THE STARS ALIGN FOR EUROPE'S RECOVERY

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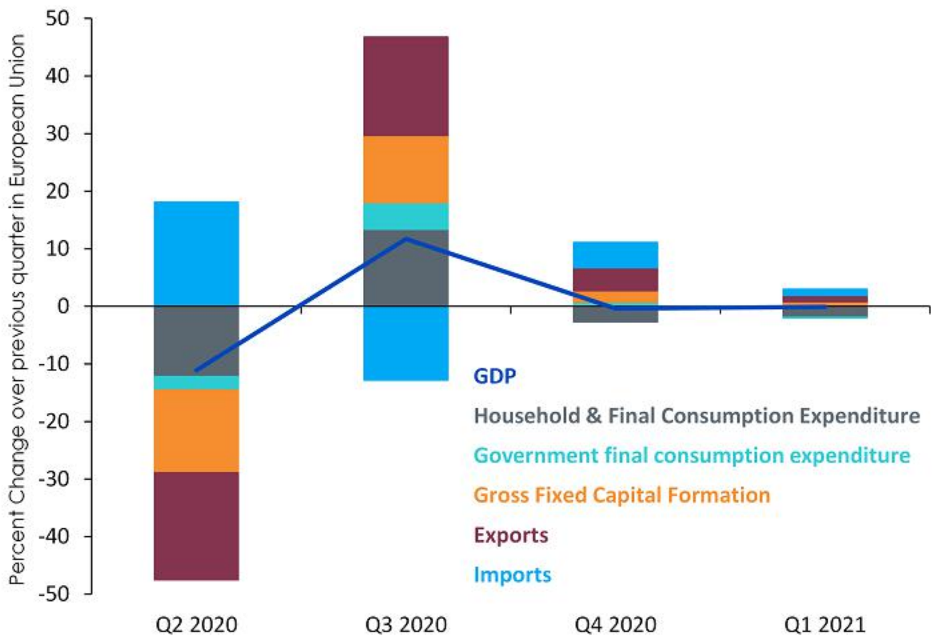
23 Jun 2021

European equities have been on a tear since the start of 2021. The Stoxx Europe 600 Index is on track for its fifth consecutive monthly advance[1], marking its longest winning streak in eight years. Since the end of October 2020[2], European equities have outpaced US equities by 5.6% helped by the first phase of the recovery - a rise in the pace of vaccinations, the recovery of the global economy (which benefited European exports) coupled with supportive valuations. Europe's higher tilt to value sectors amidst an inflationary backdrop favours an allocation to Europe, as discussed here. The second phase of the recovery marked by the reopening of international borders, higher relative earnings revisions, and accommodative monetary and fiscal policy, is likely to be more sustainable. For the first time in a while, the stars appear aligned for Europe's recovery. For this reason, we believe Europe's equity rally has further to run.

Consumption growth to drive Europe's recovery

Until now the manufacturing sector was holding the mantle of the recovery but with vaccination rates steadily rising and the forthcoming reopening of several European countries, we expect consumer led sectors to pick up where they left off prior to the COVID pandemic. In May, the sentiment indicator in the retail sector rose to the highest level since December 2019, underscoring an improvement in consumer demand. Economic growth appears to be on the rebound evident from the less than expected decline of 0.1%[3] in Q1 2021 compared to a decline of 1.2% in the EU a year ago. Household final consumption expenditure had a 1% contribution to GDP growth in the EU. It declined 1.9% in the EU in Q1 2021 versus 2.7% in the prior quarter, we expect the reopening of economies to provide a significant turnaround to household consumption expenditure which should bolster growth in the second half of 2021. As we enter the summer season, the European hospitality and services sector are likely to benefit from the resumption of international travel within the EU[4]. A full restart between Europe and the US is also in the pipeline.

Figure 1 – GDP & Expenditure components



Source: Eurostat, WisdomTree, data available as of close 14 June 2021.

Historical performance is not an indication of future performance and any investments may go down in value.

European earnings revision point to further upside

Earnings are a primary driver of returns in equity markets. After a strong first quarter earnings season for European equities, earnings momentum remains very positive. This is evident from consensus earnings revision rising 15% in 2022 versus just 6% for the US. Europe is the only region where earnings revisions are still higher than sales revisions, which suggests fewer signs of margin pressure compared to other regions in the current period. The subdued rise in wages in Europe is likely to impose less pressure on margins supporting higher earnings revisions in the future. Against a backdrop of recovering global growth, rising bond yields and tightening credit spread we favour stocks with a pro-cyclical bias such as financials, industrials, consumer discretionary, information technology and materials.

