Europe is treading a fine line between growth and inflation

Published 15 March 2023

Aneeka Gupta
Director, Macroeconomic Research

European equities have ushered in 2023 with a strong rebound, up 7.72%[1]. Exchange-traded fund (ETF) flows into the European region have risen by US$13bn, in sharp contrast to the US that has seen US$9bn of outflows year-to-date (YTD)[2].

Source: Bloomberg, WisdomTree as of 27 February 2023.

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

The confluence of China re-opening its economy and prudent management of resources during the energy crisis, alongside better valuations, helped European equities flourish. Essentially, the worst impact from the energy crisis that was priced in for Europe did not end up materialising, thereby improving sentiment.

Resilient Q4 2022 earnings season but outlook remains cautious

Europe is seeing better earnings growth for Q4 2022, up 8.81%[3]. The deep value parts of the market – financials, energy, utilities, consumer staples, and healthcare – continue to contribute to positive earnings growth. At the same time, China's reopening has benefitted cyclical sectors across consumer discretionary and communications which posted the strongest earnings growth up 49% and 38% respectively[4].

Source: Bloomberg, WisdomTree as of 24 February 2023.

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

At 8% of sales, Europe has the second-highest exposure to China after Asia-Pacific (ex-Japan). It therefore would make sense to position for a better China macro-outlook in the sectors with the highest revenue exposure to China – semiconductors, materials, consumer durables, energy, and automobiles. We also know Chinese consumers saved one-third of their income last year, depositing 17.8 trillion yuan ($2.6 trillion) into banks, and investors are pinning their hopes on those savings finding their way into Europe's luxury goods market.

Another factor favouring European equities has been European buyback activity which has increased to a record level, with a net buyback spend reaching around 220bn thereby creating an additional yield of around 2%[5]. This has helped Europe's total yield (that is, buyback + dividends) outpace that of the US for the first time in 30 years.

Headwinds persist from further tightening by European Central Bank (ECB)

Euro-area Purchasing Manager's Indices (PMI) continued their rebound in February reaching a nine-month high of 51, helped by easing headwinds from the energy crisis and resilient consumer spending amidst fading inflation. Headline inflation in the Euro-area for January dipped to 8.6%, showing further evidence that price pressures are easing[6]. However, core inflation in the Euro-area rose to 5.6%[5] from 5.2% in December, highlighting that underlying price pressures continue to remain sticky. The more resilient economic data of late is likely to keep the ECB on a more hawkish monetary path. As monetary policy works with approximately a 10 - 12 month lag, we are yet to see the full impact of the recent spate of tightening.

Source: Bloomberg, WisdomTree as of 24 February 2023.

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

Euro-area M1 growth is down to 0.6%, marking the second weakest reading on record pointing to weaker growth ahead. Furthermore, the Q1 results of the ECB Bank Lending Survey showed Euro-area credit conditions tightening at the fastest pace since 2009. In the Euro-area, moves in M1 growth tends to lead economic momentum by six months. This suggests that tighter monetary policy is leading to reduced credit availability for the real economy.

Tailwinds from looser fiscal policy to aid the Euro-area recovery

Prior to the Ukraine war, the Euro-area was characterised by relatively tight fiscal policy. However, the shock of the energy crisis drove a shift in fiscal policy. Governments are loosening their fiscal purse strings again, offering significant support to both consumers and businesses amidst the recent energy shock. Government expenditure, as a share of GDP, surged to almost 60% as COVID-19 hit (from just over 45% prior to the virus) and it is now rising again higher than before the pandemic[7]. The Eurozone budget deficit is now widening and heading towards 4% of GDP. Eurozone government expenditure as a share of GDP in 2022, through Q3, was 3% higher than the average from 2017 to 2019, with revenues up less than 1%. The think tank, Bruegel, estimates that EU economies have set aside €680bn to date to protect consumers from the energy crisis, which comes in addition to the EU Recovery Funds (€750bn from 2021 to 2027) which are now flowing. This is close to 10% of GDP, which excludes the cost of COVID-19 support.

The European economy remains caught between tailwinds – loose fiscal policy, easing energy prices, strong labour market, the re-opening of the Chinese economy – and headwinds of a weakening credit cycle in response to tighter monetary policy. Amidst this macro backdrop we expect investors to be more selective as the existing tailwinds should help Europe endure a milder than expected recession.

[1] Bloomberg performance of EuroStoxx 600 Index from 31 December 2022 to 13 February 2023.

[2] Bloomberg ETF flows from 30 December 2022 to 24 February 2023.

[3] Bloomberg, as of the reporting date, 273 of the 443 companies on the EuroStoxx 600 Index have reported earnings.

[4] Bloomberg, WisdomTree as of 24 February 2023.

[5] Factset, Refintiv as of 30 January 2023.

[6] Eurostat.

[7] Factset.

Related blogs

+ Value, Growth or neither?

