Europe Insights

Closing the gaps

November 2024

For professional investors only

HSBC Asset Management

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In a nutshell

Macro review

Europe’s accelerating transformation

- Estimates from various recent reports reveal that Europe requires annual investments of about 5% of EU GDP, or €750 billion, to spur growth and close the persistent gap in economic competitiveness with the US.
- New challenges for the region came to the fore during the pandemic and the energy crisis. EU has already undertaken several region-wide initiatives to address these issues by improving energy resilience, cross-border transport infrastructure, and digital data security among others, aiming for a more integrated economy.
- Europe's complex regulatory landscape also often hampers firms, especially SMEs, from fully capitalising on intra-EU investment opportunities. The Capital Markets Union and the proposed Savings and Investment Union could potentially alleviate these issues.

European equities

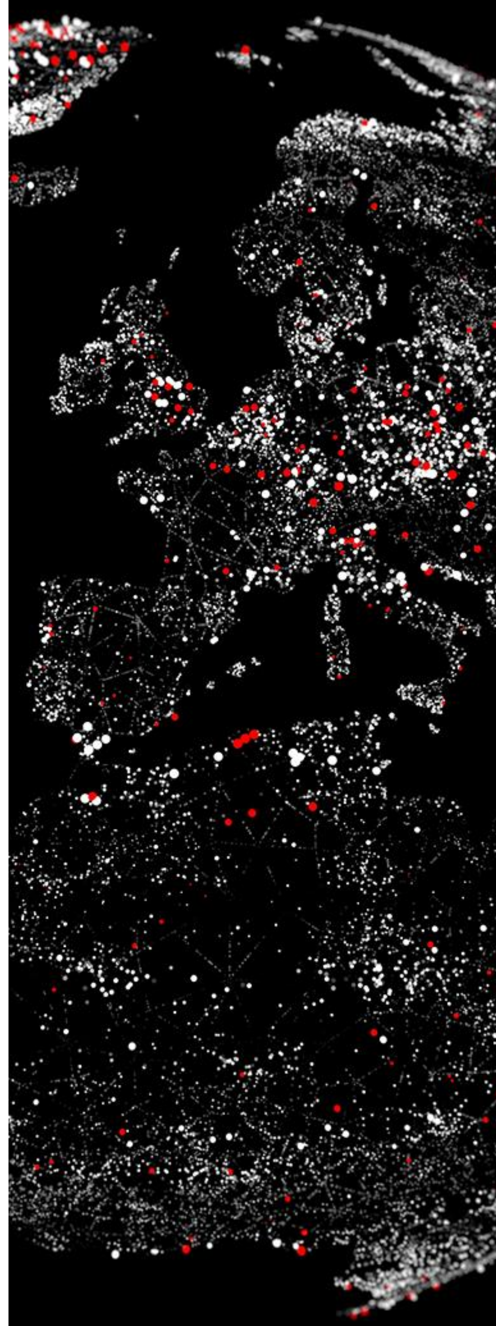
The return of high dividend yielding stocks?

- The previous underperformance of high-yield stocks was primarily attributed to a contraction in valuation multiples. However, as these multiples normalize, these stocks could potentially provide capital appreciation alongside a stable and growing income stream.
- European high-dividend stocks have emerged as winners in the ongoing competition between growth and value stocks. The top dividend quintile in the European market offers yields of around 7%. These stocks may be worth considering due to their high carry trade advantages and defensive qualities, especially when compared to their global counterparts.

European fixed income

Spread differential between US and Euro credit

- European bonds have shown wider credit spreads compared to US bonds in recent years, particularly following the economic disruptions from the COVID-19 pandemic.
- The comparison between the two markets is complicated by structural differences—such as sectoral exposure—but the spread differential seems to be mostly driven by contrasting macroeconomic conditions.
- While European default rates have normalized, forecasts indicate further widening growth divergences between the US and Europe, which might cause the spread differential between the two regions to endure.



