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# Positives for Europe, but the Middle East could be a headache

European equities | May 2024

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- **Inflation is a stubborn problem in the US due to labour shortages, but this is much less of a factor in Europe**
- **European activity is dull, but likely to recover as the consumer is well supported**
- **China is cheap but problematic given property market challenges**

Growth expectations have improved since Chair of the US Federal Reserve, Jerome Powell, turned dovish in December, causing financial conditions to ease. But inflation is now expected to be higher: corporate margins are under pressure, so prices are rising, while wage growth remains stubbornly high.

The inflation swap rate has returned to its high of October 2023. The last time it was this high, the S&P 500 was at 4200; it now stands at 5200.[1]

There is a disconnect between the market and Fed funds futures. The effects of US monetary policy are taking longer to have an impact (Figure 1) due to long-term fixed mortgages and corporate debt and fiscal largesse. But high interest rates will eventually be felt. Credit growth is weak in both the US and Europe. Default rates for US consumer loans and mortgages and job cuts are rising (Figure 2). Q1 earnings, excluding the Magnificent Six[2], fell 11% year-on-year.

The equity risk premium has rarely been this low. Markets have front-run the Fed. The options market is suggesting the chance of a 20% drawdown or more is the lowest ever. JP Morgan's recession probability indicator is at a record low.[3] The gap between BBB and B credit is the lowest since 2007, suggesting peak complacency.

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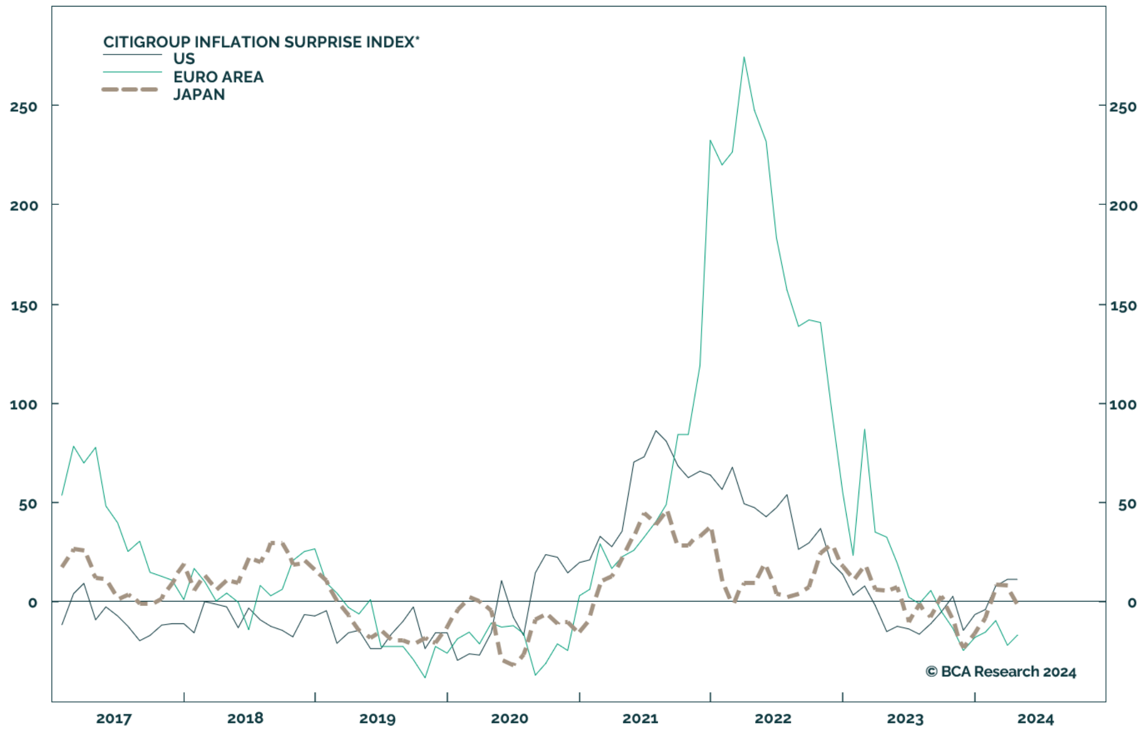
[1] All markets data Bloomberg, as at April 2024, unless otherwise stated

[2] Alphabet, Amazon, Apple, Meta, Microsoft and Nvidia. Tesla has been a poor performer in 2024

