



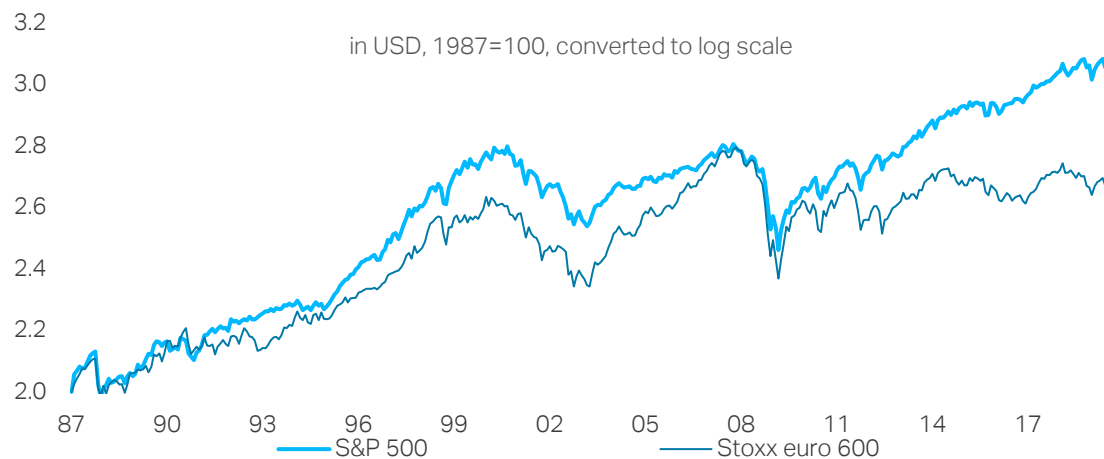
Macro Picture

VALUE TRAP

Dario Perkins

The euro area keeps underperforming the United States, both in terms of macro and equity markets. After the latest bout of investor optimism, any lingering bullishness on European equities seems to be disappearing. If the global economy survives the current growth scare, Europe should be OK (though uninspiring). But in a global recession...

Chart 1: Euro-area underperformance since 2011



Source: Datastream, TS Lombard

FALSE ECONOMY

Some investors were hoping European underperformance would become outperformance in 2019. Special factors had temporarily depressed GDP growth, while the euro area would benefit from Chinese stimulus and possibly 'trade diversion' from the US-China trade war. With the consensus gloomy about Europe and stocks relatively 'cheap', there were reasons for optimism.

RISK RETURNS

Yet the global slowdown has hit Europe particularly hard, with the trade war undermining the euro-area expansion even with minimal EU involvement. True to form, Germany has failed to provide an offsetting domestic catalyst. Once again, there are doubts about how European officials can revive growth in the region, especially if the Chinese fail to reflate global demand.

NOT SO CHEAP

Even the valuation case for European equities is exaggerated. Euro-area stocks have been 'cheap' for a reason –underperforming corporate profits. While two sectors have weighed particularly heavily on relative EA/US valuations, namely banks and the FANGs, poor euro-area fundamentals play a critical role. European equities need a premium for deflation/'bad politics'.

VALUE TRAP

European stocks have significantly underperformed the US market since 2011. Based on our regular interaction with clients, it was clear some investors were hoping this relative decline would end in 2019, perhaps even reverse. The bulls listed a number of reasons to support their thesis, including 'cheap valuations' (on traditional measures, such as PE, the US market is more expensive) and an improving global environment. After all, until recently, the consensus blamed Europe's downturn on temporary factors that would unwind in 2019. Meanwhile, European stocks stood to benefit from new ECB TLTROs and another Chinese credit splurge. There were even hopes Europe would be relatively immune to the US-China trade war, especially if President Trump resisted the temptation to levy large tariffs on European auto manufacturers (which he has done... so far). While this final point was particularly controversial, the bulls pointed out that large bilateral US-China tariffs would make both countries less competitive versus the euro area.

Mid- 2019 and the bullish case for European equities has lost most of its appeal. Today, TS Lombard clients seem more concerned about Europe 'turning Japanese'. The global downturn, which started in China and other EMs, has hit Europe particularly hard. Far from being immune to the China-US trade war, the uncertain international environment has caused a synchronized plunge in European capital orders. The euro area's role in global supply chains is an additional source of pain, as disruption to global trade further discourages investment. This latest slump, which started outside the euro area, is another reminder that the region lacks genuine domestic growth catalysts. Once again, the German consumer is failing to live up to expectations, unable to provide the euro area's *deus ex machina*. While a recession in Europe is not inevitable, the outlook remains heavily dependent on events elsewhere. If there is a trade deal and the world recovers, Europe should fare OK. But the region is scarily ill-equipped to handle a more serious global downturn, especially with an uncertain ECB response and a souring political environment.

Far from 'cheap', European stock markets surely require a risk premium to compensate global investors for the danger of deflation and deteriorating politics. Italy remains a genuine threat to EMU stability. In fact, European equities are not as good value as the conventional wisdom assumes. While PEs are lower in Europe, this is because the return on equity is also significantly inferior. European companies have consistently underperformed their American peers, delivering a relatively poor return. Revenues are subdued and euro-area companies struggle to expand their margins, hampered by relatively sticky wages and consistently poor productivity. It is true that US stocks also have specific 'sector' advantages, supported by high FANG valuations and without the drag from Europe's ailing financial institutions. But these advantages also reflect diverging macroeconomic fundamentals. The US has a vibrant group of superstar companies, which invest heavily and capture most of the benefits of new technologies. This is a source of dynamism, not monopoly power. At the same time, the problems at European banks, a major drag on the stock market, reflect the reality of high debts and perma-low interest rates.

