Outlook on

Europe

JAN 2024

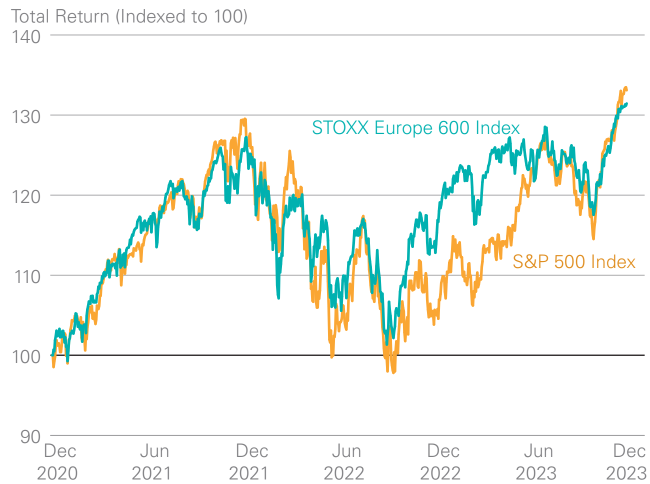
Summary

- Major European economies including Germany have either entered recession or are flirting with it as monetary conditions bite.
- European stocks have been boosted by expectations of interest rate cuts, but our European Equity team is perplexed by the level of markets at the start of a recession. Equity markets run the risk of hitting an air pocket should optimism subside as the full effects of multiple interest rate rises since 2021–2 hit home.
- Although the region's macroeconomic outlook is unpromising, European stocks remain lowly valued versus history and on an international basis, suggesting there could still be scope for share price gains in 2024.
- Our European Fixed Income team also views market expectations of imminent rate cuts in Europe as being overly optimistic, although anticipates a positive year for European fixed income overall.

European Equity

Christmas arrived a fortnight early for many equity investors this year amid hopes of rate cuts in the not-too-distant future. The US Federal Reserve's (Fed) decision to maintain the fed funds rate at 5.25%–5.50% was widely anticipated, but it was also accompanied by a softer-than-expected tone from Chair Powell. For market participants, Powell channelled his inner Santa by indicating the benchmark rate was now "likely at or near its peak for this tightening cycle." Coupled with the release of the Fed's "dot plot", which showed most Fed officials expected the fed funds rate to sit at 4.5%–4.75% by the end of 2024, implying cuts, equity markets surged: the S&P 500 Index hit its highest level since January 2022, while the pan-European STOXX Europe 600 Index touched a 22-month peak (Exhibit 1).

Exhibit 1
US and European Stock Markets Rallied into 2024



As at 31 December 2023
Source: FactSet

LAZARD ASSET MANAGEMENT

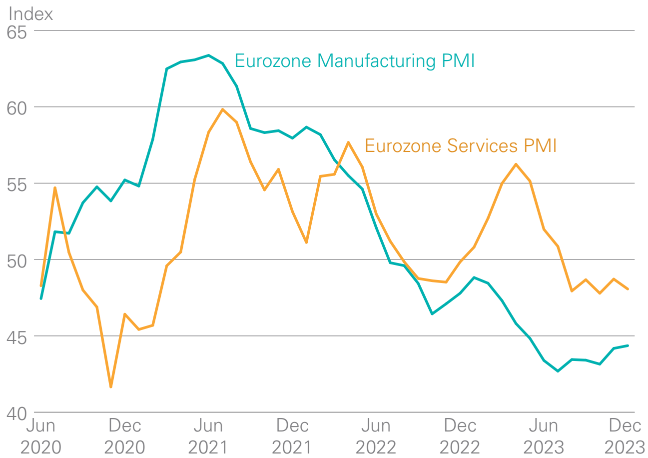
A puzzling market response

For all the end-of-year bonhomie, we think the market's exuberance was just the latest instance of an old market adage: it is often better to travel than to arrive. We believe stock markets have probably got ahead of themselves in this journey, particularly on the question of interest rate cuts. Indeed, our European Equity team finds the stock markets' interpretation of what central banks will do next in each region puzzling.

