The cyclical case for European equities
Synchronised global economic recovery

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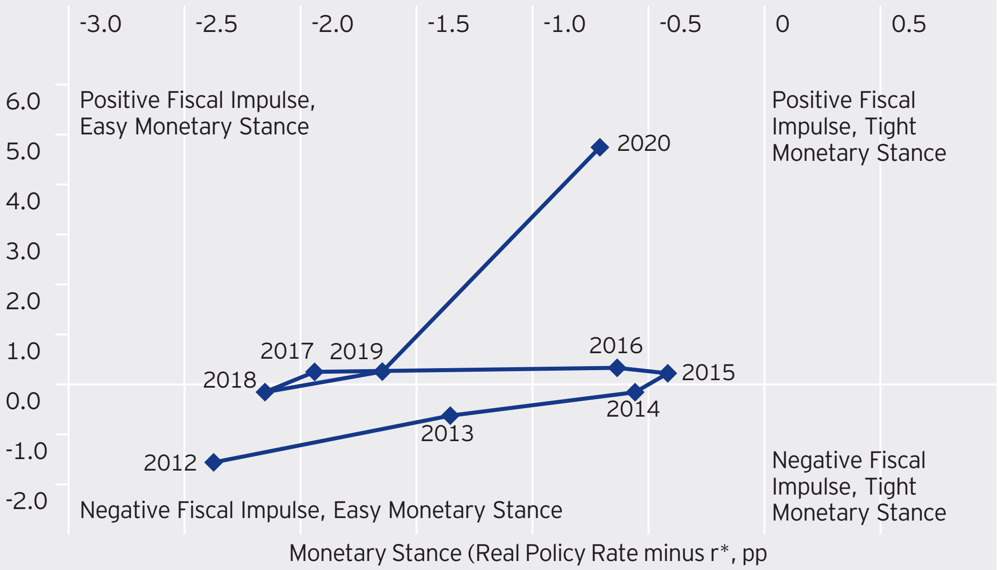
Ever since the Global Financial Crisis, global economic growth has been sluggish. Europe, burdened by fiscal austerity and the sovereign debt crisis, has been a notable drag in particular. However, as vaccines are rolled out and economies gradually re-open, we expect European/global economic activity to recover rapidly.

The real question is, can this be sustained? The last time we had a prolonged period of global growth – between 2003 and 2007 – not only did European equities outperform global and US equities, but European value fared even better.

The pandemic has changed the policy mix… for the better
Austerity ended abruptly last year as European policymakers and governments were forced to provide massive amounts of fiscal support in response to the pandemic. Far from being transitory we expect fiscal stimulus to stay for some time to come. This is as much the case for Europe as it is elsewhere. The change in policy mix should allow Europe to grow above trend and hence be additive to global growth on a multi-year basis.

Figure 1
Euro area: Fiscal impulse vs Monetary Stance



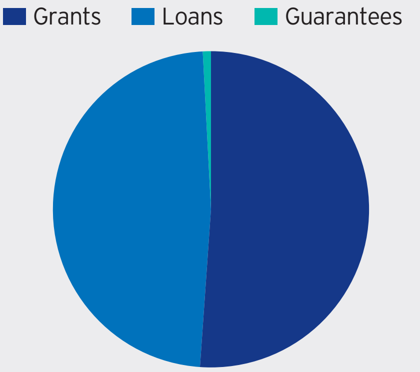
Source: Morgan Stanley research estimates, National governments as at 22 October 2020. (Fiscal Impulse (pp)).

Why fiscal stimulus is here to stay?
We believe that the lack of fiscal stimulus has been a key factor in the lacklustre rate of global growth in recent years. Hence why the direction of fiscal policy from here is so important. In our opinion, significant stimulus is here to stay for the long run, and this is why:

New, long-term investment programmes
The newly created Next Generation EU €750bn investment programme – equivalent to c.5.4% of EU GDP – is a real game changer. The long-term nature of these grants (approximately half of the total) is significant and will be directly invested in growth enhancing projects with an emphasis on climate protection and digitalisation. This investment will likely provide growth opportunities for European companies across a wide range of sectors, ranging from renewables to telecommunications to IT specialists.