1. FALSE ECONOMY

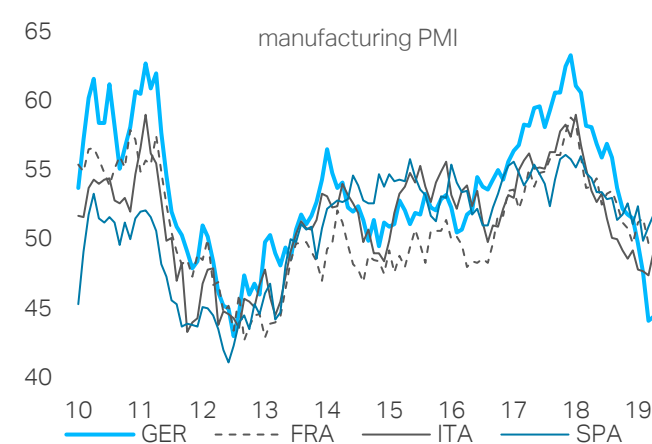
Through our regular interaction with clients, it is possible to tell when a certain theme or market idea is gaining traction among buy-side investors (though clients sometimes test views they don't necessarily hold, which complicates things). Until recently, one particular trade kept cropping up in our discussions: the bullish case for European equities. It would be wrong to describe this view as the consensus position – in fact, BoAML surveys show fund managers have been holding a record underweight position in European equities since late 2018. But perhaps this was the reason our clients were keen on the trade – it was 'non-consensus'. They also had valuations on their side – Chart 1 shows euro-area and US stocks diverged sharply after 2011, with Europe continually underperforming. If you were constructive about the global economy and wanted to be bullish equities, 'unloved' European stocks offered good value.

Chart 2: Euro-area downturn



Source: Markit, Eurostat

Chart 3: Industrial plunge



Source: Markit

"Temporary" slowdown

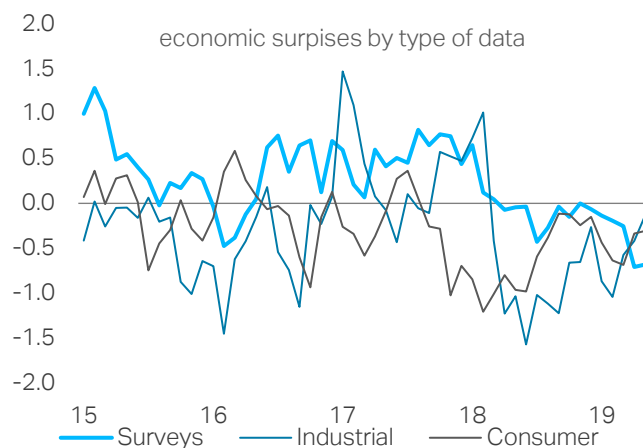
The bulls took particular comfort in the idea the euro area's macro outlook was 'not as bad as it seemed'. Business surveys had deteriorated sharply but they had also wildly overstated the strength of the economy in 2018. Official 'hard' data show a less gloomy picture, especially GDP, which beat expectations in Q1. In fact, the region's macro surprise index is edging back towards zero in 2019, which means euro-area statistics are no longer missing consensus expectations by such a wide margin. While GDP growth for 2019 is still looking rather sluggish (the Bloomberg consensus is now 1.2% YoY, down from 2% last summer), there is no real evidence of recession. And some of the temporary forces that had weighed on activity in 2018, such as the German auto industry, were also showing signs of improvements (Chart 7). German vehicle registrations collapsed last summer, mainly due to new regulations. They have since recovered.

While temporary forces had depressed headline activity, investors could also point to important areas of resilience in the euro-area economy. Labour markets looked robust and this was supporting consumer confidence. Even today, euro-area households remain relatively upbeat about the economic environment, saying they will continue to make major purchases. The bulls were particularly confident about what was happening in Germany. German unemployment had reached its lowest levels since the 1980s and there were signs some of the most rate-sensitive parts of the economy were responding to a decade of monetary stimulus. House prices were growing vigorously (by German standards) and consumers were even starting to borrow. A

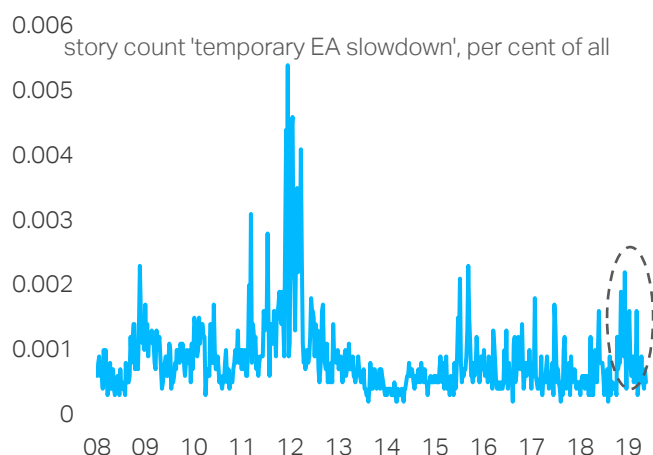
German domestic revival would be seriously good news, not just for Germany but for the entire euro area. Countries like France and Italy, which struggled for decades at the hands of German austerity and wage restraint, stood to benefit from German reflation and EMU 'rebalancing'.

Chart 4: Signs of stabilization?

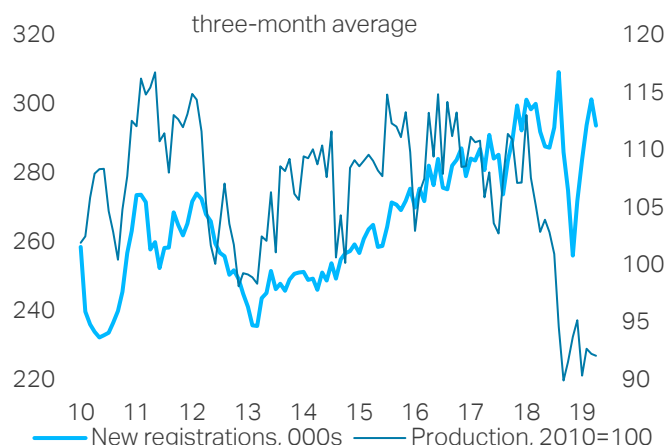

Source: Bloomberg

Chart 5: Hard data stabilize but surveys down


Source: Bloomberg

Chart 6: No longer 'temporary'?