The greatest optimism on near-term rate cuts is seemingly in the US, but the macro data is weakest in Europe. Most obviously, the wheels of the German economy are spinning slowly. It contracted by 0.1% in Q3 2023 after negligible growth (+0.1%) in Q2 2023, while recent forward-looking survey data have proved disappointing. December's reading for the Ifo business conditions index was well down on forecasts; the latest services and manufacturing purchasing managers' indices (PMI) showed both sectors remain in the doldrums; and the German unemployment rate, at 5.9%, is in touching distance of its pandemic peak. Adding to Chancellor Scholz's woes was a recent surprise ruling by the country's constitutional court. It decreed that €60 billion of unused pandemic borrowing could not be allocated to clean energy and industrial projects. The spending cuts—encompassing transport, industry support measures, and green energy and construction subsidies—now scheduled to fill the resultant hole in the federal government's budget may further crimp German economic growth at the margins.

Elsewhere, the French and Italian economies have also stalled, based on their Q3 2023 GDP figures (-0.1% and +0.1%, respectively) and latest PMI survey readings (Exhibit 2), although the Spanish economy is performing slightly better, growing by +0.3% in the third quarter of last year and enjoying growth in its services sector helped by resurgent tourism.

Exhibit 2
Eurozone Manufacturing and Services Purchasing Managers' Indices (PMI) Indicate Contraction



As at 31 December 2023
Source: FactSet

We have been forecasting for some time that central banks will cause a recession. Based on the above, this now seems to be unfolding in Europe's economic heartland. Received wisdom is that the full effects of interest rate rises are typically not felt until 18 months later. Therefore, if monetary history remains a trustworthy guide, this suggests the impact on economic growth and unemployment from one of the most extreme tightening cycles in modern times is happening now and is far from over, given the European Central Bank (ECB) was raising rates as recently as September. Adding to our caution, with the cost of capital for businesses now at elevated levels, at least by the standards of the 15-year post-Global Financial Crisis period, the risk of some form of financial accident befalling a key sector or component of the economy is accentuated.

It could be much bleaker, though. While the economic backdrop is clearly challenging, the worst-case scenario of policy overshoot seems to have been avoided. Headline and underlying core inflation (which strips out volatile energy and food costs) were on a downward trajectory within the US and Europe over 2023: at 2.4%, the annual eurozone consumer price inflation rate for November was its lowest lowest level since July 2021 and only slightly above the ECB's 2% target, although December's flash number showed an uptick to 2.9%. Meanwhile, important leading indicators in parts of the global economy, most notably within the US, suggest growth is stabilising, even if the picture is less benign in Europe. Given the speed and scale of the monetary tightening undertaken by most major central banks in the past two years, the resilience to date of the global economy and stock markets has been surprising and somewhat remarkable.

Corporate Europe: cheaper, stronger, improving returns, and returning cash

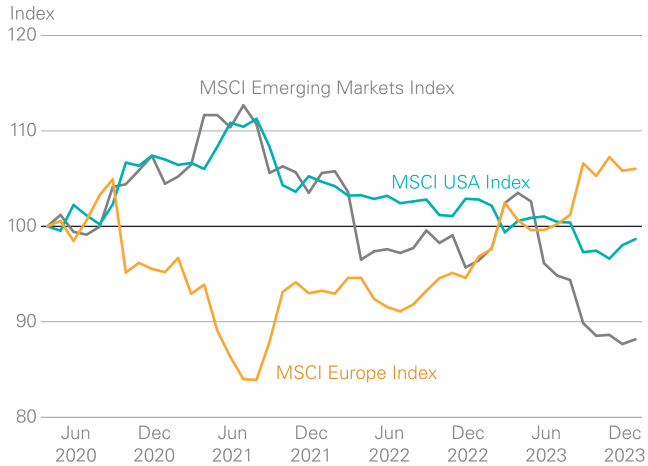
To us, this looks like a normal economic cycle playing out. As such, it puts Europe further down the rate cycle road than other parts of the world and therefore closer to rate cuts. However, we should not get ahead of ourselves. Central banks are likely to be cautious about declaring victory over inflation and will presumably take their time in adjusting policy. Therefore, there is significant potential for the current market optimism, which has built very quickly, to evaporate just as speedily.