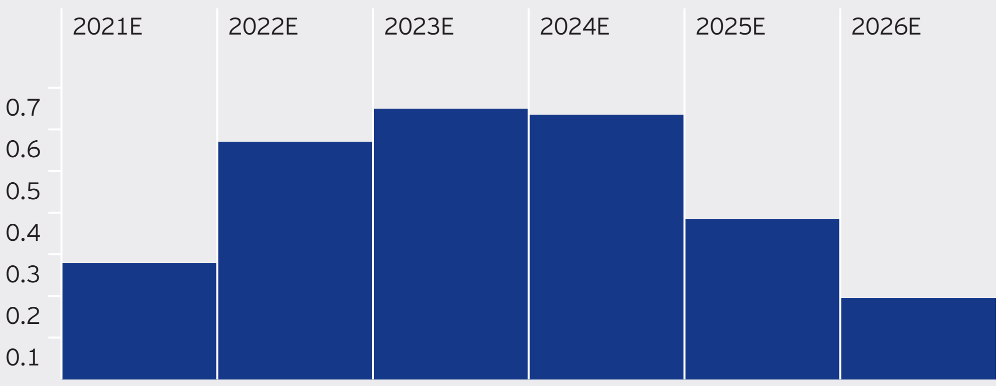
In addition to these grants, individual national governments are also able to access additional loans from the EU at virtually zero cost.

Figure 2
Next Generation EU €750bn
(equivalent to 5.4% of EU GDP, 2019 basis)



Source: UBS as at 26 November 2020

Figure 3
Next Generation EU – projected payments of Grants, % of GDP



Source: UBS as at 26 November 2020

Ongoing, recurring fiscal support

As well as grants and loans provided from the EU, individual national governments have other fiscal levers too: government spending and lowering tax. And in our view, governments and policymakers will have little option but to use these levers much more aggressively going forward than was the case following the GFC. Don't forget that fiscal austerity did little to help European GDP growth in the past decade.

The severity of the pandemic has forced governments and policymakers around the world to react in an unprecedented manner – in short, they've crossed the Rubicon. Nowhere is this more evident than in Europe where policymakers quickly suspended the EU fiscal stability and growth rules for 2020 and 2021.

Could this suspension be extended? It seems counter intuitive to make all this effort to protect governments, corporates, and households from the pandemic to then implement fiscal austerity quickly thereafter.

The backlash from those that have suffered more during the pandemic could be severe too. We wonder if Milton Friedman might well be right again this time too. He famously said:

"Nothing is so permanent as a temporary government program."

We should also not underestimate the influence of Germany in determining the fiscal rules at a European level. For example, Wolfgang Schauble, former Minister of Finance for Germany and a fiscal hawk, was asked about the EU fiscal rules recently and his response was:

"After the pandemic a lot of things will be completely different to the way they were before. Whether they'll be better depends on us."

