A MOMENT IN MARKETS – EUROPEAN EQUITIES ARE CHEAPER BUT…

Mobeen Tahir – Director, Research
20 Jul 2020

Following the recovery in stocks since March, European equities appear 'cheaper' compared to US equities. But this is old news.

Professor Shiller's Cyclically Adjusted Price Earnings (CAPE®) ratio measures the long-term value of assets by dividing the price of an equity index by the moving average of the preceding 10 years of earnings. This helps remove the impact of cyclical variations in earnings. Figure 1 shows the divergence between US and European equities on this metric since the 2008 global financial crisis. The story of European equities being cheap now is the same tale that has been told in markets for the last decade.

Source: Barclays. Monthly data to 30/06/2020. **US equities** refer to the S&P500 Index. **European equities** refer to the Bloomberg European 500 Index.

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

Monetary stimulus is not the reason

Accommodative monetary policy from the US Federal Reserve (Fed) and the European Central Bank (ECB), has helped fuel equity markets in both regions since 2008. But have European equities lagged behind US equities, since the global financial crisis, due to less firepower from the ECB? This doesn't appear to be the case. Figure 2 shows that the monetary injection from the ECB, relative to the size of the economy, has – if anything – been larger than the one from the Fed.

WisdomTree®

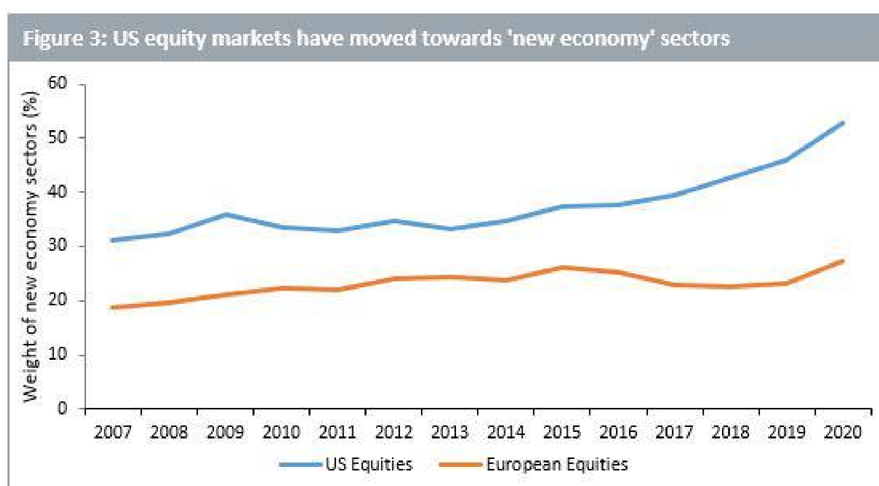
Source: Bloomberg. Monthly data to 30/06/2020.

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

A tilt towards the 'new economy'

Stocks belonging to the new economy have commanded increasingly larger weights in US indices compared to European ones – especially in the last 5 years. 'New economy' refers to businesses at the forefront of innovation. Technology and healthcare are the leading candidates in this category and valuation multiples in these sectors have expanded in recent years, as markets continue to bet on the innovation from these sectors to drive growth in the future.

In contrast, European equities still hold large weights in 'old economy' sectors including financials, consumer staples and industrials. It isn't fair to say that old economy businesses can't and don't innovate. They do indeed, however, these businesses tend to be more mature and are built on 20th century style business models compared to 21st century internet-driven new economy businesses.



Source: WisdomTree, Bloomberg. Data as of 17 July 2020. Each data point is as of 17 July for the respective year. **US equities** refer to the S&P500 Index. **European equities** refer to the Bloomberg European 500 Index. **'New economy'** sectors refer to the combines weight in information technology, health care and communication services.

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

What investors should consider

Strong performance in equities comes when high quality businesses generate robust profits. This can happen in any sector – whether it belongs to the old or new economy – and any region. There are three important takeaway points from the discussion above:

1. It is useful to keep an eye on valuation multiples, but they cannot be relied upon to predict future performance. US equities have historically traded at higher multiples compared to European equities and may continue to do so in the future.

2. If the sector mix using market cap weights is not the most desirable, investors can opt for approaches that use fundamental factors to assign weights.

3. There are opportunities to achieve targeted exposure to areas of innovation. New growth is coming from new economy sectors. This should also encourage new ways of investing.

Related blog

+ A moment in markets – not quite a V-shaped recovery

+ A moment in markets – cautious optimism about Chinese equity

View the online version of this article here.

Important Information

Marketing communications issued in the European Economic Area ("EEA"): This document has been issued and approved by WisdomTree Ireland Limited, which is authorised and regulated by the Central Bank of Ireland.

Marketing communications issued in jurisdictions outside of the EEA: This document has been issued and approved by WisdomTree UK Limited, which is authorised and regulated by the United Kingdom Financial Conduct Authority.

WisdomTree Ireland Limited and WisdomTree UK Limited are each referred to as "WisdomTree" (as applicable). Our Conflicts of Interest Policy and Inventory are available on request.

For professional clients only. The information contained in this document is for your general information only and is neither an offer for sale nor a solicitation of an offer to buy securities or shares. This document should not be used as the basis for any investment decision. Investments may go up or down in value and you may lose some or all of the amount invested. Past performance is not necessarily a guide to future performance. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

The application of regulations and tax laws can often lead to a number of different interpretations. Any views or opinions expressed in this communication represent the views of WisdomTree and should not be construed as regulatory, tax or legal advice. WisdomTree makes no warranty or representation as to the accuracy of any of the views or opinions expressed in this communication. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

This document is not, and under no circumstances is to be construed as, an advertisement or any other step in furtherance of a public offering of shares or securities in the United States or any province or territory thereof. Neither this document nor any copy hereof should be taken, transmitted or distributed (directly or indirectly) into the United States.

Although WisdomTree endeavours to ensure the accuracy of the content in this document, WisdomTree does not warrant or guarantee its accuracy or correctness. Where WisdomTree has expressed its own opinions related to product or market activity, these views may change. Neither WisdomTree, nor any affiliate, nor any of their respective officers, directors, partners, or employees accepts any liability whatsoever for any direct or consequential loss arising from any use of this document or its contents.