Europe Sentiment: So Bad It's Good

Changes in sentiment may drive the performance of the eurozone equity markets, even with disappointing economic data.

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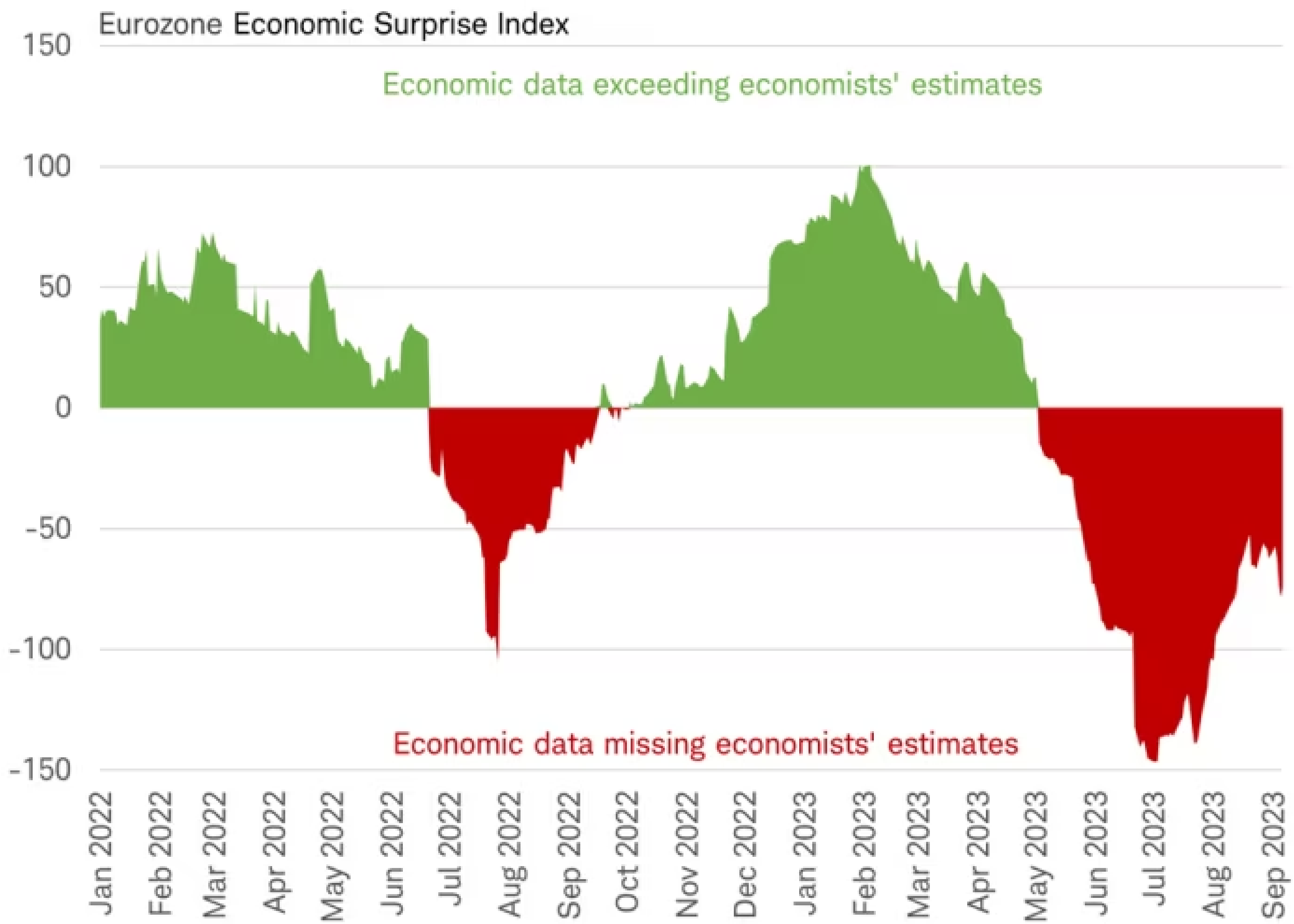
Economic data for the U.S. is now tracking close to 6% GDP growth for the third quarter, according to the Atlanta Fed's GDPNow forecast, which provides a running estimate of real GDP growth based on available economic data for the current quarter. In contrast, the data for Europe shows the economy may be back in recession. Yet, the stock markets are favoring Europe with the average European stock outperforming the average U.S. stock this year and there is a tie in the race so far in the third quarter. Why the weak economy yet strong stock market? Because sentiment matters.

