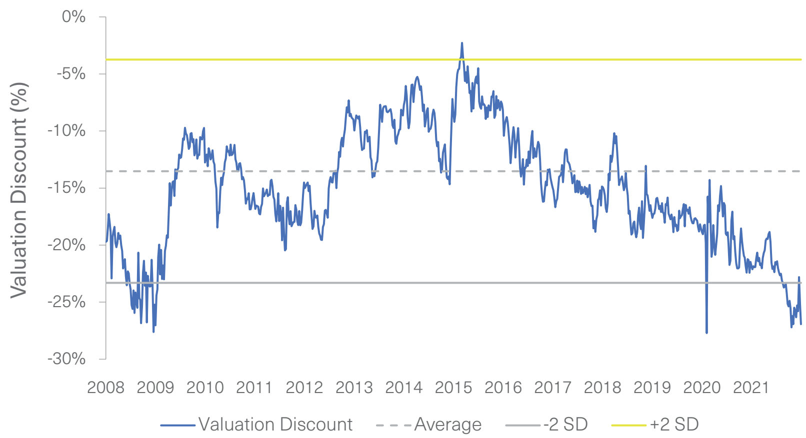
The Stage is Set for Europe

Fund in focus: Brompton European Dividend Growth ETF (EDGF)

European equities have held up better than their U.S. peers during the recent market pullback. Year-to-date, the STOXX 600 Index has dropped less than the S&P 500 Index, while the FTSE 100 Index has actually seen a positive return. Moreover, the STOXX 600 experienced a maximum drawdown of 7.7%, 2.1 percentage points less than the S&P 500. Recent developments show that valuations of European equities have become more appealing than last year, and that the growth picture still looks resilient. Current monetary shifts and fiscal support also sets the stage for Europe.

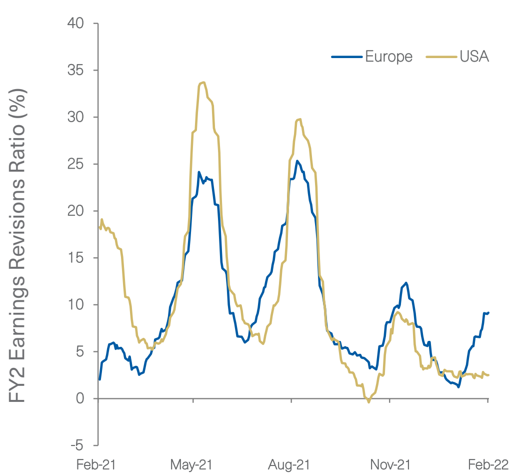
European stocks have never been this cheap compared to the U.S since 2008. The valuation discount of the STOXX 600 vs the S&P 500 has fallen to 27%, which is the same level as during the Great Financial Crisis (Chart 1). On a sector level, 8 out of 11 European GICS sectors are trading at discounts to the U.S., while the discounts are deeper than their corresponding 10-year averages[1]. On a country level, the U.K. is the most inexpensive equity market among major regions and acts as one of the main contributors to Europe's low valuation. Nonetheless, low valuations do not compromise the European corporate earnings profile. Earnings revisions for Europe are picking up and have exceeded its U.S. counterpart by the widest percentage difference over the past 12 months, indicating a higher likelihood of "beat and raise" in the ongoing earnings season (Chart 2). Meanwhile, it is worth noting that around 28% of companies within the MSCI Europe Index trade below 12x forward 12-month P/E, while only 17% trade below that level within the U.S. market[2].

Chart 1: Europe Valuation Discount to the U.S.