Source: Bloomberg, share of total Bloomberg stories

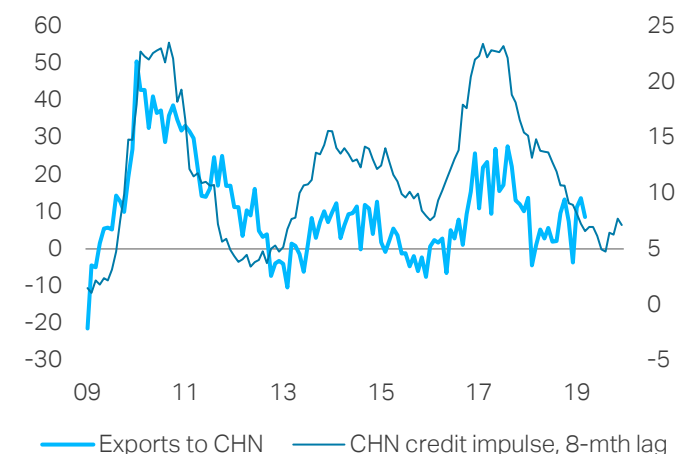
Chart 7: Rebound in German auto demand?


Source: Datastream

Stimulus-response

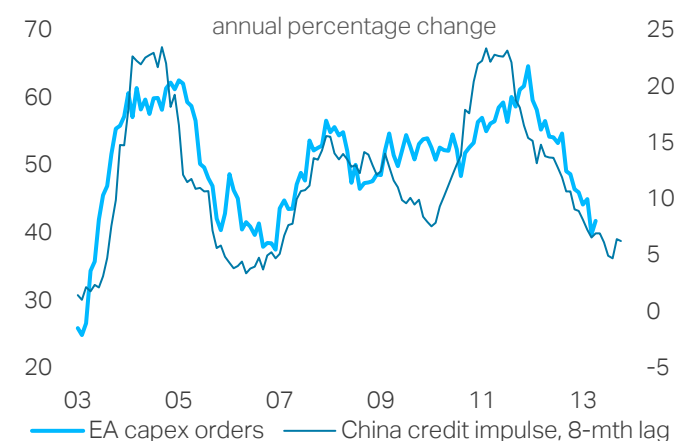
With the euro-area economy arguably stronger than it seemed, the region also stood to benefit from fresh policy stimulus. The ECB's new TLTROs didn't live up to expectations in Q1 (this was no '[back-door helicopter money](#)'), but investors were confident the authorities in China would provide a more powerful boost. After all, China's economy had deteriorated sharply in 2018 and the State looked poised to introduce another major credit splurge in 2019. This would repeat the stop-go pattern of the last decade, where each new round of Chinese stimulus provided a powerful boost to euro-area industry. Charts 8 and 9 show euro-area exports and capital spending are now increasingly tied to China's domestic policy cycle. If you believed the Chinese were serious about reviving their economy in 2019, European companies would surely be among the main beneficiaries – another good reason to be bullish euro equities.

Chart 8: Chinese boost disappeared in 2018



Source: Eurostat, TS Lombard estimates for China credit

Chart 9: Euro area industry and China

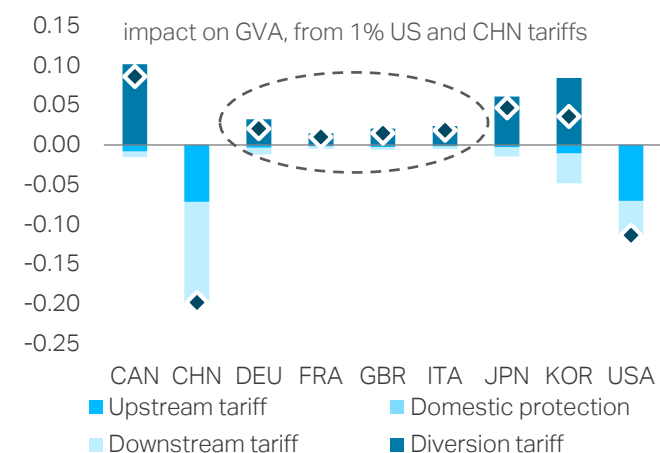


Source: Eurostat, TS Lombard

Protected from US Protectionism?

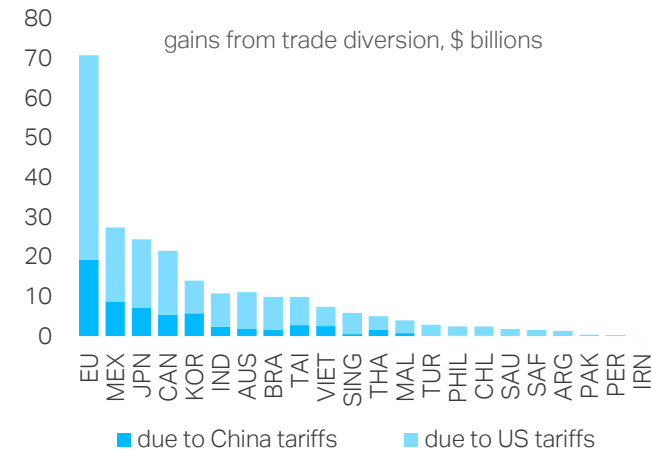
A more controversial reason to be bullish European equities was based on the idea that the euro area was not directly exposed to the trade war between China and the United States. President Trump kept threatening to impose tariffs on European auto-makers, but it was clear he was more interested in 'beating' China. In fact, Trump has recently postponed any action against the EU for another 180 days. Based on the economic models used by the [IMF](#) and United Nations, a trade war *that is confined to just the United States and China* should not be particularly damaging to Europe. In fact, by levying large tariffs on each other, China and the US undermine their own competitiveness. This could lead to 'trade diversion', as US/Chinese consumers switch to cheaper alternatives. According to some estimates (Charts 10 and 11), European companies might eventually gain from this rerouting of global trade. Detailed [UN projections](#), for example, predicted an EU boost of up to \$70bn (3% of exports) from the US-China conflict.

Chart 10: Euro area to benefit from trade war?