Disappointing data

The Eurozone's economic indicators have continued to surprise on the downside since April. August saw the Eurozone composite Purchasing Managers Index (PMI) fall to 47, from 48.5 in July, with the services PMI unexpectedly dropping into contractionary territory alongside the manufacturing index. In Europe's largest economy, Germany, factory orders for July fell the most since the lockdowns in 2020. The Eurozone consumer confidence recovery also stalled unexpectedly in August, remaining below its long-term average.

The economic surprise index for Europe has been below zero since April. A reading for the Citi Economic Surprise Index below zero means data is coming in worse than Bloomberg-tracked economists' forecasts and above zero means it is better than forecast.

Disappointing economic data since April

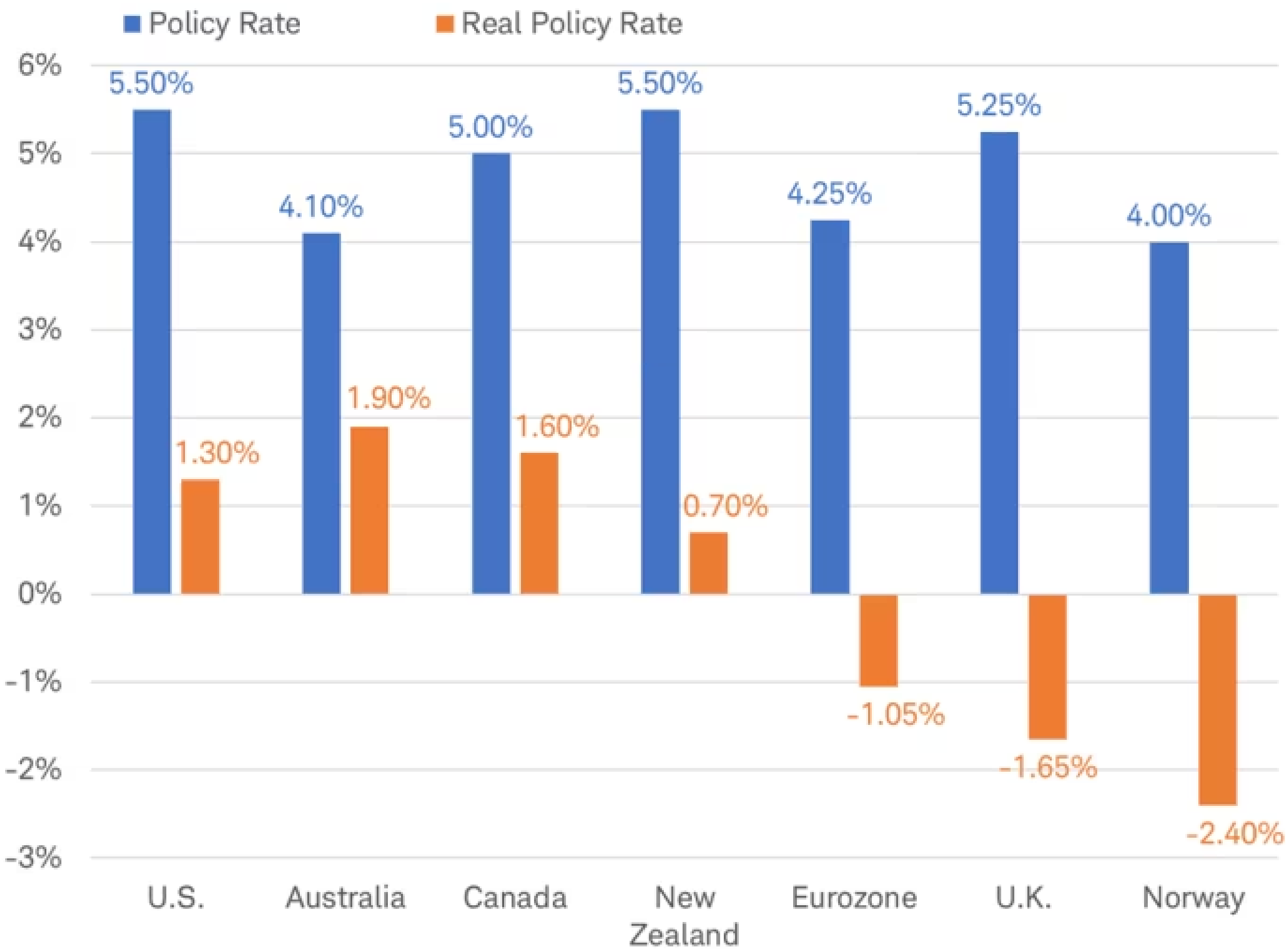


Source: Charles Schwab, Bloomberg data as of 9/6/2023.

ECB to blame?

In short, the modest momentum the Eurozone gained in the second quarter of 2023, when real GDP grew +0.3% (not annualized), seems to be evaporating. Does this mean the European Central Bank (ECB) hiked interest rates too far in their efforts to slow demand and cool inflation? The table below suggests not. While the ECB has hiked rates into the 4.0% to 5.5% range of other major central banks, when we adjust the policy rate for core inflation—to determine how restrictive the rate actually is—we can see that the real policy rate is still negative by over 100 basis points (bps). That remains below neutral and nowhere near the positive 130 bps in the U.S., where economic growth continues.

Real policy rates differ widely



Source: Charles Schwab, Bloomberg-tracked economist consensus forecast, data as of 9/5/2023.

Real policy rate is current rate less the year-over-year change in core inflation.

Performance

The performance of Eurozone equity markets does not seem to reflect this extended string of disappointing data. While the average European stock, measured by the equal-weighted MSCI EMU Index, is down from this year's peak at the end of July, it has not broken out to the downside. Rather it has traded sideways over the past five months that the economic surprise index was below zero. And the average European stock has maintained its outperformance of the average U.S. stock so far this year, despite the big gap in economic momentum.

