30. Sep 2019 Equities

Always in second place? Why US equities are a step ahead of European stocks.

Stock exchanges in the USA have left Europe for dust over the past ten years. Will this remain the case?

— For years, US equities have outstripped their European counterparts and they keep posting new highs.
— Corporate strategy, earnings performance and sector weightings in equity indices are what differentiate this side of the pond the most from the other side.
— For US dominance to falter, much would need to happen in Europe.

5 minutes

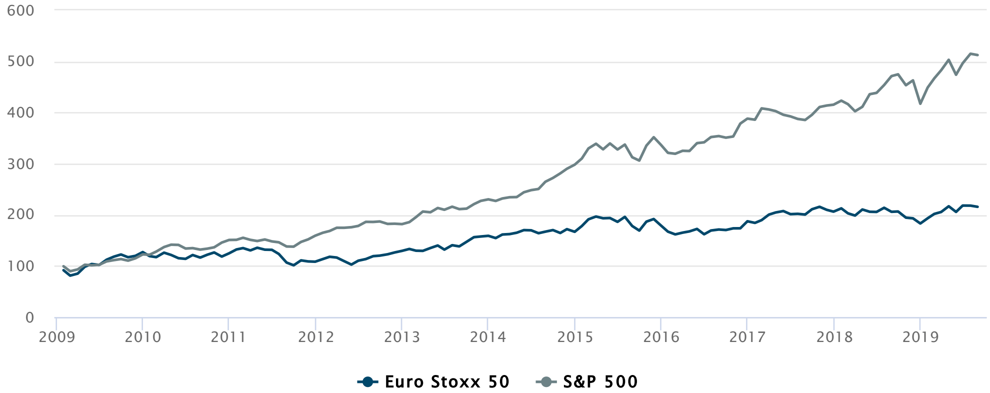
The US stock exchange simply has not broken stride. Simmering trade disputes with China and Europe, an impending Brexit, signs of a global economic downturn: none of these geopolitical risks has so far been able to make much impact on US equities' upwards trajectory. To the contrary, the broad S&P 500 US stock exchange index[1]<javascript:;> actually reached a new high recently. In Europe, the situation is completely different. For example, the Euro Stoxx 50 index of the eurozone's largest companies is far off the all-time high that it achieved in 2015.

Significantly better returns from US equities

If they look back a whole decade, investors in European equities have fallen far behind. Back then, stock exchanges had regained a firmer footing after major price falls during the financial crisis and the subsequent economic collapse in 2008. After that, North America and Europe swiftly went their separate ways. Since then, the Euro Stoxx 50 Total Return Index[2]<javascript:;>, which also takes account of dividend payments from the companies it includes, has only doubled in value. By contrast, its US counterpart, the S&P 500 Total Return Index, grew by more than 300 percent.

Up, up and away

Shortly after the end of the financial crisis, share prices in the eurozone and the USA headed upwards at broadly the same pace. However, the first signs of divergence were already visible by the end of 2009, and prices gradually continued to diverge over the next few years.



Source: DWS International GmbH, as of: 17/09/2019

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Long-term performance

Index	08/14 - 08/15	08/15 - 08/16	08/16 - 08/17	08/17 - 08/18	08/18 - 08/19
Euro Stoxx 50 Total Return Index in euros	6.6%	-3.9%	17.1%	2.7%	4.7%
S&P 500 Total Return Index	0.5%	12.6%	16.2%	19.7%	2.9%

Past performance, simulated or actual, is not a guarantee of future results.

What is the explanation for this huge differential and might the gap soon close again? According to Thomas Bucher, DWS equity strategist, one reason for the trans-Atlantic gap is that US companies have seen significantly higher profit growth in the past few years.

“This is partly due to the fact that after the crisis US companies focused earlier on ‘shareholder value’ – a strategy that gives top priority to added value for shareholders, for example through more rigid cost savings,” Bucher explains.

Corporate earnings in the USA and Europe also drifted further apart as a result of the “crisis after the crisis”. “We had barely begun to overcome the global financial crisis when heavily-indebted countries in the eurozone ran into difficulties,” Bucher says.

