RBC WEALTH MANAGEMENT

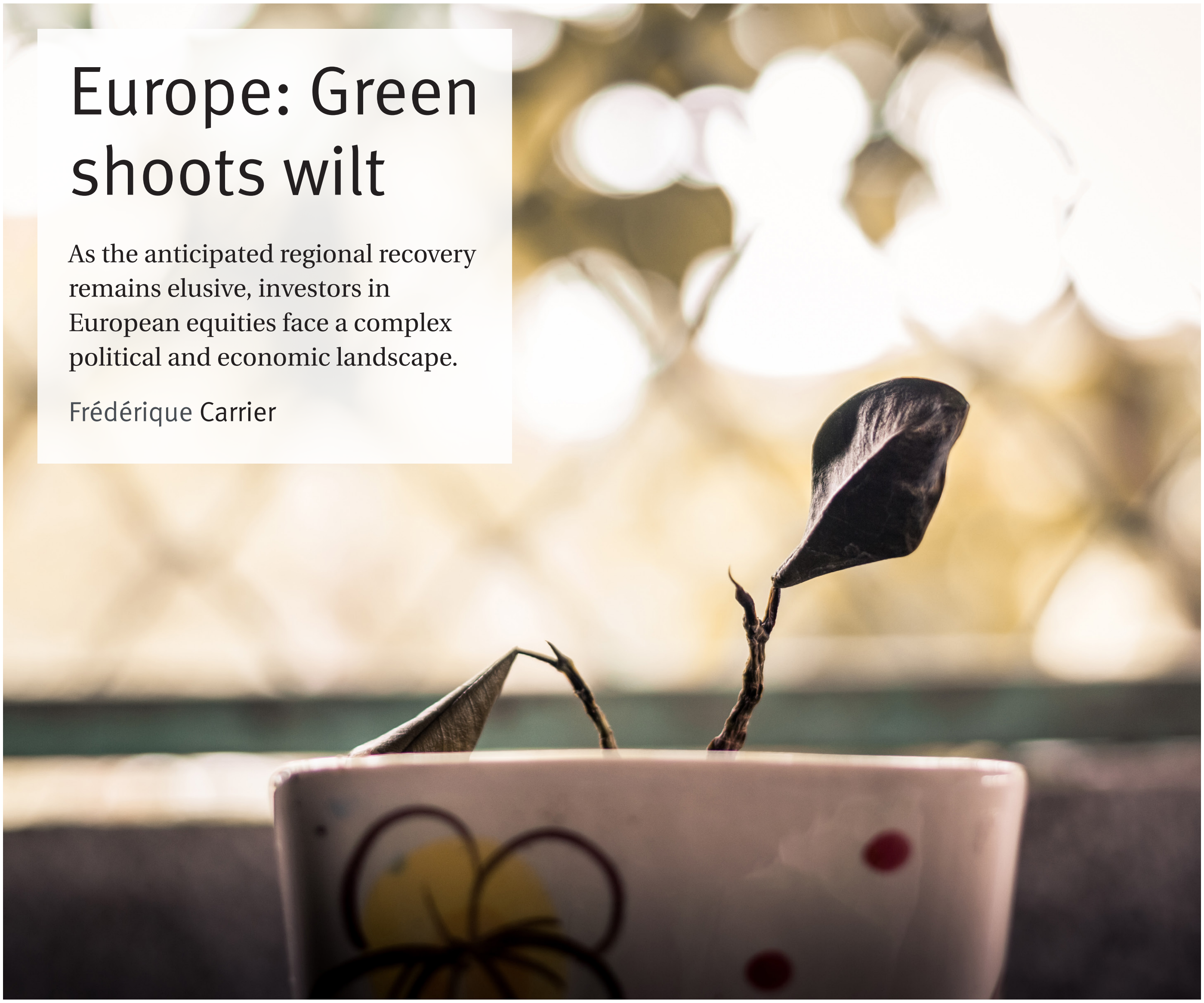
Global Insight

Focus Article

Europe: Green shoots wilt

As the anticipated regional recovery remains elusive, investors in European equities face a complex political and economic landscape.

Frédérique Carrier



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All values in U.S. dollars and priced as of June 30, 2019, market close, unless otherwise noted.

