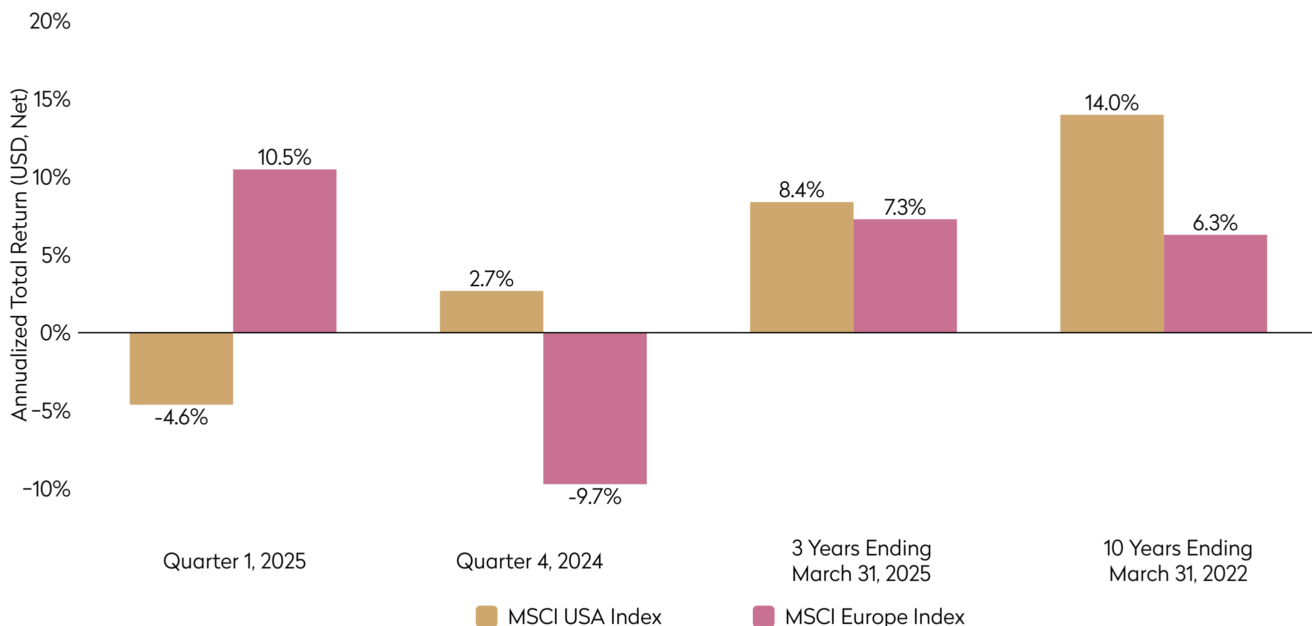
Mondrian
INVESTMENT PARTNERS

Global Equity Investment Outlook

Over the past decade, the European equity market has significantly lagged behind its U.S. counterpart. This underperformance was particularly pronounced in the final quarter of 2024, in the immediate aftermath of the U.S. election. At the time, the prevailing view was that the differential in economic growth rates and equity market performance may become more extreme in the context of pro-growth policies being implemented domestically, and with tariffs and the "America First" agenda set to weigh on Europe. In our most recent outlook, we expressed some reservations about whether all the optimistic expectations surrounding the Trump administration's policies could realistically materialize and ultimately benefit the U.S. economy. We wrote: "Ever-higher long-term growth rates are required to justify current U.S. equity valuations, whereas the potential returns from international equities have become comparatively more attractive. Consequently, the risks for long-term investors in U.S. equities have increased, creating an unfavorable skew towards future outcomes."

In the first few months of this year, the market's view has become more balanced. Although there is still a great deal of uncertainty, as the fears around tariffs have started to crystallize the concerns have also spread to the U.S. market itself. In addition, as a result of the new administration's focus on efficiency and reining in the deficit, the policy mix looks less unambiguously pro-growth. Concurrently, there have been some positive developments in Europe, where expectations were generally depressed, and this combination of events appears to have drawn greater attention to the stark differential in valuations between the two regions. The outperformance of Europe over the U.S. in the first quarter of this year has almost fully unwound three years of underperformance (Chart 1, below). In this Investment Outlook, we outline our perspective on the European market and the recent mini-renaissance, and we argue that over the long term there is potential for a lot more upside based on relative valuations.