Source: IMF World Economic Outlook, [Chapter 4](#)

Chart 11: UN trade diversion estimates

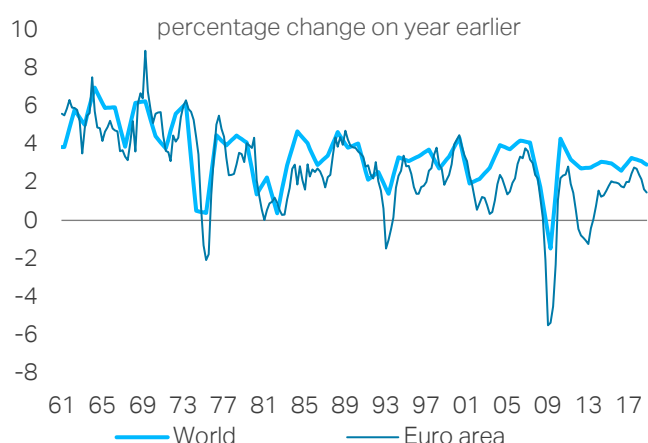


Source: [United Nations](#)

2. RISK RETURNS

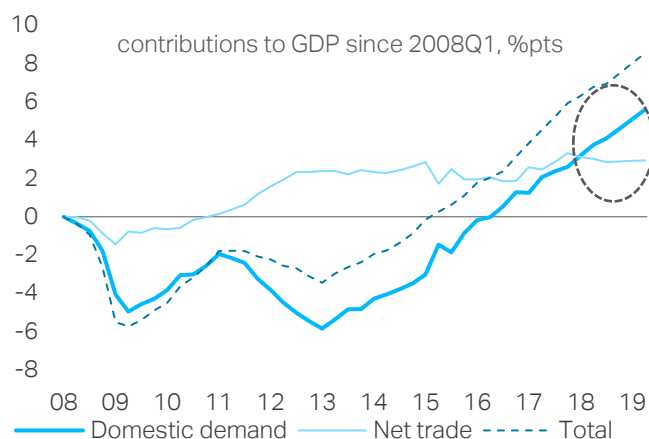
For a while, the bullish case for European equities seemed to be playing out rather nicely. The Chinese introduced a large (front-loaded) stimulus at the start of the year and with scattered signs of 'green shoots' in the global economy, European stock markets rallied 15% by May. But sentiment has shifted decisively since then and investors are now much more sceptical about the European 'value' story than they were two months ago. Disappointing global demand is again a big part of the story. After a strong start, the authorities in China are now talking down the prospect of further stimulus and with global leading indicators continuing to disappoint, the 'green shoots' story is looking rather ropey. Worse, trade tensions between the United States and China have suddenly re-escalated, with the Trump administration aggressively hiking its import tariffs. Not only do US-China trade negotiations seem increasingly irreconcilable, but the conflict is also having a larger negative impact on the euro-area economy than many investors had anticipated – even with the EU managing to stay out of President Trump's direct firing line.

Chart 12: Euro area levered to global cycle



Source: OECD, Eurostat

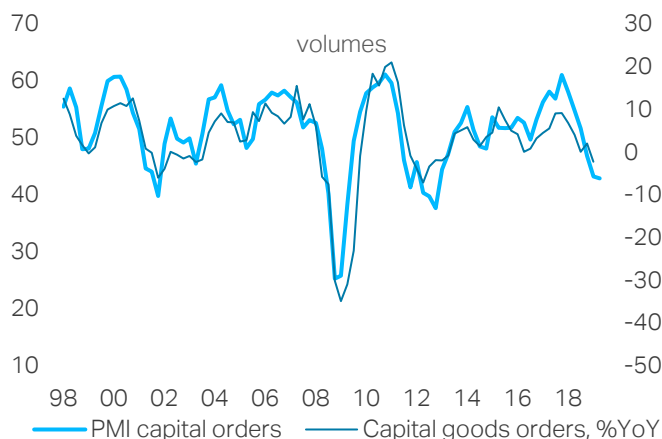
Chart 13: Domestic recovery was recent



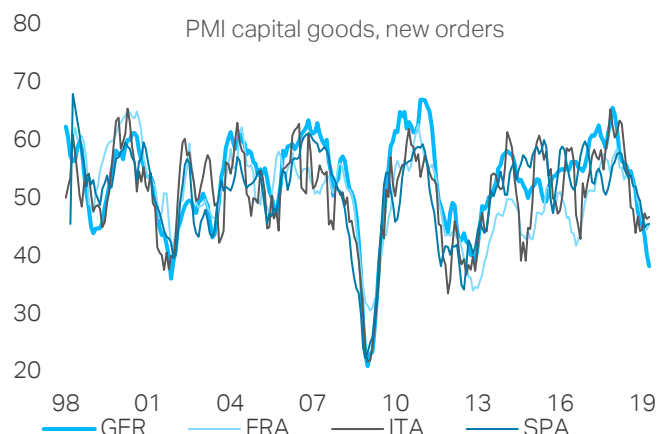
Source: Eurostat, TS Lombard estimates

Trade-war spillovers

The euro area's vulnerability to the trade war mainly reflects 'indirect' effects from the conflict, particularly via uncertainty and global supply chains. Capital orders have deteriorated rapidly, at a rate last seen during the global financial crisis. Because European exporters are uncertain about future demand, they have put their capex plans on hold. The euro area's exposure to global supply chains has compounded this weakness. Though American and Chinese tariffs have not hit European companies directly, they have suffered indirectly through their supply linkages to both countries. Global trade is now contracting. Remember also that the euro area remains the world's major source of excess saving and deficient demand, leaving it particularly vulnerable to any global downturn. Though domestic activity has picked up in recent years, the region continues to run its largest current-account surplus in history. In fact, a record number of EMU countries have been running surpluses simultaneously – a highly unusual state of affairs.