Source: Bloomberg (February 4, 2022)

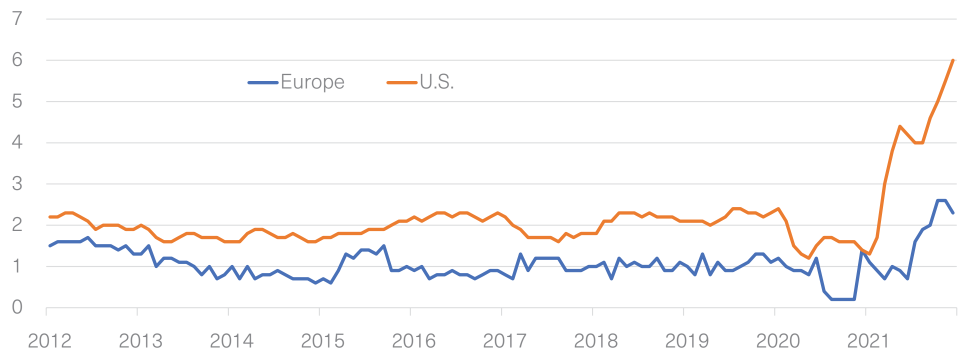
Chart 2: Europe Sees More Upside on Earnings Revision



Source: Morgan Stanley (February 4, 2022)

Economic conditions in Europe are improving as well. Even though inflation is still surging across every country (Chart 3), Europe has had fewer labour problems than the U.S. with higher unemployment of 7.1% vs 4% in the US. We expect to see sequential inflationary pressure ease on the back of the European Central Bank (ECB)'s hawkish rhetoric and the Bank of England (BOE)'s rate hike actions. As 10-year U.K. and German bond yields continue rising, many investors are worried that monetary tightening may cause European stock markets to stumble. It is a valid argument that some sovereigns and corporates with high debt levels may be under pressure in a tightening cycle, but in Brompton's view this will be largely offset by further economic growth. We believe value stocks should benefit from rising yields and the expanding economy, suggesting that Europe has the potential to outperform the world (e.g. MSCI World Index) given its value-oriented structure.

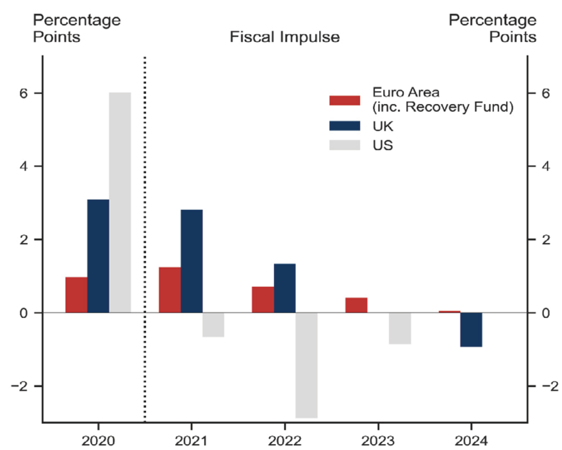
Chart 3: Core CPI %Y



Source: Bloomberg (January 31, 2022)

Furthermore, fiscal policy in European countries will remain expansionary through 2022-23. The European Union Recovery Fund will continue to drive investments in Spain and Italy. The new German government is committed to increasing public investment and fiscal stimulus is extended in France ahead of the presidential election. The U.K. October budget is also expected to support an expansionary fiscal impulse until 2024. This is in direct contrast to the United States where the fiscal impulse has turned negative in 2021 and the drag is set to escalate this year (Chart 4)[3]. In addition, energy transition spending is on the rise, propelled by the Recovery Fund and a "Greener" German government. With climate goals in mind, the energy transition also targets reducing exposure to external fossil fuel suppliers, as more than 60% of energy in Europe relies on fossil fuel imports. ESG dedicated funds should continue to flow into Europe.

Chart 4: Fiscal Impulse



Source: Goldman Sachs (January 7, 2022)

To conclude, we see the recent market turbulence as a buying opportunity and remain bullish on European equities, which now offer an even more attractive risk-reward profile.

Brompton's Approach

Brompton European Dividend Growth ETF (EDGF) focuses on European companies that are leaders in their respective segments. Their leadership positions allow them to remain resilient in times of uncertainty and their operational scale drives strong economics.

[1] Société Générale, The Big Picture, November 24, 2021.

[2] Morgan Stanley, The Risks and Opportunities around Higher Real Yields, January 13, 2022.

[3] Goldman Sachs, 10 Questions for 2022, January 7, 2022.

BROMPTON FUNDS

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