Invesco

Why invest in European equities

Europe has grand ambitions and a once in a generation opportunity

Page 07

John Surplice
Head of European Equities

Welcome

Ever since the Global Financial Crisis (GFC), global economic growth has been sluggish. Europe, burdened by fiscal austerity and the sovereign debt crisis, has been a notable drag in particular. However, we are now seeing a significant shift coming through towards the meaningful use of fiscal tools.

The range and size of stimulus packages, both at national and EU level, have gone well beyond what any of us could have envisaged and are likely to have a significant impact on the investment landscape now and in the future.

Europe as an asset class works when we get global economic recovery, and particularly European economic recovery. Given that, today, the base for both is so low, it shouldn't be underestimated how strong the recovery is likely to be both this year and beyond. There are also some key themes emerging that should drive structural change and growth across Europe for many years to come: climate change, digitalisation, and social inequality.

Proven capability

For over 30 years, our Henley-based European Equities team has been successfully investing across European markets.

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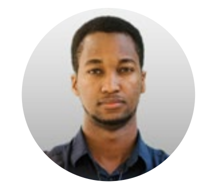

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The structural case for European equities

The Just Transition

John Surplice
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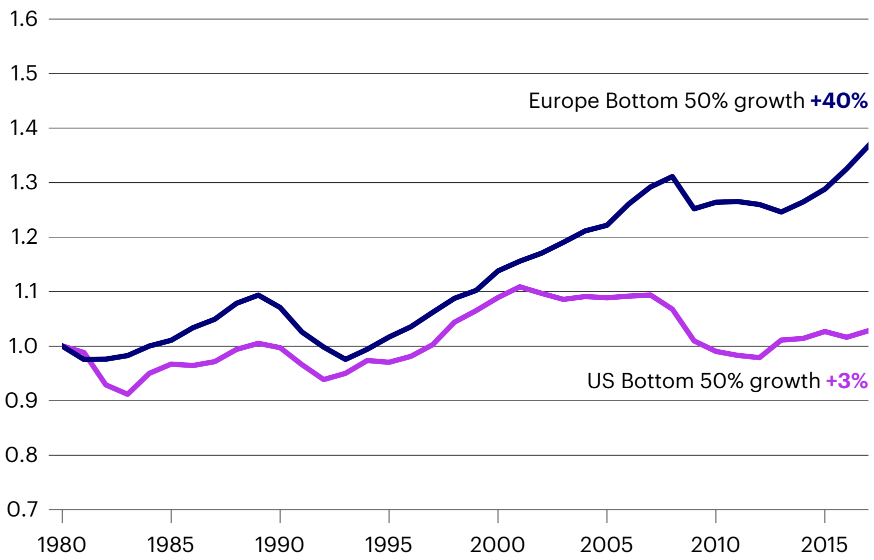
Inequality can manifest in multiple ways, including ethnicity, gender and race and many others. When we think about Economic, or Income inequality, we see a renewed political will post COVID to address the issue. Actions taken will have important economic and investment consequences.

Income inequality is nothing new and reviewing the data in Europe over the last 40 years, Blanchet et al concluded a mixed picture. On the one hand across Europe the top decile clearly took a rising share of national income whilst on the other European enlargement had clearly led to more rapid growth in Eastern Europe and, unlike in the US, at least the lower half of income earners have at least seen income growth (Figure 1).

Figure 1
Income inequalities in Europe and the US: bottom 50% income growth (1980-2017)



Source: authors' computations combining surveys, tax data and national accounts for Europe; Piketty, Saez, and Zucman (2018) for the United States. (NB. Page 53 of How Unequal is Europe? WID.world Working Paper 2019).

"Inequality, along with climate change, is now at the very top of the political agenda. The narrative has moved towards redistribution. This will likely impact investment decisions for the years ahead."

