# Europe is treading a fine line between growth and inflation

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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.*

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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.*

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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.

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