
European smaller companies outlook

European equities | October 2023



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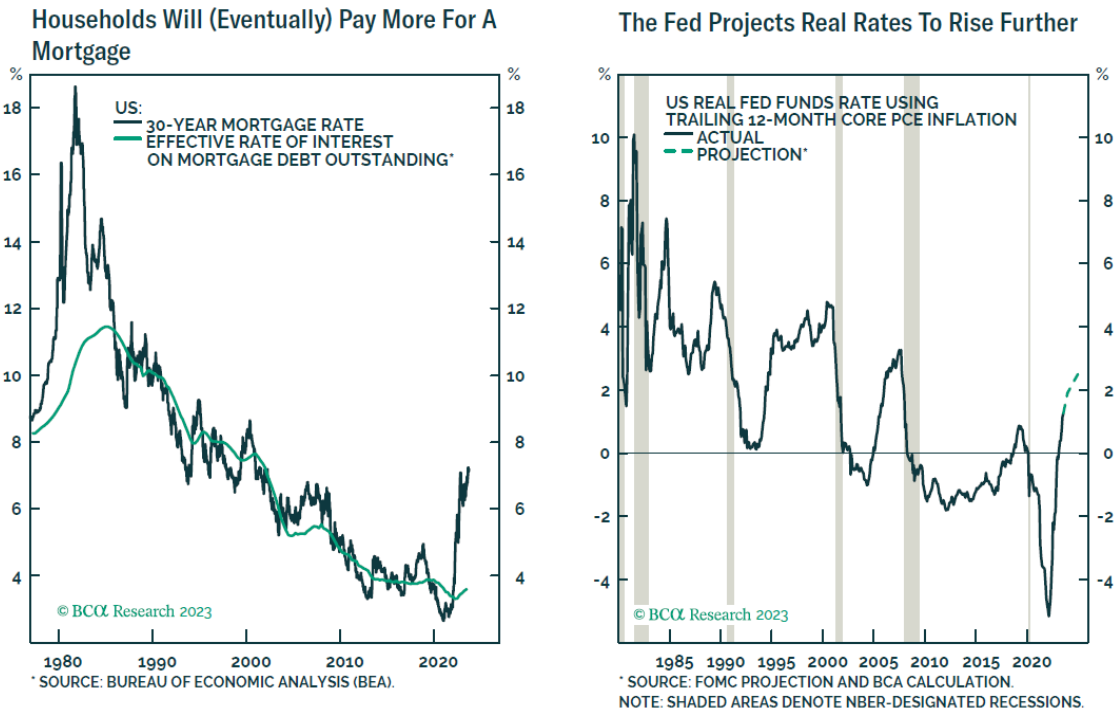
- **Higher oil prices, inflation and interest rate pressures are unhelpful to the performance of small cap and growth stocks. However, interest rates are peaking and inflation is beginning to fall**
- **Earnings per share are growing and therefore small cap valuations are increasingly attractive**
- **This supports the case for renewed outperformance from small cap stocks, particularly those with high-quality and growth characteristics**

The news over the past two years has been dominated by inflation and interest rate forecasting, as the long period of low inflation and low rates ended abruptly. As Covid-19 restrictions reduced and demand picked up, supply chains came under pressure and inflation rose dramatically. While some of the drivers of this were temporary and supply chains have adjusted, inflation in the west has not yet returned to pre-Covid levels. This is due to less globalisation, greater government stimulus and higher energy prices.

Central banks underestimated the inflation problem and had to raise interest rates at a faster-than-usual pace to levels with which they could be more comfortable. There may be just one more rate rise to come in the US, though this is less likely following events in Israel and Gaza. Further rises in the UK and the eurozone are even less likely.

As inflation falls, so real interest rates have risen in the US and are now positive after years of being sub-zero (Figure 1).