In the eurozone, Lagarde highlighting that the labour force contracted by almost

7%

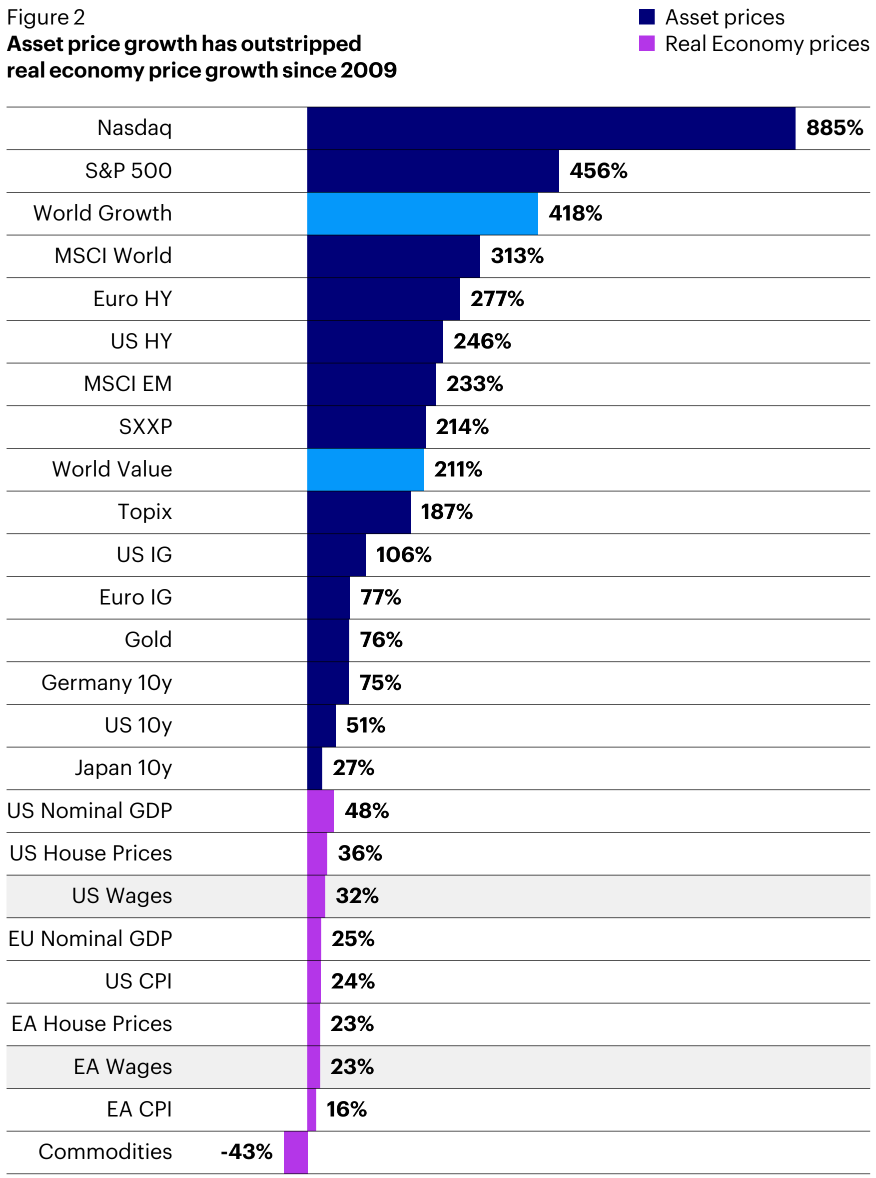
for people with low skills and rose by

3.3%

for those with high skills.

What is clearer, is that the heavy reliance on monetary policy, combined with austerity, as the solution to the Global Financial Crisis (GFC) has exacerbated these inequalities, particularly if you broaden the analysis away from just income to consider wealth (assets) too. From this perspective, asset owners have done rather better than income earners since 2009 (Figure 2).

Figure 2
Asset price growth has outstripped real economy price growth since 2009

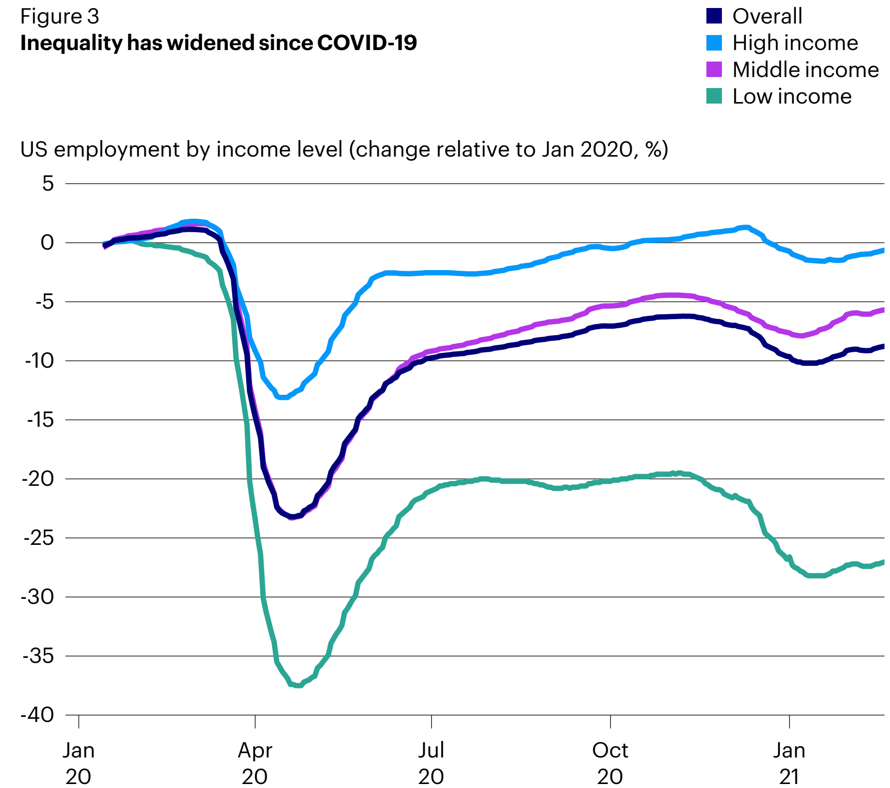


Total return performance in local currency since January 2009

Source: Goldman Sachs, as at 15 March 2021.