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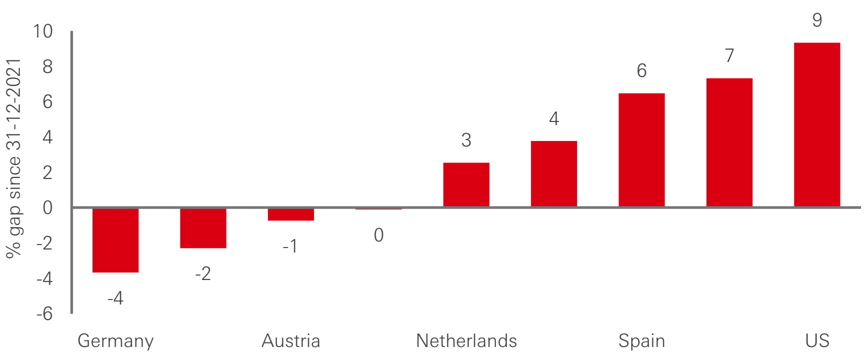
Europe’s accelerating transformation

As the Capital Markets Union matures, it could lessen the region's reliance on public funding, fostering a more dynamic and competitive European economy.

The longstanding concern of Europe's lagging economic competitiveness compared to the US has persisted for over three decades. A series of recent reports[1] highlight the need for Europe to close this gap, estimating that annual investments amounting to approximately 5% of EU GDP, or €750 billion, are required to stimulate growth and competitiveness. However, the Eurozone, particularly since the 2022 energy crisis, has struggled to match the investment momentum seen in the US, driven by a downturn in Germany and stagnation in France. The investment trend differs elsewhere. Private investment has seen a rise in Italy, Spain, Belgium and Greece, and to a lesser extent in the Netherlands.

Europe lags behind the US in economic competitiveness and faces an annual investment gap of around 5% of EU GDP.

Figure 1: Private investment change by country



Source: OECD, European Union websites – Data as of 4 October 2024

These reports recommend a series of comprehensive measures to strengthen the EU’s institutional framework by enhancing interconnectivity and synergies across the EU's 28 member states. Greater cooperation, the development of pan-European infrastructure, and regulatory harmonisation are seen as key to enabling businesses to better exploit intra-EU opportunities. A fully realised Capital Markets Union (CMU) could also reduce companies' dependency on fragmented national financial instruments, providing greater resilience to economic shocks and bolstering regional competitiveness. All these proposals are expected to be a focal point for the newly-elected European Parliament and Commission.

The pandemic and the energy crisis highlighted the need for cross-border infrastructure to address emerging security and supply chain challenges.

1. The Draghi report on “The future of European competitiveness” (September 2024). Enrico Letta report “Much more than a market : “Speed, Security, Solidarity” – April 2024. European Parliament report “Pan-European Public Goods: Rationale, Financing and Governance” – June 2024.

In response, several EU-wide initiatives are now underway. The EU's RePower plan aims to enhance energy resilience through projects such as gas pipeline connections for its delivery and storage, and electricity grid integration. Meanwhile, the Trans-European Transport Network regulation seeks to establish common standards to spur investment in cross-border transport infrastructure, including rail, ports, airports, and key logistics hubs. Other EU initiatives include the Common Market for the Security and Defense industry, promoting collaboration in cutting-edge technologies with potential spillovers to the private sector. On the digital and data infrastructure front, the EU is working on securing cross-border data flows, ensuring the interoperability of data protection regulations, and facilitating efficient transfer of non-personal data vital to research and innovation.