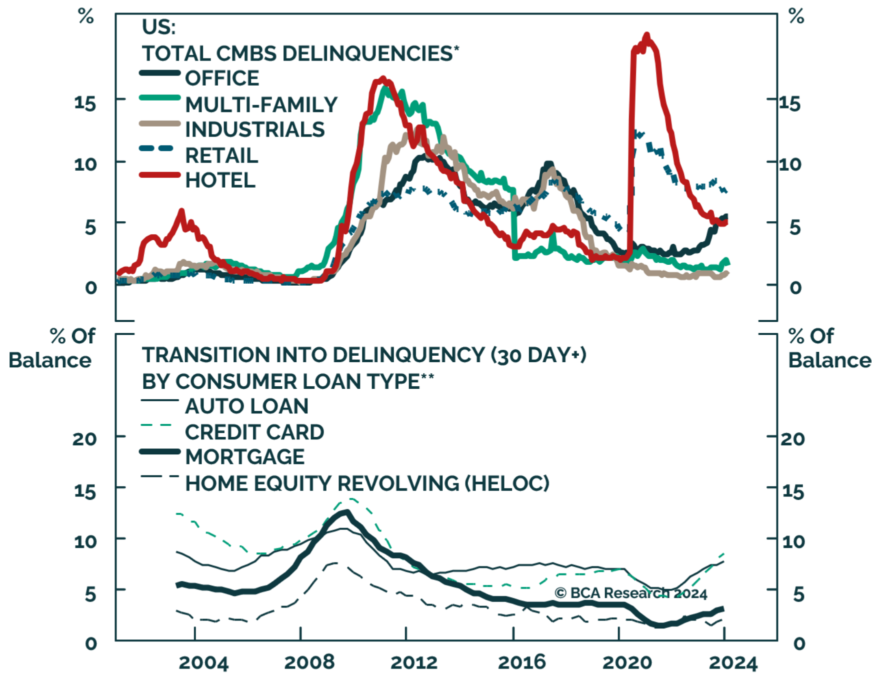
[3] JP Morgan, Recession Probability Indicator, March 2024

Figure 1: Inflation is surprising to the upside




Source: Citi Group Global Markets Inc, April 2024

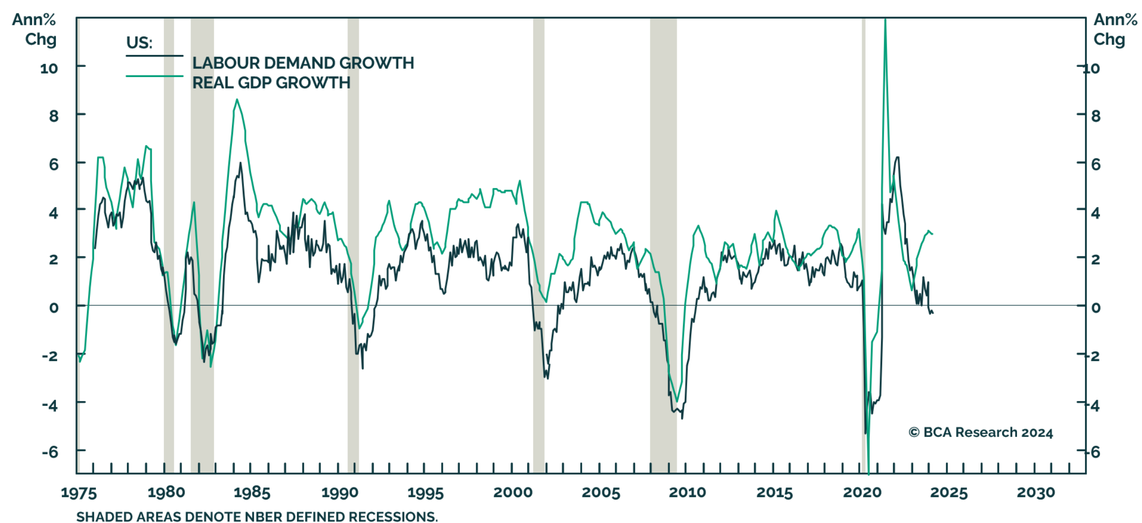
Figure 2: Defaults are on the rise




Source: Federal Reserve Bank of New York. *source: Moody's Investors Service, Trepp, and LCC. **shown as a four-quarter moving total

For a recession, labour supply needs to contract (unlikely given immigration) or labour demand must contract so sharply that the normal relationship between demand and supply reasserts. If labour demand continues weakening it will not feel like a recession: falling demand implies earnings under pressure, but if accompanied by moderation in wage inflation margins might not be impacted. This suggests a range-bound to modestly lower stock market after the recent rally. Such has been the euphoria in technology and AI, any disappointment could have worse consequences.