Unfortunately, COVID-19 has stretched this further. Again, the initial policy response came through a further loosening of monetary policy, supporting asset prices, as well as directly impacting those least able to afford it the most. A clear illustration of the unequal impact is to look at how unemployment trends have changed by income bands. The low-income band has clearly suffered the most as these jobs either do not transition to a work-from-home environment or require some level of physical contact (Figure 3).

Figure 3
Inequality has widened since COVID-19



Source: ASR Ltd., Refinitiv Datastrean and Opportunity Insights.

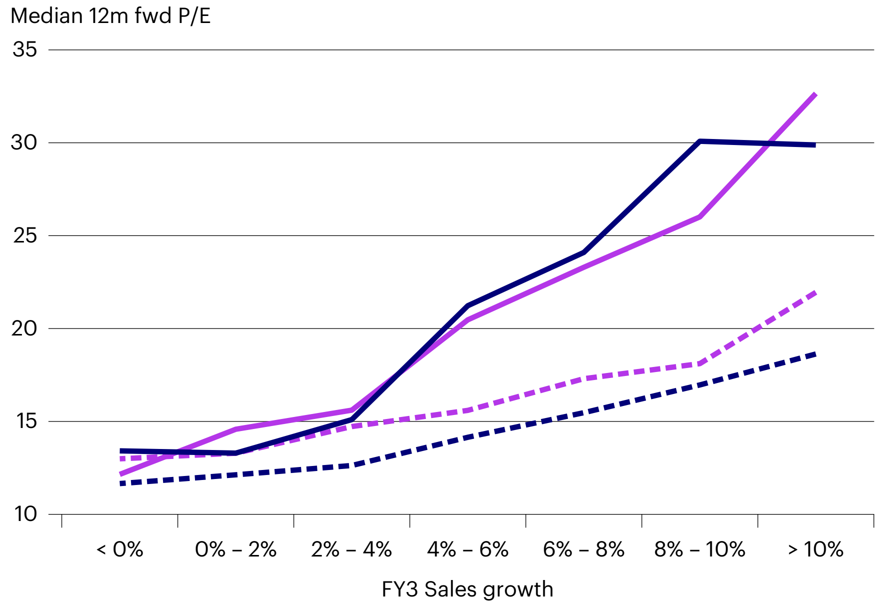
As Jerome Powell put it in June 2020: "The burden of the downturn has not fallen equally on all Americans. Instead, those least able to withstand the downturn have been affected the most." Turning to the eurozone, a similar picture with Lagarde highlighting that the labour force contracted by almost 7% for people with low skills and rose by 3.3% for those with high skills.

There are signs of encouragement as we emerge from COVID-19. Inequality, along with climate change, is now at the very top of the political agenda. The narrative has moved towards redistribution. This will likely impact investment decisions for the years ahead.

The single biggest change is likely to be a shift to sustained fiscal expansion. This is a dramatic shift from the austerity of the post GFC world and will likely have the biggest impact from a portfolio point of view as the "lower forever" narrative is likely to be tested. Low interest rates have supported the dominance of capital over labour as well as the markets predilection for duration assets (Figure 4). Could the tide reverse?

Figure 4
Growth stocks have re-rated significantly in the prior investment regime

Median 12-month forward consensus
P/E by consensus sales growth bands (FY3 estimates)



Source: Morgan Stanley, as at 28 February 2021.

The emergence of ESG has given rise to not only the "Green Transition" but also the "Just Transition" to ensure that the benefits are widely shared. The Solidarity and Just Transition Silesia Declaration signed by 50 countries at COP24, which states that: "a just transition of the workforce and the creation of decent work and quality jobs are crucial to ensure an effective and inclusive transition". We would expect more headlines along the lines of "Ex-steelworks to make wind farm parts in plan for 6,000 green jobs" (The Times, March 21, 2020).

Reshoring or near shoring is likely to be high on the agenda of many corporates given potential issues highlighted with supply chains dominant in Asia. From a European perspective, this is likely to benefit the economies of Eastern Europe. Governments could help accelerate that with policies to encourage this and bring employment back into Europe.

A final change that appears highly likely is a global deal on digital tax with Yellen recently dropping a contentious part of the proposal (that it was voluntary) had been a stumbling block. Whilst there is still a long way to go, this could be a step towards levelling the playing field.

There is now an opportunity presenting itself to today's politicians that was denied to governments in Europe during GFC due to the financial constraints resulting from the sovereign crisis. By using fiscal policy as well as monetary tools there is an opportunity to have a more robust economic recovery from the COVID-19 crisis than we saw in Europe from the GFC.