Chart 1: European and U.S. Equity Market Returns Over Selected Time Periods



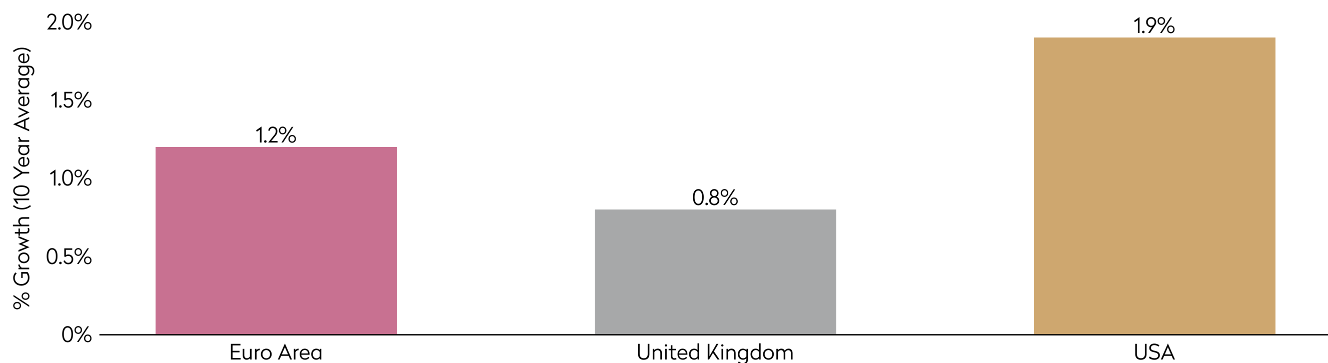
Source: MSCI, FactSet

Drags on the European economy are likely to ease

In recent years, as we have repeatedly made the valuation case for non-U.S. equities over U.S. equities, the common refrain from clients and investment consultants has been that Europe is a sort of economic also-ran, handicapped by its static industrial structure and sub-optimal governance and social model. This is understandable considering that, in the post-GFC period, Europe feels like it has bounced from one crisis to another, with only short periods of respite. Moreover, this perspective on Europe has a good basis in empirical fact. If we contrast Europe's growth with the U.S., we can generally say that it has shown a decent resilience to shocks (which is not nothing), but unfortunately when those shocks have faded, we have not seen a strong uplift or catch-up. As a result, the GDP growth gap relative to the U.S. is significant, even after adjusting for different rates of population growth (Chart 2, below).

Chart 2: Real GDP Per Capita Growth

10 Year Average (2014-2024)



Source: ESTAT/H, IMF, Haver

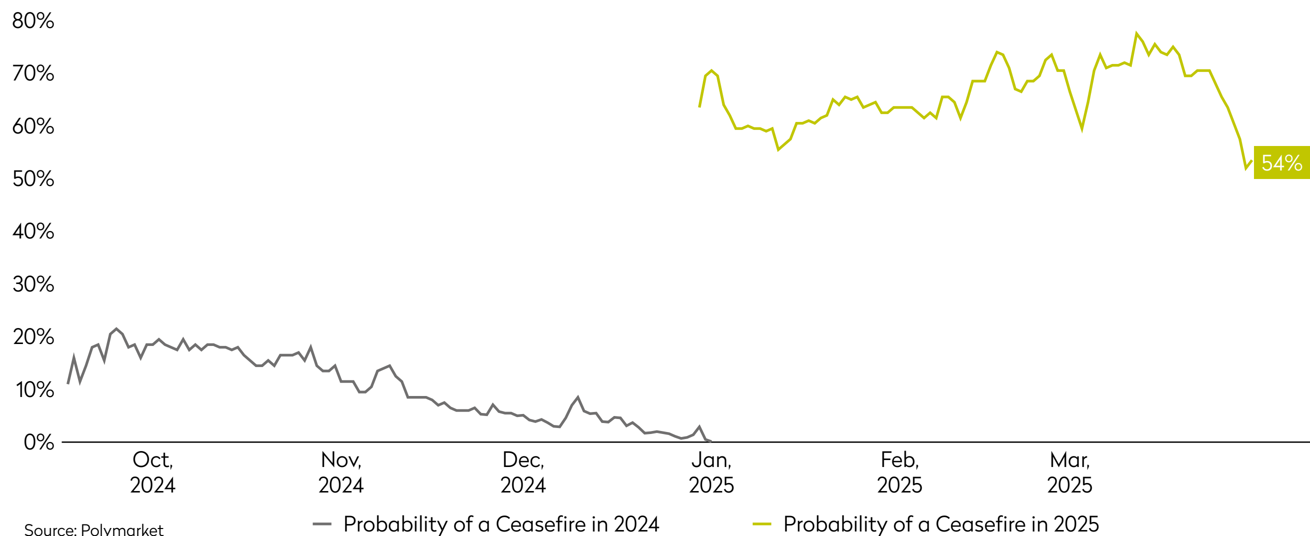
There is a growing recognition on the part of European politicians and policymakers that there are structural challenges to the region's growth. Encouragingly, these factors are attracting more commentary than we can recall at any previous time. "America innovates, China replicates, Europe regulates" was the pithy explanation from Italian Prime Minister Giorgia Meloni late last year. More substantively, Mario Draghi, the former ECB president and ex-Prime Minister of Italy, produced a detailed report on European competitiveness around the same time, calling-out the innovation gap versus the U.S. and China, structurally high energy prices (2-3x U.S. levels), and a need to bolster physical security and secure supply chains. Unsurprisingly, there are few quick-fixes: the prescriptions mainly involve less red tape and more joined-up policymaking. Whilst we should be clear-eyed about the structural constraints on growth, other potentially temporary factors have weighed disproportionately on the region, including the conflict in Ukraine (and the resulting spike in energy prices) and a more restrained fiscal stance in Europe. In both those areas, events in recent months point to some possible relief.