Figure 3: For the first time in 50 years the US has entered a labour demand recession without a GDP recession




Source: BCA Research, 2024. NBER: National Bureau of Economic Research

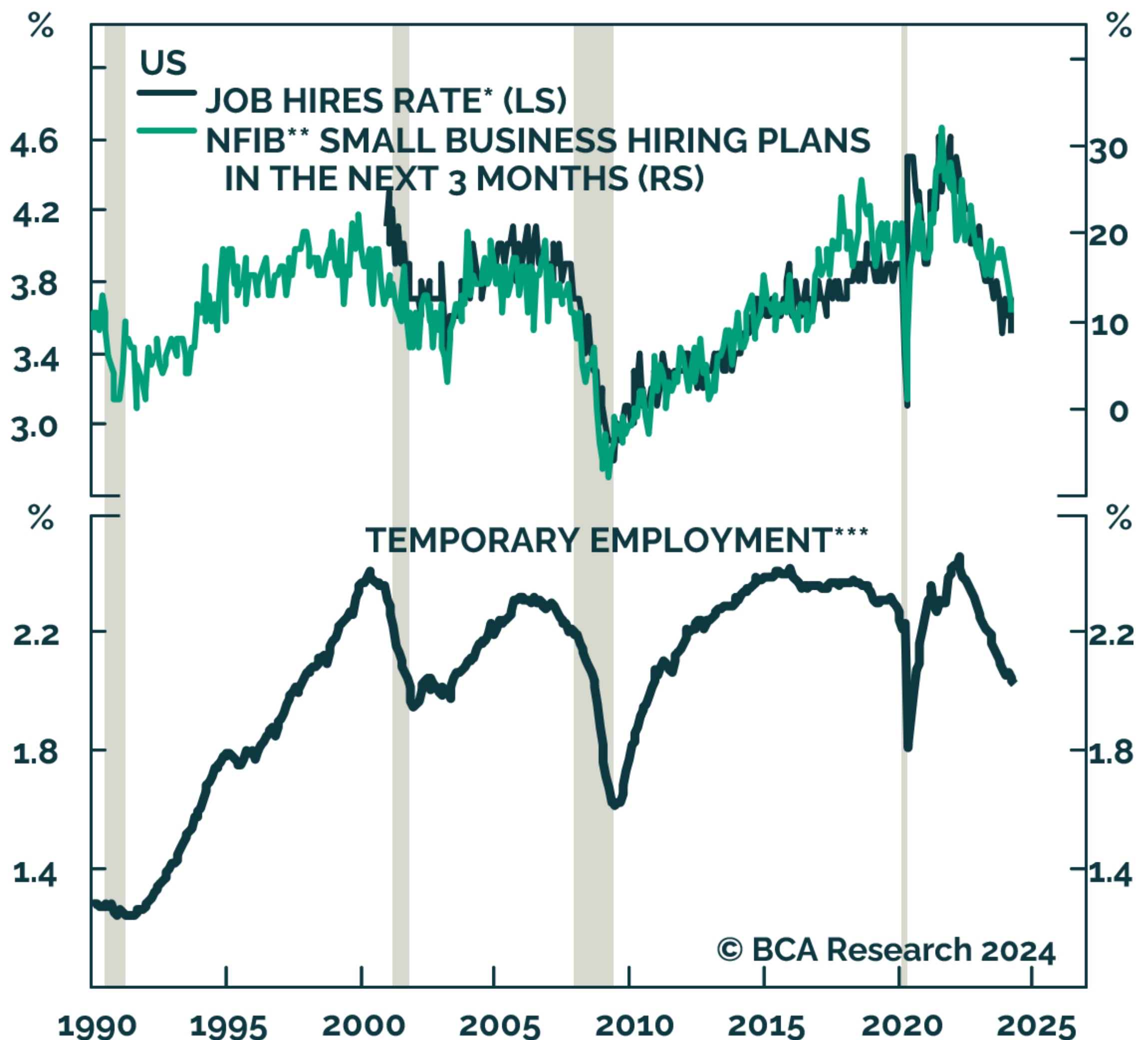
The surge in inflation in 2022 cannot be repeated without being embedded into expectations. That is why the Fed must err on the side of caution. The personal consumption expenditures (PCE) deflator is back where it would have been if inflation had averaged 2% since the financial crisis (prior to the pandemic it was below this). So the Fed has already shot its bolt because it undershot its target for so long and then overshot after the pandemic. It now must get inflation expectations back to 2%.