+ Looking back at equity factors in Q4 with WisdomTree

+ 2023: Time to dive deep into value

Important Risks Related to this Article

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. Past performance is not a reliable indicator of future performance. Any historical performance included in this document may be based on back testing. Back testing is the process of evaluating an investment strategy by applying it to historical data to simulate what the performance of such strategy would have been. Back tested performance is purely hypothetical and is provided in this document solely for informational purposes. Back tested data does not represent actual performance and should not be interpreted as an indication of actual or future performance. The value of any investment may be affected by exchange rate movements. Any decision to invest should be based on the information contained in the appropriate prospectus and affer seeking independent investment, tax and legal advice. These products may not be available in your market or suitable for you. The content of this document does not constitute investment advice nor an offer for sale nor a solicitation of an offer to buy any product or make any investment.

An investment in exchange-traded products ("ETPs") is dependent on the performance of the underlying index, less costs, but it is not expected to match that performance precisely. ETPs involve numerous risks including among others, general market risks relating to the relevant underlying index, credit risks on the provider of index swaps utilised in the ETP, exchange rate risks, interest rate risks, inflationary risks, liquidity risks and legal and regulatory risks.

The information contained in 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 in the United States or any province or territory thereof, where none of the issuers or their products are authorised or registered for distribution and where no prospectus of any of the issuers has been filed with any securities commission or regulatory authority. No document or information in this document should be taken, transmitted or distributed (directly or indirectly) into the United States. None of the issuers, nor any securities issued by them, have been or will be registered under the United States Securities Act of 1933 or the Investment Company Act of 1940 or qualified under any applicable state securities statutes.

This document may contain independent market commentary prepared by WisdomTree based on publicly available information. Although WisdomTree endeavours to ensure the accuracy of the content in this

document, WisdomTree does not warrant or guarantee its accuracy or correctness. Any third party data providers used to source the information in this document make no warranties or representation of any kind relating to such data. 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.

This document may contain forward looking statements including statements regarding our belief or current expectations with regards to the performance of certain assets classes and/or sectors. Forward looking statements are subject to certain risks, uncertainties and assumptions. There can be no assurance that such statements will be accurate and actual results could differ materially from those anticipated in such statements. WisdomTree strongly recommends that you do not place undue reliance on these forward-looking statements.

Issuer Disclaimer The products discussed in this document are issued by WisdomTree Issuer ICAV (“WT Issuer”). WT Issuer is an umbrella investment company with variable capital having segregated liability between its funds organised under the laws of Ireland as an Irish Collective Asset-management Vehicle and authorised by the Central Bank of Ireland (“CBI”). WT Issuer is organised as an Undertaking for Collective Investment in Transferable Securities (“UCITS”) under the laws of Ireland and shall issue a

separate class of shares (''Shares”) representing each fund. Investors should read the prospectus of WT Issuer (“WT Prospectus”) before investing and should refer to the section of the WT Prospectus entitled 'Risk Factors' for further details of risks associated with an investment in the Shares.

Notice to Investors in Switzerland – Qualified Investors This document constitutes an advertisement of the financial product(s) mentioned herein.

The prospectus and the key investor information documents (KIID) are available from WisdomTree's website: **https:** //www.wisdomtree.eu/fr-ch/resource-library/prospectus-and-regulatory-reports

Some of the sub-funds referred to in this document may not have not been registered with the Swiss Financial Market Supervisory Authority (“FINMA”). In Switzerland, such sub-funds that have not been registered with FINMA shall be distributed exclusively to qualified investors, as defined in the Swiss Federal Act on Collective Investment Schemes or its implementing ordinance (each, as amended from time to time). The representative and paying agent of the sub-funds in Switzerland is Société Générale Paris, Zurich Branch, Talacker 50, PO Box 5070, 8021 Zurich, Switzerland. The prospectus, the key investor information documents (KIID), the articles of association and the annual and semi-annual reports of the sub-funds are available free of charge from the representative and paying agent. As regards distribution in Switzerland, the place of jurisdiction and performance is at the registered seat of the representative and paying agent.

For Investors in Monaco This communication is only intended for duly registered banks and/or licensed portfolio management companies in Monaco. This communication must not be sent to the public in Monaco. For Investors in France The information in this document is intended exclusively for professional investors

(as defined under the MiFID) investing for their own account and this material may not in any way be distributed to the public. The distribution of the Prospectus and the offering, sale and delivery of Shares in other jurisdictions may be restricted by law. WT Issuer is a UCITS governed by Irish legislation, and approved by the Financial Regulatory as UCITS compliant with European regulations although may not have to comply with the same rules as those applicable to a similar product approved in France. The Fund has been registered for marketing in France by the Financial Markets Authority (Autorité des Marchés Financiers) and may be distributed to investors in France. Copies of all documents (i.e. the Prospectus, the Key Investor Information Document, any supplements or addenda thereto, the latest annual reports and the memorandum of incorporation and articles of association) are available in France, free of charge at the French centralizing agent, Societe Generale at 29, Boulevard Haussmann, 75009, Paris, France. Any subscription for Shares of the Fund will be made on the basis of the terms of the prospectus and any supplements or addenda thereto.