EQUITY

Closing the European Performance Gap

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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.

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1. Source: Bloomberg, as of January 24, 2020.