Europe's stocks outperforming

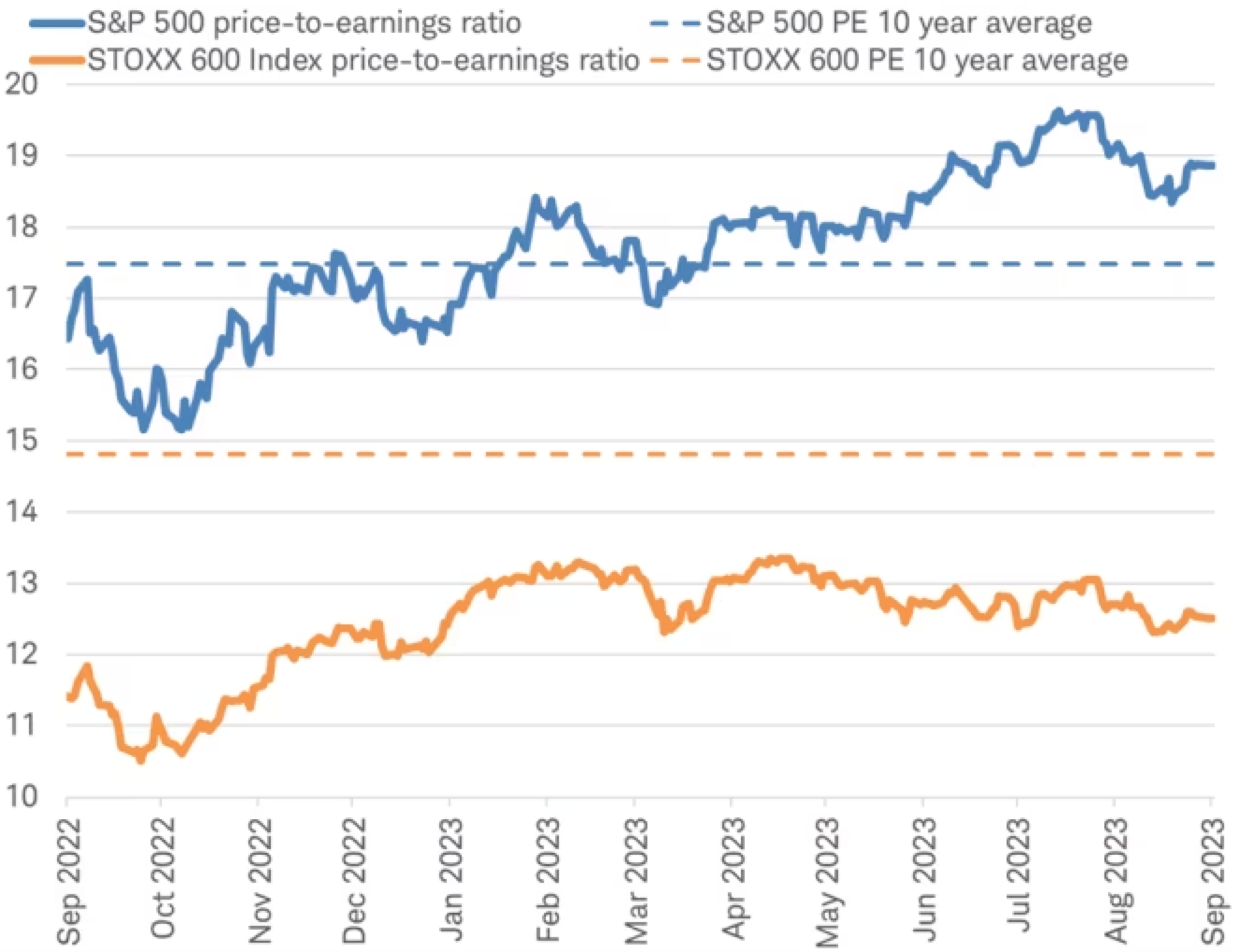
Source: Charles Schwab, Bloomberg data as of 9/6/2023.

EMU = European Monetary Union (Eurozone). Both indexes measured in US dollars. Indexes are unmanaged, do not incur management fees, costs and expenses, and cannot be invested in directly. Past performance is not guarantee of future results.

Sentiment matters

In contrast to the U.S., where an upbeat growth outlook by investors supports an above average multiple on earnings (price-to-earnings ratio) for the S&P 500 Index, investors in Europe have been valuing European stocks in the STOXX 600 Index well below the long-term average. The low earnings multiple indicates that investors have been expecting weaker earnings compared to history and the United States.