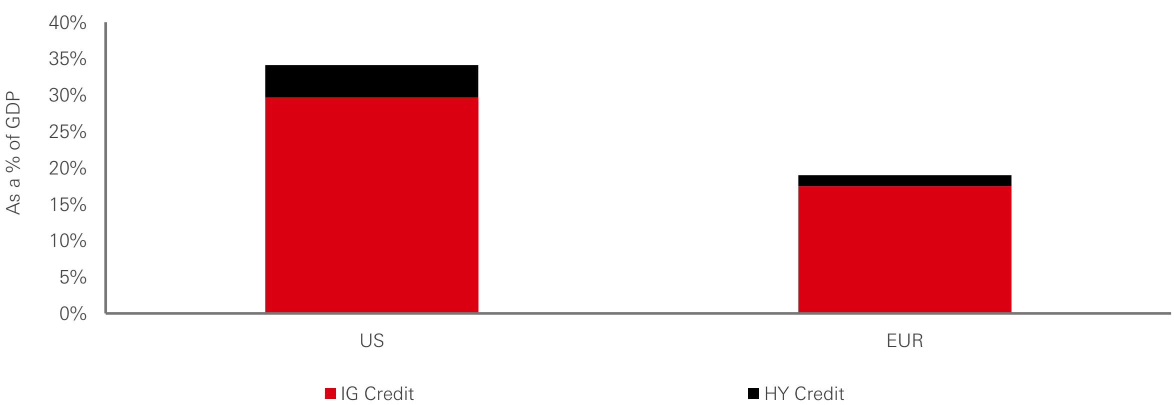
Addressing funding availability for firms

One of the key reasons behind the EU's investment shortfall compared to the US is the inherent fragmentation of the EU's funding system, which is burdened by its complex web of regulations. Nevertheless, Europe is not short of either public or private resources — for example, private savings across the region amount to approximately €33 trillion, much of which is held in currency and deposits. However, these vast resources are often diluted across various national and EU funding instruments. Firms, notably small and mid-size companies, lack the legal expertise to fully exploit intra-EU investment opportunities, unlike larger corporations.

Moreover, the inherent regulatory constraints, including those for the green transition, pose challenges for key sectors such as automotive, agriculture, and food production, which are crucial for employment. Financing this transformation requires extensive negotiations to optimise the allocation of both national and EU public resources. Streamlining these efforts could enable the region to benefit from the competitive advantages of its diverse economies. However, the whole process slows down the necessary transformation of the European economy.

An alternative to the extensive negotiations is accelerating the CMU. This would simplify and expand access to funding for businesses by enabling the issuance of harmonised financial instruments capable of supporting a wide range of projects across the region. To address the challenge of harmonising national regulations, an EU-wide financial supervision model, similar to the Single Supervisory Mechanism for the banking sector, could be developed. This model would focus on overseeing major entities based on their size, cross-border activities, and systemic importance.

Figure 2: Credit market capitalisation – US versus EU



Source: Merrill Lynch, IMF – Data as of 4 October 2024

Additionally, the creation of a Savings and Investment Union is being considered, with the aim of expanding European savings products. These instruments would complement existing long-term plans promoted by banks[2] and provide more efficient means of channeling capital to high-priority projects.

Ultimately, these recommendations will be placed on the agenda of the newly elected EU parliament and the Commission, but national governments will have the final say on their implementation. With many EU countries facing high public debt levels and fiscal constraints, the increased political resistance could potentially diminish for an accelerated capital market integration. As the CMU matures, it could reduce the region's dependence on public funding, facilitating a more dynamic and competitive European economy.

As many EU countries grapple with high public debt and fiscal constraints, growing political resistance may hinder the acceleration of capital market integration.

2. The European Long-Term Investment Fund (ELTIF) was introduced in 2015 with minimal results so far (fewer than 100 funds distributed over 8 years, primarily in France and Italy). The ELTIF aims to raise long-term financing for infrastructure projects, unlisted companies and listed SMEs. The 2024 reform brings simplifications for asset managers and distributors, and is expected to provide momentum to this instrument The Pan-European Personal Pension Product (PEPP) set up in 2019 offers portability if a saver moves from one EU Member State to another.

European equities

The return of high dividend yielding stocks?

> High dividend yield stocks have lagged behind growth stocks over the past decade, but the valuation gap between these segments may now be set to normalize.

