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Why the historic undervaluation of Corporate Europe seems unjustified

26 February 2024

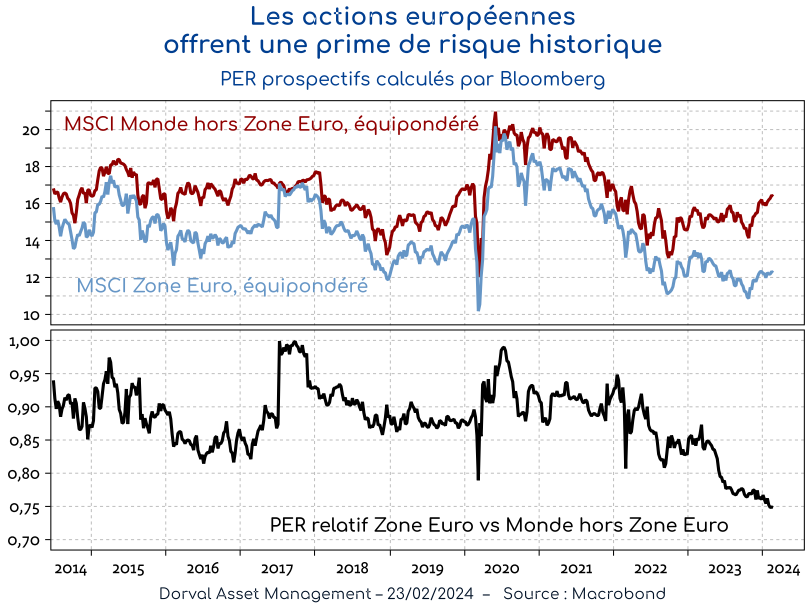
Dear Clients and Partners,

Many investors remain reluctant to invest in the European equity market due to a weak local economic environment. However, European companies listed on a stock exchange are the most often globalised and have an attractive risk-valuation profile, with even the most domestic stocks showing improvement prospects.

Still reeling from the impact of the 2022 energy shock on industry and purchasing power, Europe is suffering from unenviable economic stagnation. This sluggishness has manifested in the stock market by heavily discounted listed European companies (cf. chart 1). On the basis of equal-weighted indices – which allow for comparisons that are less biased by differences in sectoral compositions – the discount of eurozone equities relative to the rest of the world is now **25%**, compared to **10%** historically. We believe that this premium seems exaggerated for several reasons.

European equities offer a historic risk premium

Prospective PERs calculated by Bloomberg

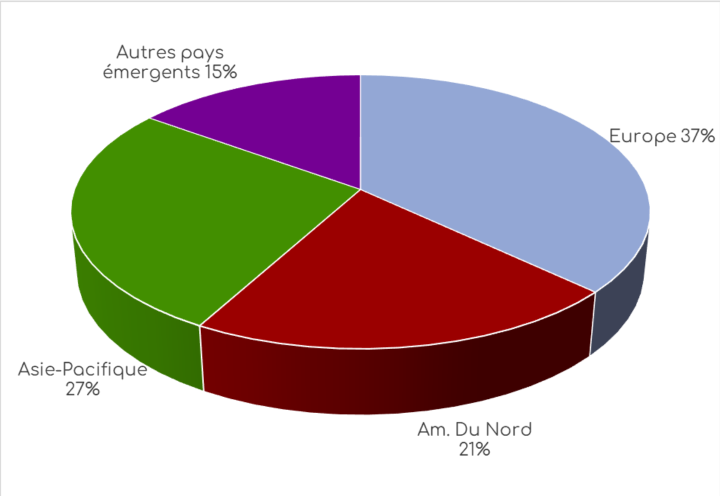


- *MSCI World outside the eurozone, equal weighted / MSCI eurozone, equal weighted*
- *Relative PER eurozone vs. World non-eurozone*

Firstly, most of the European market capitalisation consists of large, often high-growth, multinational companies that suffer only moderately from the local situation. On a weighted average, Europe accounts for less than 40% of the turnover of EURO STOXX 50 companies, compared with 21% for North America, 27% for Asia-Pacific (including China) and 15% for emerging countries (cf. chart 2). Excluding financials, exposure to Europe falls further to only 30%. Made up mostly of attractive, globalised growth securities, the EURO STOXX 50 index logically shows slightly higher security prices than other European indices. However, at 13.5 times expected earnings, its PER remains rather modest compared to the S&P 500 (20.7 times earnings) and the Nikkei (22.1 times earnings).

