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US and Europe – significant differences persist

Market Comment, November 2019

Although European equities have made up some ground on their US counterparts this year, they lag well behind US equity markets in a long-term comparison. There are a number of key reasons why Eurozone stocks in particular have underperformed American equities over the longer term. And even if some of these factors change, we are still not expecting the kind of dramatic turnaround that would threaten the long-term superiority of US stock market performance. Below we highlight the important differences between the US and Europe – from both an economic and an equity market perspective.

With 6% less, the performance of the European equity market last year was much weaker than its US counterpart. And although European equities have made up some of the lost ground this year, the US continues to lead the way in a long-term comparison. For example, since the recession-related nadir of 2002, the US S&P 500 index has risen by around 390%, the wider European Stoxx 600 index by about 250%, and the Eurozone's Eurostoxx 50 by approximately 190%. When measured from the peak recorded at the start of 2000, the S&P has risen by around 210% (overall return as per November 2019), whereas the European Stoxx 600 has risen by only around half this amount, namely 105%, and the Eurozone's Eurostoxx 50 by just 55%. By contrast, the Swiss SMI rose by 133%. What are the reasons for these significant differences in performance?

These relate first and foremost to fundamentals – in earnings development, varying levels of profitability in key sectors, and differences in economic development. On the profitability front, operating profit margins in the US are at 13%, compared to 12% in Switzerland and just 10% for the European Stoxx 600 or the Eurostoxx 50.

This means that US companies are some 30% more profitable than their European counterparts. One reason for this difference is the higher weighting in the US of sectors with structurally higher profit margins: Technology and communications account for some 20% of the US stock market, almost three times the European equivalent figure of approximately 7%. By contrast, the weighting of the financial sector in Europe, in which profitability has been coming under pressure for many years, amounts to some 20%, which is the figure accounted for by sectors with high profit margins in the US.

It is therefore only logical that corporate earnings in the US have risen much more strongly than in Europe. For example, the reported earnings of the S&P 500 have risen by 400% since the recessionary low of 2002, which is broadly in line with the gains made by this index and puts the higher valuation of the US stock market in better context. Europe meanwhile has recorded an increase in corporate earnings of just 230%, whereas Switzerland has seen 300%.

> "The profitability of the companies in the S&P 500 is 30% better relative to the firms in the European Stoxx 600."
>
> Gérard Piasko, Chief Investment Officer

It is true that absolute valuations in the US – as reflected in price/earnings ratios or price/book value ratios – are higher than they are in Europe. However, this appears perfectly justifiable in view of the higher earnings growth described above and the far superior profit margin in a long-term comparison.

The key question here is what else lies behind the lower earnings growth of European stocks, aside from the previously described difference in profitability. It is likely that two further factors are having an impact. On the one hand, the dependency of European profits on interest rates due to the high weighting of the financial sector, and on the other Europe's dependency on exports and therefore its great sensitivity (and indeed vulnerability) to rising geopolitical and trade policy risks. With regard to interest rate dependency, a couple of statistics illustrate this clearly. During the era of rising interest rates in the 1990s, the relative performance of the Eurozone (as measured through the Eurostoxx 50) compared to the US (S&P 500) amounted to some +65%, yet this is the very same figure by which it has underperformed the US market since the era of declining interest rates began, i.e. around the peak equity year of 2000. This also highlights the higher beta – i.e. the greater overall market sensitivity – of European equities. They are more volatile because they are fundamentally more dependent on the economy, and specifically on exports, which means they are dependent on growth in global trade.The superior performance of Europe in parts of the 1990s and between 2004 and 2009 is explained by the above-average growth of global trade (and therefore export growth) during these periods. A key difference between the US and Europe is the different breakdown in economic activity or gross domestic product (GDP). The US traditionally generates a significant proportion of its economic output domestically, especially through consumer spending. Indeed, the latter is a crucial part of the economy, accounting for a historically stable 68% of all economic activity. By contrast, consumer spending accounts for a lower proportion of economic activity in the EU, where exports play a much more significant role. Back in 2001, exports accounted for a proportion of just 30% of economic activity in the EU, but now account for more than 45%, as consumer spending has grown at a much lesser rate than in the US. All of this brings us to the current situation.

The relatively strong performance of European equities this year has unfolded against a backdrop of rising optimism over a defusing of tensions in the Sino-US trade conflict and a possible resolution of this dispute. While this parallelism appears plausible on the one hand (given the export dependency of European stocks as described above), the risk of a trade dispute between the US and EU is not factored into current prices. This also highlights Europe's vulnerability in the event that the trade conflict with China is not properly resolved. As an additional factor, it is doubtful whether the uncertainty hanging over Europe in the form of the Brexit saga will be truly banished even after the UK general election in December (the third in four years!). All in all, it seems reasonable to conclude that European equities still exhibit greater risks than US stocks, and are therefore likely to remain more volatile going forward.

Gérard Piasko

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