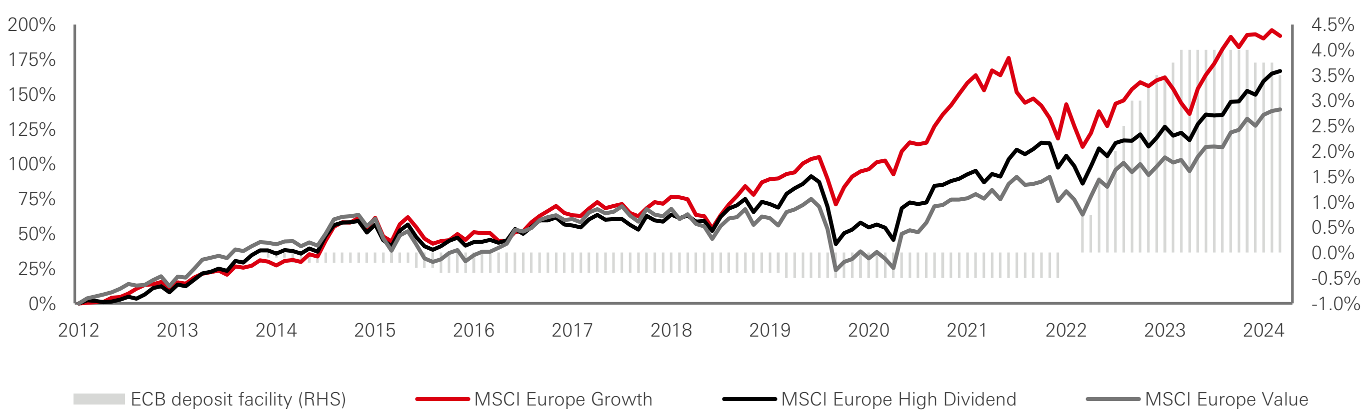
In July 2012, ECB President Mario Draghi's landmark 'whatever it takes' speech ushered in a period of quantitative easing, lowering the ECB deposit policy rate to 0%. Low interest rates and abundant liquidity provided strong tailwinds for value stocks, which saw a cumulative outperformance of 15% versus growth stocks over the following two years, despite their short-duration characteristics.

However, this unprecedented monetary stimulus did not significantly boost economic growth, leading to an extended period of low interest rates. By 2017, the appeal of value stocks had waned, as investor sentiment shifted towards growth stocks, particularly those demonstrating sustained growth regardless of domestic market performance. It led to a widening valuation gap between growth and value segments which was exacerbated by the pandemic, with growth stocks delivering an additional 60% of outperformance from late 2019 to the end of 2021.

A shift occurred in early 2022, as rising inflation drove a rotation from growth to value stocks amid expectations of interest rate normalization. However, the value rally had already lost momentum by the time the ECB initiated its first-rate hike in July 2022. Since then, markets have oscillated between growth and value, with no clear leadership emerging.

Since the beginning of ECB' hiking cycle, markets have oscillated between growth and value stocks without any clear direction.

Figure 1: European style returns across the interest rate cycle



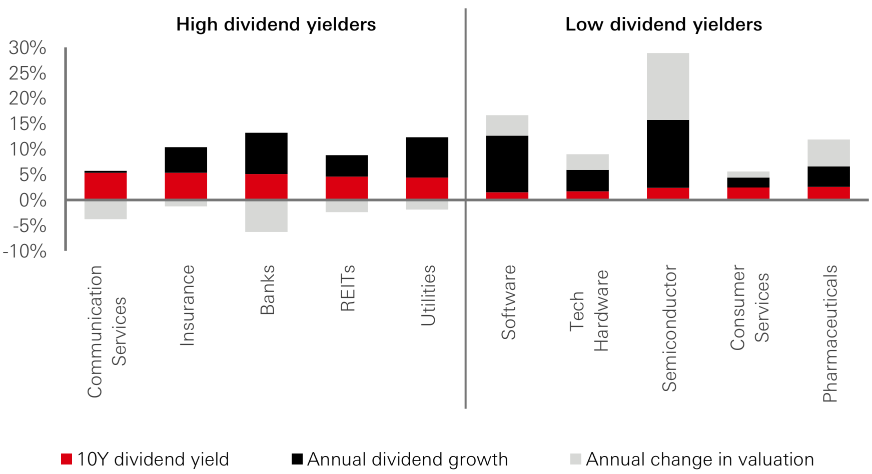
Sources: HSBC AM, Bloomberg, data as of October 2024.

