiring. State spending grew 14.4% in 2024, after a rise of 7.2% in 2023, and is expected to shrink by 6.2% in 2025. State and local government spending has added 0.46 points to GDP over the past four quarters, well above the 10-year average of 0.18. State and local government payrolls have grown 40,000 a month over the past four quarters, six times faster than the 10-year average. The Federal government deficit is 7%, despite nearly full employment. Even though interest rates are being cut, average rates on business loans and mortgages will continue to rise. The Fed may also ease cuts while excess liquidity deteriorates.

In spite of strong payrolls, the labour market differential (the share of jobs that are easy to get versus those that are hard to get) continues to deteriorate, but the Merrill Lynch investor survey shows 85% of investors still believe in a soft landing. In the payroll survey, the length of the working week has fallen so much that the aggregate weekly hours worked fell 0.1% in September. Employment of 16-19-year-olds surged even as their unemployment rate rose from 14.1% to 14.3%. ADP payrolls fell 260,000, seasonally unadjusted – the worst for any September since 2010 against an average of 38,000.

When households see job opportunities fall, they curtail spending, hitting investments and hiring. Banks are lending more selectively. The Conference Board's Consumer Confidence Survey shows that this is affecting consumer confidence. The marginal rate of interest on 30-year US mortgages is above the average, since a third of US mortgages were refinanced at low rates in 2020. Rates in the US will have to come down a long way before they act as a stimulus, given this duration. The same is true for corporate loans.

US household ownership of stocks is at a record high. The market has been strong but leadership defensive. Cyclicals typically underperform for four to six months when the Fed starts easing, even if there is a soft landing. Cyclicals are not as expensive as at year-end – the opposite of 2022 – and are correlated with bond yields.

The Fed needs to cut rates aggressively for the market to become cheap. Earnings revisions are rolling over: expectations for S&P 500 earnings growth over the next 12 months are almost 14%. Given trailing margins are 12.5% – versus 8.1% at the 2000 peak – this is challenging. On a price-to-earnings (PE) basis the market is cheaper than 2000, but on a price-to-sales basis it is 26% dearer. Earnings expectations have risen more than trailing earnings: 12-month forward earnings have risen 21% since December 2021, while operating earnings are only up 5%.

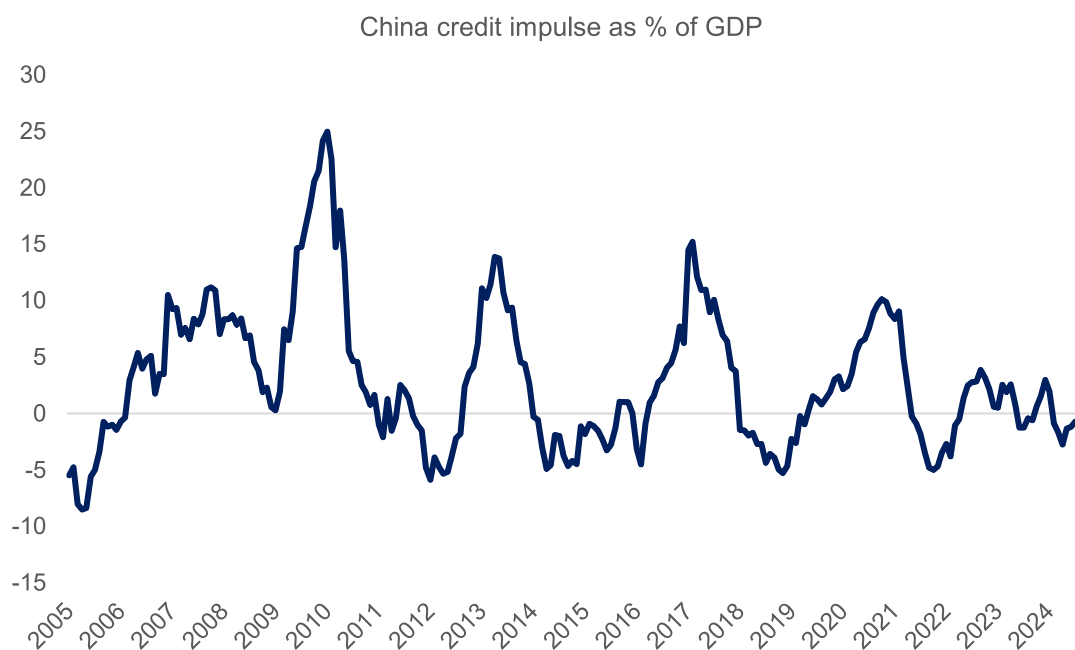
### China

Expectations are high. Having cut bank reserve requirements and lowered interest rates, with little effect, China has ramped up monetary and fiscal measures. There is much hope that China's reflation attempt last month repeats the boost from earlier pump-priming: the reflation in 2015 saw the stock market double in six months. However, back then China's credit impulse peaked at RMB13.5 trillion, 15% of GDP. Given China's economy has doubled in nominal terms, it would now need RMB27 trillion to match this … but the latest credit impulse did not even reach RMB5 trillion. Stimulus measures have been getting smaller as a percentage of China's economy. In the GFC the credit impulse peaked at 25% of GDP, in 2015 it was down to 15%, during the Covid pandemic it was 10%, and now 3%. As the credit impulse moderated, so has the boost to growth (Figure 3).