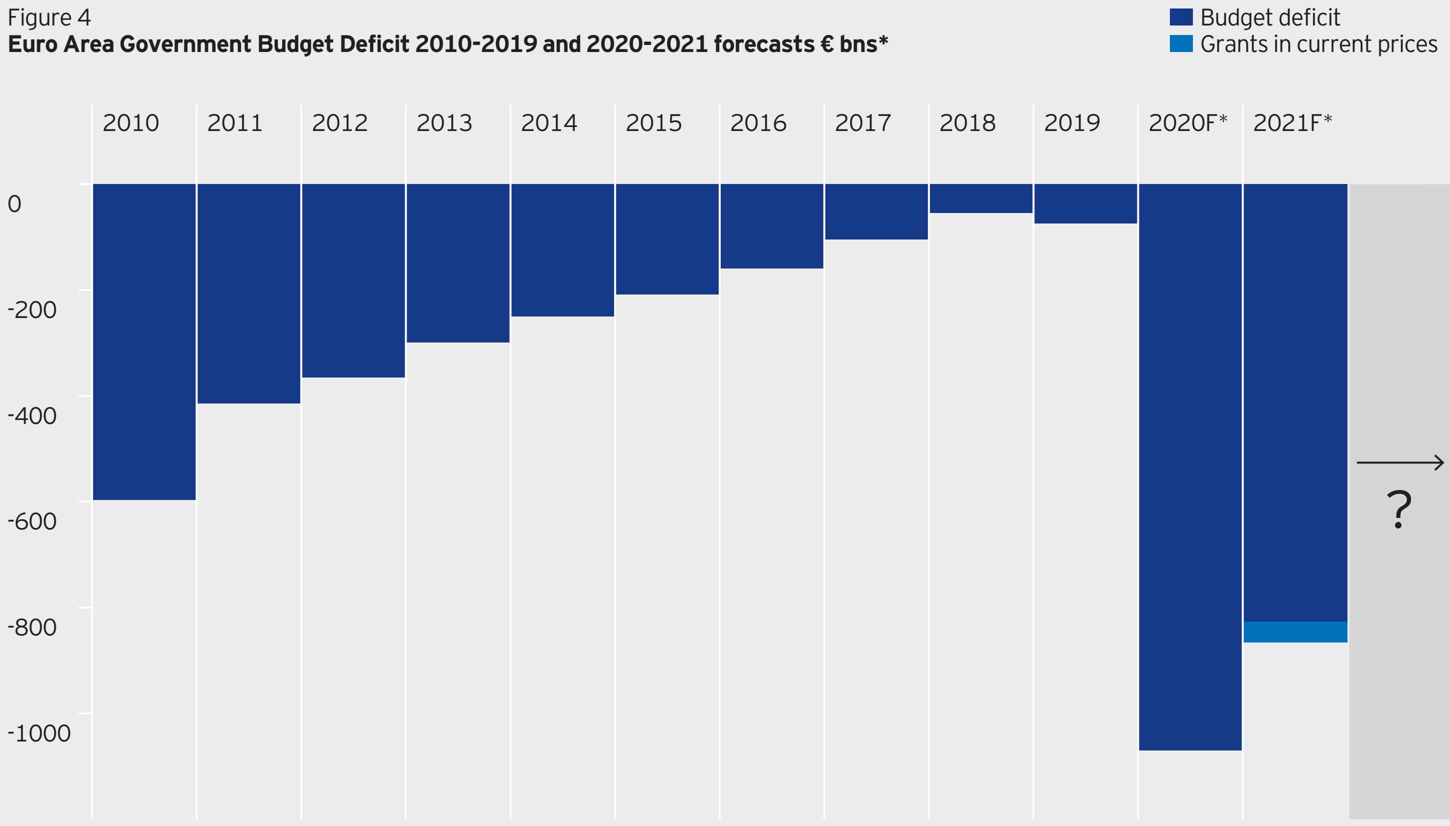
This acknowledges that the policy currently in place may be no longer appropriate. As it stands, if the 'debt brake' was to be re-introduced in 2022 (currently suspended for 2021) borrowing would need to fall from €180bn this year to €10bn. Is that level of support sufficient to help the economy recover from the pandemic? Unlikely.

Chances are that there will need to be some relaxing of the rules. This situation would also make it a lot more difficult for Germany, one of the key architects of fiscal austerity since the GFC, to promote EU wide fiscal stability and growth rules in the future.

All of this indicates that the radical shift in fiscal policy that we are seeing is likely here to stay. We think European governments will need to run much higher budget deficits going forward to be able to support higher spending and/or providing tax incentives to boost demand. Grants made available via the EU recovery fund will likely further boost public investment. Such a scenario would be consistent with higher European GDP than has been the case in recent years.

Also, it is not just what is happening in Europe that makes us optimistic on the outlook for global growth either: the medium-term growth prospects for US also look particularly strong given their progressive fiscal plans. The budget deficit in the US is set to be much more expansive than it was in the last ten years.

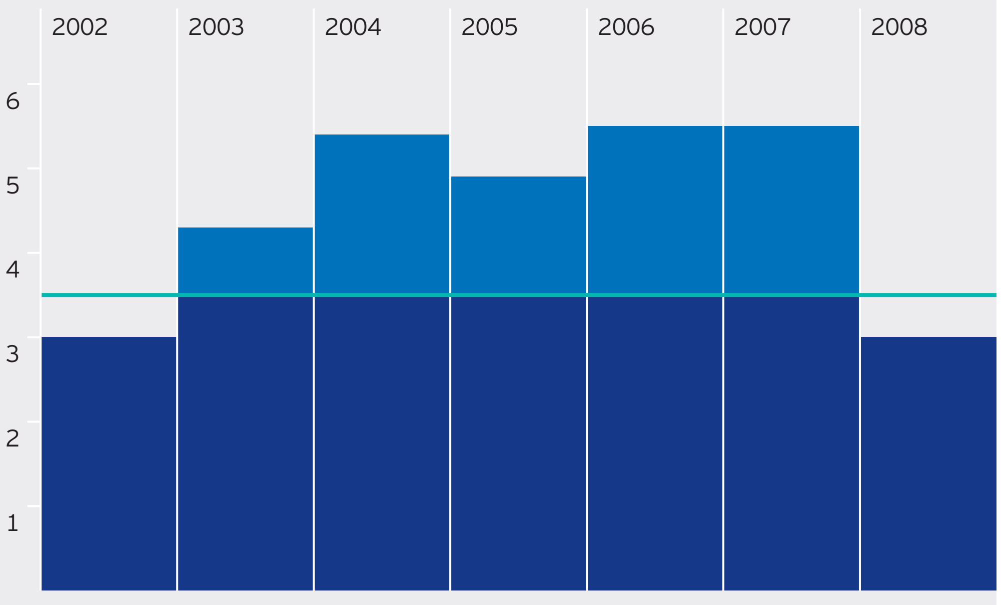
Figure 4
Euro Area Government Budget Deficit 2010-2019 and 2020-2021 forecasts € bns*



