European Equities:

Since the equity market put in its lows last October, we have seen a robust outperformance in European stocks versus the United States. As can be seen on the chart below, the S&P 500 (daily candlesticks) has gained just under 19% over the course of this time, however the EuroStoxx50 (blue line) is up over 26% during the same period. Over the last couple of years, we have laid out numerous reasons why we believed European equities were likely to outperform from a longer-term standpoint, and that they were fundamentally undervalued relative to their US peers. In the meantime, changing market dynamics, macroeconomics, and mostly geopolitics (namely the Russia-Ukraine war) have delayed this shift towards European equities, in our view. Finally, as is evidenced by price action over the past few months, we believe that we may now be seeing the end of Europe's structural underperformance which itself started in 2008.

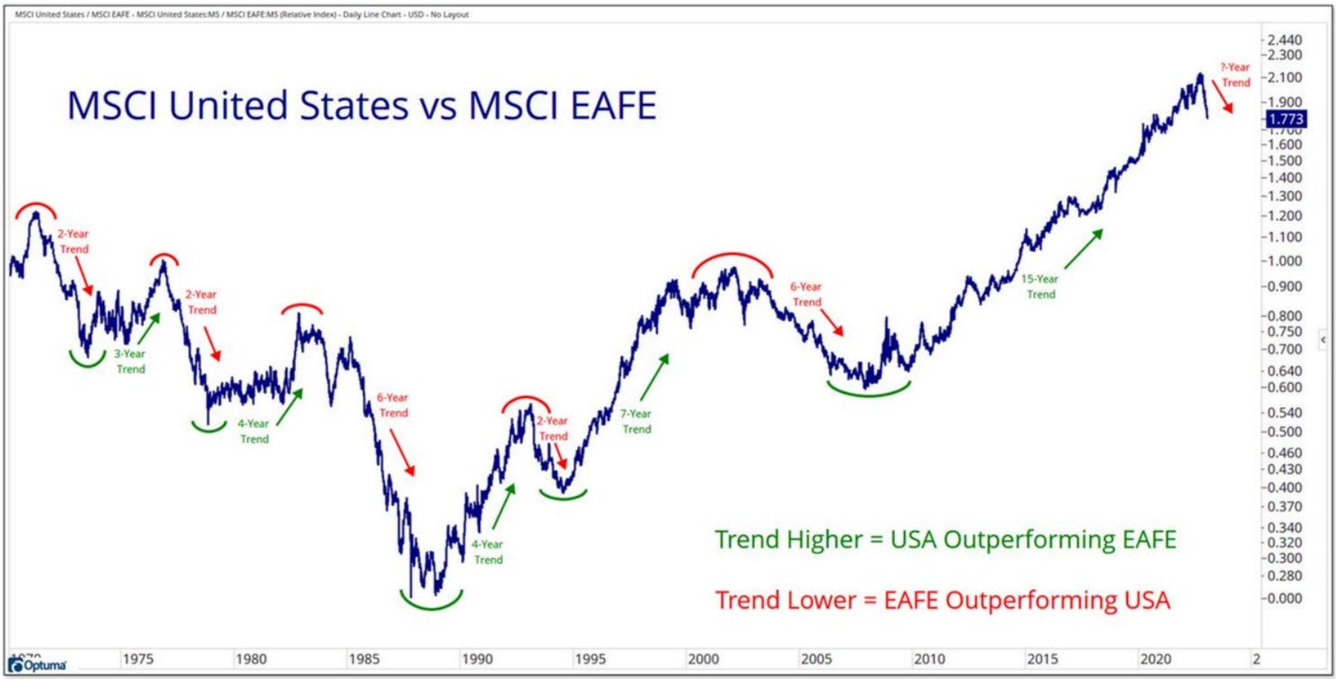
When we analyze the drivers behind the region's recent rally, we can identify four main catalysts:

- The economic news-flow is holding up better in Europe than in the US, with leading economic indicators such as the purchasing managers' surveys stabilizing in Europe over the last few months, while they continue to deteriorate in the US.
- European natural gas prices have continued to fall sharply since last summer, and are now trading below €60/MWh, their lowest price since September of 2021. The commodity has fallen from a 2022 high-point of €345/MWh, helping boost household balance sheets and consumer confidence, and somewhat easing headline inflation concerns at the ECB.
- Europe is more geared to China than the US, both economically, and in terms of corporate profits. US investment bank Morgan Stanley recently estimated that European companies generate roughly 8% of their sales from China, versus just 4% for US corporates. The recent Chinese reopening has helped hugely in this regard.
- Lastly, companies in Europe have recently seen better earnings revisions trends than their competitors in the States. This has correlated quite nicely with relative price performance too.