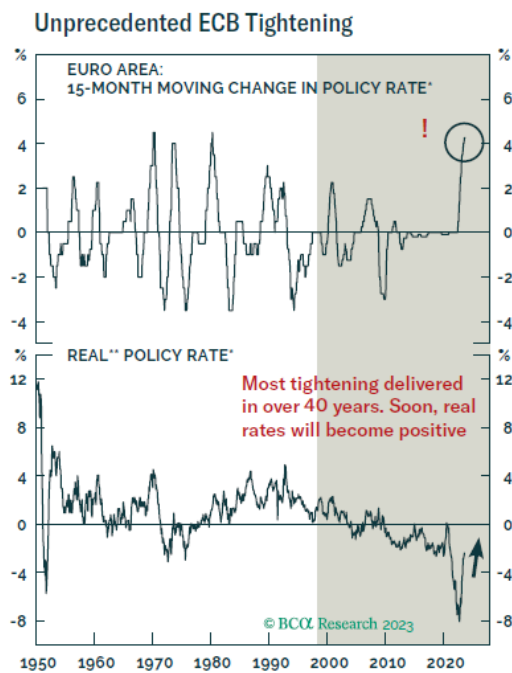
Figure 1: real interest rates in the US are rising



Source: BCA Research, October 2023

The situation in Europe is similar, though lags the US (Figure 2).

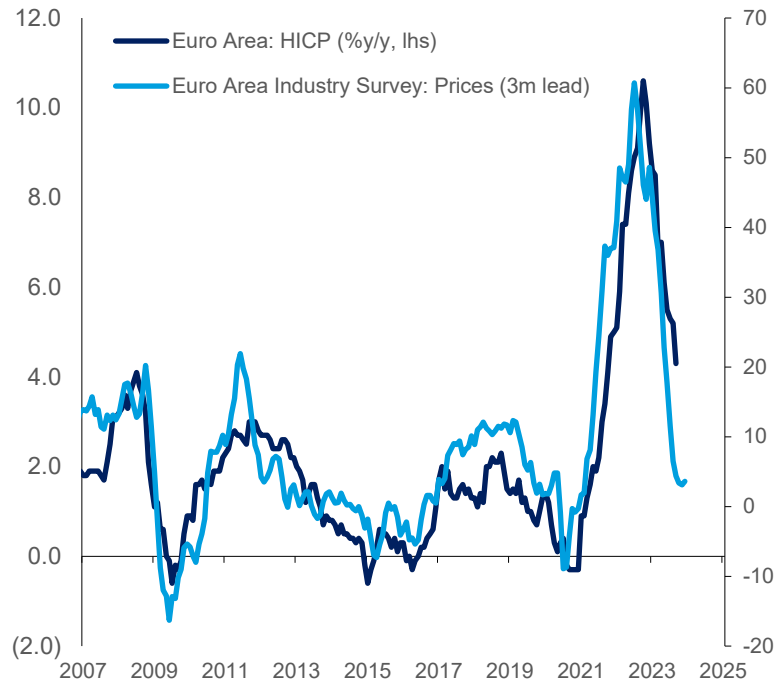
Figure 2: real interest rates in the eurozone are rising



Source: BCA Research, October 2023. *Bundesbank discount rate from 1950-1999. European Central Bank facility rate from 1999 to present. ** Deflated using German headline CPI. Note: shaded area denotes period of ECB existence from 1 June 1998 to present.

