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European Equity Markets Commentary

European equities viewpoint: structural tailwinds vs. cyclical headwinds?

The recent earnings season represented a resilient start to the year, with revisions largely remaining positive. While expectations had previously been lowered by downgraded analyst expectations, this is nevertheless a positive foundation and sets an upbeat tone for the rest of 2023. Indeed, earnings in Europe are proving to be very resilient, with both revisions and 12-month forward earnings trends performing better than the US. While a shallow European recession may appear in H2, a deeper corporate recession across FY 2023 is now unlikely.

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The trend this year is thus one towards normalization after a disruptive and distortive 2022. Natural gas and power prices have normalized, and supply chain issues have begun to ease with many corporates now converting order backlogs into sales and profits. While some cyclical concerns do remain, the parts of the investment universe that follow these patterns have delivered convincing performances; chemicals, industrials and automotive all posted strong results, while parts of the consumer sector have been standouts with extremely strong demand for luxury goods couple with price increases – rather than volume growth – across other subsectors.

Looking beyond the recent impressive earnings season, we see structural opportunities emerging across several sectors. Industrials in particular stands out, as it increasingly sees the benefit of supply chain problems beginning to ease – order backlogs are still high in some areas, but lead times are normalizing so we expect decent growth in 2023 and an improving outlook for 2024. Indeed, while there will certainly be some short-term destocking, in the medium to longer term the key players will benefit from a range of trends. For instance, software solutions represent a strong growth area for some, with recurring revenues that are naturally adjacent to the growth in automation products. One example here that should be of interest to investors is PLM – product lifecycle management – software that enables the development and manufacture of products based on digital twins, shortening the time to market for innovative products. Indeed, cloud-based PLM software will allow a broader base of clients to benefit from these opportunities.

Other beneficial trends include decarbonization – where we see good growth in solutions that permit the more efficient use of resources – and the move to on/nearshoring where the need for automation becomes an even greater imperative due to higher costs – and indeed scarcity – of labour. So, while we undoubtedly see strong structural tailwinds, the question is whether these are sufficient to compensate for any cyclical weaknesses we are likely to see in the coming months? We believe that, in many cases, they are, as evidence by recent guidance upgrades for several big players across the industrial and semiconductor sectors. However, risks, of course, remain. In this respect, interest rate uncertainty looms large, and may cause concerns in some sectors – such as real estate stocks with significant leverage – if rates remain elevated for longer than expected.

Earnings in Q1 certainly exceeded expectations and a severe recession has likely been avoided, yet weak growth endures and uncertainty remains around both the war in Ukraine and the resilience of some US regional banks – overall sentiment is thus optimistic but certainly not, yet, euphoric. However, there remain several sectors and subsectors that should be of interest to equities investors in the coming months. The service sector is showing good levels of activity, while consumer goods – especially luxury goods – have recently performed very well and look promising for the coming months.

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