Focus article

Europe: Green shoots wilt

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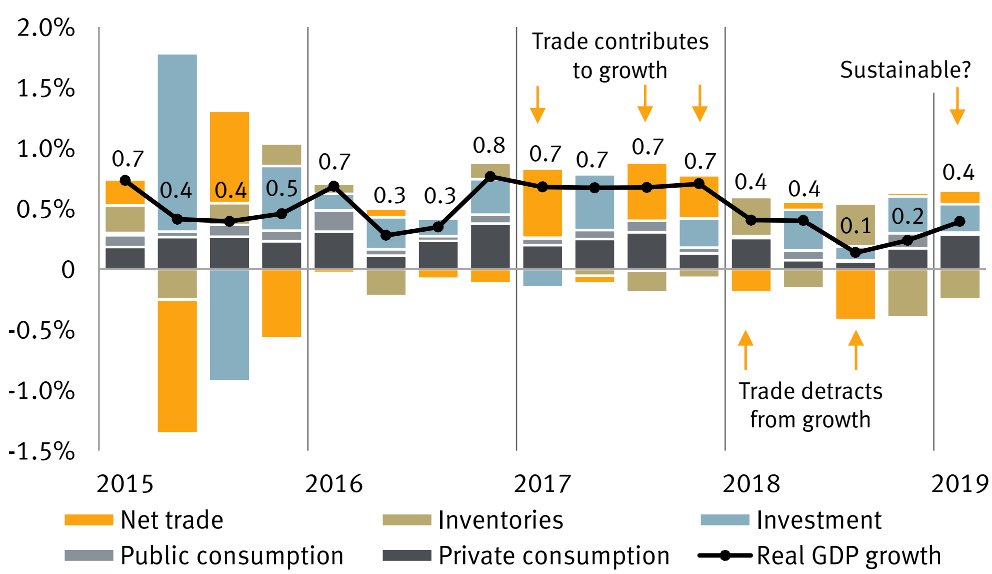
With trade tensions simmering and the economies of its largest trading partners slowing, the expected European economic recovery in the second half of 2019 will likely prove elusive. In our view, European equity valuations do not reflect political and economic factors including tariff negotiations, a reinvigorated populist Italian government, and Brexit uncertainty. We recently downgraded European equities to Underweight.

Fading optimism for new growth

Our thesis on European recovery was two-pronged. We expected the temporary factors that had crimped growth in Q4 2018 and Q1 2019, such as new auto emissions testing standards and the Yellow Vest protests in France, to recede during 2019. We also expected a stabilization in global trade and growth during the second half of this year after a difficult 2018. Together, these developments would have enabled the sturdy roots supporting the Eurozone economy—falling unemployment, healthy loan growth to the private sector (6% for the euro area), and gently supportive fiscal policy in France, Italy, and Germany—to support new growth.

Trade's contribution to Q1 growth is unlikely to be sustainable

Euro area real GDP growth breakdown (q/q)



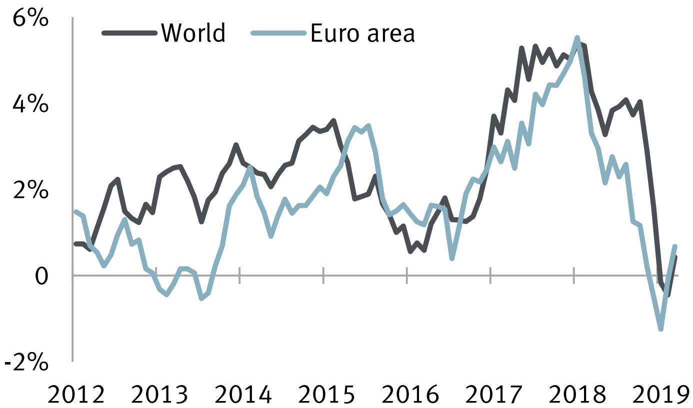
Source - Haver Analytics, RBC Capital Markets

As we move further into the second half of 2019, many of the temporary factors are indeed waning, albeit slowly. But given the recent ratcheting up of trade tensions, it seems unlikely that global trade will indeed stabilize in the near future. Even if relations between the U.S. and its trading partners thaw somewhat in the short term, tariffs will remain in place as negotiations continue. The uncertainty will continue to damage global growth prospects, in our opinion.

Europe's economy depends heavily on trade. Exports represent a high 44.4% of regional GDP, compared to 30.1% for the U.K, 18.6% for Canada, and 12.1% for the U.S., according to the World Bank. Of those exports, 39% go to Europe's three largest trading partners: the U.K. (16%), the U.S. (15%), and China (8%), according to European Commission data. Hence, slowdowns in the economic growth of major trading partners due to trade tensions and the spectre of a hard Brexit create substantial headwinds for the region.

Trade volumes rising, but for how long?

CPB World Trade Monitor 3-month rolling average, y/y



The March uptick may prove short-lived as trade disputes evolve.

Note: last data point is March 31, before the May escalation of the trade war
Source - RBC Capital Markets, Bloomberg, CPB World Trade Monitor

European economic data featured some green shoots in the spring, culminating in Q1 GDP growth of 0.4% q/q following a lackluster 0.2% in Q4 2018. However, recent releases have been less encouraging, with most falling short of consensus expectations. Consequently, the European Central Bank (ECB) has pared back its growth projections for FY 2020 and FY 2021.