An environment of a period of above trend growth in Europe, aided by fiscal expansion, will likely provide a different investment backdrop than we have become used to over the last decade of anaemic growth and low inflation.

There is a delicious irony that responding to the impact of climate change (caused partly by the pursuit of economic growth) will require significant investment to transition our economies that can accelerate economic growth potentially for an extended period. Arguments about income inequality are unlikely to go away but they will likely diminish if we see investment in new economy job creation and rising incomes and wealth for all rather than a few.

"The emergence of ESG has given rise to not only the "Green Transition" but also the "Just Transition" to ensure that the benefits are widely shared."

The Silicon Valley of Green Tech?

Oliver Collin
European Equities Fund Manager

Steve Smith
European Equities Fund Manager

“Europe has grand ambitions and a once in a generational opportunity to steal a march on other continents through early adoption of climate change regulation and technology.”

The health crisis of 2020 created a synchronised economic depression requiring equally radical policy responses.

Europe’s response was the creation of a €750bn European Recovery Fund. However, rather than just deploy the capital, member states chose to focus on a Green Recovery and hence use the funds to address the existential threat of climate change. In practice this means the European Commission spending is being guided by the newly developed sustainable finance taxonomy. Promoting activities supportive of the environmental objectives of climate change mitigation and adaption:

- Sustainable use and protection of water and marine resources
- Transition to a circular economy
- Pollution prevention and protection of biodiversity and ecosystems
- It also contains criteria that ensure activities ‘do no significant harm’

At least

€150bn

is being made available to address socio-economic effects of the transition out to 2027.

European environmental legislation is not new. For years Europe has been a first mover in safety standards and best practices that become global standards, however, the European Green Deal marks a more dynamic approach. Taxonomy is the means by which the market will administer the carrot or the stick to companies. Winners will be those seen to solve the environmental crisis and losers will be those thought to be the cause.

This comes at a time of other changes to the investment landscape. Savers now demand their asset managers embed sustainability into allocation decisions. Fund regulation is playing its role too, through the deployment of SFDR this year, funds will be classified dependant on embedding ESG principles thereby making it easier for savers to pick compliant funds and avoid others. Lastly, the pandemic has created the political cover to deploy the significant European Recovery Fund to sustainable companies.

Combined these elements create the foundations for success. European companies that comply with taxonomy will see their cost of capital fall vs those that don't.

The EU Recovery Plan is interlocked with the Commissions' 2019-24 priorities that included the realisation that "Europe needs a new growth strategy that will transform the Union into a modern, resource efficient and competitive economy". This is an inclusive plan with The Just Transmission Mechanism's goal that 'no person or place left behind'. At least €150bn is being made available to address socio-economic effects of the transition out to 2027 – a topic we discuss in greater detail in The Just Transition. However, the real prize isn't intra-Europe – it's global.

The goal of climate neutrality requires significant investment and innovation. If the transition is effective through taxonomy rewarding companies in the transition phase, we will grant our existing enterprises a competitive advantage though access to the cheapest capital. This will create more dynamism through more innovation and the creation of products, services and refreshed skilled jobs to achieve all the EU goals. Brown companies can become Green.

This idea of creating a pathway isn't new. Europe has 2030 targets not just 2050, including transition plans for hybrid ahead of full electric vehicles, coal to gas electricity generation and developing blue hydrogen ahead of green hydrogen being viable. Through this approach we can incentivise European companies to allocate their existing cashflow towards green innovation as opposed to being forced into ever larger dividend yields.

Silicon Valley is perhaps the best example of the prize on offer. The birth of Silicon Valley was a confluence of skilled science-based research, education, venture capital and defence spending, particularly through the creation of NASA and the space race. The success and longevity of which is a function of being the first and with it a sustainable multiplier effect.

We are already starting to see the positive effects from this focus on transition. European oil companies lead the way in reallocating hydrocarbon cashflows towards greener alternatives (**Total**, **Repsol**, **BP**). In renewable energy, Europe is home to the leading wind turbine manufactures (**Vestas**, **Nordex** and **Siemens Gamesa**) and our power generators are world leaders in green production (**Enel**, **EDP**, **Acciona**). In technology, European semiconductor companies have leadership in Auto electrification (**Infineon** and **STMicro**).

We also have expertise in building materials and renovation focused on reducing energy consumption (**SaintGobain**, **Wienerberger**, **Kingspan**). Europe's paper companies are transitioning to sustainable packaging and biofuels (**UPM**) and Europe is home to worldwide leaders in the circular economy (**Veolia** and **Suez**). All are stocks that are held in portfolios across the team, to a varying degree.

Europe has grand ambitions and a once in a generational opportunity to steal a march on other continents through early adoption of regulation and technology. Through incentivising companies to innovate and embrace climate change Europe can become a global exporter of Greentech products and services to the rest of the world and enjoy the multiplier effect. Europe has the potential to achieve net zero and in doing so become the Silicon Valley of Green Tech including the vibrancy, jobs and sustainability that comes with it.