But while we argue European equity investors should be on their guard entering 2024, we balance this caution by again noting that the region's stock market valuations remain at very modest levels by historic and international standards. We believe the current economic gloom and insipid near-term outlook for Europe are already baked into share prices. Once markets have become more realistic about the near-term environment, there is still scope for European equities to make ground in 2024.

Barring a fresh energy shock, inflationary pressures should continue to subside across the euro bloc. Meanwhile, consumer demand and confidence may well benefit from wage growth running ahead of inflation, boosting real incomes: annual eurozone wage growth accelerated to 5.3% during Q3 2023, well above the prevailing consumer price inflation rate.

And there are other potential tailwinds for European stocks. Returns on equity (RoE) for European companies have been climbing, in contrast to falling RoEs in other parts of the world (Exhibit 3). Corporate Europe has also been bolstering balance sheets, with European net debt/EBITDA levels dropping by roughly 20% relative to the MSCI World Index. Furthermore, European companies are taking advantage of beaten down valuations to buy back stock at twice their historic average. Coupled with decent dividend yields—the MSCI Europe Index currently yields 2.9%—shareholders may be able to look forward to cash returns of up to 10% in some cases over the next 12 months.

Exhibit 3
Post-Pandemic Returns on Equity by Region



As at 31 December 2023
Source: FactSet

Taking a longer-term perspective, as we detailed in our recent paper '[Europe's Stock Markets: Challenging Misperceptions](#)', the profile of Europe's stock markets has transformed in recent years, even if this change seems to have passed many investors by. The continent's equity markets have become more focused on growth sectors, such as technology, healthcare, and industrials, and less exposed to the cyclical financials and commodities sectors. European companies now also derive more of their earnings from outside the region.

As to where specific opportunities reside, we believe there is currently a great deal of value in many of Europe's global leaders in environmental technologies, from whom market sentiment has swung violently away in the past year. Elsewhere, we find the German residential property market particularly interesting, based on the prospect of higher rents and compelling valuations: the sector is trading on half of its net asset value.

2024: off to the polls

As ever, there is always the chance of unanticipated geopolitical events upending markets. In a bumper year for elections globally, there will be plenty for investors to keep an eye out for, not least the US presidential election late in the year, which could directly affect the fortunes of sectors such as pharmaceuticals. For something more immediate, however, the Taiwanese presidential election on 13 January will help ensure crucial US-China relations start the year high up the agenda.

In summary, the widely anticipated turn in the global interest rate cycle in 2024 may result in a renewed focus on valuations and increased appetite for equities in general. Both would potentially be good news for modestly priced European equities, particularly if the dollar weakens, causing losses for the many global investors who may have become too focused on the US in recent times. As the European economy potentially bottoms out before other parts of the world, diverging economic cycles could lead to a reassessment of asset allocations. Unquestionably, the outlook for European economies in 2024 remains challenged. However, head-scratchingly low equity valuations mean it may not take much for European stocks to progress this year in light of such low expectations.

Outlook on European Fixed Income

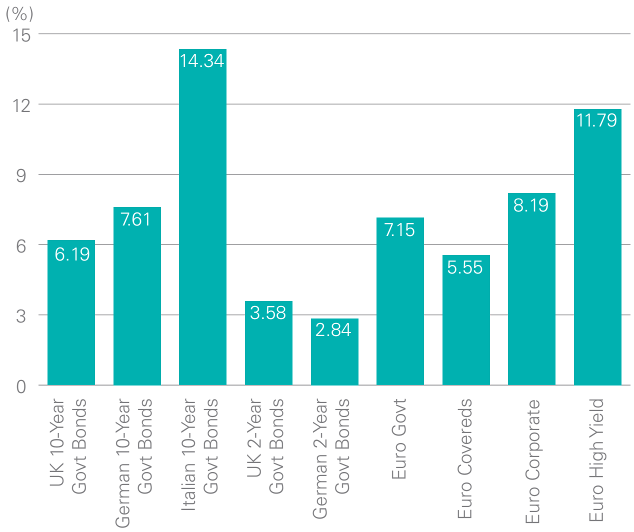
The ECB's tighter monetary policy is increasingly working. At the beginning of 2023, headline inflation in the eurozone was 8.6%; it had cooled to 2.4% for the year to November, still slightly above the central bank's 2% target but marking enough progress for the ECB to leave its benchmark rate unchanged in December at 4.5%, the highest level in 22 years.