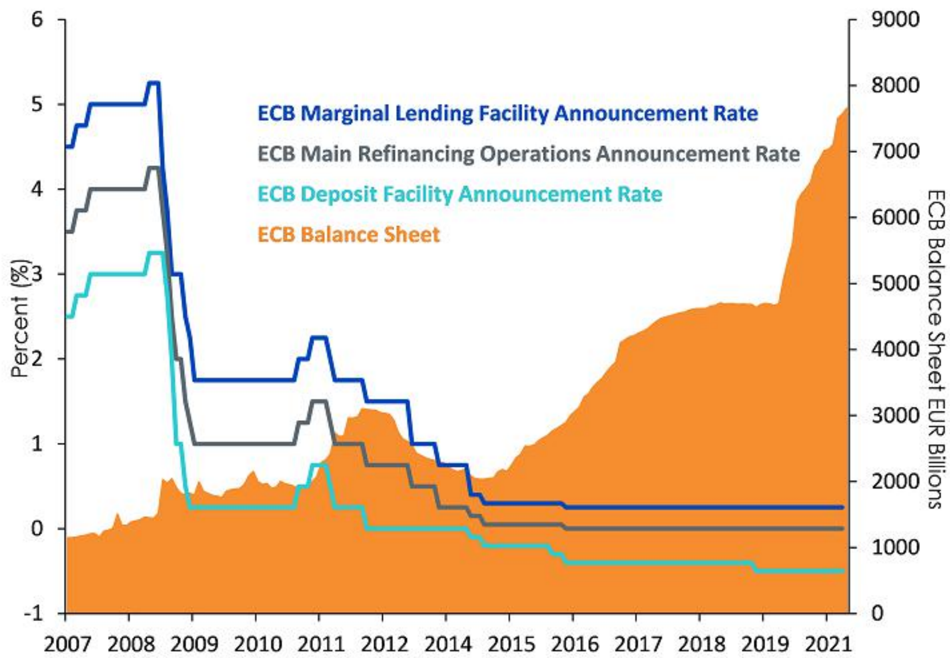
During the COVID pandemic, European dividends faced a 35% drop, its largest in the past 50 years. The fall in dividends was most severe in – financials, energy and consumer discretionary. While the materials and industrials sector held up better. Even with the dividend cuts, European equities (at 3%) offer attractive yield opportunities versus government bonds. Dividend growth for European companies is starting to look much more promising in comparison to 2020. As dividends are expected to rebound by 18% in 2021 and 6% in 2022[5].

Monetary policy remains accommodative

The European Central Bank (ECB) confirmed on June 10, that net asset purchases under the PEPP[6] over the coming quarter would continue at a significantly higher pace than during the first months of the year. According to the ECB, the risks surrounding the economic outlook were broadly balanced. The latest staff projections revised growth and inflation forecast upwards for this year and 2022. GDP growth is now expected to be at 4.6% in

2021 and 4.7% in 2022. The ECB avoided any discussion on taper talk at its latest press conference as it sees the current inflation as being transitory. The accommodative stance of the ECB adds further impetus to Europe's recovery.

Figure 2 – ECB keeps stimulus at a high pace despite raising growth and inflation forecasts



Source: Bloomberg, WisdomTree, data available as of close 31 May 2021.

The recovery fund makes progress

The Next generation EU program (NGEU) which will finance loans and grants to member states, is also likely to boost growth prospects for economies in the EU. NGEU was designed to advance the twin goals of making the bloc more sustainable and digital. Among the 27 member states, 23 countries have submitted their proposals and the largest part of the available grants will be tapped if approved. The EU has started borrowing from the market now that all countries have ratified the Own Resources Decision[7]. The total proposals amount to €493.2bn, short of the total €672.5bn in the fund. Italy takes the lead as the country with the maximum number of applications for grants and loans. While the Netherlands has not tapped into the funds. The European Commission (EC) will review the proposals within two months of receipt, which should be at the end of June for the largest countries. After the commission agreement, the Council will have to approve the plans as well. Once agreed, the countries will receive 13% as an early payout to kick start projects. This implies that funds should be received by the third quarter of this year, earlier than previously anticipated.

Europe small cap opportunity

European small caps companies have fared markedly better than their large cap counterparts evident from the outperformance of the MSCI Europe Small Cap Index versus the broader Stoxx Europe 600 Index. As we turn towards the second phase of the consumption led cyclical European recovery, we expect small cap stocks that are more geared to the local economy to remain a key beneficiary. The WisdomTree Europe Small Cap

Dividend UCITS Index is tilted towards sectors with a pro cyclical bias such as – Industrials (20.73%), Financials (17.27%), Consumer Discretionary (10.72%), Information Technology (9.31%) and Materials (8.14%) respectively.

Figure 3- European small cap stocks outperform large cap stocks

Source: Bloomberg, WisdomTree as of 16 June 2021.

You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.

Sources

[1] As of 14 June 2021

[2] As of 29 October 2020, Stoxx Europe 600 Index outperformed S%P 500 Index by 5.6%

[3] Eurostat

[4] From 1 July 2021, European Commission

[5] based on company announcements in Q1 2021

[6] PEPP – Pandemic Emergency Purchase Programme

[7] Own Resources Decision – the legal instrument which will enable the European Commission to borrow the necessary cash on the financial markets and repay it over the next decades.

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