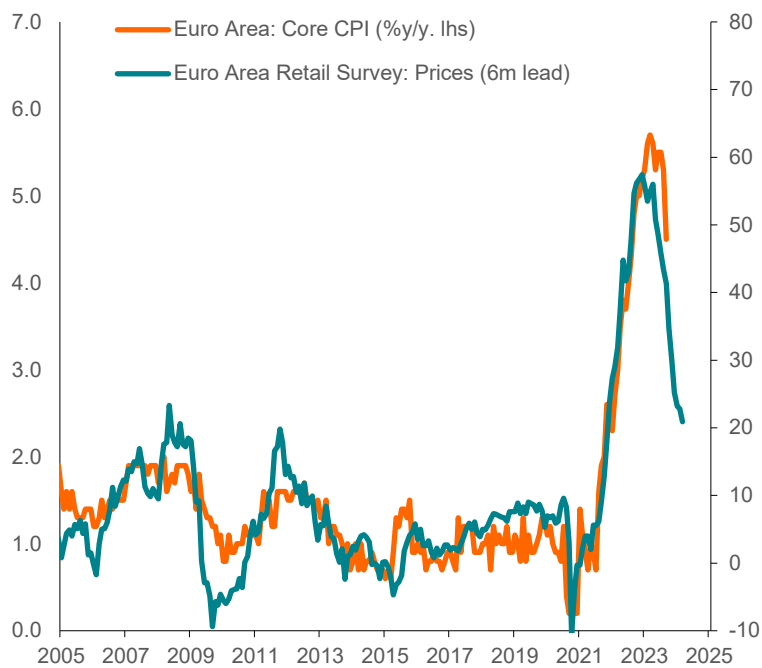
Also, in Europe natural gas prices drove inflation higher than in the US. The recent fall in the gas price should bring lower inflation in Europe (Figures 3 and 4), and so mean a peak in rates.

Figure 3: inflation is likely to fall in the Eurozone



Source: BNP Paribas Exane, October 2023

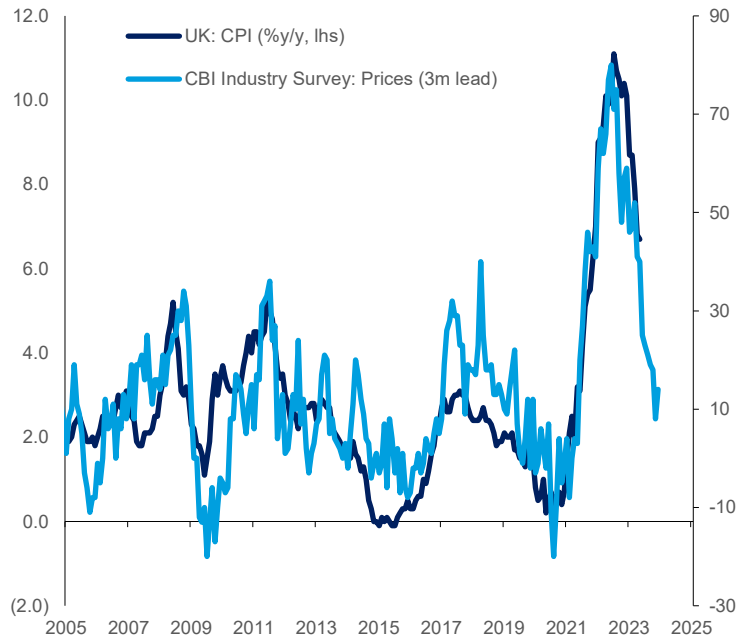
Figure 4: eurozone core inflation is starting to ebb



Source: BNP Paribas Exane, October 2023

This should also be the case in the UK (Figure 5).

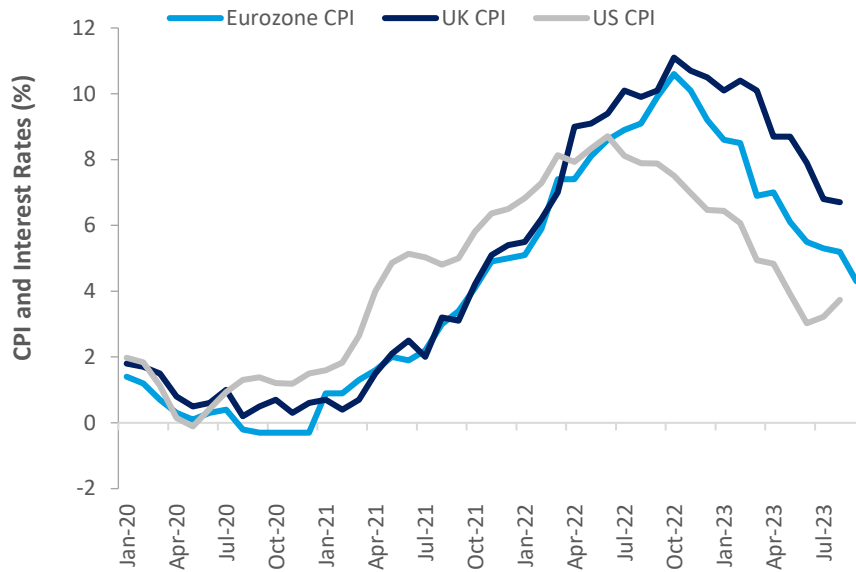
Figure 5: UK core inflation is turning too



Source: BNP Paribas Exane, October 2023

Both are behind the US to some extent (Figure 6).

