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Time for some European flavour in your investment portfolio.

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With the US S&P 500 stock market index continuing to reach record highs, it may be time to look elsewhere to build your portfolio's equity exposure.

The European market might just be the place for investors seeking to diversify their portfolio and take advantage of an overdue economic recovery. Europe is the largest market outside the US for diversifying investments – and with relatively favourable valuations and depressed earnings, the region is poised for strong growth.

Ever since the GFC, Europe's equity market performance has been sluggish. But this year has seen it bounce back with vigour, outperforming most regions and keeping pace with the buoyant US market.

With the recent reporting season over, earnings forecasts have now been upgraded. When assessed against broad market valuations, a strong case can be made to consider investing in European equities.

A positive outlook

There's currently an opportunity for strong double-digit returns over the next 12 months, especially for growth-orientated investors who are willing to accept the volatility that may be part of this European journey.

Various investment banks have upgraded their earnings forecasts for Europe-based companies, together with upgrades for the Euro Stoxx 600 and Euro Stoxx 50 broad market indices.

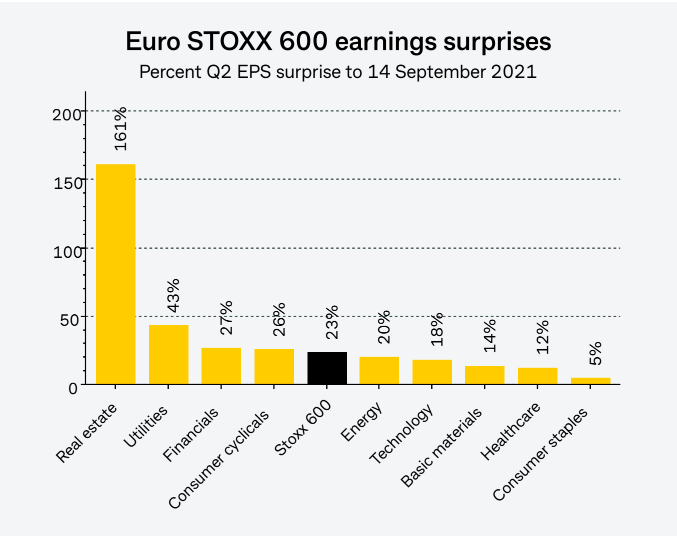
As an example, Goldman Sachs have raised price targets for Euro Stoxx 600, anticipating a total return of 13% over the next 12 months (Goldman Sachs,13 August 2021, Raising Targets & Earnings Forecasts). The investment research community also estimates that the end-of-year Earnings Per Share (EPS) for 2021 will be around 15% above 2019 levels – a marked improvement considering it took 11 years for European equities to regain 2007 levels (Bloomberg & FactSet Consensus Forecasts).

A review of the recent reporting season in Europe indicates sales growth of over 23% year on year, with the median stock seeing sales growth above 15%. Moreover, the EPS across most sectors has surprisingly been on the upside.

Earnings growth on the rise

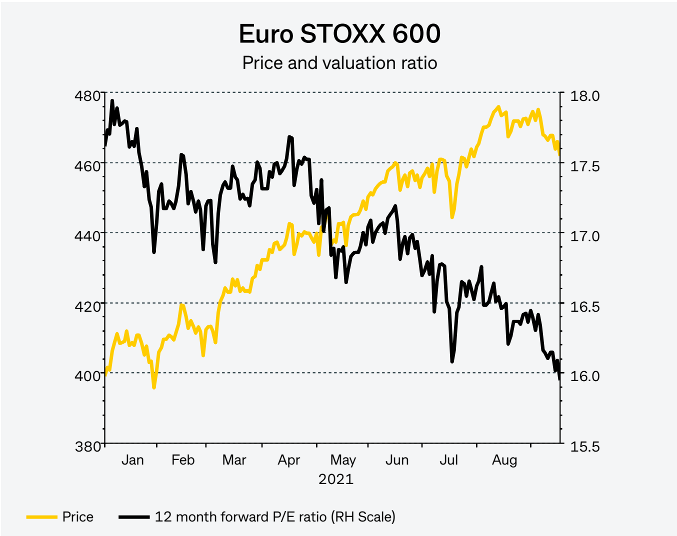
Even with the Euro Stoxx 600 increasing over 18% in 2021, European companies still offer comparatively good value. Figures 1 and 2 below highlight the valuation benefits of European companies as their earnings growth rise.

Figure 1:



Source: Refinitiv Datastream 20/09/2021

Figure 2:



Source: Refinitiv Datastream 20/09/2021

European stocks look attractive when compared to US and Australian equities on a forward price-to-earnings measure, as shown in Figure 3. On EPS growth (Figure 4), they have lacked the acceleration experienced across equivalent sectors only in the broader US market.

