



European equities may rally strongly in the near term, fuelled by improving macro indicators, attractive valuations and low investor exposure. While nimble investors can take advantage of this rally, we caution that the Eurozone’s structural problems are likely to continue to weigh on the region’s growth and inflation, limiting the market’s upside potential over the longer term.

European equities have underperformed even Japanese stocks by over 10% in the last five years and returned 78% less than US equities in total return terms (USD). This lacklustre performance is partly the result of the Eurozone’s persistent structural problems. Yet the prospects for European equities may be looking brighter in the near term.

ON THE CUSP OF A CYCLICAL UPTURN

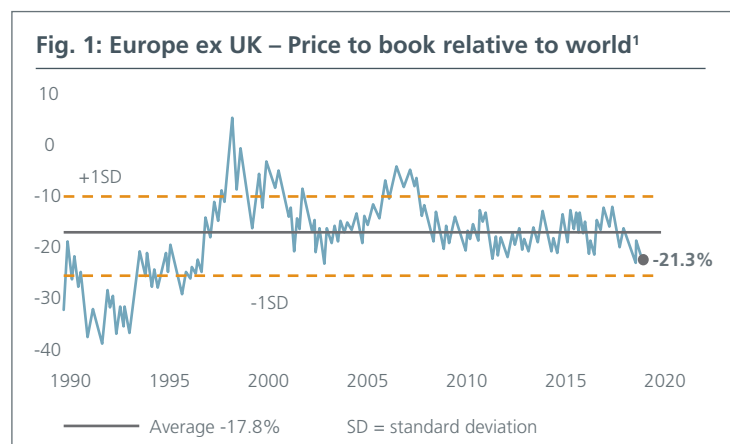
Following years of underperformance, valuations of European equities are now attractive. Trading at a discount of 21% versus global stocks on some measures (see Fig. 1), European equities are at the lower end of their relative valuation band since the Eurozone banking crisis.

Valuations have also been depressed by last year’s slowdown in China, which is an important



David Hollis
Investment Director, Global Asset Allocation
Eastspring Investments

export market for the region. Whilst Japan has increased its exports to China by 400% of gross domestic product (GDP) since 1999, Germany trumped this with a 700% increase over the same period. Given the strong links between the two economies, the rebound in China’s manufacturing sentiment in March is likely to have a positive spill over into the Eurozone and its stock market.



The potential upside in European stocks is also high, given investors' current low exposures. According to the Bank of America Merrill Lynch's Global Fund Manager Survey², global institutional investors are currently 8% underweight in European equities, nearly one standard deviation below the long-term average.

PERSISTENT STRUCTURAL PROBLEMS SHOULD SUSTAIN LOW RATES

Despite the potential cyclical uplift Europe is likely to enjoy, concerns over the high levels of debt in the peripheral countries, challenging demographics and the absence of wage inflation, are expected to persist and keep rates low.

➤ *Unsustainably high levels of debt*

For some, Draghi's seminal speech to "do whatever it takes", implicitly promising to provide liquidity for the Eurozone to overcome unsustainable levels of debt in the peripheral countries, marked the end of the Eurozone crisis. Yet, seven years on, several peripheral countries remain mired in a prolonged crisis. These countries either need interest rates to remain at or below current levels for a sustained period to stabilise their debt to GDP ratios, or must generate historically unachievable primary surpluses. Italy, for example, can only stabilise its debt level at 154% of GDP if interest rates remain below current levels of 2.5%.

There are many lessons on Europe which investors can draw from Japan. Japanese debt amounted to 125% of GDP in 1990 and the average financing cost over the prior 10 years was 3.7%. Fast forward to today, it is sobering to note that average financing costs have plummeted to 0.8% in Japan while its debt has grown a further 100%.