While eurozone inflation is moving in the right direction, the Bank of England (BoE) has a greater job on its hands, even if November's inflation data brought some cheer just before Christmas with larger-than-expected falls in both the headline and core numbers. At 3.9%, UK headline consumer price inflation is still well above the central bank's target, while core inflation stands at 5.1%. After a phase of rapid interest rate hikes (14 in a row), the BoE paused in December, for the third month in a row, and left the UK base rate unchanged at 5.25%. However, the decision to pause was the subject of internal debate—three members of the Monetary Policy Committee (MPC) were in favour of a further 25-basis point hike while six MPC members voted for the status quo.

2023: a good year

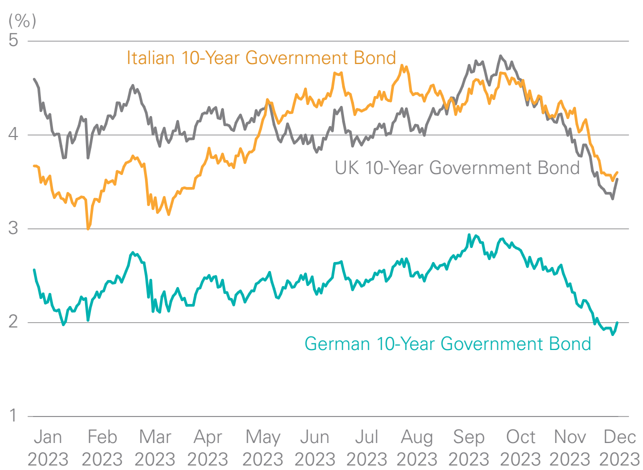
Overall, 2023 was a good year for European fixed income. All segments ended the year with a positive performance (Exhibit 4). In our view the perception that central banks have won the battle against inflation and the possibility of rate cuts in the first half of 2024 caused government bond yields to fall sharply at the end of the year (Exhibit 5). Corporate bonds also performed strongly due to their falling risk premia (Exhibit 6), shrugging off the weak economic backdrop. Despite elevated recession risks forecast by many investors, European high-yield bonds performed significantly better than investment-grade bonds over the year.

Exhibit 4
European Fixed Income Performance in 2023



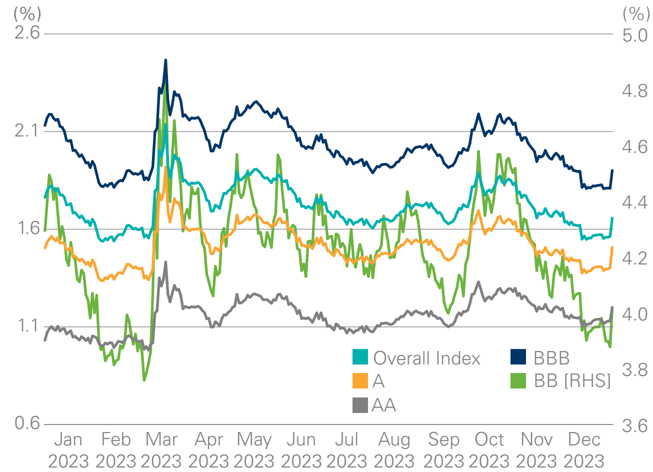
As at 31 December 2023
Source: Datastream