Figure 3:

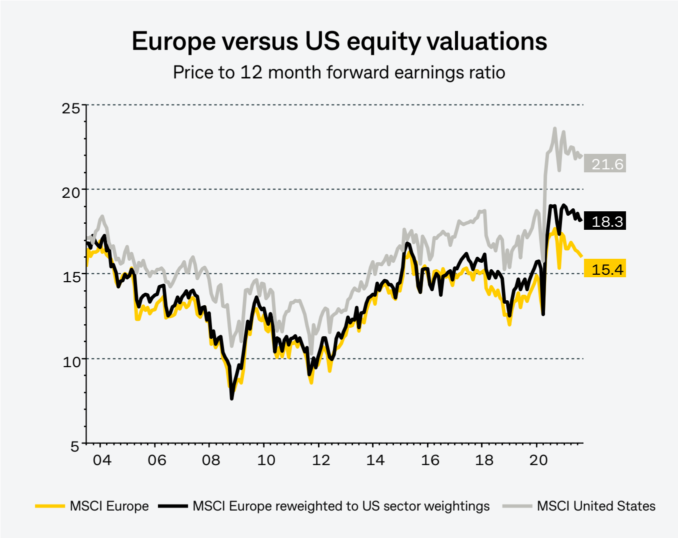


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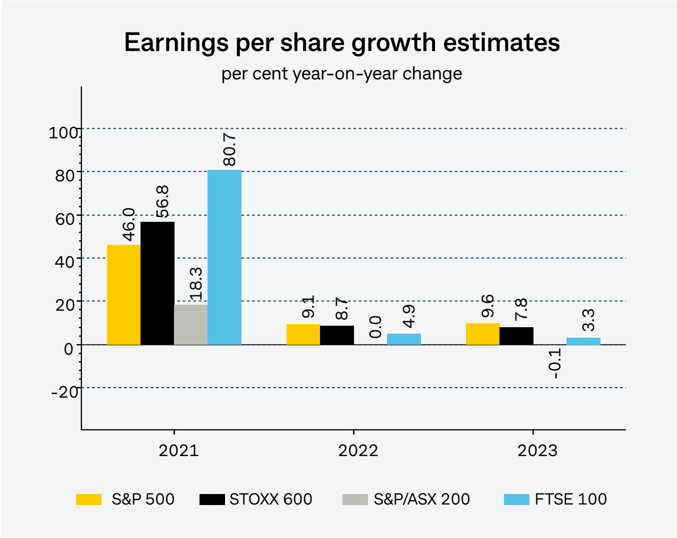
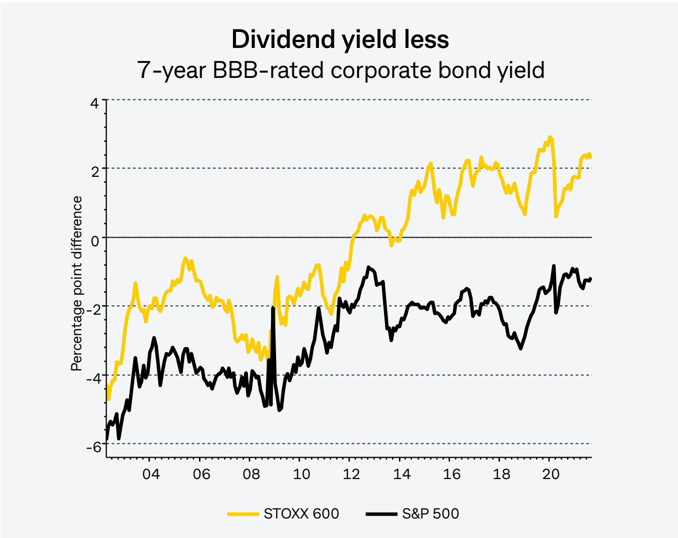
Figure 4:



Source: Refinitiv Datastream 20/09/2021

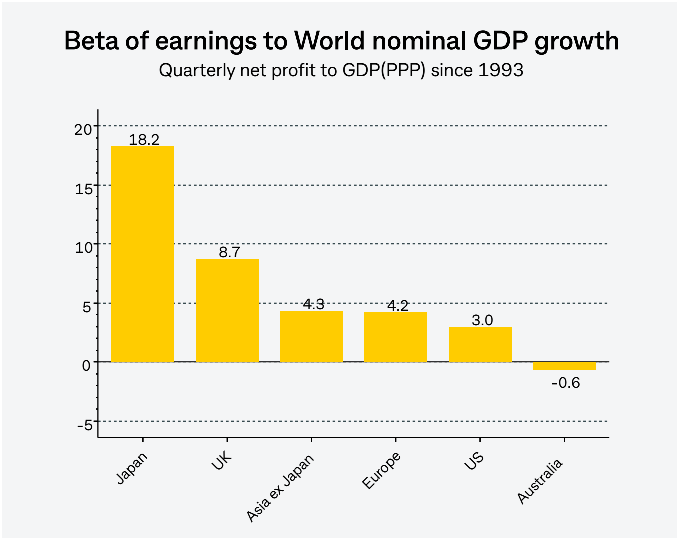
Dividends for European equities also look promising. As Figure 5 illustrates below, the Euro Stoxx 600 dividend yield is valued more than 2% higher than investment grade bond yields. In the US market this is not the case, with the S&P 500 dividend yield consistently lower than investment grade bond yields.