The reason these reflations are losing their effect is that their uses have dried up. The early ones boosted investment, construction and housebuilding. Because China does not have a

social care system, Chinese families save; for years, savings went into housing, prompting a bubble. House price-to-rent ratios topped 75x, which was higher than in the property bubbles of Ireland, Spain and Japan. Chinese property is now worth $100 trillion – the largest asset class in the world – but there are between 130 million and 150 million empty homes, so property prices have fallen for the past three years. Thus the reflations of 2008 and 2015 cannot be repeated; they funded construction and housing booms that are complete. Even so, housing construction has not fallen as much as housing starts because there is a pipeline. Starts are down 65% from their peak, completions only 11%. Once the pipeline projects are complete, however, activity will fall rapidly.

Figure 3: China's peak impulse has dwindled




Source: People's Bank of China/BCA Research, 2024. 1-year credit impulse based on total social financing

The only way China could reflate successfully is if people save less and spend more (its savings rate is the highest of all major economies). Saving and lack of spending are feeding deflation and growing the trade surplus as China shifts production to the rest of the world. The UN expects a 70% fall in China's working age population by the end of the century.[1]

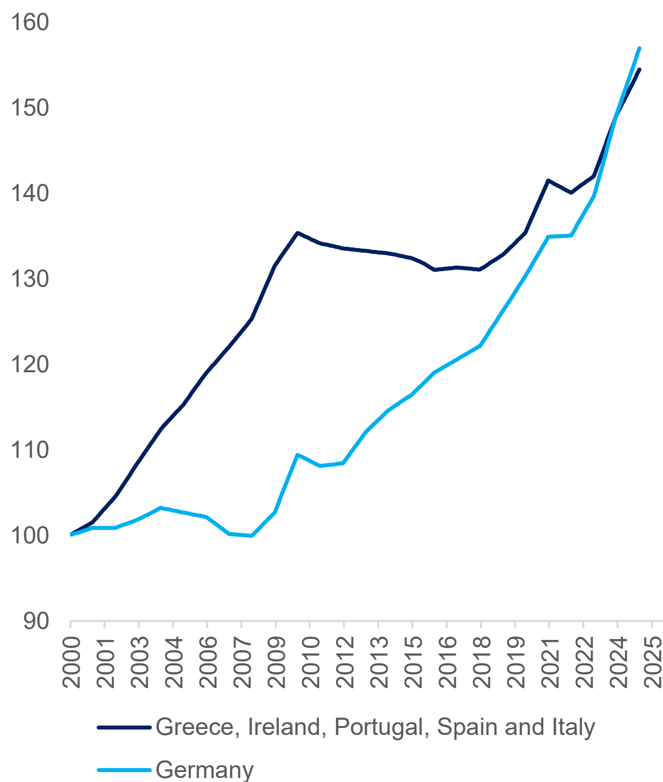
## Europe

Europe, with a savings rate of 15%, has firepower to spend. But the European Central Bank (ECB) needs to cut interest rates more than is forecast. Job openings continue to fall, so unemployment will rise, which in turn will cause a further downturn in spending. The composite flash euro area PMI fell to 48.9 in September – 1.7 points worse than expected. The service sector remains in expansion but at 50.5 was the lowest in seven months, compounded by

[1] United Nations, 2024 Revision of World Population Prospects

France. Manufacturing PMI fell to 44.8, and in Germany was 40.3. Germany's business model – selling capital goods to China using cheap Russia energy – is broken. Wages in Germany have risen faster than elsewhere in the EU, so they are increasingly uncompetitive (Figure 4). The employment component of services PMI slowed from 56.1 in August 2021 to 50.9 this year. This does not bode well for consumption, with retail sales slowing and consumer confidence turning down. Inflation is below target in Europe for the first time in three years, while core inflation slowed to 2.7%. So even if the ECB cuts rates as expected, it might not stave off recession.