Exhibit 5
10-Year Government Bond Yields



As at 31 December 2023
Source: Datastream

Exhibit 6
Credit Spreads over 5-Year German Bunds

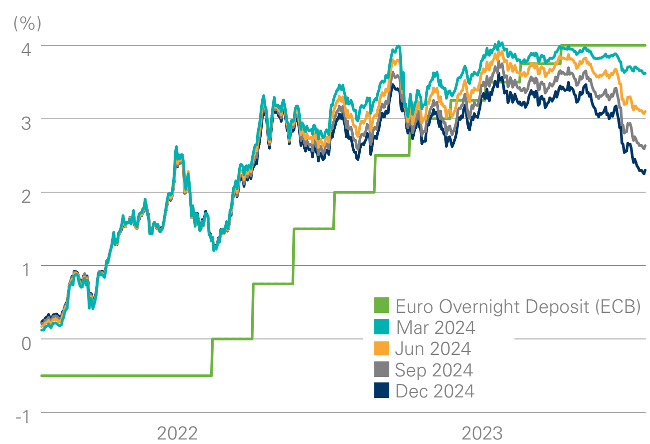


As at 31 December 2023
Source: Datastream

As 2024 kicks off, the outlook for the eurozone is mixed. While encouragement can be drawn from data showing inflation cooling, high wage growth, and a solid labour market, recession risks are pronounced, as evidenced by PMIs signalling a sharp slowdown in economic activity. Inverted yield curves are another crisis indicator that have proven effective over many decades, and these suggest heavy economic weather lies ahead.

Markets are pricing in cuts in eurozone interest rates as early as Q1 2024 (Exhibit 7). We disagree and believe markets are being too optimistic. We also anticipate rate cuts this year, but we expect the ECB to continue to assess economic developments in the first half and only trim over the course of the second half if appropriate. This view is supported by ECB President Lagarde's statement that rate cuts have not even been discussed yet.

Exhibit 7
Eurozone Implicit Rates



As at 31 December 2023
Source: Datastream

We also expect that the BoE will follow the ECB's rate cut path. However, with inflation falling more slowly in the UK, it may initiate cuts later than the ECB. The economic outlook for the UK is rocky. Inflation is still high, although at least it is now responding to the central bank's actions. UK rates will probably have to remain at their current level for a longer period to push inflation down to a sustainable 2% level.

We are optimistic over the performance potential and appeal of European fixed income in 2024. In our view, bonds look more attractive (even compared to equities), and we believe they could offer scope for significant returns.

Where are the risks? Overall, we believe the environment will be uncertain, with rate volatility risks staying high. We think the greatest risk is a major economic shock that drives up default rates dramatically. However, this scenario lies outside consensus expectations for now. Of course, Europe is facing low, even slightly negative, economic growth in some parts, but a sharp downturn is not our base scenario. Nevertheless, we believe default rates will tick up and cracks might appear in the economy, particularly in corporate earnings. Much tighter monetary policy is not yet fully reflected in weaker economic data. This could potentially have an increasingly negative impact on companies.

Given the above, we still prefer investment grade over high yield. In the eurozone high-yield segment, higher quality issuers might offer some relative value. In addition, Nordic high-yield debt may be interesting. Scandinavian high-yield issuers have a superior debt profile on average (better interest coverage ratio and lower net leverage), and we believe the economic risks here are more fairly priced, given substantially higher spreads than in the eurozone or US high-yield markets.

Another downside risk could arise from a reawakening in inflation. This would call for further restrictive monetary policy steps that would likely have negative economic repercussions. As described above, this is not an expected scenario for us. We anticipate inflation (headline and core) will moderate further, but do not exclude the possibility that there will be some upside surprises due to shocks (e.g., attacks by Houthi rebels putting strains on global shipping). However, we expect the direction of inflation to be downwards in 2024.

Considering everything, we expect a positive environment for fixed income overall. However, as described above, we believe particular caution should be exercised in the high-yield segment. Active management will be the key to success.

This content represents the views of the author(s), and its conclusions may vary from those held elsewhere within Lazard Asset Management. Lazard is committed to giving our investment professionals the autonomy to develop their own investment views, which are informed by a robust exchange of ideas throughout the firm.

Important Information

Published on 8 January 2024.

Information and opinions presented have been obtained or derived from sources believed by Lazard Asset Management LLC or its affiliates ("Lazard") to be reliable. Lazard makes no representation as to their accuracy or completeness. All opinions expressed herein are as of the published date and are subject to change.