For a time, the euro teetered on the brink. This hampered household and corporate consumption, as well as investment demand. And European companies that export within the eurozone’s profits suffered the most from this.

Global market leaders "Made in USA" drive the stock exchange

few years. The chart has 1 X axis displaying Time. Range: 2008-12-22 08:38:24 to 2019-10-07 15:21:36. The chart has 1 Y axis displaying values. Range: 0 to 600.

View as data table.

The sector mix probably also helped the US market to extend its advantage. Service companies and companies with digital business platforms are more highly represented in the S&P 500 index than in the Euro Stoxx 50 index. Many of these innovative companies have emerged as undisputed global market leaders and experienced rapid share price rises. As a result, the global digital brands of Microsoft, Apple, Amazon, Facebook and Alphabet, Google's parent company, whose share prices have quadrupled since the crisis, are among the top ten[3]<javascript:;> in the S&P 500 index.

In the Euro Stoxx 50 index, by contrast, heavyweights such as Total, Linde, Sanofi and Unilever come from the more traditional energy, chemicals, pharmaceutical and consumer goods industries. Their growth is comparatively modest. Only two businesses from the software and semiconductor technology sectors – SAP and the Dutch company ASML (the world's largest provider of lithography systems for the semiconductor industry) – are currently among the ten largest[4]<javascript:;> companies in the Euro Stoxx 50 index.

"The high-tech sector's comparatively small presence is another factor that holds European equity indices back," argues Bucher.

The automobile sector currently exemplifies Europe's problems. Europeans long ignored the shift to new mobility concepts such as electric drive systems and autonomous vehicles. Now they have to cope with the fact that competitors from the USA and Asia enter their markets, putting ordinarily successful domestic brands under pressure. The result? Europe's automobile equities, which are heavyweights in, for example, Germany's leading equity index, the Dax[5]<javascript:;>, are currently weighing heavily on European stock exchanges because of their share price weakness.

European banks are losing ground

Even the finance sector, which has a comparatively high weighting of approximately 16 percent[6]<javascript:;> in the Euro Stoxx 50 index, seems to be putting quite a brake on overall stock-market performance. In the USA, banks have been able to put legacy issues from the financial crisis behind them quickly and are now back on top profitable form. By contrast, many European institutions are still struggling to make the huge write-offs they need to and are losing their way strategically.

"The European Central Bank's low interest-rate policy is also having a negative impact on finance companies, whereas in the USA, where interest rates are higher, net revenue from interest is once again an important source of income for competitors," explains Bucher.

S&P 500: Top 10 constituents by index weight

Constituent	Symbol	Sector*
Microsoft Corp	MSFT	Information Technology
Apple Inc	AAPL	Information Technology
Amazon.com Inc	AMZN	Consumer Discretionary
Facebook Inc A	FB	Communication Services
Berkshire Hathaway B	BRK.B	Financials
Alphabet Inc C	GOOG	Communication Services
Alphabet Inc A	GOOGL	Communication Services
JP Morgan Chase & Co	JPM	Financials
Johnson & Johnson	JNJ	Health Care
Visa Inc A	V	Information Technology

*Based on GICS® sectors, as of Aug 30, 2019

Source: https://us.spindices.com/indices/equity/sp-500<https://us.spindices.com/indices/equity/sp-500>

Top 10 constituents Euro Stoxx 50

Name	Supersector	Country
TOTAL	Oil & Gas	FR
SAP	Technology	DE
Linde	Chemicals	DE
Sanofi	Health Care	FR
LVMH Moet Hennessy	Personal & Household Goods	FR
ASML HLDG	Technology	NL
Allianz	Insurance	DE
Unilever NV	Personal & Household Goods	NL
Siemens	Technology	DE
Anheuser-Busch INBEV	Food and Beverage	BE

Source: https://www.stoxx.com/index-details?symbol=SX5E<https://www.stoxx.com/index-details?symbol=SX5E>, as of Sep. 26, 2019