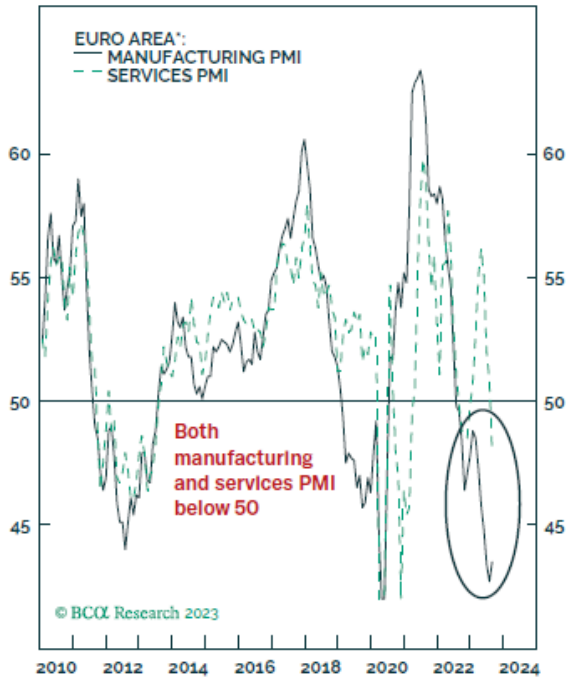
Figure 6: European inflation trends have been lagging the US



Source: Bloomberg, October 2023

Chinese growth, meanwhile, disappointed as the country’s exit from Covid restrictions faltered, with consumer spending not picking up to the expected extent. This has hurt European manufacturing (Figure 7), which is export driven, and European PMIs are now below 50.

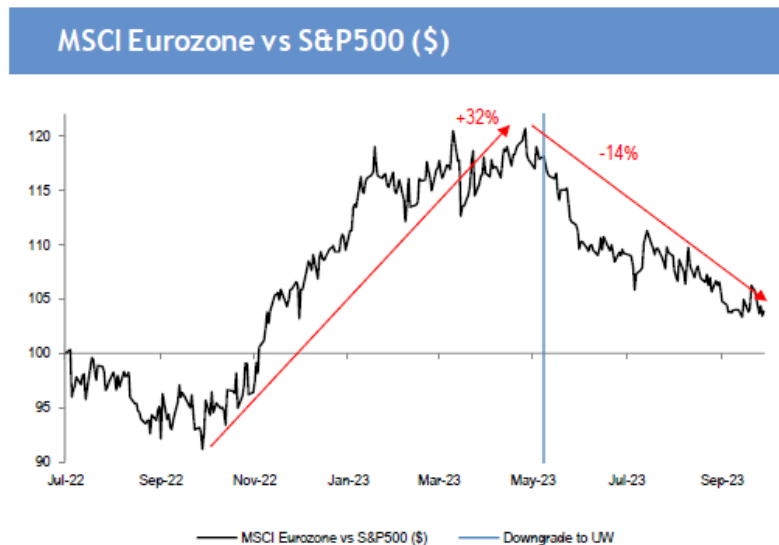
Figure 7: weak manufacturing and services PMIs in Europe



Source: BCA Research, October 2023 * source: HCOB, S&P Global PMI. Note: series truncated at 42 for presentation purposes.

European GDP has been stagnant this year and the eurozone has recently underperformed the US, after outperforming over the six months to September 2022 (Figure 8).

