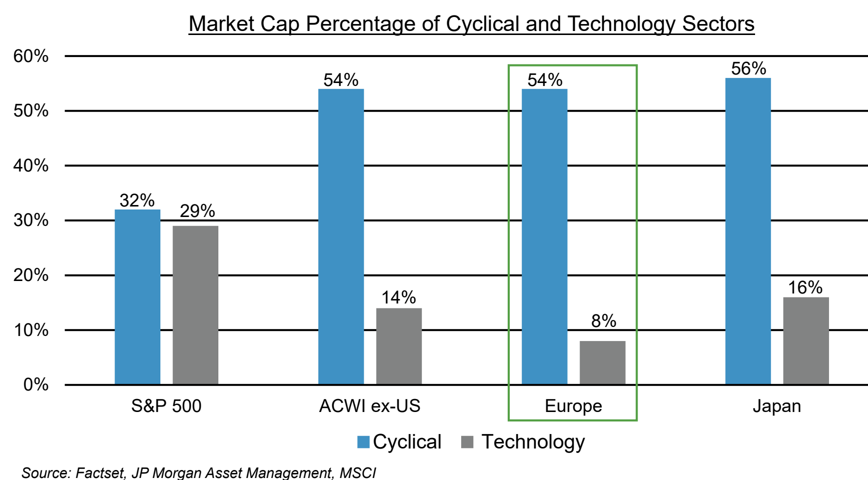
WATERLOO CAPITAL

Foreign Equities: Europe

Quicktake: **High exposure to value oriented, defensive, and inflation beneficiary positions provide Europe with an attractive backdrop. Additionally, ongoing monetary and fiscal policy support will help boost sentiment and provide some volatility protection. These positives could be overrun by the dislocations in local European economies and a slowdown in global growth prospects later in the year. We think both the upside and downside potential are lower than US equity markets. With relative outperformance more likely to come from shallower drawdowns rather than higher peaks, an allocation to European equities will provide diversification benefits if US markets struggle to cope with high valuations and policy headwinds.**

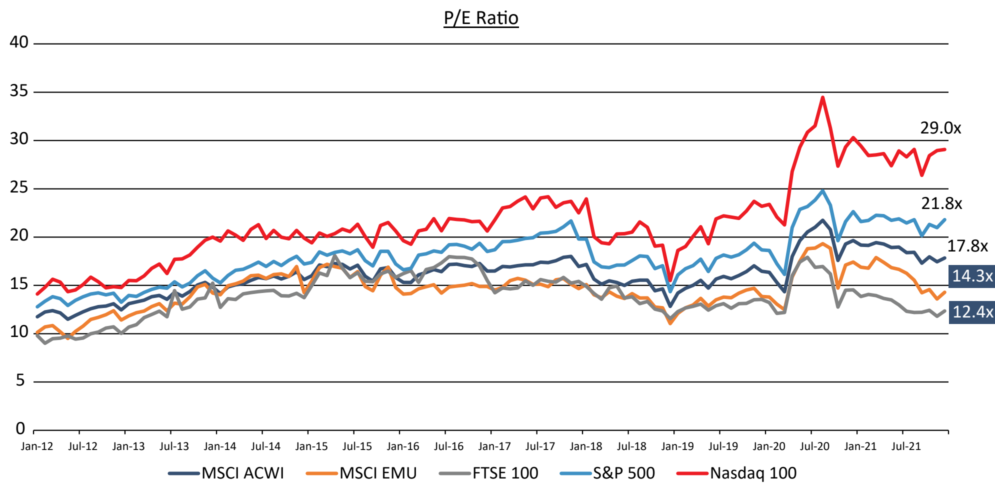
On the positive front for European markets, corporate profits have gained momentum and consumer demand is trending in the right direction. Earnings growth exceeded even the highest expectations last year and comes into 2022 with strong momentum. Multiple expansion is likely to dissipate this year, but expectations of double-digit earnings growth will support strength in the region. Also, European equities will likely benefit from their relatively higher exposure to value and defensive sectors versus other developed markets. These sectors historically perform well when inflation and interest rates are rising. During the last resurgence in European equities, which occurred during 2010 and 2011, foreign markets outperformed or performed in-line with US equities. Positive momentum heading into 2022 and strong performance in these inflation sensitive sectors could help close the gap that the growth heavy US stock indexes have widened in recent years. Finally, 2022 may be the year when relative valuations matter. Many European countries are trading at significant valuation discounts to peers and may attract capital as investors look for value and quality opportunities during volatile market periods.

European markets have the lowest exposure to high-growth technology stocks



Central bank influence may be more important than ever this year, but this time around we are watching for ways central bankers may stymie growth rather than support it. The ECB continues to kick the can down the road and has stated that rate hikes might not happen until 2023. ECB president Christiane Lagarde has made some suggestions that policy makers are targeting the second half of 2022 for their first rate hike, but at this point we'll believe it when we see it. The good news is that forward guidance remains extremely transparent. Markets hate uncertainty, and if the ECB continues to put their money where their mouth is, policy error risks will be subdued. Ongoing policy support

Relative valuations for European equities have rarely been deeper over the last 10 years



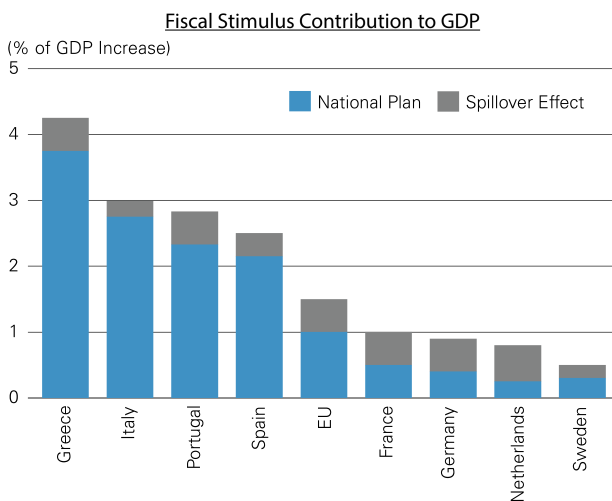
Source: Morningstar, Waterloo Capital

from the central bank and government is a feature we expect to become harder for investors to find this year. In Europe, both monetary and fiscal stimulus measures remain supportive which could fuel demand for equities or put a backstop behind market drawdowns.

Stimulus measures from the European Commission (EC) will provide ongoing support for business and government spending this year. The long-term EU budget and the Next Generation EU stimulus package included more than two trillion euros to support digital modernization, clean energy, healthcare, and agriculture. The long-term nature of many of these projects makes it difficult to gauge the effects on the equity market this year, but markets are always looking forward as investors try to price in the potential ramifications. Signs of positive results from the initial outlays would boost sentiment for higher future revenues, but earnings may not be affected until late Q3 or Q4 of this year.

As the year goes on, signs that the market cycle may be closer to injury time than half time would be a major headwind to European equities and lead to a continuation of lackluster relative performance.

Fiscal stimulus is expected to add a significant boost to periphery European economies



Source: European Commission

Unfortunately, we think this may be the case and the negatives will begin to outweigh the positives towards the middle of the year. Overall, the underlying exposures and policy supports are likely to lead to a less volatile price range for European markets to both the upside and the downside. We see value in the region to provide some volatility protection and diversification benefits. That being said, while a strengthening global economy is likely to provide upside, we think relative outperformance is still more likely for US equities. Based on the unbalanced upside and downside relative return expectations we recommend a market weight to begin the year with the potential to shift towards a relative overweight should we see greater downside risks for US assets as the economic and interest rate landscapes evolve.

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