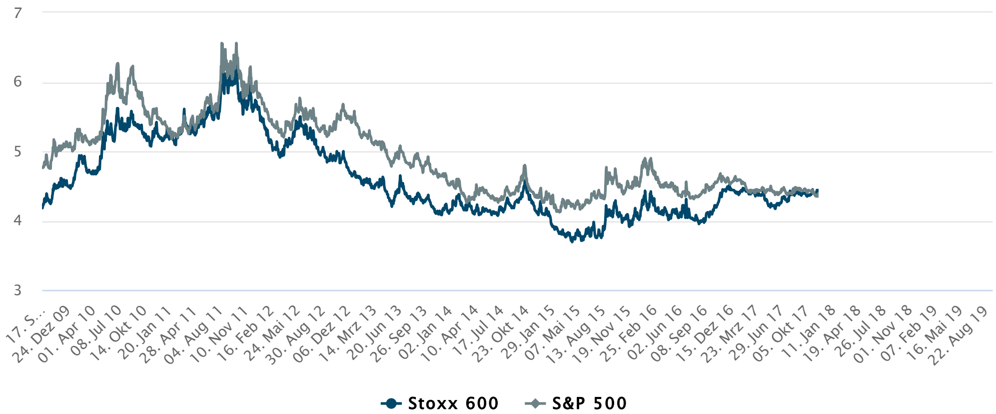
According to traditional valuation criteria, such as the price-earnings ratio or the price-book value ratio (market price per share divided by the book value per share), European equities are trading at a clear discount to US equities. But these indicators flatter to deceive and would have long since supported being overweight Europe against the USA.

However, if free cash flow (FCF) is used for market valuations, i.e. liquid funds that the companies in the index generate from their business activities, a different picture emerges. The justification for this approach is that these are the only funds that shall ultimately remain for dividend payments, equity buybacks and debt repayments. This indicator also takes account of company debt.

Measured by FCF yield (free cash flow divided by market capitalisation and net financial liabilities), a low number tends to mean a higher stock-market valuation. As the chart shows, Europe and the USA are currently trading at exactly the same level of 4.4% and have remained at around that level since 2014.

Free Cash-Flow Yields indicate a draw

The free cash flow of a business, set in relation to its market capitalisation and net debt, works as an valuation indicator where lower readings point to higher market valuations. In this perspective US and European stocks are roughly equally valued.



Source: DWS International GmbH, Factset, as of: 17/09/2019

US equities' improved performance can be explained and understood

Equity expert Bucher interprets it as follows:

- First, the US and EU equity markets may not have become quite as expensive as some people think.
- Second, significantly improved liquid funds generation – as mentioned above – and shareholder value creation fully explain US equities' strong past performance.

Equities' fundamental attraction remains

How does this affect the outlook? DWS continues to view equities as an attractive asset class, especially in the current low interest rate environment. This assumes that a recession can be avoided and that both profits and free cash flow will grow in the low single-digit percentage range.

A lot needs to happen if Europe's equities are to recover

If European equities are to do better than US equities, then some fundamental changes are necessary; in Bucher's analysis, European equities must become more profitable. They simply have to become much better if they are to generate liquidity for dividend payments and equity buybacks from a euro turnover. A great deal of money continues to be spent on restructuring, overpriced investments and extraordinary expenses. As long as the European economy continues to grow as slowly as it is doing right now, a significant improvement in European equities compared to US equities looks unlikely.

Conclusion for investors:

In the current environment, investors will have to come to terms with low, single-digit equity returns in Europe as well as the USA.

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1. ^ <javascript:;> The index covers the equities of 500 of the biggest listed US companies.
2. ^ <javascript:;> The Euro Stoxx 50 TR Index contains the 50 largest listed companies in the eurozone. Total return means that dividend payments are included in the price calculation.
3. ^ <javascript:;> https://us.spindices.com/indices/equity/sp-500
4. ^ <javascript:;> https://www.stoxx.com/index-details?symbol=SX5E
5. ^ <javascript:;> Index that measures the performance of the 30 largest and most liquid companies on the German stock market and represents around 80 percent of the market capitalisation of listed stock corporations in Germany.
6. ^ <javascript:;> https://etf.dws.com/LUX/ENG/Download/Factsheet/LU0380865021/-/Euro-Stoxx-50-UCITS-ETF

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