> "Europe needs a new growth strategy that will transform the Union into a modern, resource efficient and competitive economy."
>
> **European Commission**

Digitalisation of Everything

Erik Esselink
European Equities Fund Manager

James Matthews
European Equities Fund Manager

“We see a bifurcation between those companies that are willing to embrace digital change versus those that are not.”

When investors think about Technology and Digitalisation as investment themes, most tend to focus on the US tech giants or some of the tech mega caps in the Far East. We think that, quietly, European policy makers have come to the realisation that they no longer want to rely on third parties for a crucial ingredient of their long-term future.

Digitalisation in Europe is not only providing investors opportunities in European technology companies, but also in industrial and consumer facing companies that are transforming their businesses rapidly into digital powerhouses.

Central to the EU’s thinking is the conviction that Europe’s future is determined by the successful achievement of the twin digital and green transitions. The COVID-19 pandemic and its impact on economy and society have underlined the crucial role of digital technologies for people and businesses. Digital technologies are critical to recover from the crisis, and to foster EU’s resilience and address the risks and dependencies on third countries, as well as to influence EU’s positioning on the global stage. Digital technologies are also essential to achieve sustainability goals. This thinking has led to the creation of a 2030 digital strategy with significant funding and ambitious targets as part of the overall EU Recovery Fund.

The Digitalisation of Everything for European corporates is about much more than just having a website or adopting a cloud strategy, it’s about sustainability and long-term value creation. It is best compared to the top performers in sports, they possess two essential qualities: speed and agility. Speed is about repetition and efficiency. Agility is about scalability, creativity and reactivity. Combined, they allow businesses to scale in a superior way, whilst testing new ideas and improving outcomes. Businesses that are digitally transformed are experiencing greater productivity and operating efficiencies. In Europe, given that these changes are still in their infancy for many industries, the implications and opportunities will be dramatic.

Standing still is not an option for corporate Europe

We see a bifurcation between those companies that are willing to embrace digital change versus those that are not. Businesses with visionary leadership and strong cultures can better navigate this complex terrain. We identify these businesses through the hundreds of company meetings we do each year provide us with valuable insights into the inner workings of the company and the mindset of the management teams.

Through this engagement we have identified underappreciated companies such as **Bankinter** in Spain which is leading the charge in digitally transforming itself in a traditional industry. This transformation has improved the banking experience for its clients, increased its market share consistently and at the same time lower its operating costs and the cost of risk by lending based on better data.

But bigger doesn't always mean better in the digital world

The internet has lowered barriers to entry, creating more competition in many industries. Starting up a business has never been easier: you can find manufacturers to make your product all over the world at the click of a button, you can advertise and find your customers easily via Instagram, and DHL will deliver. Digitalisation is allowing small companies to take on even the very biggest players, creating significant disruption. Consumers want a seamless e-commerce and omnichannel experience. Whilst e-commerce brings additional complexity, a successful omnichannel approach allows businesses to connect with their customers across different touch points, learn more about their customers, build new revenue streams and create a more resilient business model.

SkiStar, a Nordic ski resort operator is an example of a business that has taken their business to the next level based on a smart digital strategy. Its ski resorts, websites and apps are providing digital win-wins for customers, property owners and the company itself. Via its app, customers can buy digital ski passes, rent accommodation, their ski's and book classes all in advance of the trip, saving the customer money, time during their holiday, as well as reducing their carbon footprint (less plastic). This is also good for SkiStar, as it gives it a larger share of costumer wallets, a more predictable business, cash up-front and lower costumer acquisition costs.

What about investing in European tech companies directly, I hear you say...

Europe has a rich history of innovation in Semiconductors and behind the likes **ASML**, **NXP**, **Nokia**, **Infineon** and **ST Microelectronics** lies a fertile hunting ground of smaller leading-edge niche tech companies. These companies are surfing the next wave of innovation by using new semiconductor materials or by creating new packaging methods, helping the Semiconductor industry continue to lower the cost of computation, driving the data revolution.

Besides the Semiconductor industry we are continued to be impressed by Europe's network of Universities and innovation hubs as a breeding ground for new technology, innovations and emerging companies. Post financial crisis the EU helped to create innovation hubs in Berlin, Paris and Amsterdam to create a start-up culture, a lot of these companies are now coming to age and making the step to the public markets. Especially in our small cap strategies we are benefitting from a rich hunting ground in software, internet, AI and IOT companies offering niche products and applications sold worldwide.

Finnish QT (pronounce Cute) started its life as a department inside Nokia, having created software to design digital user interfaces. It has a great business model charging its clients a small subscription fee and when a client designs a user interface with its software QT collects a royalty on a per product sold basis. Given the strong growth in developer subscription licences that QT has seen in 2020 we expect to see many years royalty income growth as the products designed with QT software are being mass produced and sold.