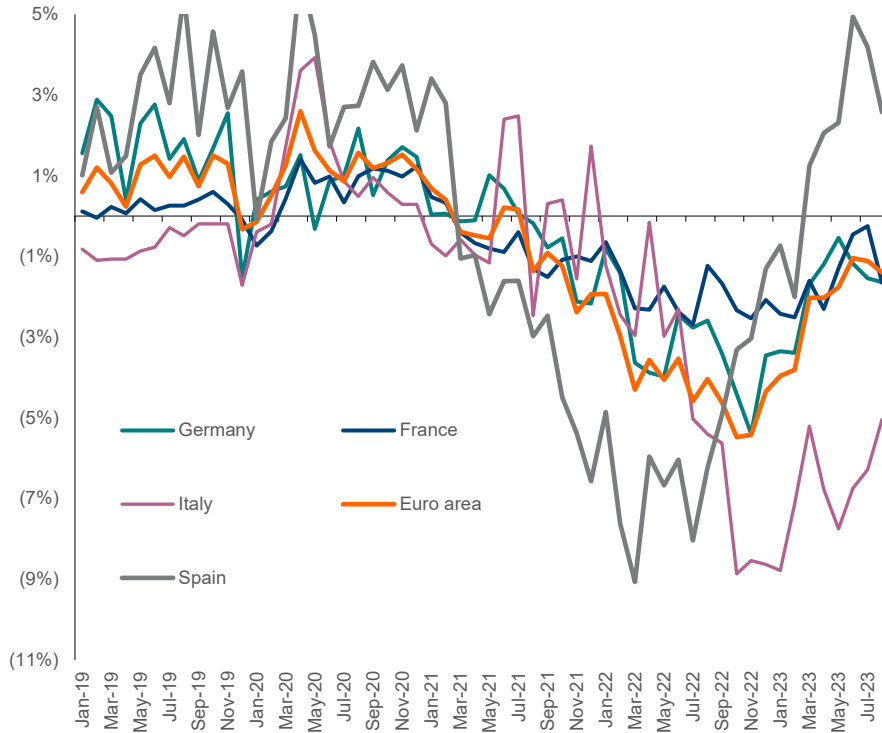
Figure 8: relative performance of MSCI Eurozone Index vs S&P500 Index



Source: Datastream, October 2023

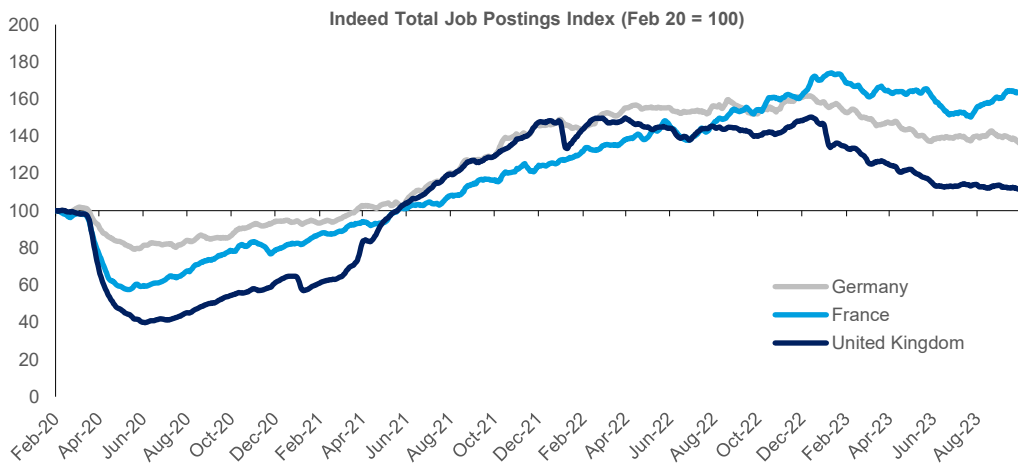
Just as we expect a soft landing or mild recession in the US, the tide could be turning in Europe (Figures 9 and 10).

Figure 9: real wage growth to turn positive



Source: BNP Paribas Exane, October 2023

Figure 10: job openings have stopped falling



Source: BNP Paribas Exane, October 2023

In the UK consumer confidence is rising (Figure 11).