ECB staff lowers 2020 and 2021 growth expectations again

ECB growth projections

	Dec 2018	Mar 2019	Jun 2019
2019	1.7%	1.1%	1.2%*
2020	1.7%	1.6%	1.4%
2021	1.5%	1.5%	1.4%

*Given robust Q1 2019 GDP data, the ECB tweaked upwards its 2019 estimates in June, though that estimate remains below the 1.7% it had calculated for 2019 back in December 2018.
Source - RBC Wealth Management

The market's inflation expectations have also fallen from 1.6% at the beginning of the year to 1.1% in mid-June.

We believe consensus corporate earnings growth forecasts will need to be adjusted to reflect this new reality, as they are too high at 8% for this year and 10% for 2020. Slightly negative Q1 earnings-per-share (EPS) growth for the region will make those full-year estimates difficult to achieve, and we believe European equities will struggle to outperform as long as downward earnings revisions prevail.

The ECB has announced it is prepared to take bold steps to prop up inflation and to support the regional economy should it weaken further. Despite interest rates already in negative territory, RBC Capital Markets now expects two 10-basis point rate cuts this year, in September and December. It is also possible that the central bank will relaunch its quantitative easing programme next year.

The ECB's actions are unlikely to remove the key obstacle to the region's growth, in our view: the global trade dispute. As discussed in a recent *Global Insight Weekly* article, central banks' ability to boost economic expansion through ever-lower interest rates appears limited, at the margin. In a possible sign of things to come, U.S. President Donald Trump lashed out at ECB President Mario Draghi and the ECB for "making it unfairly easier for them to compete against the USA."

Political tensions return

Beyond this, we believe regional political tensions are likely to increase over the course of the next few months in three key areas.

U.S.-EU auto tariffs – The U.S. has postponed a decision on European auto tariffs until the autumn. But if President Trump were to attempt to use auto tariffs as a lever to open up the EU agricultural market, he would likely face stiff opposition from Europeans, who passionately protect their agricultural sector. Should the dispute escalate and the U.S. slap new tariffs on European auto imports, it would significantly impede growth given the importance of auto trade flows, in our view.

A bolstered populist government in Italy – The right-wing Lega is the main political force in Italy's coalition government, and the party's strong showing in the recent European Parliament elections has emboldened its leader, Matteo Salvini. He has resumed talk of breaching EU fiscal rules and issuing a parallel currency. So-called "mini-BOTS," named after the country's ordinary Treasury bonds, would be used to pay public sector bills, in a direct provocation to the ECB.

It is unclear at this stage whether Rome's dispute with Brussels will escalate. Our base case is that rising yields would act as a control mechanism to contain the crisis. Italian banks, which own 8% of the country's bonds, remain fragile due to non-performing loans reaching a high 9% of total loans. They would be weakened further by rising yields, something we believe most governments would prefer to avoid.

But the current government might opt for confrontation, and the vicious cycle of rising yields and credit rating downgrades that would likely ensue. Faced with that reality, the country's political leadership could decide to head further into the storm or to change course, much as Greece did in 2015. Either way, we believe the developing situation would weigh on business sentiment and further dampen growth.

Europe: Green shoots wilt

Brexit uncertainty – As things stand, the deadline for the U.K. to exit the EU is October 31, 2019. Whilst the EU would prefer to avoid the chaos of a no-deal Brexit, it is far from clear that Brussels would grant the UK another extension. Avoiding a no-deal Brexit would require the country's parliament to finally accept the Withdrawal Agreement negotiated by former Prime Minister Theresa May, which it has thrice rejected. In our view, the probability of a no-deal Brexit is not inconsiderable, at around 30%.

Equities have performed well, but ...

After a strong rally in Q1 that brought European equity performance in line with the MSCI World Index, the MSCI Europe ex UK Index now trades at 13.4x 2020 earnings, in line with its long term average. Valuations are thus not low enough, in our view, to price in the challenges ahead. Moreover, when compared to the U.S. on a sector-adjusted basis that takes into account the lower representation of Tech in the European index, the discount of less than 4% appears minimal, and is not nearly as deep as the prevailing discount over the past 10 years. This doesn't leave the region much of a valuation buffer, and supports our move to an Underweight position in European equities.

Taking all of this into account, we maintain that there is room in portfolios for an allocation to select European companies with strong business models and which operate in niche markets buoyed by secular growth, are supported by a global revenue base, and generate strong cash flows. We find these opportunities particularly in Consumer sectors, Health Care, and some Industrials.

Research resources

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