Sustainability through digitalisation

As we eventually emerge from the clutches of the global pandemic, we see the issue of Sustainability receiving a boost from digitalisation. From an environmental viewpoint, the pandemic has strengthened Europe's resolve when it comes to the fight against climate change. To reach the EU's ambitious goals, society will need to stick to many digital experiments that were successfully tested during the pandemic. In order to create Smart Cities and Smart Grids, e-Mobility, Industry 4.0 and eventually decarbonise Europe's economy the role of technology cannot be overstated.

At the cross-roads of technology and the green economy we see amazing innovation creating leaps forward that were unimaginable only a few years ago. This innovation manifests itself in many investment opportunities for European investors, in the Technology sector itself but also in adjacent sectors like Industrials, Utilities and Automotive. The need for digital and green transformation are interlinked and absolutely crucial for businesses in every sector and industry. It is in these traditional sectors like Healthcare, Financials and Retail we see further opportunity to pick tomorrows global winners.

In conclusion, we understand that for most investors, Europe is not the first place to start looking for new technology stocks, but backed by EU commitment, a highly educated work force, a rich industrial and university infrastructure, we think there are 'European tech acorns' to be found.

Secondly, when it comes to the fusion of Technology and the Green Economy, Europe is world leading in our view. Lastly, we see large numbers of companies in other sectors of the market making very promising digital and green transformations that will ensure their long-term sustainability, while being valued by the market for a less favourable outcome.

This misperception is what is giving investors that are willing to look deeper into Europe a real valuation opportunity.

"Backed by EU commitment, a highly educated work force, a rich industrial and university infrastructure, we think there are 'European tech acorns' to be found."

The cyclical case for European equities

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.

Joel Copp-Barton
European Equities
Product Director

Synchronised Global Economic Recovery

Joel Copp-Barton
European Equities
Product Director

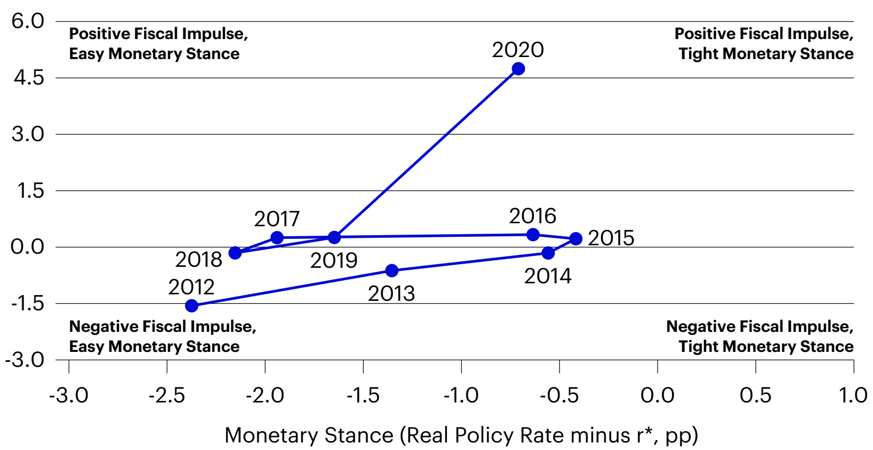
Ever since the Global Financial Crisis, global economic growth has been sluggish. Europe, burdened by fiscal austerity and the sovereign debt crisis, has been a notable drag in particular. However, as vaccines are rolled out and economies gradually re-open, we expect European/global economic activity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

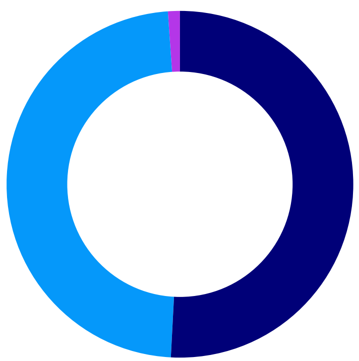
We believe that the lack of fiscal stimulus has been a key factor in the lacklustre rate of global growth in recent years. Hence why the direction of fiscal policy from here is so important. In our opinion, significant stimulus is here to stay for the long run, and this is why:

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.

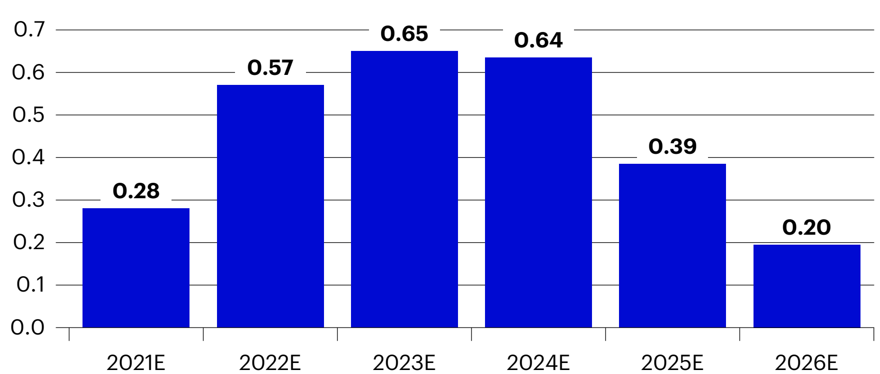
Figure 2
Next Generation EU €750bn
(equivalent to 5.4% of EU GDP, 2019 basis)



Grants	384.4	51%
Loans	360.0	48%
Guarantees	5.6	1%

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.