Chart 14: Sharp euro-area capex downturn


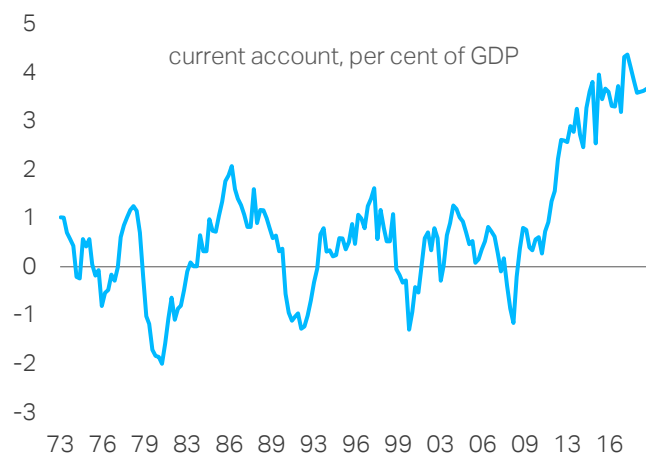
Source: Markit, Eurostat

Chart 15: Synchronized capex plunge


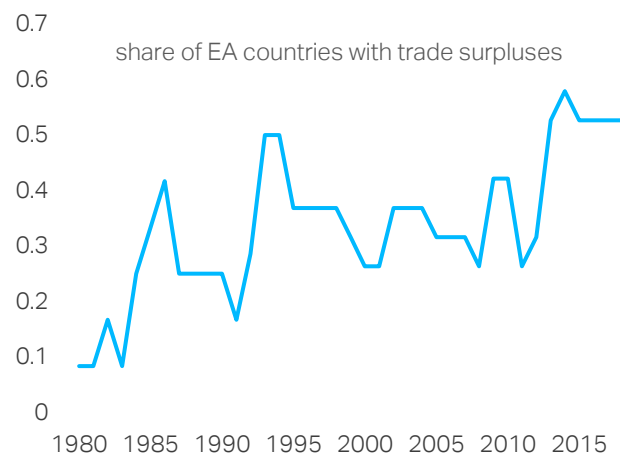
Source: Markit

Domestic disappointment

With the outlook for euro-area exports souring, potential domestic growth catalysts have also disappeared. Once again, Germany is the region's biggest source of disappointment. Far from stronger German demand 'rebalancing' the euro area in 2019, German consumers have done what they always do – the uncertain international environment has encouraged them to raise their precautionary saving. House prices have slowed and private credit is once again looking rather moribund. Perhaps the domestic situation in Germany is not as alarming as some of the most recent data suggest (manufacturing sentiment has plunged and the latest employment numbers are particularly horrible – artificially so) but the idea that the German consumer will become a catalyst for the wider euro area is looking increasingly improbable.

Chart 16: Unprecedented EA trade surplus


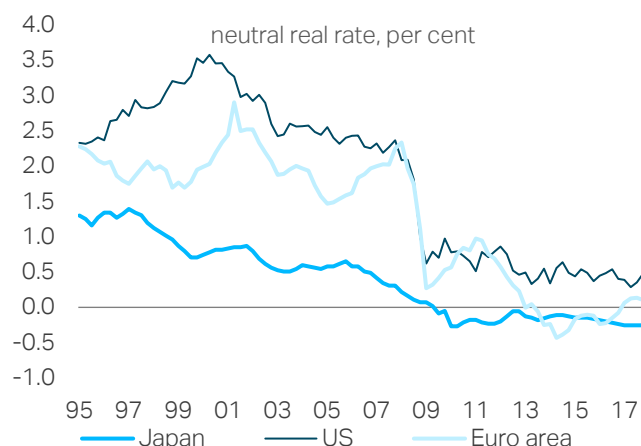
Source: OECD, TS Lombard

Chart 17: Record share of EA in surplus


Source: IMF, TS Lombard

Chart 18: Germany turning Japanese?

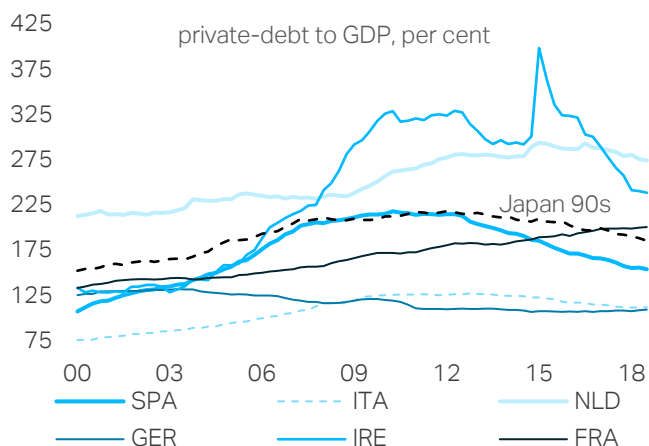

Source: Bloomberg

Chart 19: Low equilibrium interest rates


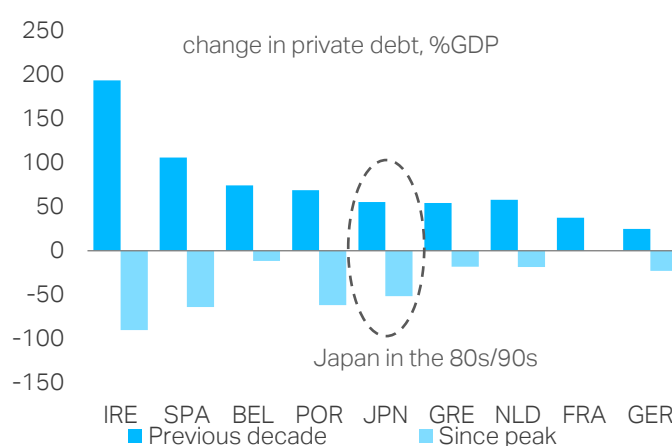
Source: Bank of Japan, US Federal Reserve

The risks from a global recession

Given the continued absence of 'green shoots' in global economic data, sluggish euro-area activity is perhaps the best we can expect for the remainder of 2019. Even this is dependent on continued expansion in the rest of the world, rather than a genuine global recession. And if the global outlook deteriorated further, the situation in Europe could quickly become rather ugly. TS Lombard clients seem only too aware of this threat, which is why today they are more likely to ask us about Europe 'turning Japanese' rather than the prospect of European equities 'outperforming'. The underlying problem, of course, is that the euro area will have gone through an entire economic cycle – an expansion that could rely on fairly solid export demand – with the ECB's policy rate at its lower bound. It is not clear the central bank has sufficient ammunition to fight a more serious global downturn. Outright deflation is no longer such a remote possibility.