Source: Bruegel, UBS calculations, UBS forecasts* as at 11 January 2021.

History suggests European equites do well in periods of sustained global growth
The last time we had a prolonged period of above trend global GDP growth was between 2003 and 2007. This economic backdrop proved to be a very good one for European equities.

Figure 5
Global GDP growth 2002-2008, annual yoy %



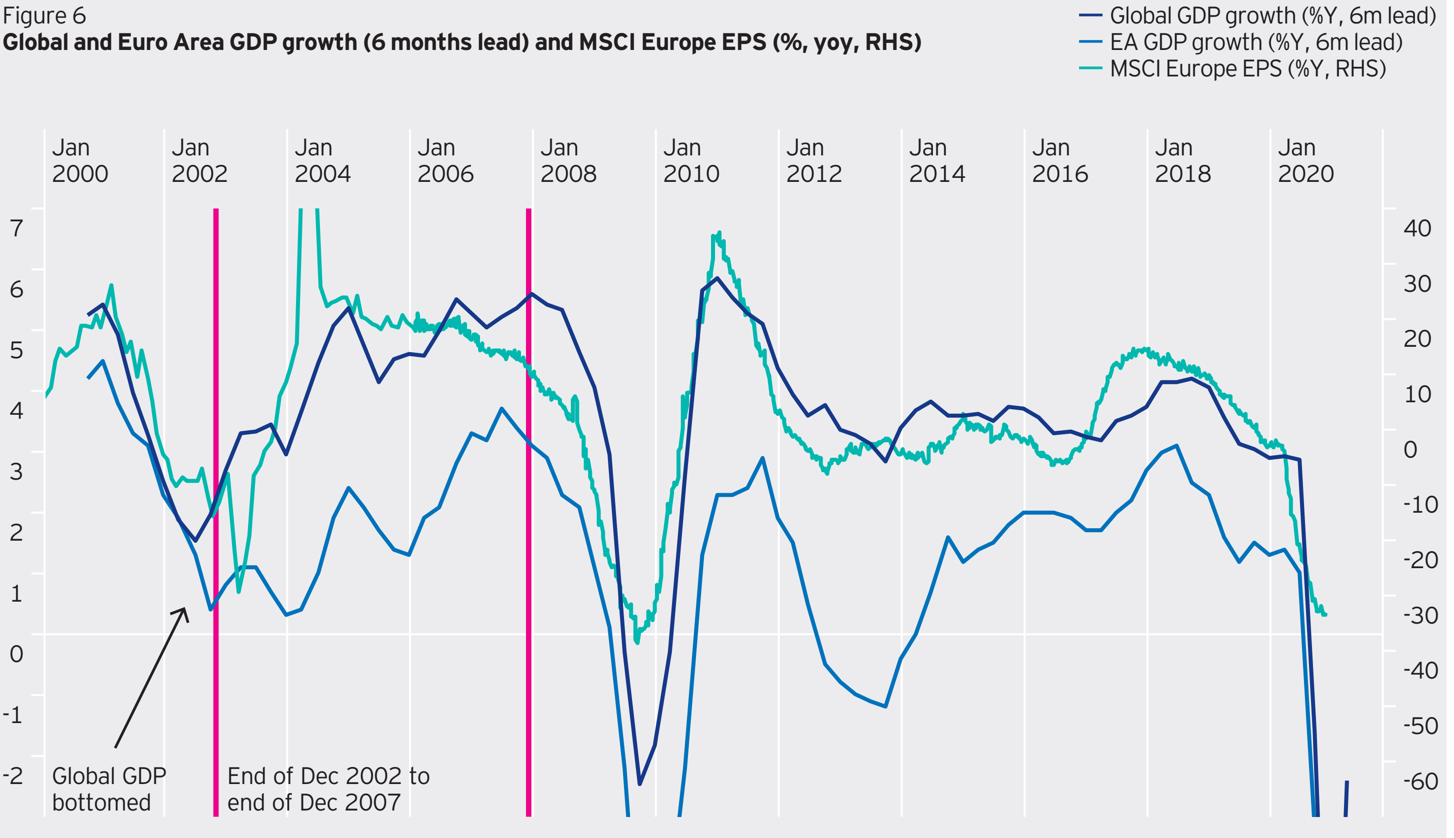
Source: Bloomberg, IMF, Invesco as at 31 December 2020.