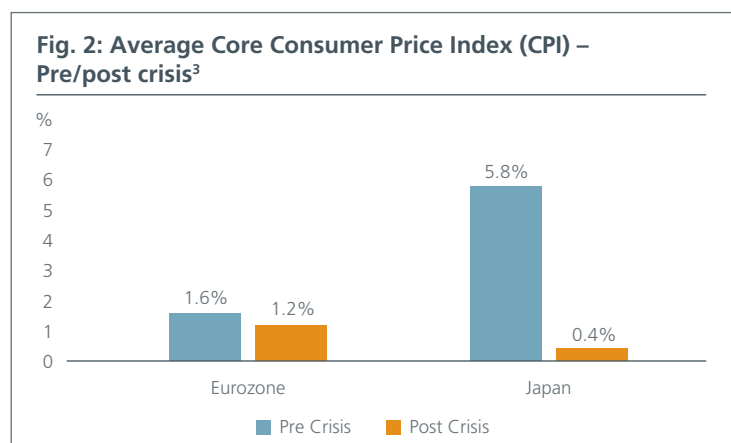
Japan was able to lower financing costs to continue growing its level of sovereign debt with the aim to support its economy and, ultimately generate inflation. However, it was aided by domestic demand for its government bonds. This contrasts with Italy where the European Central

Bank has had to step in to purchase sovereign debt by expanding its own balance sheet. Germany has effectively supported Italy by lending to it via the back door. This ongoing support cannot be assumed to be infinite, as in the case of Japan.

➤ *Absence of wage inflation*

Barring periods of a cyclical rebound in prices, structurally low inflation in the Eurozone is likely to help interest rates remain low. Average core Eurozone inflation (see Fig. 2) has fallen to 1.2% since the 2008 Global Financial Crisis (GFC). This is similar to the pattern observed post Japan's banking crisis in the 1990's. Average inflation then fell to 0.4%, down from over 5% during the 70's and 80's.

Developed markets are suffering from unusually low levels of investment at a time in the cycle when we would ordinarily expect animal spirits to be picking up. If Japan is a guide, the lack of investment can be blamed on the slower growth in its labour force. In Japan, investment peaked at above 20% of GDP (5-year average) prior to its banking crisis in 1990, to around 15% of GDP today. This is almost in lock-step with the declining growth in its labour force, which is barely above zero today. The slower growth in the labour force was, in turn, associated with lower wage growth in Japan post crisis in the 90's. It is only after many years, and a loosening in some of its immigrant labour laws, that Japan experienced an acceleration



in wages, together with an increase in its labour force.

The Eurozone has likewise suffered a significant contraction in its labour force since the GFC, prompting a decline in the rate of investment to GDP. While an influx of migrant labour has helped to counter demographic headwinds affecting the labour force, relief is expected to be temporary given the political unpalatability of open border policies in Europe. Wage growth may remain tepid in the Eurozone for a long time, mirroring Japan's earlier experience. See Fig. 3.

STILL CHALLENGING OUTLOOK FOR KEY SECTORS

The performance of the broad European stock market is heavily reliant on the banking sector (see Fig. 4) given its heavy weighting (19%). Many European banks continue to be afflicted with poor quality legacy assets, despite having increased the amount of high-quality capital held on their balance sheets. Recent government pressure for Deutsche Bank to merge with Commerzbank, even if it potentially results in the loss of thousands of jobs, is a sign that Berlin is keen to bring an end to a crisis that has dragged on for nearly a decade.