Amidst this backdrop, high-dividend yield stocks have started to gain prominence, particularly since the ECB’s first rate cut in June. One obvious reason for this trend is that Europe offers some of the highest dividend yields globally, with the top quintile of high-dividend stocks exceeding 7%. across various sectors. With growth stocks currently trading at over 2.5 times the broader market's valuation – which makes them sensitive to even minor earnings downgrades – high dividend stocks have also attracted investors fearing a potential recession in the region.

Since total stock returns are dependent on dividend yields, dividend growth and changes in valuation multiples, then total returns can be estimated through the sum of dividend yield and its growth rate when valuation multiples remain unchanged. The long-term growth rate of dividends generally is in line with earnings growth, but dividends tend to be stickier and more stable than earnings. This is because companies are reluctant to reduce dividends. In fact, many firms provision dividends even during loss-making years to maintain investor confidence.

Although financial theory suggests that high-yield stocks typically have lower growth rates, empirical data shows that sectors with high dividend yields often also exhibit strong dividend growth. For instance, dividend growth has been the dominant driver of total returns for sectors such as banks and utilities over the past decade.

Figure 2: Performance gap between European high and low yielders explained by extreme changes in valuation multiples



Sources: HSBC AM, Bloomberg, data as of 3 October 2024.

Over the last decade, high dividend yield stocks have underperformed their growth counterparts, which benefited from a substantial expansion of multiples. High yield sectors experienced an average annual valuation contraction of 3.1%, while low yield sectors saw an annual expansion of 5.4%. This suggests that high dividend investors could now benefit from both a significant income stream and capital gains as the valuation gap normalizes.

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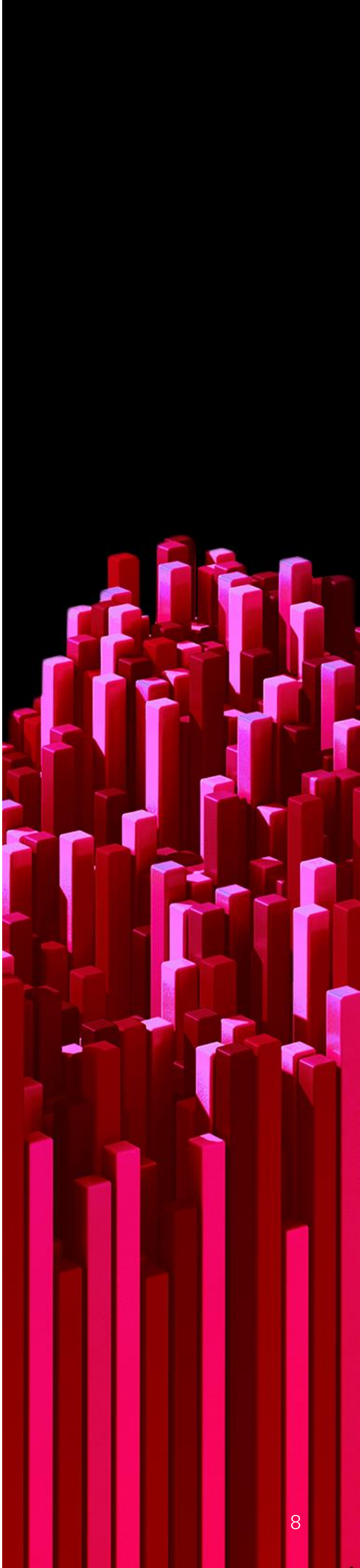


Spread differential between US and Euro credit

> The spread differential between European and US bonds cannot be attributed solely to structural market differences; it also reflects deeper macroeconomic contrasts.