Chart 20: Balance-sheet recessions


Source: BIS, TS Lombard

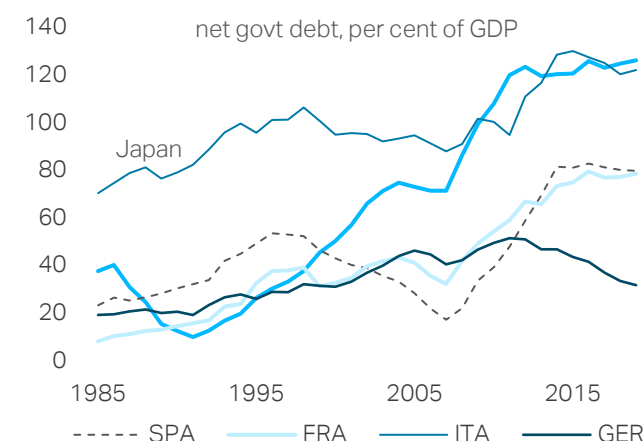
Chart 21: Credit boom and bust


Source: BIS, TS Lombard

As we explained in [a previous Macro Picture](#), the European economies – in aggregate – have several important advantages compared to Japan in the 1990s. Private debt levels are generally lower in Europe and the ECB has managed to keep the euro exchange rate down, contrary to what happened after Japan's asset-price collapse. Those countries that seemed most at risk from repeating Japan's experience during the euro crisis, particularly Spain and Ireland, have

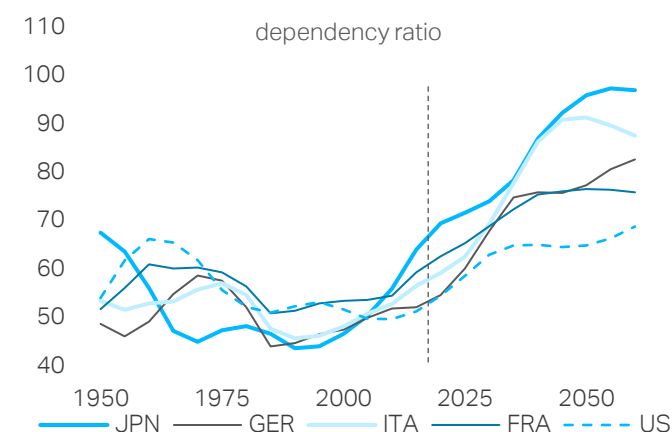
actually achieved a remarkable amount of deleveraging since 2012. To the extent Japan's problems can be traced to excessively high private debt levels and a 'balance sheet recession', rapid deleveraging has left some of Europe's most vulnerable economies in a healthier position. Euro-area wages and prices have also proved fairly sticky since 2008, growing slowly in nominal terms rather than experiencing outright contraction. This has helped to prevent deflationary expectations taking hold. Of course, there is no guarantee this nominal 'stickiness' can survive another global recession – especially without a forceful policy response. 1% underlying inflation and zero interest rates don't provide much room for manoeuvre.

Chart 22: Public-sector indebtedness



Source: OECD, TS Lombard

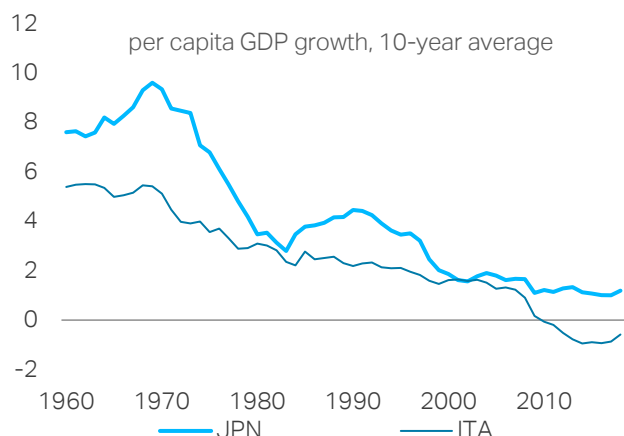
Chart 23: Demographic inflexion points



Source: United Nations projections

Yet it seems odd to worry about Europe 'turning Japanese' when some euro-area countries are already performing *worse than Japan*. Italy remains our biggest concern. Italy's economy has already suffered two lost decades, failing to grow even in per capita terms. And while Japan rarely suffered unemployment rates above 5%, 10% of the Italian labour force remain out of work. If there is another global recession and the ECB struggles to revive the euro-area economy, which looks increasingly likely, the political and financial risks associated with Italy's long-term economic malaise will only increase. While there is no way of knowing if or when the Italian public might become more Eurosceptic, the country is clearly a critical threat to the stability of the European Monetary Union. We think this justifies a risk premium on euro assets.

Chart 24: Italy worse than Japan



Source: Conference Board productivity database

Chart 25: Japan didn't suffer mass joblessness

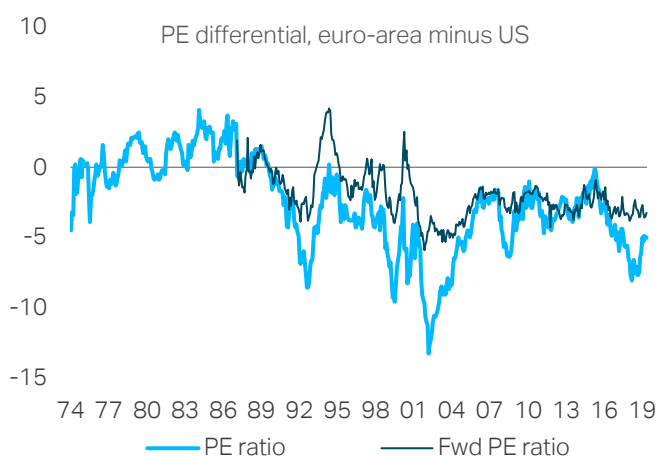


Source: OECD standardized unemployment rates

3. RISK PREMIUM

If euro-area assets require a risk premium for policy uncertainty and the threat of future political crises – issues that will become more dangerous after the next global downturn – then it is harder to argue that European equities are 'cheap'. And actually the relative valuation case for euro-area equities has always seemed a little dubious. While popular valuations metrics – such as PE and price to book ratios – are lower in the euro area than the US, the return on equity is also inferior. European investors are paying less for an asset that yields lower returns. There is nothing particularly remarkable about this situation. Weak corporate profits have been Europe's underlying problem, particularly since 2011. Low nominal GDP growth has depressed revenues, while the combination of sticky wage inflation and poor productivity has damaged margins.

