Can European Equities Continue to Thrive Amid Economic Stagnation?

Sector and industry dynamics offer insight into European equity performance trends and future opportunity.

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Europe is hardly a picture of economic dynamism at the moment. While the US defies predictions of both a hard and soft landing, Japan shakes off decades of deflation, India booms, and China registers "disappointing" gross domestic product growth rates of 5%, Europe is stagnating. Germany, its largest national economy, contracted in 2023. The continent overall is stuck near zero growth.

Yet, European equities have posted solid recent returns. Over the past year, the Morningstar Developed Europe Index[1] has risen 11% in euro terms—not as high as its US counterpart—but a strong absolute gain. Novo Nordisk of Denmark has seen its share price soar as a result of its weight loss therapies. Netherlands-based ASML has ridden global demand for semiconductor manufacturing. Higher interest rates have benefited banks across the region, while higher oil prices have lifted energy companies.

The dichotomy is a reminder that economies and markets can diverge. Asset prices are affected by a range of forces: macro and micro, foreign and domestic. Company-specific factors are key.

Analysis of Morningstar's European sector and industry index[2] range can help explain the disconnect between the macroeconomic backdrop and equity returns, as well as the mixed fortunes across market segments. Morningstar Equity Research's company-level price/fair value estimates reveal risk and opportunity across markets.

Key Takeaways

- Some of the past year's best-performing European equity sectors, such as financials and energy, have been long-term laggards. Technology and industrials have posted strong short- and long-term returns.
- Geographic revenue sources explain some, but not all, of the disconnect between Europe's strong equity returns and weak macro picture. Energy, technology, healthcare, and industrials are highly globalized sectors. Financials and real estate are the most domestic.
- A lackluster economic backdrop does not preclude strong equity returns for European equities.
- Morningstar Equity Research sees opportunity across European equity sectors. Most sectors are trading at discounts to intrinsic value. Within sectors, secular growth drivers are plentiful.

1 For a full discussion of index methodology, see "Construction Rules for the Morningstar Global Markets Indexes."
2 For a full discussion of index methodology, see "Construction Rules for the Morningstar Global Sector Indexes."

European Equity Sector Surprises

Solid recent returns for European equities have surprised in several ways. First and foremost, they come against a challenging macroeconomic backdrop. The Morningstar Developed European Index's 11% strong absolute gain for the trailing 12 months through April 30, 2024, contrasts with Europe's near-zero growth in GDP.

Also, some of the best-performing European equity sectors recently have been long-term laggards. As displayed in Exhibit 1, the Morningstar Developed Europe Financial Services Index has paced the market over the past 12 months, despite having weak returns over the past 10 years. Energy is another long-term laggard that has become a recent bright spot. Even real estate, the worst performer since 2014, has shown signs of life. Technology and industrials have been stars of both the short and long term.

Exhibit 1 Some of Europe's Best-Performing Recent Sectors Are Long-Term Laggards

Developed Europe - Equity Sector Indexes	1-Year Return (%)	10-Year Return (Annualized %)
Cyclical		
Basic Materials	11.6	7.6
Consumer Cyclical	3.6	6.6
Financial Services	25.7	5.6
Real Estate	7.8	2.4
Sensitive		
Communication Services	2.5	1.6
Energy	17.0	5.5
Industrials	17.7	9.0
Technology	21.0	12.9
Defensive		
Consumer Defensive	-8.4	5.7
Healthcare	8.1	8.1
Utilities	-3.9	5.7

Source: Morningstar Direct. Morningstar Sector Indexes' trailing 12-month and 10-year annualized returns through April 30, 2024, in net return euro terms.

The financial services sector's strong recent returns owe much to the banking industry. HSBC, the largest constituent of the Morningstar Developed Europe Financial Services Index, has gained 30% in 12 months. The Morningstar Eurozone Large-Mid Bank Index, which includes continental lenders like Banco Santander, BNP Paribas, UniCredit, ING, and Deutsche Bank, is up near 50% over the past year. Central bank rate hikes have increased net interest margins. It's a welcome departure from years of negative rates following the global financial crisis during which European lenders watched US rivals like JPMorgan Chase, Bank of America, and Wells Fargo surpass them in market value.