Higher equity and house prices are bolstering household wealth and consumer confidence. Fiscal policy remains loose: the US budget deficit was more than 6% of GDP last year.[4] Capital expenditure is booming in manufacturing due to onshoring. Manufacturing is stabilising. But CPI and PPI are both surprising to the upside – hence the need for Fed vigilance. But wage growth continues to moderate and job openings, the quit rate and labour availability are softening.

Companies stop hiring before they fire, and the hiring rate is at a six-year low. Temporary employment is a leading indicator of labour intentions and is back to 2010 levels (Figure 4). Bank lending is slowing, money supply shrinking and corporate bankruptcies rising.

[4] Congressional Budget Office, 2023

Figure 4: Declines in the hiring rate and temporary employment are consistent with a softening labour market




Source: BCA Research, 2024. * Job Openings and Labor Turnover Survey (JOLTS), Bureau of Labor Statistics (BLS). Spikes in the reported hiring rate in May and June 2020 trimmed to 4.5%. ** National Federation of Independent Business. *** BLS. Persons employed in temporary help services as a share of total nonfarm private employment. Note: shaded areas denote NBER-designated recessions

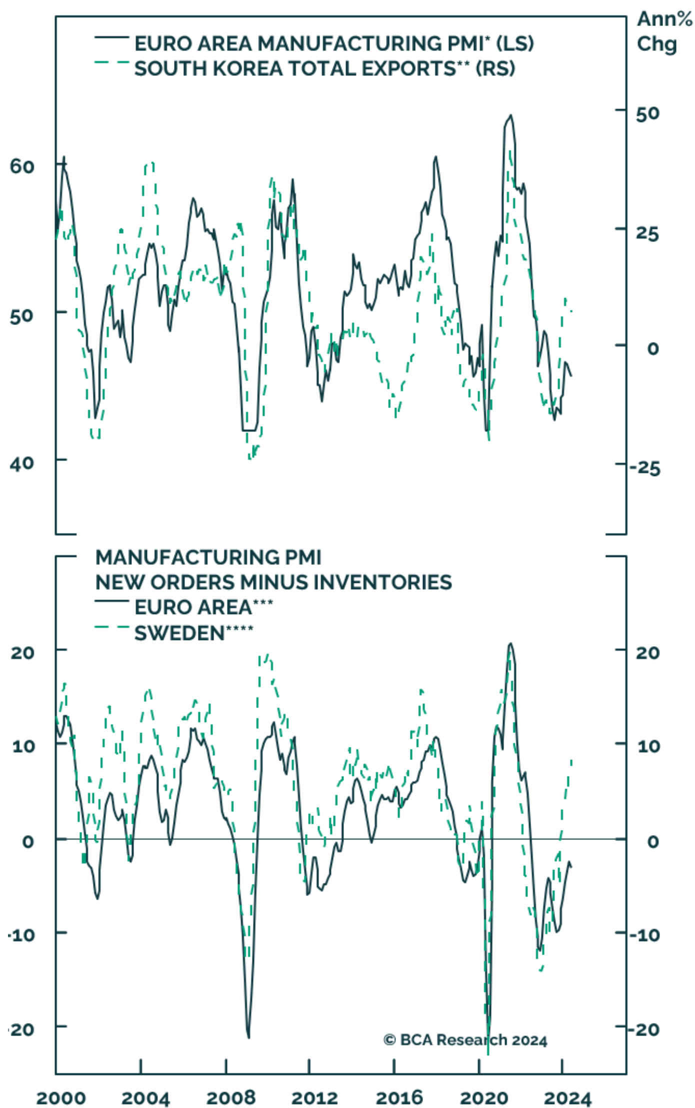
Meanwhile, credit card and auto loan delinquencies have risen to their highest levels since 2012 – surprising given unemployment then was in excess of 8% versus 3.9% now. This is because the average interest rate on credit card debt is 21%, the highest ever, so balances are 15% higher than a year ago; and 40% of recent home buyers' income goes on mortgage payments, the highest in 40 years. The personal savings rate has fallen to 3.8%, half its level in 2019.[5]

[5] All figures BCA Research, 2024

### Europe

In Europe, real GDP was flat in Q4 and barely up at all over 2023. German GDP actually shrank; weaning off cheap Russian gas and introducing net zero policies came at a price. Southern Europe fared better. Manufacturing is improving (Figure 5). But most data remains mixed. The ZEW Indicator of Economic Sentiment for Germany is improving and the IFO Business Survey has bottomed, while the EU Economic Sentiment Index is moving sideways.