Chart 26: Euro-area equity discount



Source: Datastream, TS Lombard

Chart 27: Another measure of relative value

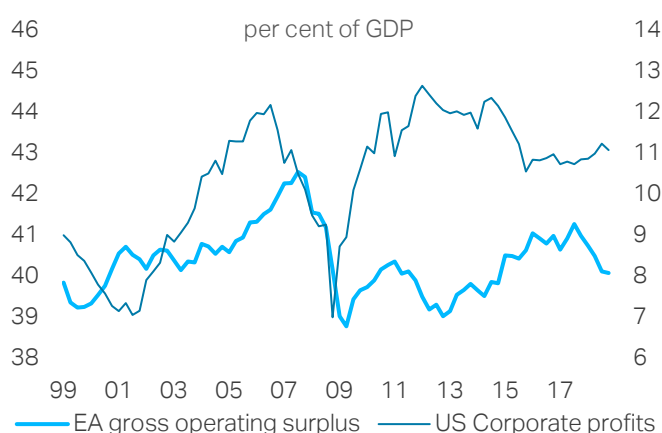


Source: Bloomberg, TS Lombard

Profits divergence

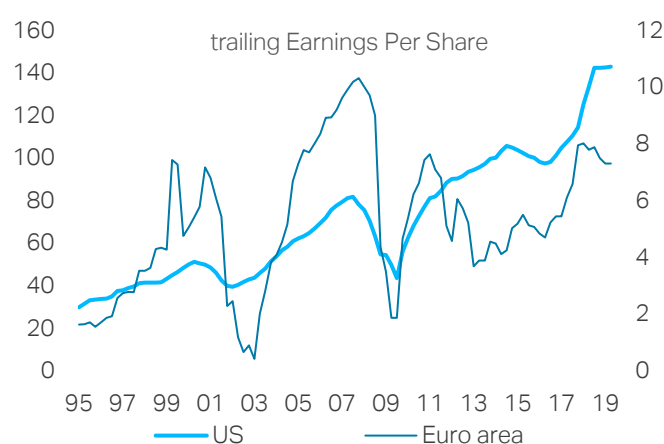
The recent deterioration in euro-area profits has been particularly discouraging. 18 months ago, investors were optimistic that Europe was entering a 'sweet spot in the margin cycle', particularly compared to the US. Economic activity had accelerated and with continued slack in labour markets, the bulls believed the corporate sector would be able to capture a greater share of Gross Domestic Product. They contrasted this to the situation in the US, where the economic cycle was more advanced and the tight labour market was starting to boost average wages. Yet the convergence between US and euro-area profits has fizzled out. As GDP slowed in the euro area, productivity slumped and margins deteriorated. Chart 28 shows the euro-area profit share has started to shrink again since 2018, actually underperforming the United States.

Chart 28: Profit shares diverge again



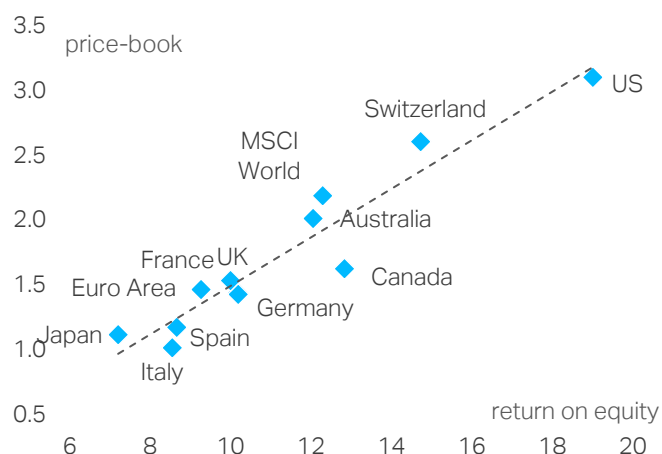
Source: Eurostat, TS Lombard

Chart 29: EPS also diverging again



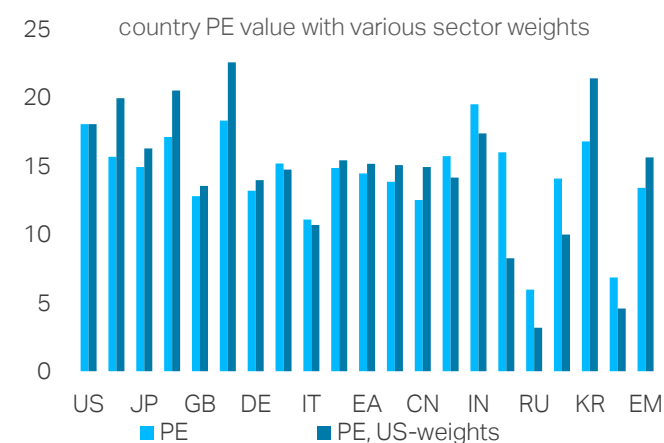
Source: Bloomberg

Chart 30: Higher PE reflects higher RoE



Source: Bloomberg, TS Lombard

Chart 31: Sector weights on part of the story



Source: Bloomberg, TS Lombard

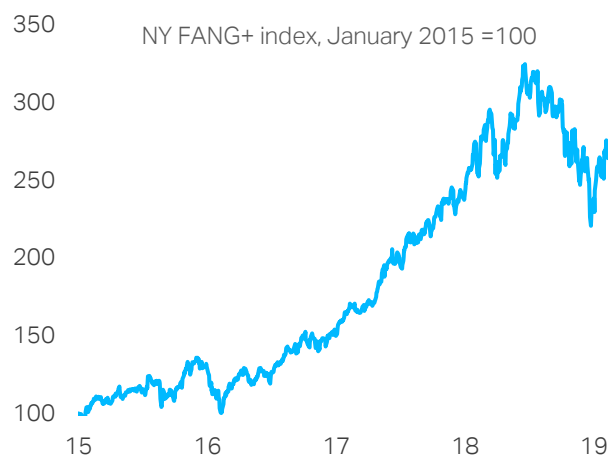
Superstars versus banks

Despite these clear differences in corporate performance, the consensus usually blames just a couple of specific sectors for America's outperformance versus the euro area: namely banks and technology stocks. If we adjust the weights of these sectors to make them more

comparable (Chart 31), some of the PE premium on US stocks disappears. It is also true, for example, that – until recently – the performance of just a handful of superstar companies had flattered relative US performance. Since there is no equivalent for the likes of Google and Amazon in the European stock market, some strategists prefer to exclude these companies completely from their PE comparisons. But if the emergence of these superstars reflects macro fundamentals, as seems likely, excluding these companies gives a misleading picture.