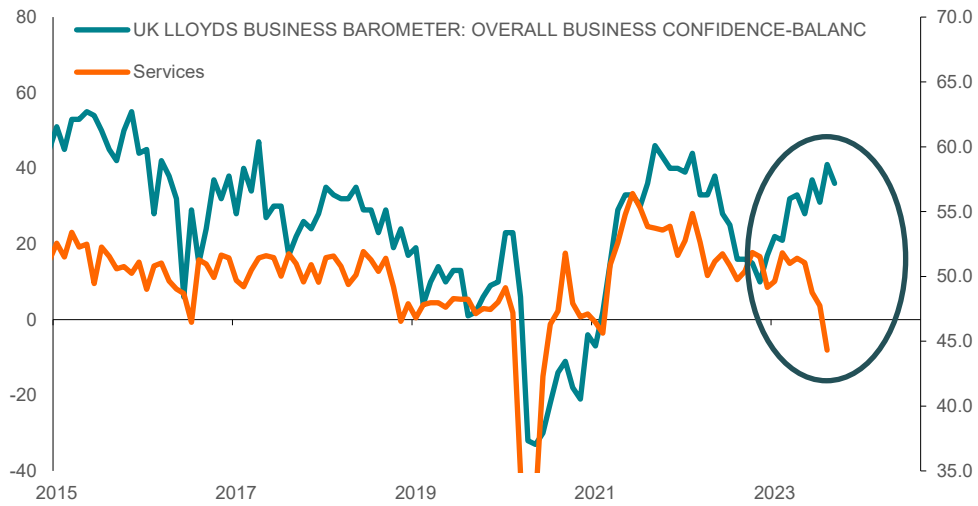
Figure 11: UK consumer confidence is on the up



Source: BNP Paribas Exane, October 2023

This should help support services PMI (Figure 12).

Figure 12: these factors should support services PMIs

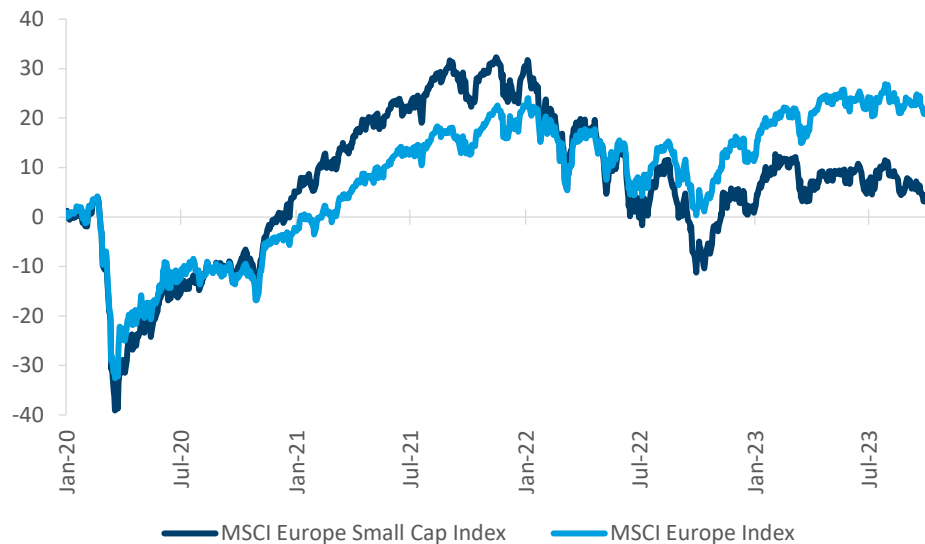


Source: BNP Paribas Exane, October 2023

Small-cap performance versus large

Smaller companies have underperformed large cap since January 2020, (Figure 13):

Figure 13: cumulative returns of MSCI Large Cap and Small Cap indices



Source: Bloomberg, October 2023

Equity valuations have been impacted by the rising discount rate. As small cap shares tend to be more growth oriented, the pressure on valuations is greater. This is due to the share of value in the later years of a discounted cash flow valuation model.