Fig. 3: Eurozone wage growth vs labour force growth⁴

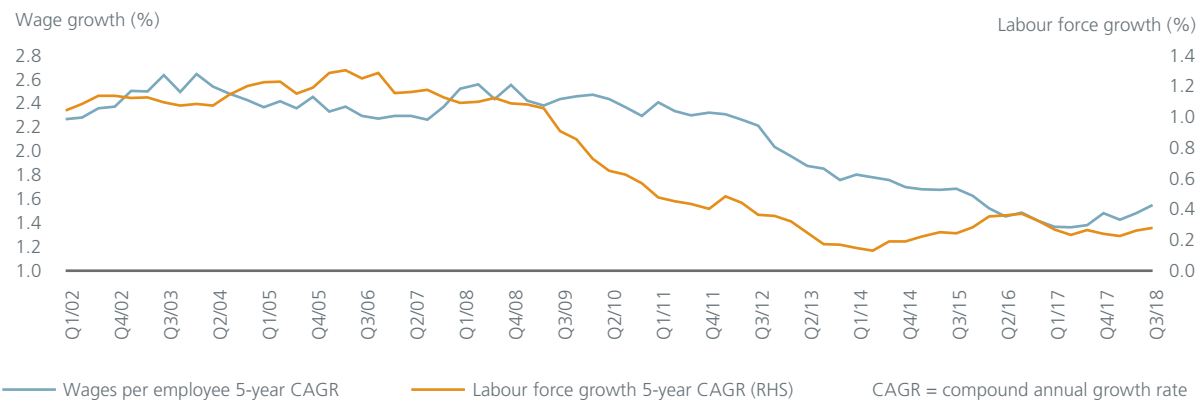
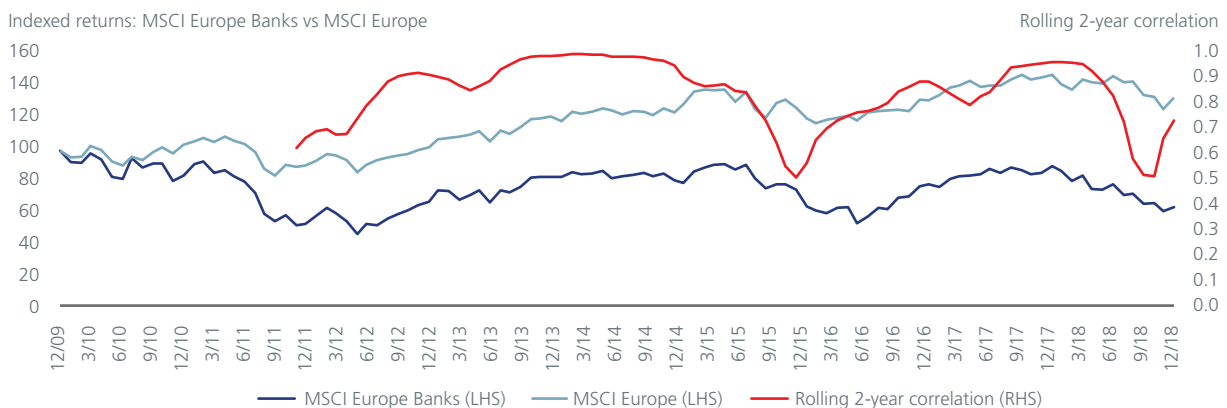


Fig. 4: European equity market and banks⁵



The diesel emissions cheating scandal which rocked the auto manufacturers (another important sector for the European equity market) in 2015 continues to weigh on the sector's earnings certainty. The ban on driving diesel cars during peak hours in some German cities has hastened the shift back to petrol cars and increased mistrust in car manufacturers. Selected manufacturers have also been hurt as US demand moved away from the sedan market to trucks and Sport Utility Vehicles (SUVs), one of the lowest margin segments. The prospects for other manufacturers have been further clouded by the overcapacity in China which had been a key driver of profits via their joint venture operations. For the first time in over a decade, total annual automobile sales growth in China fell in 2018 as subsidies for electric and hybrid vehicles were scaled back.

Over the coming decades, therefore, the outlook for European equities is likely to remain depressed, occasionally punctuated by aggressive counter trend rallies that subsequently fail to be supported by improving fundamentals. Longer term investors, particularly those in Europe may want to look to Asia. For now, however, we may be about to enjoy one of these aggressive counter trend rallies in Europe.

