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Europe's Underperformance Has Gone Far Enough: Taking Stock
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(Bloomberg) -- A gloomier economic outlook in Europe compared with the US has driven the underperformance in regional equities in early 2024, but some investors say ignoring European stocks any longer now represents the biggest risk to portfolios. The Stoxx 600 has eked out a gain of less than 1% this year, and so far has failed to breach the January 2022 record high. An underwhelming corporate earnings season in the euro area has also capped the rally. Meanwhile, the S&P 500 briefly climbed above the historic 5,000-mark on bets of resilient economic growth, before sliding on hotter-than-expected inflation data.

Most fund managers in Bank of America's latest regional survey say Europe's underperformance may have gone far enough. A net 14% of respondents said European equities are now undervalued, a sharp turnaround from last month, when a net 6% indicated they were too pricey. About 40% warned that cutting equity exposure by too much was the main risk. That's starting to reflect in asset allocations, with the share of global investors underweight European stocks dropping to 10% from 12%.

"Macro creates stress, but it also creates opportunity," says Christopher Hart, a portfolio manager at Boston Partners. "It's about finding an idiosyncratic positive risk in businesses that are mis-priced by the market just because the macro would negatively affect the perception of a whole cohort of stocks." Economically sensitive financials and industrial stocks carry the biggest weights in Hart's Robeco BP Global Premium Equities fund.

To be sure, there's been ample reason to worry recently. Where corporate America is tracking another blow-out earnings season, European firms are set to post a bigger-than-expected drop in profits, according to data compiled by Bloomberg Intelligence. An analysis by Morgan Stanley shows this reporting season has seen the weakest revisions in analysts' forecasts in recent years.

At the same time, projections for earnings over the next 12 months have remained strong, says Bernstein's Sarah McCarthy. Does that create a risk of significant downgrades through 2024? McCarthy says no, particularly for sectors such as banks, semiconductors, energy, autos and capital goods. While she expects some cuts in estimates over the near term, the strategist says an era of relatively higher interest rates will support banks, while cost cuts and new business verticals will bolster the case for energy. And although sales and margin estimates for capital goods stocks are at a record high, pent-up demand means margins can remain strong, McCarthy says.

The outlook for so-called cyclical stocks — which are generally more sensitive to economic growth — is also improving. After a rocky start to 2024, cyclical stocks are outperforming their defensive peers as European business activity shows signs of picking up. UBS strategist Gerry Fowler says the Stoxx 600 could rise above 500 points — an all-time high — in the absence of renewed economic weakness or a jump in bond yields.

That estimate is well above the average target of 477 in Bloomberg's poll of strategists last month. It also matches the bullishness seen in BofA's survey this week, where about 78% of respondents said they expect stocks to gain over the next 12 months.

Technical indicators are also supportive of European stocks relative to the US. The relative strength index of the S&P 500 was above 70 before the inflation figures on Tuesday. The level is considered by some market participants as a precursor to a selloff. The Stoxx 600 hasn't breached that RSI level since the early days of January.

And while data from Citigroup shows exposure to European stock futures fell last week, overall long positioning continues to be relatively bullish. Like in the US, all of the short positions are out of the money for the Euro Stoxx 50 index, indicating there's potential for covering if the market can maintain these levels or higher, strategist Chris Montagu writes in a note.