Figure 5: Some green shoots for European manufacturing




Source: BCA Research, 2024. * S&P Global. Truncated at 42 for presentation purposes. ** In US dollar terms. Shown as a three-month moving average. *** S&P Global. Shown as a three-month moving average. **** Swedbank and Silf. Shown as a three-month moving average.

Although European inflation has disappointed, it has continued to fall and lifted real wages and consumer confidence. While US consumers have spent their excess pandemic savings, European consumers are still sitting on theirs, meaning upside for consumer spending in Europe.

But it is not all rosy: banks have tightened lending standards, money supply is shrinking and the credit impulse remains negative. Southern Europe has performed the best of late, but in the next 12 months two-thirds of loans there will mature and reset higher – the figure is 30% for Europe as a whole. Nor will fiscal policy come to the rescue, as happened in the US. Europe is suffering a 1% fiscal tightening this year, with an even bigger tightening in Germany. Despite no GDP growth in the eurozone, unemployment fell to 6.4% last year[6] – although job vacancies are now falling. The UK is worse: vacancies have fallen 30% from mid-2022.[7]

Moderating inflation and an improvement in the credit impulse – the flow of new credit issued from the private sector as a percentage of GDP – will lift European activity, so the European Central Bank (ECB) might not cut rates as much as investors want. The credit impulse moved from 3.2% in 2022 to a disastrous -5% in 2023. Hardly surprising Europe spent a year in the doldrums. The credit impulse is unlikely to crash again, so even a move to zero in terms of incremental credit will be positive. This means real GDP growth will turn positive this year. As prices fall – average inflation in Europe is now 2.4%[8] – real wages are growing. The rise in bond yields helped turn the credit impulse negative. It follows that as yields moderate, the credit impulse should pick up, easing credit conditions. The Eurozone Bank Lending Survey shows credit conditions are no longer tightening and deleveraging is slowing.

While none of this adds up to a bullish picture, it is an incremental positive – in spite of Europe's fiscal drag worsening from 0.4% in 2023 to 1% in 2024. Improving global conditions and the credit impulse more than outweigh this drag. Europe looks good value at 13.5x earnings versus more than 21x for the S&P 500. Europe is below the average valuation of the past 10 years while the US is 70% above its average. The consensus expects lower earnings in Europe this year, with growth in the US, but earnings revisions are improving in Europe. The ratio of market cap to money supply is at an all-time high of 2.4x in the US, but only 0.6x in the Eurozone – the lowest of all major markets. In addition, the energy price premium relative to the US, due to the Ukraine war, will dissipate. Europe's gas inventories are at record levels, French nuclear is online and exporting, renewables continue to grow and liquefied natural gas will face a glut helping European industry and consumers. Europe has underperformed the US by 15% since last May.[9]

Half the return in global equities since November 2022 has come from the US's Magnificent Seven. With Tesla's poor performance in 2024 we now talk of the Magnificent Six. The S&P 500 trades on less than 19x excluding these six. But the earnings of those other 494 stocks fell throughout 2023, so they are cheaper for a reason. Maybe a darling like Nvidia will avoid the dangers of hype. In 2000, Cisco was the most valuable listed company in the world on 37x sales (like Nvidia today). Since then, Cisco increased earnings per share tenfold yet its share price remains 40% below March 2000.

Europe has underperformed the US due to poor productivity: insufficient and misallocated capital expenditure. This won't change anytime soon as it goes down the road of net zero. So Europe remains a cyclical play on China, global trade and relative energy prices, with an expectation that earnings will lag the US. European cyclicals have done better this year and are

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[6] Eurostat, Euro area unemployment at 6.4%, October 2023