2022 saw a dramatic reset in growth valuations compared with those of value stocks. There has been a similar though smaller effect this summer, due to changing expectations for interest rates.

Weakness in markets has a greater effect on small cap share prices (compared to larger companies) if asset allocators move away from a perceived riskier or more volatile asset class.

Valuations

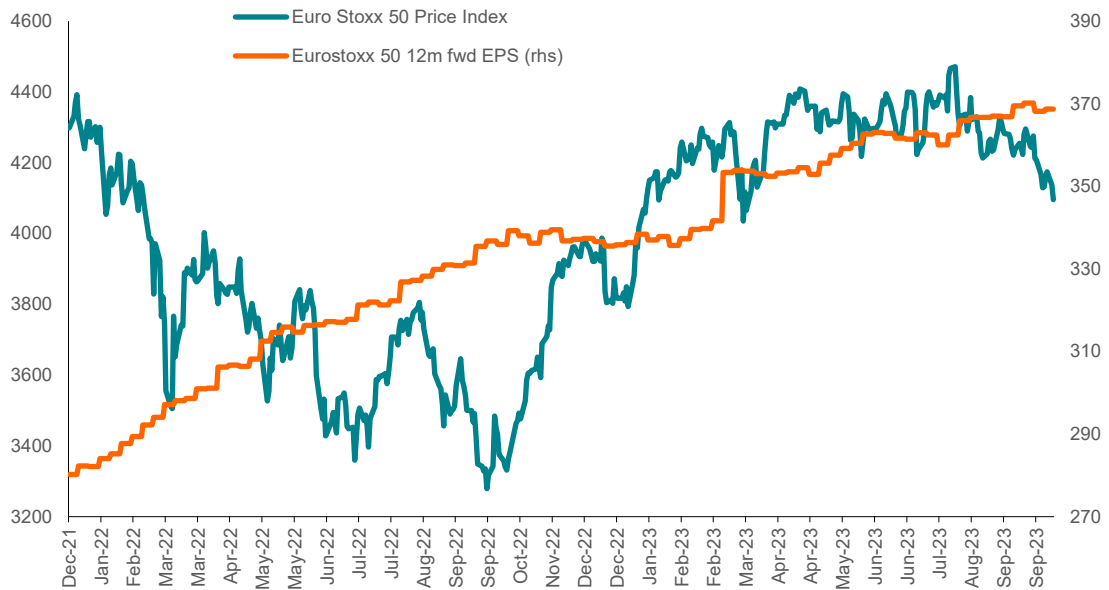
Despite the weak economic backdrop and geopolitical volatility, eurozone earnings-per-share revisions have been positive through 2023 to-date. This means Europe now looks attractively valued, particularly compared to the US. Even excluding the largest technology stocks in the US, the discount is interesting for long-term investors.

Figure 14: index valuations across markets – Europe is attractive

Valuation levels	2023 P/E	2024 P/E	2023 P/CF	2023 DY
Europe	12.6	12.0	11.2	3.5%
US	19.6	17.4	15.1	1.6%
Japan	14.7	14.0	9.9	2.2%
Asia ex Japan	14.4	11.7	9.2	2.6%