In recent years, particularly after the economic disruptions caused by the Covid-19 pandemic post-2020, European bonds have exhibited wider credit spreads than their US counterparts. Looking at historical patterns of representative indices, we observe that euro credit spreads (both investment grade and high yield) were narrower than or similar to those of the US, notably when quantitative easing was applied on both sides of the Atlantic.

Figure 1: IG corporate credit spreads (OAS vs. Gvt)

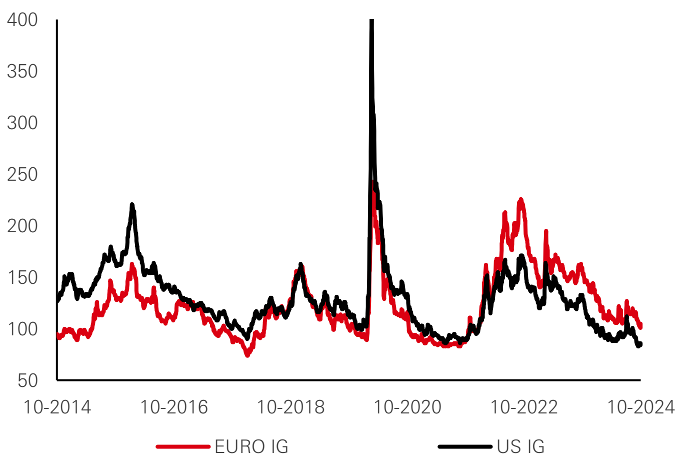
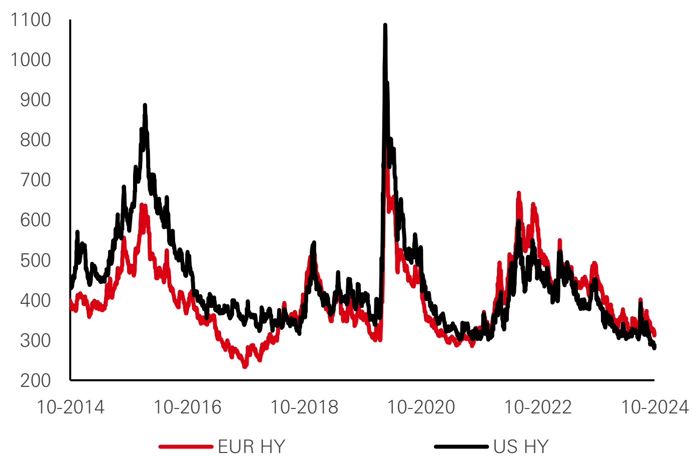


Figure 2: HY corporate credit spreads (OAS vs. Gvt)



Sources: HSBC AM, Bloomberg, data as of November 2024.