Chart 32: Bank stocks have diverged

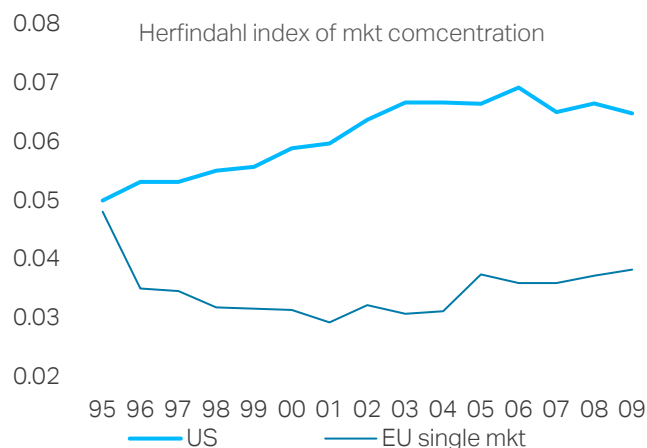

Source: Datastream

Chart 33: FANGs boosted US equities


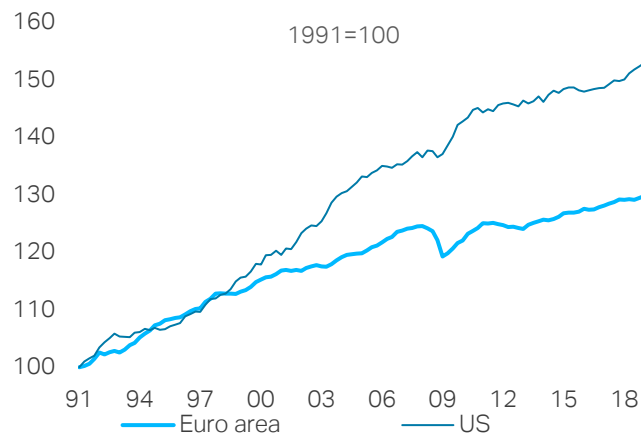
Source: Bloomberg broad measure

US industry has become increasingly concentrated in recent years, a phenomenon that is much less pronounced in Europe. Some economists believe this reflects a breakdown in anti-trust legislation in the United States versus the newly competitive pressures of the Single Market in Europe. On this basis, American superstars should be bad for economic welfare, sapping efficiency and ripping off consumers. Yet the evidence suggests this is not the case. Instead, the forces that have created these US superstars – especially new digital technologies – have actually enhanced competition and reduced consumer prices. Recent OECD research looked at this issue in detail by studying the behaviour of the most efficient companies. They find that superstar margins have increased, not because a few large incumbents were becoming more monopolistic, but rather because new higher-productivity companies were entering the market. On average these new entrants were around 60% more productive. On this basis, US superstars are a symptom of American dynamism and euro-area companies are falling behind.

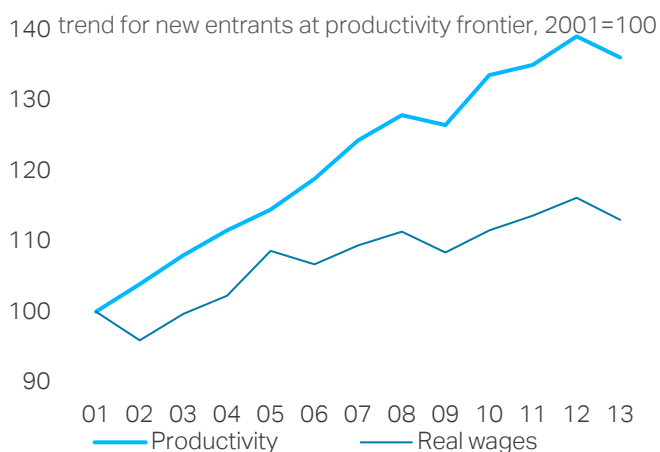
Meanwhile, European banking problems have also weighed down the European stock market. If we totally exclude this sector, part of the US-EA divergence disappears. But it is important to remember why the European banks are struggling. In some countries, such as Italy, this is a legacy of bad loans made before the subprime crisis. The authorities repeated the errors of Japan and were too slow to write off bad debts and recapitalize/close failing institutions. But the broader problems for euro-area banks are essentially 'macro'. How can European banks perform well when yields are extremely low – even negative in some countries – and likely to remain depressed far in the future? Once again, there are good reasons why European equities should be 'cheap' right now. But like any 'value trap', we shouldn't expect big changes going forward.

Chart 34: US markets more concentrated


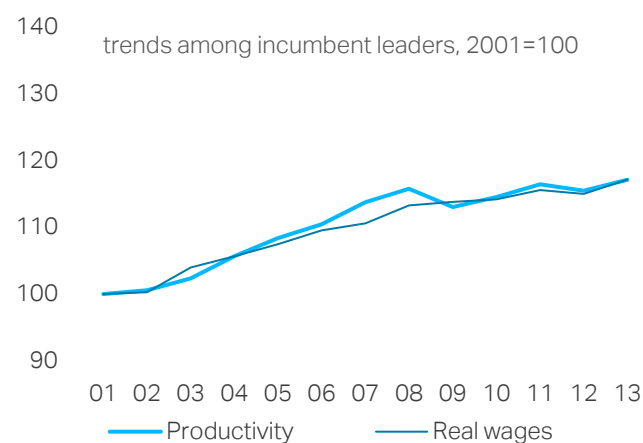
Source: Gutierrez and Philippon (2017)

Chart 35: But US also more dynamic


Source: OECD Economic Outlook

Chart 36: Dynamism boosted US margins


Source: OECD

Chart 37: Incumbents' margins no wider


Source: OECD

Bottom line

While some investors were quietly bullish on European equities earlier in the year, sentiment has shifted over the past couple of weeks. China seems to be backtracking on policy stimulus, global 'green shoots' seem to be turning brown, and trade tensions between the United States and China have intensified. Perhaps most worrying, the US-China trade war is having a much greater impact on euro-area growth than many economists expected. In short, this is a timely reminder that the euro-area economy remains overly dependent on external demand, especially now that domestic growth catalysts have disappeared (thanks German consumers...). The best scenario is that the global economy avoids recession, in which case the euro area should achieve modest – but unspectacular – growth in 2019-20. But we would caution against the idea that European stock markets are 'cheap'. Lower valuations reflect not only weak macro fundamentals, especially corporate profits, but also the rising threat of deflation and 'bad politics'.

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