Geographical distribution of sales of EURO STOXX 50 companies

2023 data weighted by the weight of the securities in the index

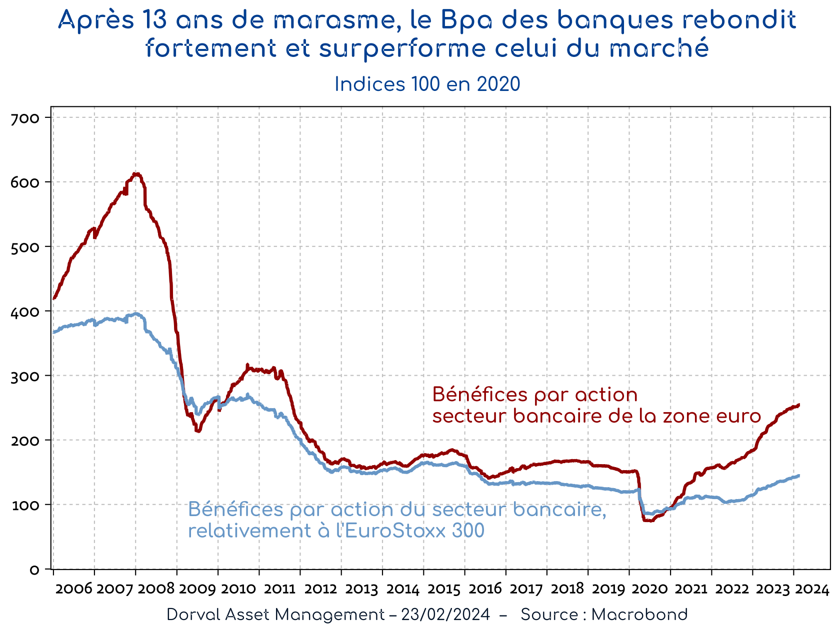


- *Other emerging countries 15% / Europe 37% / North America 21% / Asia-Pacific 27%*

Secondly, the financial sector, which compromised the European stock exchange from 2007 to 2020, is now benefiting from an increasingly convincing turnaround. With 17% of the eurozone's free-float market capitalisation (MSCI EMU), financials just about remain the largest sector of the market according to the GICS 1 classification. Eurozone banks – in a lethal crisis in 2008 and then again during the euro crisis of 2011–12, forced by massive capital increases, and lastly undermined by the ECB's negative rates – have shown a significant recovery since 2020. For the first time since the financial crisis, European banks' return on equity has risen above 10% over the past year. Since the low points of the COVID crisis, eurozone banks' EPS (earnings per share) have increased more than 2.5 times, and banks' outperformance compared to the market in terms of EPS is confirmed again this year (cf. chart 3). As for insurers, they also benefit from a new long-term interest rate regime that is less depressed than in the previous decade.

After 13 years of stagnation, bank EPS had a strong upturn and outperformed the market

100 indices in 2020

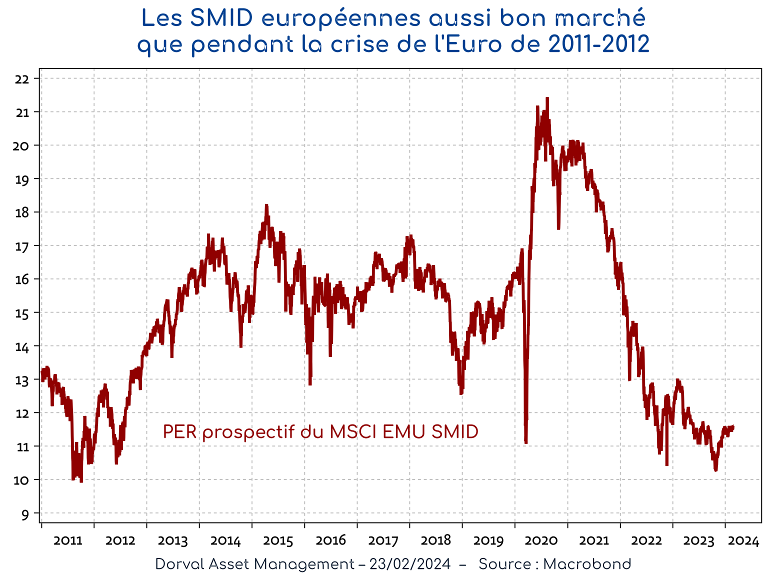


- *Eurozone banking sector earnings per share / Banking sector earnings per share, relative to EURO STOXX 50*

Finally, listed companies in Europe that are most sensitive to the local economic context should benefit from the gradual tandem growth-interest rate improvement that we are expecting for 2024/2025. Currently feeling the impacts of economic stagnation, the highest short-term interest rates since 2008 and fiscal consolidation, these companies will see their environment change. The fall in inflation is putting purchasing power back on an upwards trajectory, and it should also enable the ECB to lower interest rates from the second quarter onwards. In addition, the industrial cycle will benefit both from the imminent end of the inventory run-down process and from the reduction of the recessive impacts of the 2022 energy shock. The price of natural gas in Europe has recently returned to its 2018 level, to €23 per MWh, compared to €50 in February 2023 and between €100 and €200 in the months following the invasion of Ukraine.

Among the listed companies most sensitive to this ever-difficult but evolving European backdrop, the universe of SMID caps (small and medium-sized securities) holds the most attractive valuation (cf. chart 4). According to Bloomberg's calculations, SMID caps' PER is now at the same level as it was during the existential euro crisis of 2011–2012. Will SMID caps see the same return to favour as the banks? This is a possibility to consider. The trigger could come either from a fall in ECB rates or from an economic recovery, or both.

European SMID caps as cheap as during the euro crisis of 2011–2012



- *Prospective PER for the MSCI EMU SMID*

In our European flexible funds, we maintain a high level of exposure to equities, with a core basket reflecting the EURO STOXX 50 index, and an overexposure to bank securities and securities benefiting the most from companies' investment in productivity and energy transition. Since the beginning of the year, we have also invested in a highly diversified basket of 50 small and medium-sized securities (between €500 million and €7 billion in assets under management).

Our exposure rates are as follows:

- **Dorval Convictions:** The equity exposure rate is 70%.

Dorval Asset Management

Public limited company with share capital of €303,924

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