*Note: chart begins at the S&P 500 open on October 13th, the index's lowest day in 2022 Source Seaspray Financial

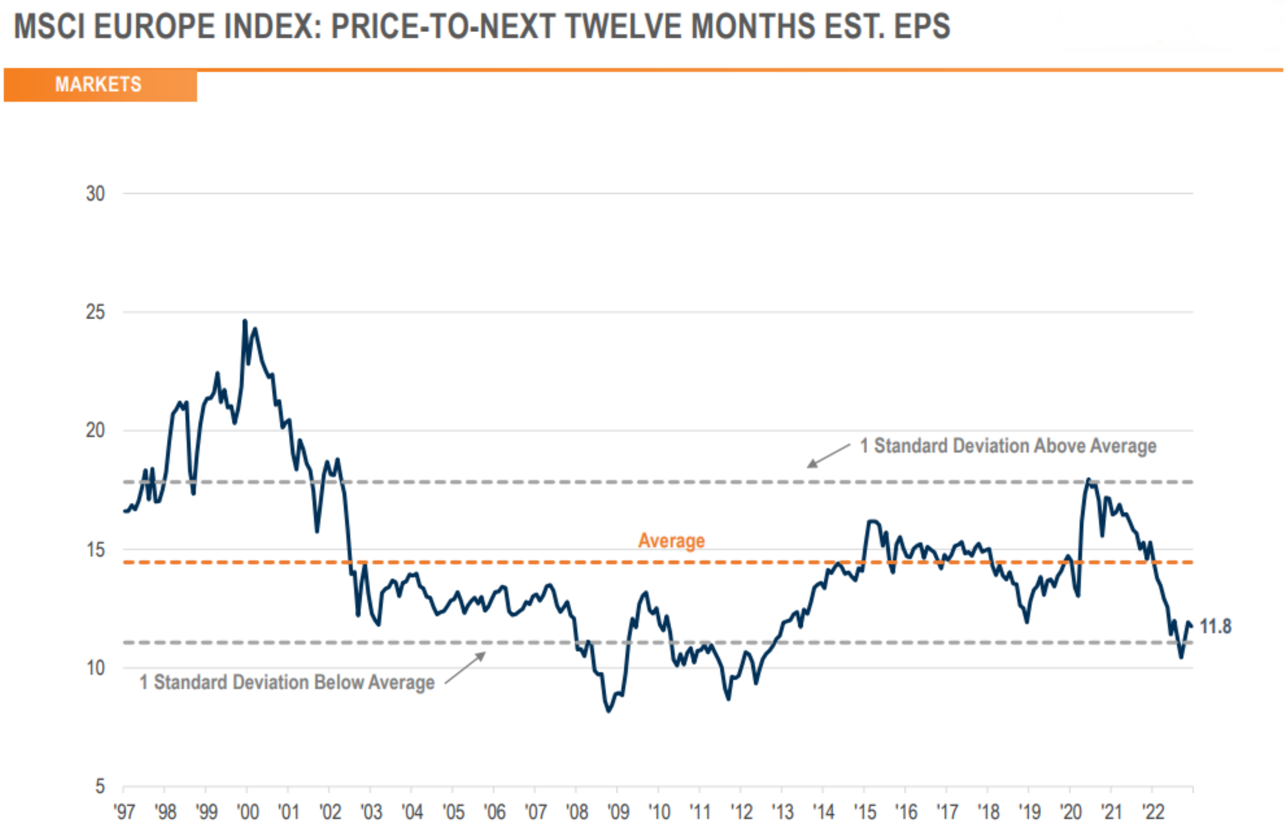
The chart below demonstrates the relative performance of the MSCI US equity index versus the MSCI EAFE (Europe, Australasia, and Far East), with a rising navy-blue line indicating a US outperformance and vice versa. The MSCI EAFE index has a c.45% allocation to Europe.

The US has had roughly a 15-year period of outperformance, but we believe there is real potential for EAFE regions to make up some of this ground as we move through the rest of this decade. The last few months of price action from European stocks may well be marking the end of a 15-year long era of outperformance for America and is without a doubt one of the most important themes underway in financial markets at present.



Source: Optuma

In our 2023 Investment Outlook we looked at the S&P 500's forward-P/E ratio, which is just above its 25-year average currently around 17x, i.e., slightly above fair value. Below, we see the same forward-P/E valuation metric but from another European equity index – the MSCI Europe. While it has picked up slightly in the past few weeks since this chart was made, the index's forward-P/E is still around 12-13x, below the 25-year average of c.14.5x (seen in orange below). This equates to a 25 - 30% discount to the S&P's forward-P/E and indicates that despite the region's outperformance during Q4 and in January, European equities still remain inexpensive versus the US in terms of valuations. We see a reasonably strong likelihood that the recent outperformance of Europe versus the US will continue as we move through the first half of 2023.



Source: FactSet, First Trust