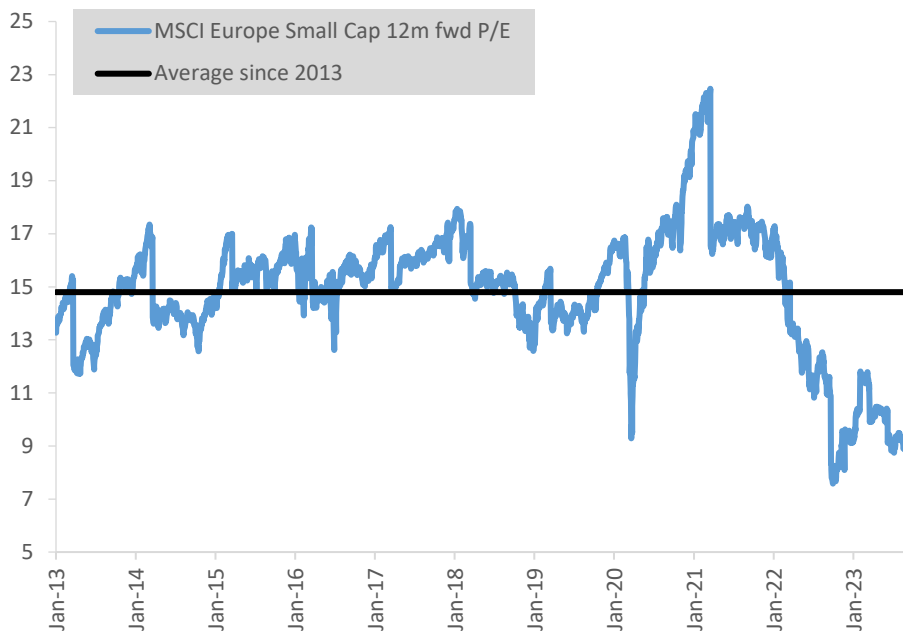
Source: Bloomberg, October 2023

Figure 15: earnings, especially in Europe, continue to see upgrades



Source: BNP Paribas Exane, October 2023

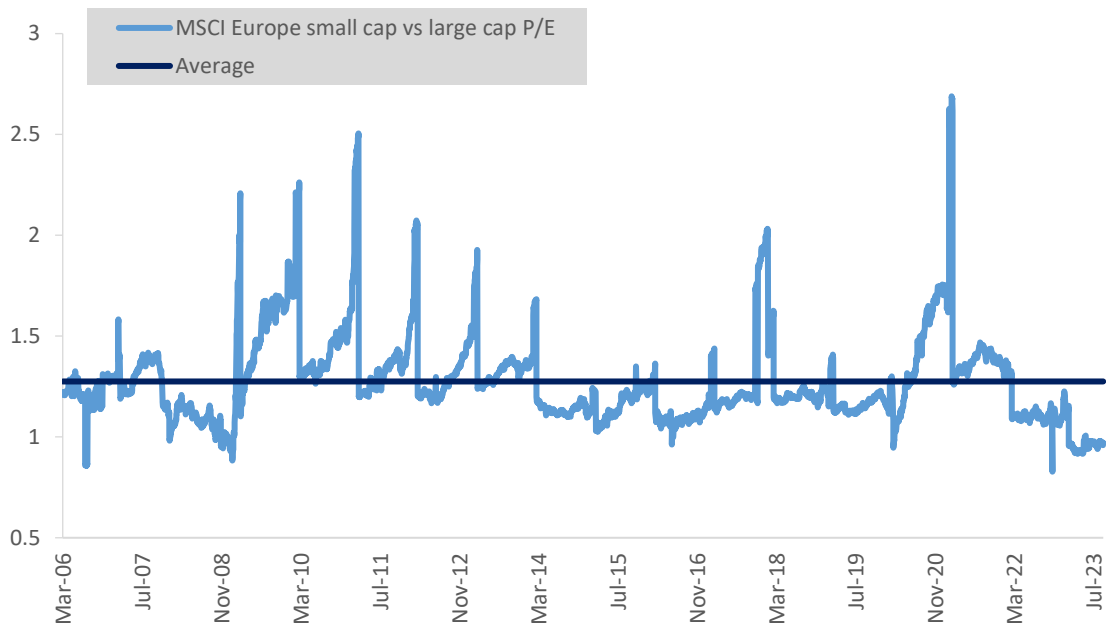
Figure 16: Small cap 12-month forward P/E



Source: Bloomberg, October 2023

As performance has lagged large caps, smaller companies in Europe are looking more interesting in valuation terms than for some time (Figure 17).

Figure 17: Relative P/E ratios show that small cap is cheap



Source: Bloomberg, October 2023

Outlook

We continue to focus on higher quality, growing businesses which can thrive whatever the macroeconomic backdrop. Higher interest rates – and thus discount rates – mean we must be ever more critical of valuations of such stocks.

The work we have done over the year-to-date puts us in a good position to outperform going forward, investing in a small cap universe which is well positioned compared to large cap in Europe and compared to the US.



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