Figure 5:



Source: Refinitiv Datastream 20/09/2021

Figure 6:



Source: Refinitiv Datastream 20/09/2021

Moreover, when assessing the historic beta to world economic growth, European equities rate quite favourably compared with the US and Australian markets (Figure 6).

In light of these favourable indicators, institutional support for European equities from global investors is expected to provide ongoing tailwinds. Foreign investment into Europe, from both Asia and the US, is increasing too. A strong argument can be made that investors are now playing catch-up on the weak flows of the last few years.

Exposure to European equities also provides exposure to the Euro. When factoring this in, the relative return over the next 12–18 months is still expected to be positive.

Opportunities to diversify

Investing outside Australia provides obvious diversification benefits. Specifically, investing in the broad European market is an opportunity to diversify away from tech-heavy US stocks and an Australian market biased towards financials. The table below shows the different weights of each sector in the relevant index for Europe, the US and Australia.

Sectors	**Euro Stoxx 600** Weights %	**S&P 500** Weights %	**ASX 200** Weights %
Industrials	15.53	8.22	6.97
Financials	15.51	11.10	30.31
Health Care	14.09	13.49	10.53
Consumer Discretionary	11.62	11.88	8.19
Consumer Staples	11.34	5.79	5.30
Materials	9.24	2.56	18.82
Information Technology	9.19	27.91	4.42
Utilities	4.18	2.54	1.48
Communication Services	3.77	11.41	4.19
Energy	3.38	2.42	2.79
Real Estate	2.15	2.68	7.01

Source: Stoxx, S&P, ASX

Europe's financial Renaissance

After many years of lacklustre performance, two recent significant developments in the Eurozone have brought Europe sharply back into focus.

Expectations for major fiscal stimulus

The restrictive fiscal policies of recent years are now showing signs of an increasing spending appetite at both national levels and throughout Europe. For instance, there is a growing political will to make Europe the heart of the green revolution and a global leader in sustainability. Against a backdrop of accommodative monetary policy, which the ECB recently reaffirmed would be in place for the foreseeable future, this is potentially very bullish for European equities.

An economy transforming

In contrast to the tech-focused US market, European equities have traditionally been 'old economy' and a value play. But in recent years they have been undergoing a quiet transformation: the rise of their own digital economy and significant luxury goods exposure has coincided with the shrinking influence of lower-growth old economy sectors like banks and energy.

Within blue chip companies there has also been significant structural change. Companies like ASML (a vital player in the semiconductor supply chain), SAP (one of the world's largest software companies), and Louis Vuitton Moet Hennessy (French luxury goods and beverage conglomerate), are global leaders in fields benefiting from significant structural tailwinds.

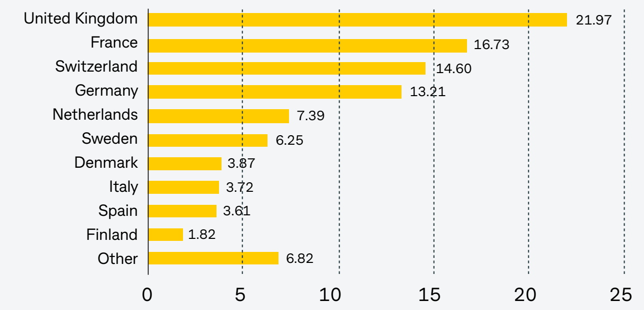
A path to European investment

Investing via an offshore ETF listed in the 'home/mother' market provides efficient exposure to the underlying market momentum for several reasons: depth of market trading volumes, lower cost and more accurate NAV pricing given time zone differences.

iShares Stoxx Europe 600 ETF is an efficient solution for gaining exposure to a broad range of companies from developed countries within the European region. This ETF is listed on the German Xetra exchange under ticker code EXSA, and settlement would naturally be in Euros.

See this factsheet for a breakdown of the past performance of the iShares Stoxx Europe 600 ETF. It shows that the fund has closely tracked the benchmark index, both through the COVID-induced economic downturn and the subsequent energetic recovery.

Geographic Breakdown (%)



Geographic exposure relates principally to the domicile of the issuers of the securities held in the product, added together and then expressed as a percentage of the product's total holdings. However, in some instances it can reflect the location where the issuer of the securities carries out much of their business.

Source: iShares by Blackrock, Sept 2021

Top Holdings (%)

Nestle Sa	2.94
Asml Holding Nv	2.82
Roche Holding Par Ag	2.28
Novartis Ag	1.84
Lvmh	1.58
Astrazeneca Plc	1.47
Novo Nordisk Class B	1.33
Sap	1.32
Linde Plc	1.32
Unilever Plc	1.18
Holdings are subject to change.	**18.08**

Source: iShares by Blackrock, Sept 2021

For clients that have a preference to invest via an ETF listed on the ASX, a Private Wealth Manager can provide advice on a suitable alternative to Euro Stoxx 600 offerings.

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Our dedicated team is ready to provide you with personalised solutions and wholesale advice.

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