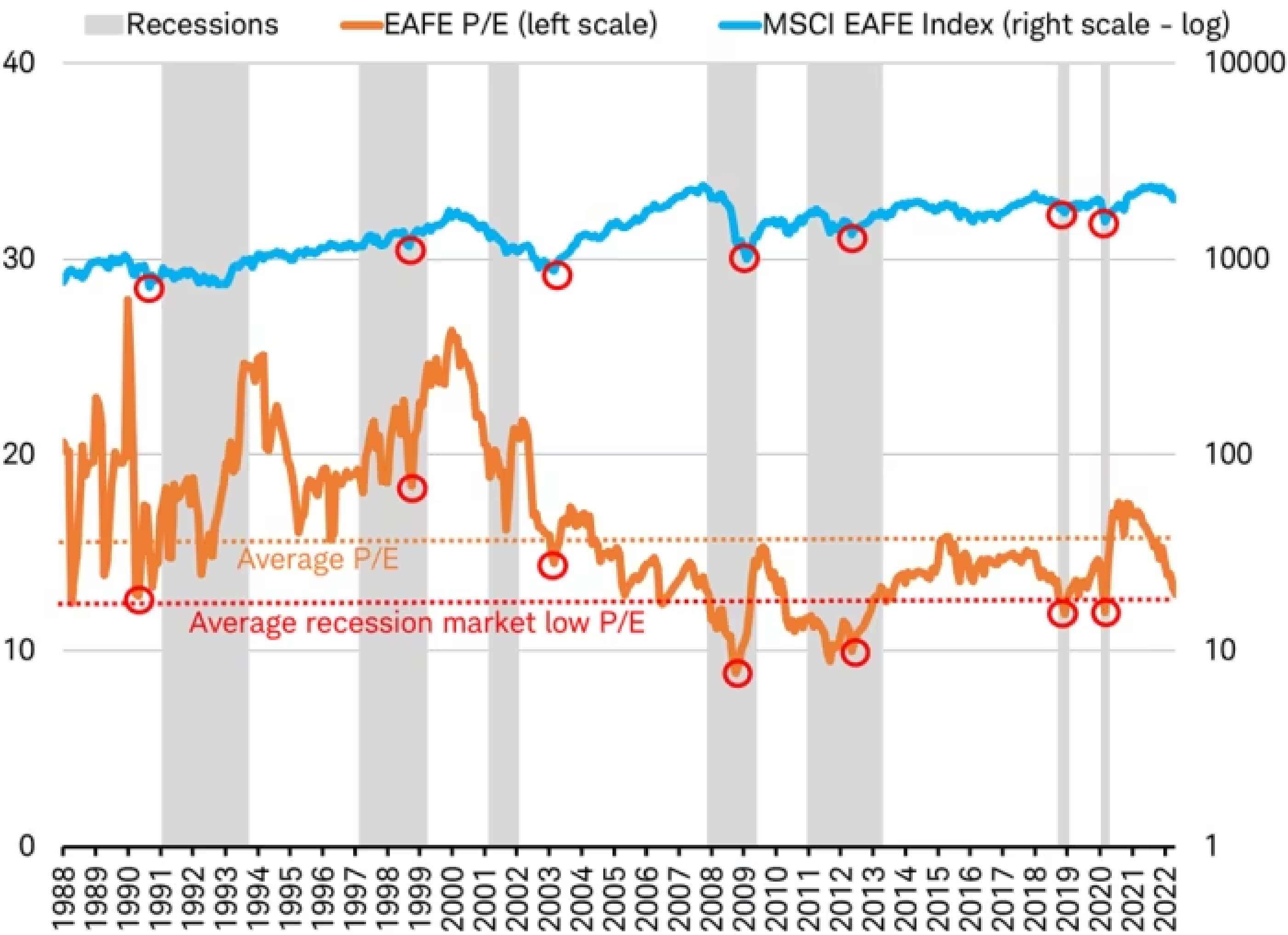
Big difference in valuations



Source: Charles Schwab, FactSet data as of 9/6/2023.

Notably, Eurozone economic sentiment by investors tracked by Sentix is currently dismal, with the confidence index near recessionary lows in August. Global investors are no more cheerful. According to Bank of America's most recent monthly survey in August, the net percentage of fund managers expecting European stock markets to weaken over the coming months climbed to 71%. This suggests any improvement in confidence could provide lift to European stocks.

Investors' economic outlook for the Eurozone



Source: Charles Schwab, Sentix Behavioral Indices, Bloomberg data as of 9/8/2023.

Investor expectations for eurozone growth may already be so low that negative surprises are now expected and no longer seem to hurt stock prices. Investors willing to look beyond the current weakness could start to drive up price-to-earnings ratios from these depressed levels as they anticipate the next upswing. Counterintuitively, a catalyst could include more disappointing economic data if that data were considered weak enough to persuade the European Central Bank to halt its unwinding of quantitative easing that began in March and start cutting interest rates. Other developments that could be seen by investors as catalysts for Europe's next economic upswing could also include effective stimulus in China, a rebound in European consumer spending as rapid disinflation pushes up real incomes, or restoration of the grain deal between Russia and Ukraine helping to ease food prices that are currently the largest component of overall Eurozone inflation.

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The Sentix Economic Confidence Index is based on a monthly survey of more than 4,000 financial market investors, both institutional and private, that assesses both the current economic situation and expectations for the next six months. The Index has global coverage, as well as coverage for several economic regions including the Eurozone, the U.S. and Japan.

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