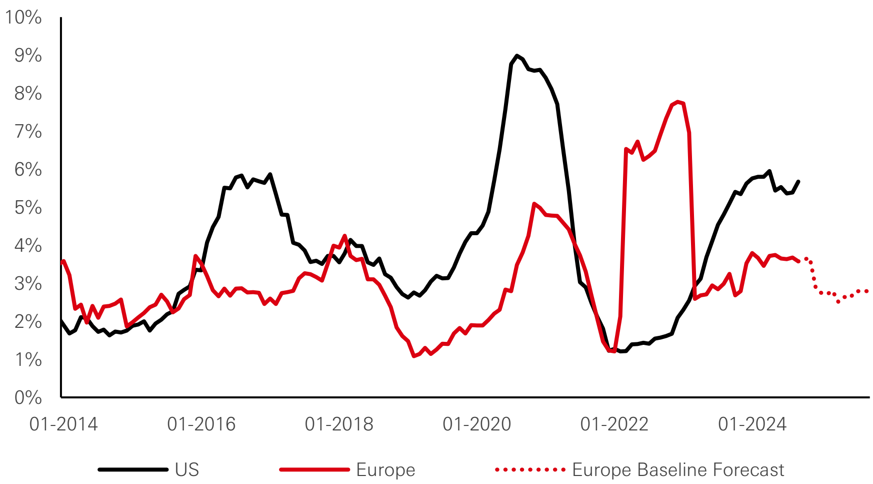
Indeed, this is not exactly a like-for-like comparison since the European market's overall duration is significantly lower (4.5 vs. 6.7 for investment grade and 2.8 vs. 3.2 for high yield). Corrected for that effect, today's credit spread gap between the two regions would be even more significant. Similarly, these indices reflect some regional differences from a sectoral perspective, with US indices being more exposed to technology, while financials are much more present in European indices. We also observe a significant difference in credit quality between Euro (stronger) and US (weaker) indices, especially on the high yield side.

With this in mind, the shift in hierarchy of spread levels cannot be solely explained by the structural differences between these two markets. It also reflects contrasting macroeconomic landscapes. Logically, one could think that lower government bond yields in Europe necessitate higher spreads to attract global capital. Similarly, the current economic landscape in Europe reflects slower growth in contrast to the robust performance of the US economy. The same applies to currencies, with the US dollar's appreciation contributing to this shift as well.

Additionally, Europe faces structural challenges, including geopolitical risks that exacerbate uncertainty for European corporates. The ongoing conflict in Ukraine has far-reaching implications for energy markets, impacting various sectors unevenly. Events in the Middle East add further uncertainty.

More fundamentally, spreads are inevitably linked to present and anticipated default rates. The significant increase in default rates in Europe in 2022 can also explain the relative increase in spreads in Europe. Since then, European default rates have largely normalized and remained below those observed in the US for over a year.

Figure 3: US and Euro default rates



Sources: Moody's and HSBC AM, data as of 30/09/2024.
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Looking forward, default rates are forecasted to continue stabilizing. Likewise, the overall Euro outlook seems brighter than a few months ago, but it won't be enough to stop the widening growth divergence~~s~~ between the US and Europe. In its October report[1], the IMF upgraded US growth forecasts while downgrading those for the Eurozone, calling for increased public investment in the region. This won't help reduce the spread differential between the two regions.

Given current spread levels and the yield curve set to steepen, asset class returns will increasingly hinge on income components rather than capital appreciation—although less inflation risk and more pronounced growth risks support the case for duration in Europe. With higher credit ratings than their US counterparts, lower probabilities of default, and a more defensive sector composition, European credit remains an option for global asset allocators to consider.

The performance of the European fixed income market increasingly relies on income rather than capital gains.

1. International Monetary Fund: https://www.imf.org/en/Publications/WEO/Issues/2024/10/22/world-economic-outlook-october-2024.

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Data watch

As of 22 November 2024

Eurozone growth surprised to the upside in Q3. While inflation was also up in October, it is still below ECB's forecasts. However, rising costs from potential US tariffs as well as from climate change adaptation will remain risk to the inflation outlook. The ECB has continued with policy easing but terminal rate remains uncertain.