Rising probability of a Russia-Ukraine ceasefire

The Russia-Ukraine war has had a significant negative effect on the European economy, primarily via higher gas prices and inflation. These challenges could ease, given the Trump Administration's apparent determination to bring forward an end to hostilities between Russia and Ukraine. In the assessment of betting markets, the probability of a ceasefire before year end is now estimated to be above 50% (see Chart 3, below).

Chart 3: Probability of a Russia-Ukraine Ceasefire

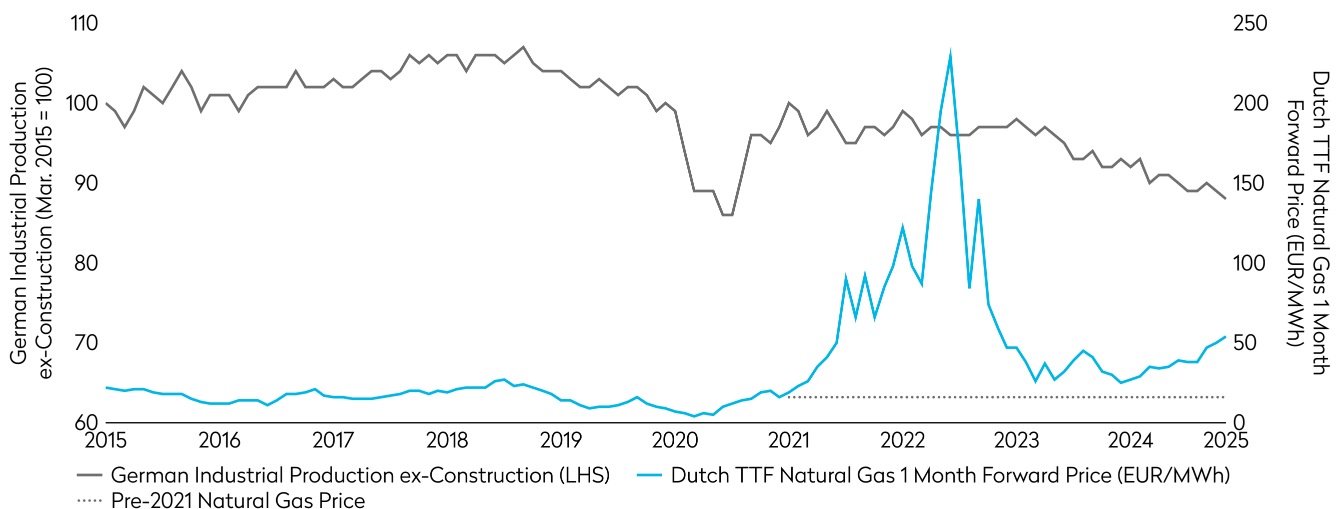
As of March 31, 2025



Source: Polymarket

To a degree, the equity market rally in Europe this year has been driven by the prospect of a "peace dividend." Of course, any meaningful positive impact on the European economy relies on the agreement being perceived as sustainable. Nevertheless, a durable peace would be supportive for the economy and for European equity markets. The cost of equity for European stocks is likely to decline with reduced geopolitical uncertainty, which would provide support for equity valuations. In addition, we could anticipate a positive impact on economic growth, from potentially lower gas prices – which have weighed on real wages and energy-intensive manufacturing – and from improved business and consumer confidence (see Chart 4, below).