Why did European equities, and value in particular, do well during that period?
To answer this question, we need to firstly understand the composition of European indices. There are two distinct characteristics of European equities.

- International: Some 50% of the revenues of quoted European companies are outside of Europe.
- Cyclical: Over 60% of MSCI Europe (based on market capitalisation) is classified as cyclical using MSCI's methodology.

This means the state of the global economy is very important: global GDP appears to be a bigger determinant of European earnings than European GDP in isolation.

Figure 6
Global and Euro Area GDP growth (6 months lead) and MSCI Europe EPS (%, yoy, RHS)



Source: Morgan Stanley Strategy Research, Invesco as at 31 December 2020.

During this period, European earnings growth was much stronger than in the US and, also globally. This in turn translated into better returns for Europe, and particularly European value, than elsewhere. **European value at that time – not too dissimilar to today – was dominated by cyclical businesses.**

Figure 7
Trailing earnings of various MSCI Europe/World & US and MSCI Europe value indices from end of 2002 to end of 2007 ($ basis, rebased to end of 2002)

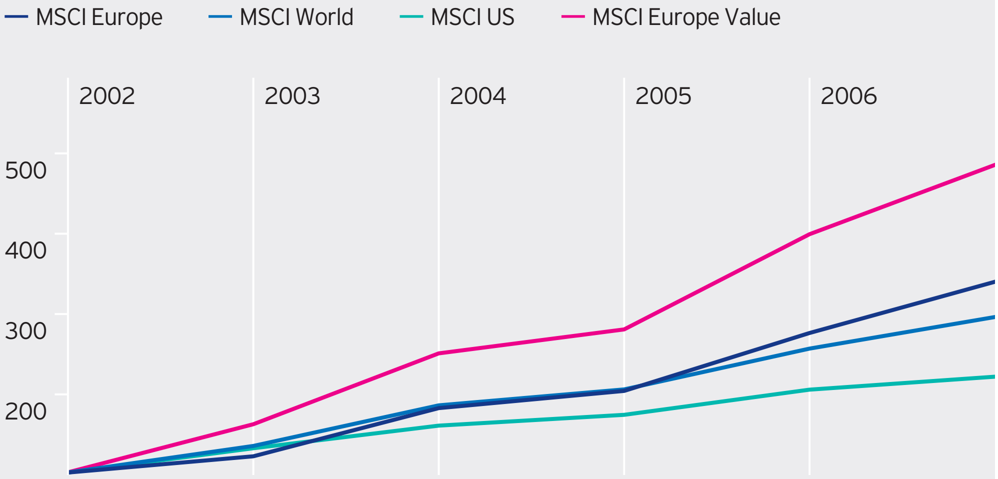
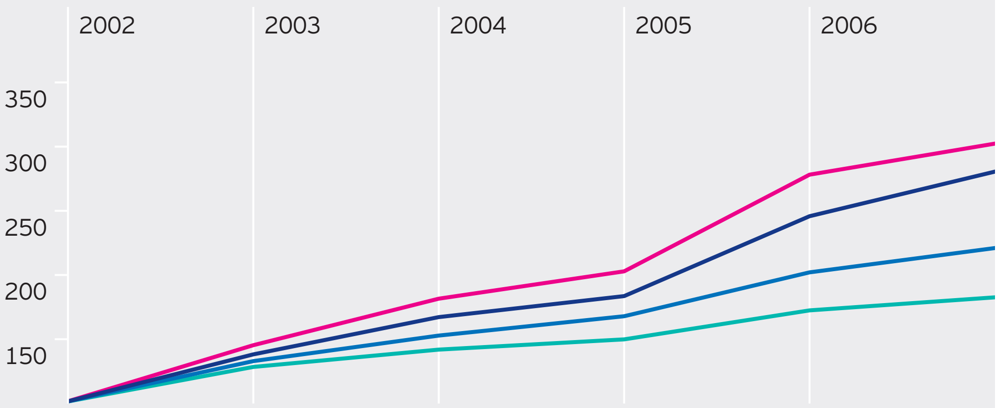
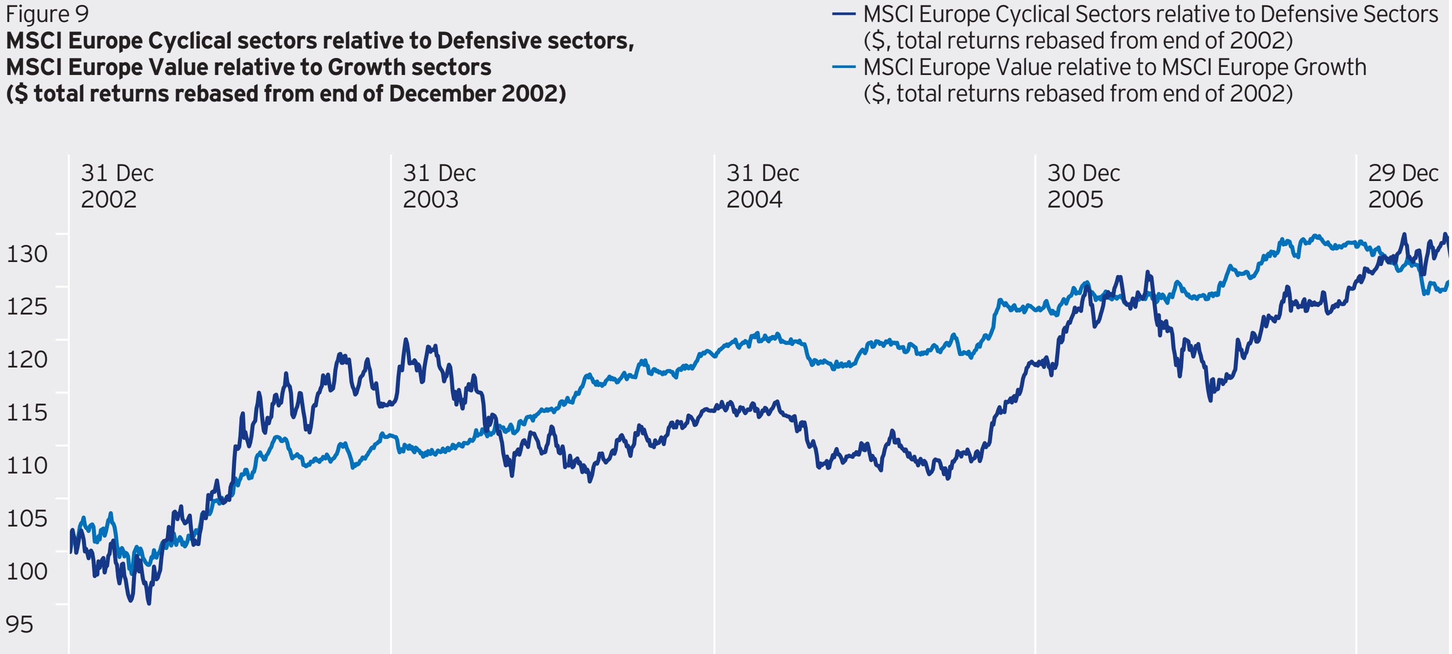


Figure 8
Total returns of various MSCI Europe/World & US and MSCI Europe value indices from end of 2002 to end of 2007 ($ basis, rebased to end of 2002)



Source: Refinitiv, Invesco as at 31 December 2020.

Figure 9
MSCI Europe Cyclical sectors relative to Defensive sectors, MSCI Europe Value relative to Growth sectors ($ total returns rebased from end of December 2002)



Source: Morgan Stanley Strategy Research, Invesco as at 31 December 2020. (Shown to 13 April 2007).

European cyclical value a good way of getting exposure to a sustainably stronger global economy

A return to the days of fiscal austerity seem completely incompatible with what waits for the European economy in a post-pandemic world. Already, we are seeing signs of drastic change in European policy. This leads us to conclude that Europe is set to deliver better economic growth in the future, and in turn drive global growth higher.

The last time we experienced synchronised economic growth globally, European equity markets benefitted, particularly, European cyclical value. We would expect similar stocks to benefit this time too. In any case, cyclicals are starting from such a depressed base versus non-cyclicals that the potential for outperformance is quite significant.

In our upcoming pieces we will explore some of the stocks, sectors and themes in greater detail.

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