An investment in bonds carries risk. If interest rates rise, bond prices usually decline. The longer a bond's maturity, the greater the impact a change in interest rates can have on its price. If you do not hold a bond until maturity, you may experience a gain or loss when you sell. Bonds also carry the risk of default, which is the risk that the issuer is unable to make further income and principal payments. Other risks, including inflation risk, call risk, and pre-payment risk, also apply. Securities in certain non-domestic countries may be less liquid, more volatile, and less subject to governmental supervision than in one's home market. The values of these securities may be affected by changes in currency rates, application of a country's specific tax laws, changes in government administration, and economic and monetary policy. Derivatives transactions, including those entered into for hedging purposes, may reduce returns or increase volatility, perhaps substantially. Forward currency contracts, and other derivatives investments are subject to the risk of default by the counterparty, can be illiquid and are subject to many of the risks of, and can be highly sensitive to changes in the value of, the related currency or other reference asset. As such, a small investment could have a potentially large impact on performance. Use of derivatives transactions, even if entered into for hedging purposes, may cause losses greater than if an account had not engaged in such transactions.

The STOXX Europe 600 Index comprises the largest 600 companies in the STOXX Europe Total Market Index (TMI), covering large-, mid-, and small-capitalization ranges. (The STOXX Europe TMI represents approximately 95% of the free-float market capitalization across countries of the European region: Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom.) The index is unmanaged and has no fees. One cannot invest directly in an index. The S&P 500 Index is a market capitalization-weighted index of 500 companies in leading industries of the US economy. The index is unmanaged and has no fees. One cannot invest directly in an index. The MSCI World Index is a free-float-adjusted market capitalization index that is designed to measure global developed market equity performance comprised of developed market country indices. The index is unmanaged and has no fees. One cannot invest directly in an index. The MSCI Europe Index is a free-float-adjusted market capitalization index that is designed to measure equity market performance in the developed markets countries of Europe. The index is unmanaged and has no fees. One cannot invest directly in an index. Certain information included herein is derived by Lazard in part from an MSCI index or indices (the "Index Data"). However, MSCI has not reviewed this product or report, and does not endorse or express any opinion regarding this product or report or any analysis or other information contained herein or the author or source of any such information or analysis. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any Index Data or data derived therefrom.

Certain information contained herein constitutes "forward-looking statements" which can be identified by the use of forward-looking terminology such as "may," "will," "should," "expect," "anticipate," "target," "intent," "continue," or "believe," or the negatives thereof or other variations thereon or comparable terminology. Due to various risks and uncertainties, actual events may differ materially from those reflected or contemplated in such forward-looking statements.

This document reflects the views of Lazard Asset Management LLC or its affiliates ("Lazard") based upon information believed to be reliable as of the publication date. There is no guarantee that any forecast or opinion will be realized. This document is provided by Lazard Asset Management LLC or its affiliates ("Lazard") for informational purposes only. Nothing herein constitutes investment advice or a recommendation relating to any security, commodity, derivative, investment management service or investment product. Investments in securities, derivatives and commodities involve risk, will fluctuate in price, and may result in losses. Certain assets held in Lazard's investment portfolios, in particular alternative investment portfolios, can involve high degrees of risk and volatility when compared to other assets. Similarly, certain assets held in Lazard's investment portfolios may trade in less liquid or efficient markets, which can affect investment performance. Past performance does not guarantee future results. The views expressed herein are subject to change, and may differ from the views of other Lazard investment professionals.

This document is intended only for persons residing in jurisdictions where its distribution or availability is consistent with local laws and Lazard's local regulatory authorizations. Please visit www.lazardassetmanagement.com/globaldisclosure for the specific Lazard entities that have issued this document and the scope of their authorized activities.

This report is being provided for informational purposes only. It is not intended to be, and does not constitute, an offer to enter into any contract or investment agreement with respect to any product offered by Lazard Asset Management, and shall not be considered as an offer or solicitation with respect to any product, security, or service in any jurisdiction or in any circumstances in which such offer or solicitation is unlawful or unauthorized or otherwise restricted or prohibited.