Economic Indicator	Data as of	Last data	Consensus	Previous data	Analysis
PMI composite	Nov	48.1	50.1	50.0	Eurozone PMIs surprised to the downside, signalling stagnation into Q4 with downside risks. Sector wise, the manufacturing PMI dropped again into contraction territory, with the prospect of lower employment as well as falling input and output prices. Led by the payback from the Olympics in France, the services PMI dipped to its lowest level since January, pointing to stagnation of the sector, amid rising prices and ongoing job creation
GDP growth qoq	Q3 2024	0.4%	0.2%	0.2%	Eurozone GDP growth surprised to the upside, driven by Spain (+0.8%), the Netherlands (+0.8%) and France (+0.4%). For several quarters in a row, Spain has outperformed, now being the engine of eurozone growth. The region saw a broad-based recovery in household consumption, notably in France (thanks to the Olympic games), but also in Germany, Italy and the rest of Europe. A recession was avoided in Germany (+0.2% in Q3), but this was offset by a downward revision to the previous quarter's contraction (from -0.1% to -0.3%)
Industrial production % yoy	Sep	-2.8%	-2.0%	-0.1%	Eurozone industrial production keeps contracting, with September production below the Q3 average. Spain is the outlier, with industrial production showing a broad-based resilience and strong growth in electronics and computers. Elsewhere, underlying manufacturing trends remain weak ahead of the potential impact of the next US administration's trade policies. Lower interest rates and demand rotation from services back to goods, as well as China stimulus could provide some offsetting support
Unemployment rate	Sep	6.3%	6.4%	6.3%	The eurozone unemployment rate remains at a record historical low level, and has barely moved since March 2023. Labour hoarding, high rates of sick-leave, a large share of the workforce approaching retirement age may have contributed to this resilience. Unemployment is rising slightly in northern-core eurozone countries (Germany, France, Austria, Belgium, and Finland) but this is more than offset by improvement in Spain and Greece, and record low levels in Italy. Eurozone job growth held up through the summer, in line with the average seen in the previous four quarters. Productivity growth is improving (flat) after being negative since early 2023
Trade balance (goods, ex EMU) EUR billion (12Mth cumulative)	Sep	179.8	174	175.2	The eurozone trade balance (on a cumulative 12-month basis) keeps increasing, due to a sharper contraction of imports (-9% yoy) compared to exports (-1% yoy). The drop of energy prices has significantly improved the terms of trade. The eurozone trade surplus now stands at 1.2% GDP, but has not reached its pre-pandemic level of EUR 208 billions in December 2019. Looking ahead, uncertainties about US tariffs should further weigh on eurozone exports, as the US is its major partner (23% of total eurozone goods' exports)
Retail sales % yoy	Sep	2.9%	1.3%	2.4%	Eurozone retail sales surprised to the upside, reflecting an improving momentum. The ongoing disinflation together with a resilient labour market, rising real income and elevated savings should keep supporting private consumption
Inflation - Headline CPI, % yoy	Oct	2.0%	1.9%	1.7%	Eurozone inflation surprised to the upside in October, but still below the ECB's forecasts. This was driven by higher food prices (2.9% yoy from 2.4% in Sept) and services prices (4.0%, amid a rebound in airfares in Italy and Germany, as well as higher education fees). Risks to the outlook are broadly balanced. Falling inflation expectations and slowing posted wage growth may signal that services' price stickiness should remain under control (services inflation has been moving sideways at around 4.0% since Nov. 2023). Upside risks to the inflation outlook include rising costs from potential US tariffs as well as from climate change adaptation
- CPI core*, % yoy	Oct	2.7%	2.6%	2.7%	
ECB Refinancing rate	17 Oct	3.40%	3.40%	3.65%	The ECB cut its policy rates, as expected, keeping no pre-commitment to a particular rate path. Ongoing disinflation and weak business confidence surveys have increased the focus on growth concerns. The ECB is widely expected to keep on cutting its policy rate over the coming months. But uncertainties remain over the terminal rate of this cycle, with divergences over the pace of rate cuts ahead. During the December meeting, the ECB will release its new projections
Deposit rate		3.25%	3.25%	3.50%	

Improved or better-than-expected | Worsened or below-expectations | Unchanged or in line with expectations | **F**: Final **A**: Advanced **P**: Preliminary estimate

* Eurozone Core CPI is CPI excluding energy, food, alcohol & tobacco
Sources: Bloomberg, Refinitiv, Eurostat, HSBC Asset Management – data as of 22/11/2024

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