

EQUITY

Closing the European Performance Gap

February 4, 2020



Katrina Dudley, CFA
Portfolio Manager
Franklin Mutual Series

Although European equities performed well in 2019, there's still a significant value and performance gap compared to US stocks, according to Franklin Mutual Series Portfolio Manager Katrina Dudley. Here, she gives reasons why she's optimistic about the backdrop for European value stocks and discusses some potential market-moving events she's monitoring.

Despite ongoing uncertainties and challenges, we think the positive performance European equities experienced in 2019 could continue in 2020. The events that drove 2019's market rally—accommodative central bank monetary policy, a clearer Brexit path and progress on a US-China trade deal—continue to be sources of optimism, in our view.

This positive backdrop, combined with recent signs of stabilization in the global Purchasing Managers Index, suggests to us that near-term recession concerns that clouded the outlook at the beginning of 2019 are no longer a risk at the outset of this new decade. Also, following the recent transition of power at the European Central Bank (ECB), with Christine Lagarde taking the helm as president in November 2019 and having just announced a review of its inflation target, policy tools and communication, we believe the ECB could potentially encourage eurozone governments to boost fiscal stimulus to revive their economies in coming years.

European Investment Themes for the Next Decade

Looking ahead, we see a number of other reasons why investors might want to consider increasing their exposure to European stocks, including to gain exposure to companies with relatively stronger environmental, social and governance (ESG) credentials. Asset flows into ESG-related investments have been steadily rising, and Europe's regulatory framework continues to support the evolution of ESG best practices and meaningful disclosures by European corporates, particularly as they relate to climate transition.

In addition, we think rising activism could be a tailwind for European equities, as active shareholder voices engage with management teams and boards. In our view, these conversations could lead companies to restructure their operations to improve performance. In some cases, we have seen companies act as their own activists, evaluating options to become more focused and streamlined by dividing businesses into separate entities.

From a valuation perspective, as we have mentioned repeatedly this past decade, the value style of investing has been out of favor for some time, and the outperformance of growth stocks compared with their value counterparts during 2019 was significant. We think there is a potential for value to begin to outperform again, particularly as investors become more sensitive to stock valuation levels.

It is relatively easy to explain what has happened over the past decade—strong performance of many of the world’s “disruptors” has driven US stock market performance, while the European market is home to many of the disrupted companies. We think the market has fully priced this situation in, as evidenced by the significant valuation gap between the US and European markets.

According to our analysis, European equity dividend yields remain attractive relative to equities in other regions, including the United States. For investors seeking yield, it is hard to ignore the 3.5% dividend yield that the European market offers, compared to the 1.8% dividend yield of the S&P 500 Index.¹

Managing Market Volatility

Against this bright backdrop for European equities, we are also monitoring other potentially market-moving events. Trade battles, geopolitical conflicts and the UK post-Brexit transition, as well as uncertainty ahead of the 2020 US presidential election, may continue to dominate economic headlines this year and account for a disproportionate source of market volatility.

Tension in the Middle East has been rising following the death of an American contractor in Iraq in late December and a January 3 US airstrike that killed Iranian General Qassem Soleimani. And although trade tensions dissipated with the “phase-one” trade deal between the United States and China, there are still a significant number of issues that need to be resolved. We think a re-escalation of hostilities is a possibility.

In addition, lingering issues tied to Brexit that still need to be worked out could lead to increased market volatility in the year ahead. As a result, we favor companies that are headquartered in the United Kingdom but are global franchises, with only a small percentage of revenues coming from the domestic UK market.

While market volatility is a concern for investors with a short-term horizon, as long-term investors, we believe we can weather this turbulence and find opportunities at attractive valuations.

To get insights from Franklin Templeton delivered to your inbox, subscribe to the [Beyond Bulls & Bears](#) blog.

For timely investing tidbits, follow us on Twitter [@FTI_US](#) and on [LinkedIn](#).

Important Legal Information

This material is intended to be of general interest only and should not be construed as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy. It does not constitute legal or tax advice.

The views expressed are those of the investment manager and the comments, opinions and analyses are rendered as of publication date and may change without notice. The information provided in this material is not intended as a complete analysis of every material fact regarding any country, region or market.

Data from third party sources may have been used in the preparation of this material and Franklin Templeton Investments (“FTI”) has not independently verified, validated or audited such data. FTI accepts no liability whatsoever for any loss arising from use of this information and reliance upon the comments, opinions and analyses in the material is at the sole discretion of the user.

Products, services and information may not be available in all jurisdictions and are offered outside the U.S. by other FTI affiliates and/or their distributors as local laws and regulation permits. Please consult your own professional adviser or Franklin Templeton institutional contact for further information on availability of products and services in your jurisdiction.

Issued in the U.S. by Franklin Templeton Distributors, Inc., One Franklin Parkway, San Mateo, California 94403-1906, (800) DIAL BEN/342-5236, franklintempleton.com—Franklin Templeton Distributors, Inc. is the principal distributor of Franklin Templeton Investments’ U.S. registered products, which are not FDIC insured; may lose value; and are not bank guaranteed and are available only in jurisdictions where an offer or solicitation of such products is permitted under applicable laws and regulation.

This information is intended for US residents only.

CFA® and Chartered Financial Analyst® are trademarks owned by CFA Institute.

What Are the Risks?

All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors or general market conditions. Value securities may not increase in price as anticipated or may decline further in value. Investments in foreign securities involve special risks including currency fluctuations, and economic and political uncertainties.

[1.](#) Source: Bloomberg, as of January 24, 2020.