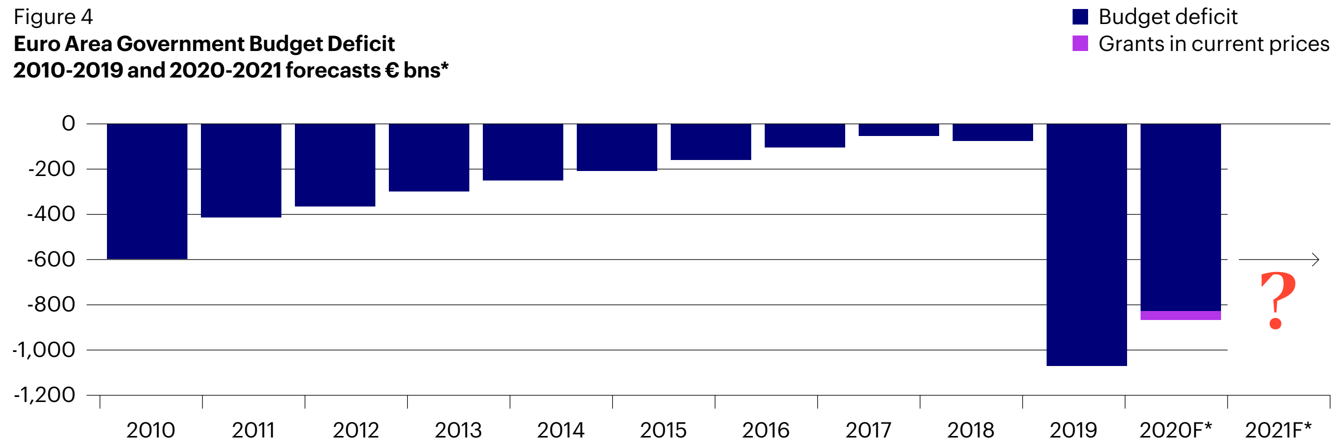
The newly created Next Generation EU

€750bn

investment programme – equivalent to c.5.4% of EU GDP – is a real game changer.

“The last time we experienced synchronised economic growth globally, European equity markets benefitted, particularly, European cyclical value.”

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 equities 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.

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.

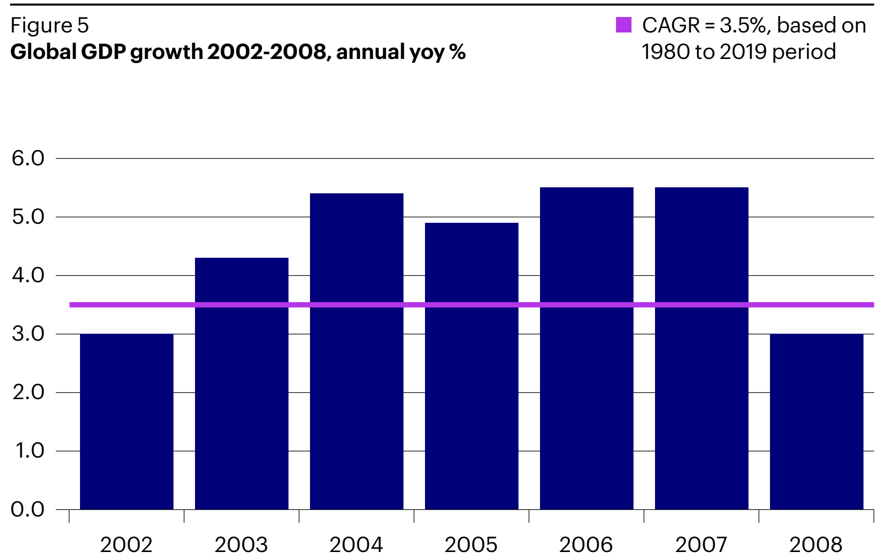
- International: Some 50% of the revenues of quoted European companies are outside of Europe.
- Cyclical: Over 60% of MSCI Europe (based on market capitalisation) is classified as cyclical using MSCI's methodology.

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.