[7] Gov.uk, Post-pandemic economic growth: UK labour markets, April 2023

[8] European Central Bank, as at April 2024

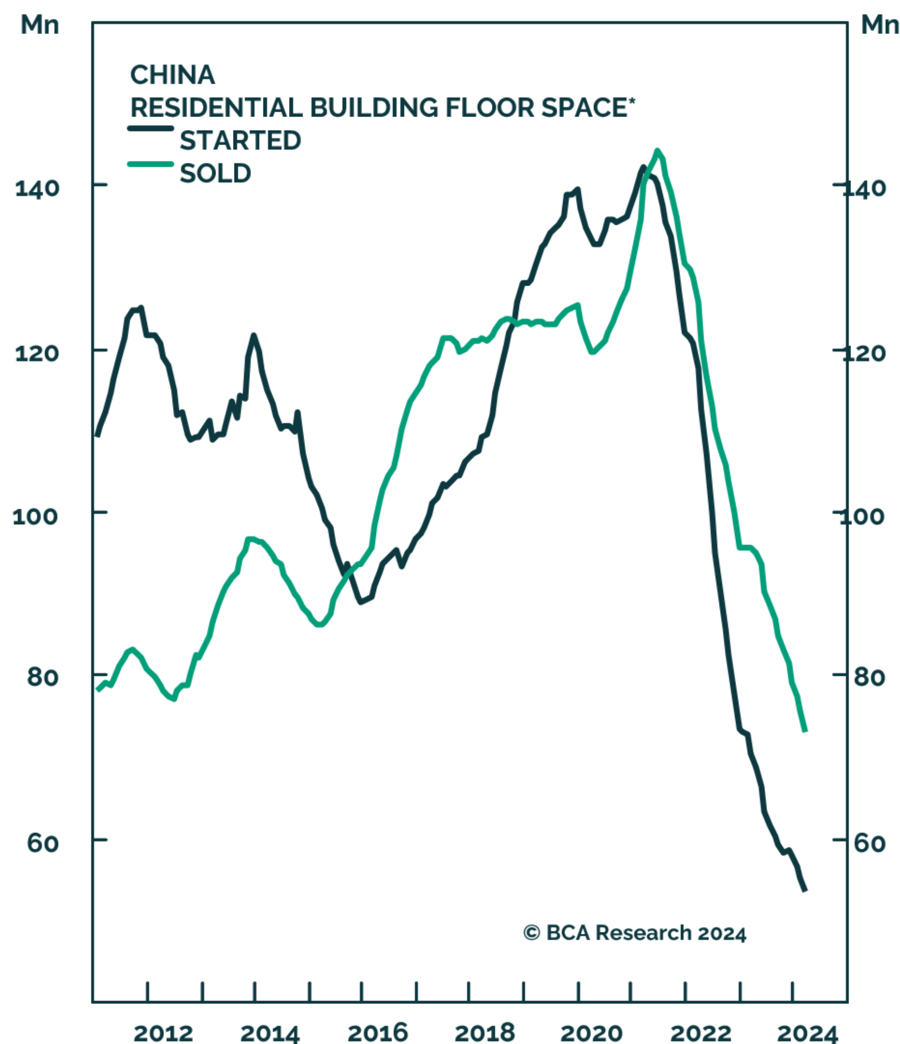
[9] Datastream, as at March 2024

a full standard deviation more expensive than defensives. Positioning in US equity futures is at the top of its recent range. China is cheap.

### China

Electric vehicles are flooding out of China, which is now the largest auto exporter. Dumping, whereby manufacturers export a product to another country at a price below normal, will ramp up trade tensions between China and the US. Housing starts in China continue to plummet: floor space started is down 61% since March 2021 (Figure 6) and home sales have halved.[10] Government interference will stave off a crash, so new home prices are down only 3%. But the secondary market is down 20% in some cities. This is a short- and long-term problem since China's demographics are so bad – the working population may drop 60% by 2099.

Figure 6: China's housing market blues continue




Source: BCA Research, 2024. * Commodity building floor space, shown in million square meters and as a 12-month moving average.

[10] BCA Research, as at March 2024

Deflation in China is setting in: the GDP deflator fell 1% in Q4; export prices are down 11%; the monthly salary for newly hired workers has been falling since last June; and the producer price index is down 2.7% year-on-year. All of this is increasing real interest rates. The government is supplying liquidity to the economy, but less than during other pump-priming episodes like 2009, 2012, 2016 and 2020.

### The Middle East

The situation is compounded by the Middle East, which is responsible for a third of global oil production. The oil price has risen because of the strong US economy, bottoming global manufacturing, OPEC oil production discipline and Russia trying to boost Republican electoral chances. An oil shock caused by war between Israel and Iran would cause recession. Even a minor oil shock causes an inflation headache.

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