FINAL THOUGHTS

The fiscal and monetary measures recently announced by China to help stabilise its economy, together with the recent improvement in China's business sentiment surveys for March, should provide a positive spill over into the Eurozone economy. While Germany's factory orders and business sentiment in February remain depressed, in the coming weeks and months, any signs that Germany, or the Eurozone, may have passed the trough in cyclical activity would buoy European stocks.

Over a longer-term investment horizon, Europe needs meaningful fiscal stimulus - which contradicts the Eurozone policy prescription of restoring imbalances through austerity - for growth and inflation to fully recover. Even then, demographics are accelerating the phenomenon of a shrinking workforce, lower wages, and disinflation, ensuring that interest rates remain at low, or even negative levels.

Disclaimer

This document is produced by Eastspring Investments (Singapore) Limited and issued in:

Singapore and Australia (for wholesale clients only) by Eastspring Investments (Singapore) Limited (UEN: 199407631H), which is incorporated in Singapore, is exempt from the requirement to hold an Australian financial services licence and is licensed and regulated by the Monetary Authority of Singapore under Singapore laws which differ from Australian laws.

Hong Kong by Eastspring Investments (Hong Kong) Limited and has not been reviewed by the Securities and Futures Commission of Hong Kong.

Indonesia by PT Eastspring Investments Indonesia, an investment manager that is licensed, registered and supervised by the Indonesia Financial Services Authority (OJK).

Malaysia by Eastspring Investments Berhad (531241-U).

United States of America (for institutional clients only) by Eastspring Investments (Singapore) Limited (UEN: 199407631H), which is incorporated in Singapore and is registered with the U.S Securities and Exchange Commission as a registered investment adviser.

European Economic Area (for professional clients only) and Switzerland (for qualified investors only) by Eastspring Investments (Luxembourg) S.A., 26, Boulevard Royal, 2449 Luxembourg, Grand-Duchy of Luxembourg, registered with the Registre de Commerce et des Sociétés (Luxembourg), Register No B 173737.

United Kingdom (for professional clients only) by Eastspring Investments (Luxembourg) S.A. - UK Branch, 125 Old Broad Street, London EC2N 1AR.

Chile (for institutional clients only) by Eastspring Investments (Singapore) Limited (UEN: 199407631H), which is incorporated in Singapore and is licensed and regulated by the Monetary Authority of Singapore under Singapore laws which differ from Chilean laws.

The afore-mentioned entities are hereinafter collectively referred to as **Eastspring Investments**.

The views and opinions contained herein are those of the author on this page, and may not necessarily represent views expressed or reflected in other Eastspring Investments' communications. This document is solely for information purposes and does not have any regard to the specific investment objective, financial situation and/or particular needs of any specific persons who may receive this document. This document is not intended as an offer, a solicitation of offer or a recommendation, to deal in shares of securities or any financial instruments. It may not be published, circulated, reproduced or distributed without the prior written consent of Eastspring Investments. Reliance upon information in this posting is at the sole discretion of the reader. Please consult your own professional adviser before investing.

Investment involves risk. Past performance and the predictions, projections, or forecasts on the economy, securities markets or the economic trends of the markets are not necessarily indicative of the future or likely performance of Eastspring Investments or any of the funds managed by Eastspring Investments.

Information herein is believed to be reliable at time of publication. Data from third party sources may have been used in the preparation of this material and Eastspring Investments has not independently verified, validated or audited such data. Where lawfully permitted, Eastspring Investments does not warrant its completeness or accuracy and is not responsible for error of facts or opinion nor shall be liable for damages arising out of any person's reliance upon this information. Any opinion or estimate contained in this document may subject to change without notice.

Eastspring Investments (excluding JV companies) companies are ultimately wholly-owned/indirect subsidiaries/associate of Prudential plc of the United Kingdom. Eastspring Investments companies (including JV's) and Prudential plc are not affiliated in any manner with Prudential Financial, Inc., a company whose principal place of business is in the United States of America.



A member of Prudential plc (UK) 