Over 60%

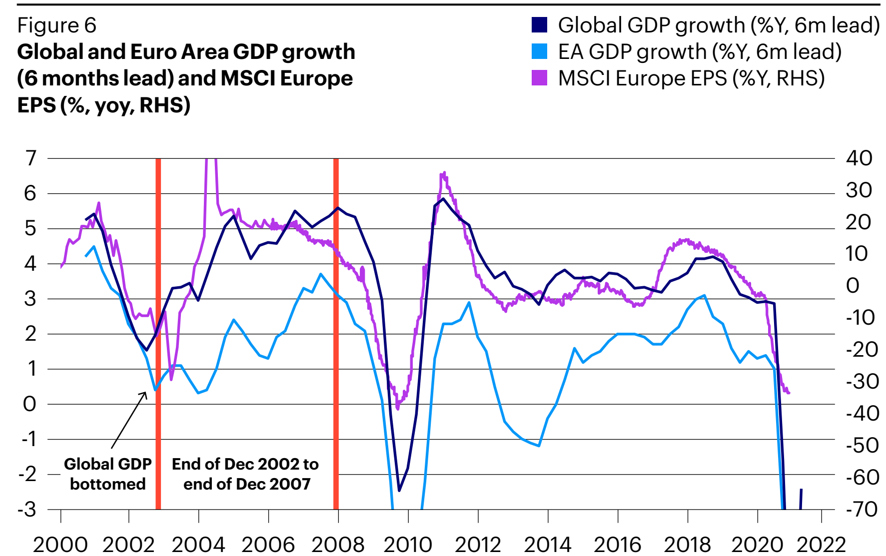
of MSCI Europe (based on market capitalisation) is classified as cyclical using MSCI's methodology.

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



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

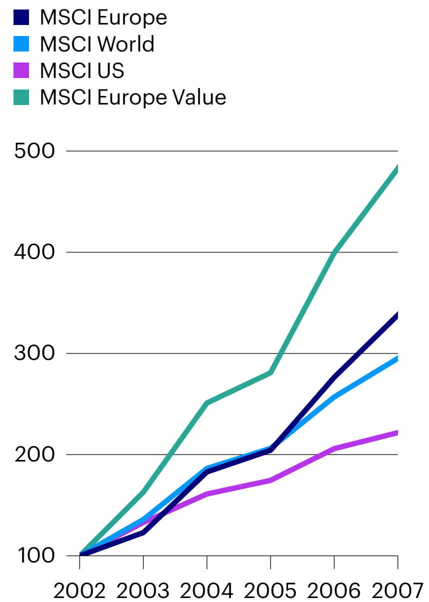
Figure 6
Global and Euro Area GDP growth (6 months lead) and MSCI Europe EPS (%, yoy, RHS)



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

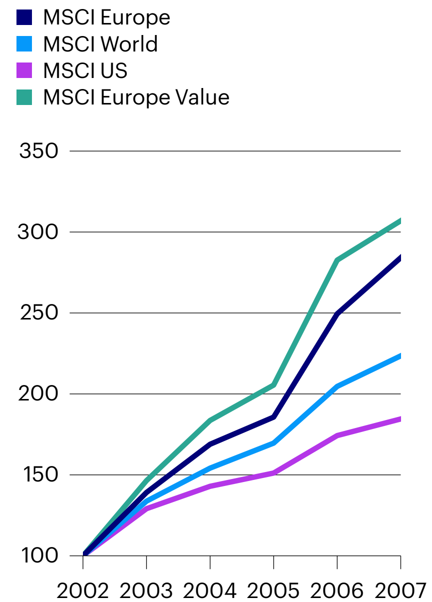
During this period, European earnings growth was much stronger than in the US and, also globally. This in turn translated into better returns for Europe, and particularly European value, than elsewhere. **European value at that time – not too dissimilar to today – was dominated by cyclical businesses.**

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)



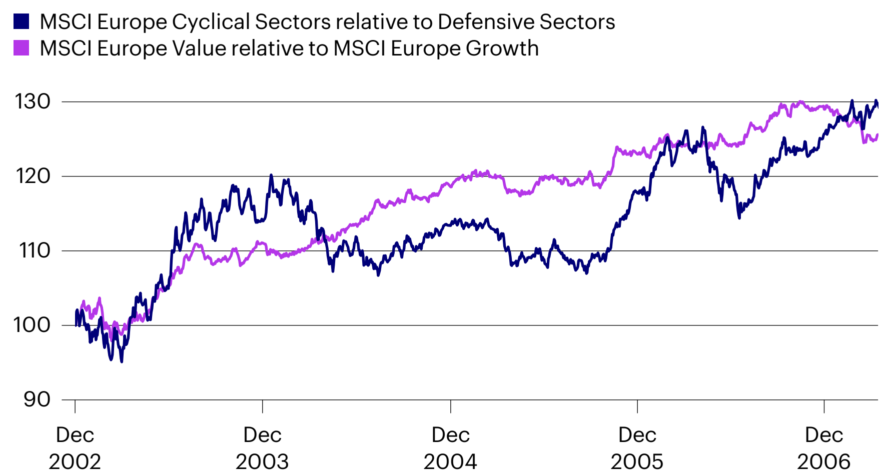
Source: Refinitiv, Invesco as at 31 December 2020.

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.

Investment Risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

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Data as at 31 March 2021, unless otherwise stated.

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