The European energy sector, for its part, has also outperformed the broad equity market over the past year despite its long-term struggles. On a global basis, energy stocks have lagged over the past 10 years, thanks to increased US supply, the rise of renewables, and other factors. But Russia's invasion of Ukraine and pandemic-related supply/demand imbalances sent the price of oil through the roof in 2022, lifting margins for many companies in the sector. While these effects have moderated, European oil and gas stocks boast strong one-year returns. Shell, TotalEnergies, and BP have all risen.

Technology has outperformed over both the short and long term. Semiconductor equipment maker ASML, which dominates the index, has been one of Europe's star stocks. Within the industrials sector, aerospace and defense players Rolls-Royce, Safran, and Airbus are key contributors.

How European Are European Sectors Anyway?

Geographic sources of revenue help explain performance. As displayed in Exhibit 2, European equity sectors vary. Financial services earn more than half their revenues from Europe. Tech is more global.

Exhibit 2 Revenue Sources for European Sectors Vary Widely—Tech Is Global, Financials More European

Developed Europe - Equity Sector Indexes	European Revenues%	US Revenues%	Asia Pac Revenues %
Cyclical			
Basic Materials	30	20	27
Consumer Cyclical	32	21	21
Financial Services	57	11	9
Real Estate	77	2	1
Sensitive			
Communication Services	46	25	6
Energy	40	17	20
Industrials	31	26	17
Technology	20	21	42
Defensive			
Consumer Defensive	26	25	23
Healthcare	23	43	17
Utilities	53	11	1

Source: Morningstar Direct. Index constituent data as of April 30, 2024. Estimated geographic segment data based on most recent corporate reporting.

The Morningstar Developed European Healthcare Index only sources an estimated 23% of its revenues from Europe, making it the most global of the 11 sectors. Novo Nordisk's largest market for obesity drugs is across the Atlantic, for example. Other index stalwarts like AstraZeneca, Novartis, and Sanofi sell their therapies across the globe.

Technology, consumer defensive, and basic materials are also highly globalized sectors. Tech leaders ASML and SAP are global players, as are Nestlé, Unilever, and L'Oréal, the largest constituents of the Morningstar Developed Europe Consumer Defensive Index, and Air Liquide and Rio Tinto on the materials side. Energy stocks track closely with their global counterparts because of their revenue orientation.

Financials and real estate are the most domestic of European sectors. HSBC still earns substantial revenues in Asia, but other players like BNP Paribas, have become less global in recent years. The constituents of the Morningstar Developed Europe Real Estate Index, such as Vonovia, Cellnex Telecom, and Segro, tend to be European focused.

In aggregate, the companies that comprise the Morningstar Developed Markets Europe Index only derive 36% of their revenues from Europe, with 23% estimated to come from the US, and roughly 18% from the Asia-Pacific region. Contrast this to the Morningstar US Market Index, with 61% of revenues sourced domestically. Non-European revenues help explain how European equities can thrive even as the European economy languishes. Novo Nordisk and ASML are global businesses that happen to be based in Europe.

What Does the Future Hold for European Equities?

Morningstar Equity Research's Europe Market Strategist Michael Field sees the macroeconomic backdrop as supportive for European equities, writing in his Q2 2024 Outlook:

> *"In many ways the European economy sits in 'Goldilocks' territory.' It's weak enough that the central banks should not be concerned about overheating it by cutting rates. At the same time, it still has some life left in it, judging by recent data points showing upticks in mortgage lending and service-industry activity. Meaning, that stimulus here, in the form of rate cuts, could effectively kindle economic growth."* [3]

Where are the opportunities within the European equity market? A bottom-up, valuation-based approach can be employed to answer that question, albeit as a long-term signal. Morningstar Equity Research's company-level price/fair value estimates aggregated to the European sector level can provide directional views. As displayed in Exhibit 3, industrials and energy were the only areas of general overvaluation as the second quarter of 2024 commenced. Given that April was a down month for equities, prices have come down.