Figure 4: Germany has become increasingly uncompetitive (unit labour costs)



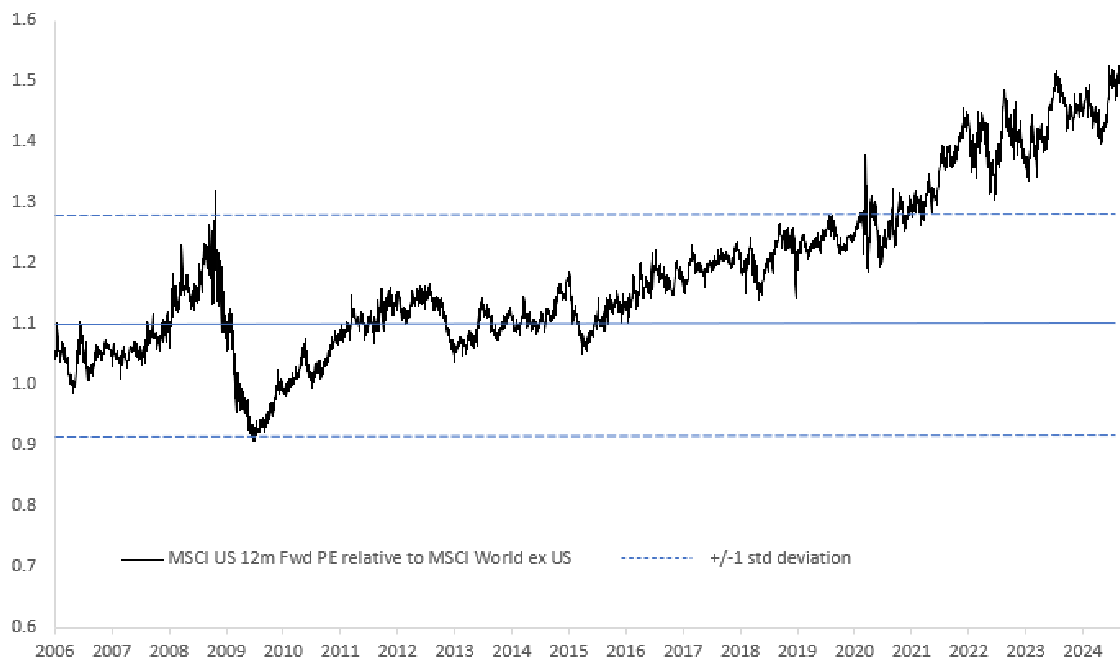

Source: European Commission / BCA Research, October 2024.
Note: all series rebased to December 1999 = 100.

## Looking forward

The US remains expensive relative to Europe and the world (Figure 5). Europe is more sensitive to China than the US. If China's reflation works, that will lift Chinese bond yields and the performance of European equities relative to the US, and boost the euro. Longer term, Europe's problems remain, highlighted in Mario Draghi's report on Europe's competitiveness.[2] His recommendations that Europe needs less regulation, more integrated markets, a coherent industrial policy, banking and capital markets union and education spending are unanswerable but perhaps not deliverable.

[2] European Commission, The future of European competitiveness – A competitiveness strategy for Europe, 9 September 2024

Figure 5: MSCI US 12-month fwd p/e relative to World ex-US




Source: Bloomberg, as at October 2024

Since the euro was created, GDP has lagged the US on a purchasing power parity (PPP) basis by 30%, or 0.84% per annum. Europe's GDP per capita is 47% below that of the US even accounting for PPP. Europe's lower number of working hours accounts for 28% of this, but most of the problem is down to productivity. It is the same story in the UK.

Europe invests less than the US in part because of a poorer return on investment, particularly in technology. The area it leads is green innovation, but it wastes that advantage on competition with China and high costs. Weak research and development spending compounds this. R&D tends to be spent on "'old economy" sectors like autos. Europe lacks leading research universities, with only three of the top 50 globally versus 21 for the US and 15 for China (the UK punches above its weight). There is too much fragmentation: we may have a single market, but local regulations, languages and other barriers block the benefits. Europe has too many businesses with low economies of scale and investment firepower, hampering productivity.

Europe's banks securitise less than in the US, making them more risk-averse and lowering funds for capital expenditure and investment. The lack of a banking union means only Germany can borrow using risk-free instruments. All other countries pay a premium, with Italy for example paying 138bps more than Germany. It will take more pain before reform.

So Europe faces tough but not insuperable challenges as we look forward. We have seen such macroeconomic headwinds before, but careful stock picking will unearth the gems – companies where brand, technology or other competitive advantages will ensure outperformance and strong returns from global business models. It will also enable us to avoid the mantraps – inflexible business models tied to an economy which risks stagnancy or worse.

Unless specified, all data is Bloomberg, as at October 2024

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