3 Field, Michael. Europe Equity Market Outlook: Q2 2024. Morningstar Equity Research. https://my.pitchbook.com/?rcpubr=381156

Exhibit 3 Most European Equity Sectors Were Considered Undervalued in Aggregate Entering Q2 2024

Morningstar European Coverage Average Price/Fair Value Estimate by Sector

Cyclical Sectors	Average Price/Fair Value	Sensitive Sectors	Average Price/Fair Value	Defensive Sectors	Average Price/Fair Value
Consumer Cyclical	0.82	Comm. Services	0.85	Consumer Defensive	0.87
Financial Services	0.92	Energy	1.01	Healthcare	0.88
		Industrials	1.06	Utilities	0.84

Source: Europe Equity Market Outlook: Q2 2024. Morningstar Equity Research. https://my.pitchbook.com/?rcpubr=381156

The European technology sector is extremely concentrated, with ASML consuming 36% of the sector's market capitalization and SAP another 20%. Morningstar equity analysts raised their fair value estimate for ASML in April 2024 due to strong continued demand for the company's lithography equipment, though they also view the share price as fairly reflecting the company's bright prospects. ASML is also considered to possess a wide economic moat around its business, supported by intangible assets, cost advantages, and switching costs. SAP is viewed as a narrow-moat company with overvalued shares.

What are some opportunities within European sectors in Morningstar Equity Research's view?[4]

- **Financials**. Opportunity exists among payment providers, banks, and insurers. Lower interest rates may weigh on bank margins but "large banks with low funding costs will be the long-term winners in an above zero interest-rate regime."
- **Healthcare**. "Within the biotech and drug manufacturing group, the market is not fully appreciating the innovation in several therapeutic areas…In the diagnostic and research industries we see compelling valuations."
- **Consumer Cyclicals**. The luxury segment is seen as fairly valued but there are "opportunities in apparel and food delivery."

4 Europe Equity Market Outlook: Q2 2024. Morningstar Equity Research. https://my.pitchbook.com/?rcpubr=381156

- **Industrials**. The sector is benefiting from secular growth trends, including "rising investment in energy efficiency in buildings, data center investment from the proliferation of AI, the energy transition requiring low- and medium-voltage electrical equipment."
- **Utilities**. The sector is "materially undervalued after falling power prices drive selloff," identifying renewables projects as "still value accretive."
- **Energy**. Shell and TotalEnergies are undervalued.
- **Consumer Defensive**. The sector, which has underperformed due to inflation and downtrading "appears to be undervalued with plenty of opportunities among confectioners, and food and beverage and household product manufacturers." Anheuser-Busch InBev, Néstle, and Reckitt Benckiser Group are undervalued.

Sector Allocation Matters

As seen in Exhibit 1, the performance of equity sectors varies dramatically. Over the past year, a nearly 35-percentage-point difference separates the best-performing sector (financial services) from the worst (consumer defensive). The gap in annualized returns over the past 10 years between technology (12.9%) and real estate (2.4%) is massive when considered in euro terms.

Sector leadership is cyclical. Sentiment waxes and wanes; macro conditions change; innovation disrupts; and business fundamentals shift. While future sector dynamics are uncertain, what's likely is that they will diverge from the past.

Valuation matters. A sector may be benefiting from structural growth trends, but if that growth is fully reflected in asset prices, results will disappoint. Conversely, a sector facing fundamental challenges can hold upside if companies beat their low expectations. Often, stock performance can be unfairly influenced by sector association. Bad companies can ride a sector wave, while good businesses are dismissed for belonging to an unfashionable sector. The macroeconomic backdrop is important, but European equities are proving they can thrive in a no-growth environment.

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