Chart 4: German Industrial Production and Natural Gas Price

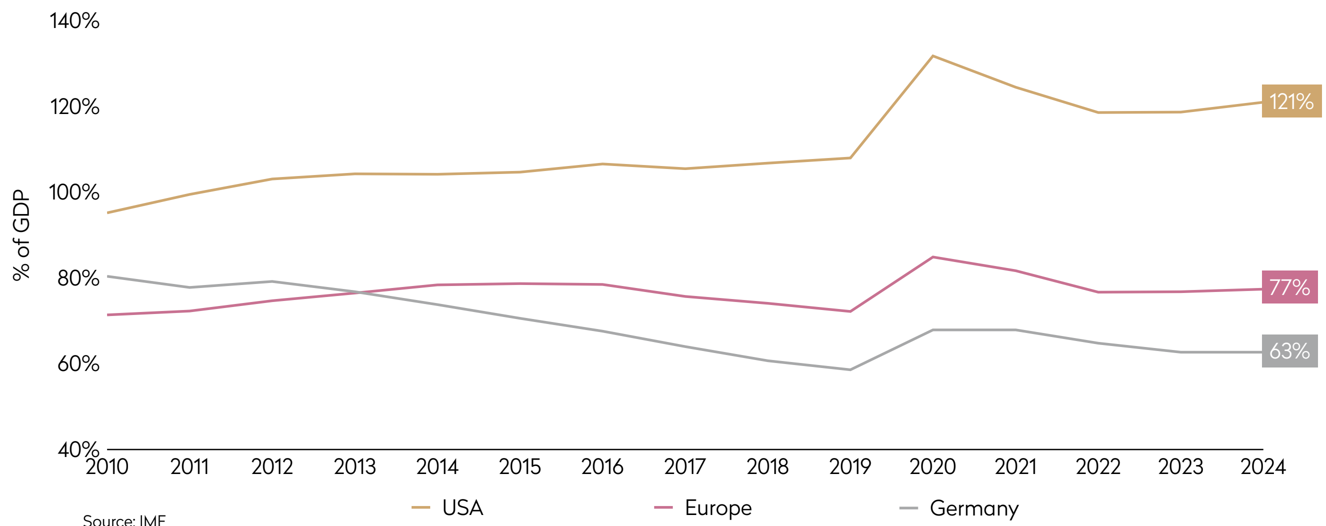


Source: Bloomberg

A shifting fiscal stance

Whereas fiscal stimulus has played a crucial role in the U.S. economic recovery, European governments overall have been less cavalier in their spending (see Chart 5, below). In Germany, given a frustrated electorate and an economy that has broadly stalled since the pandemic, this was widely expected to change following federal elections held in late February. Nevertheless, the fiscal shift in Europe's largest economy has surprised on the upside both in terms of timing and in terms of quantum. Already in early March, the Chancellor-in-waiting Friedrich Merz set out his plan to reform the legendary "*Schuldenbremse,*" known outside the country as the "debt brake." This self-imposed fiscal rule, enshrined in the country's constitution, has constrained the structural component of the fiscal deficit to a miserly 0.35% GDP. The proposed reform has mainly two parts. First, it carves out any defense spending over 1% of GDP. As such, it provides enormous flexibility for additional defense spending (in principle, unlimited!). Second, it creates a special €500b fund dedicated to infrastructure spending over 12 years. The amount is material, being equivalent to around 12% of GDP. The impact of the overall program could be significant in the context of a moribund economy, historic underinvestment in public infrastructure, and a shrinking automotive base. Concurrently, the European Commission has proposed to loosen Europe's fiscal debt and deficit rules to create space for more defense spending. The combination has effectively led to a re-appraisal of the capacity and willingness of European governments to spend, and this was the main driver of strong European equity market returns in the first quarter.

Chart 5: General Government Gross Debt-to-GDP

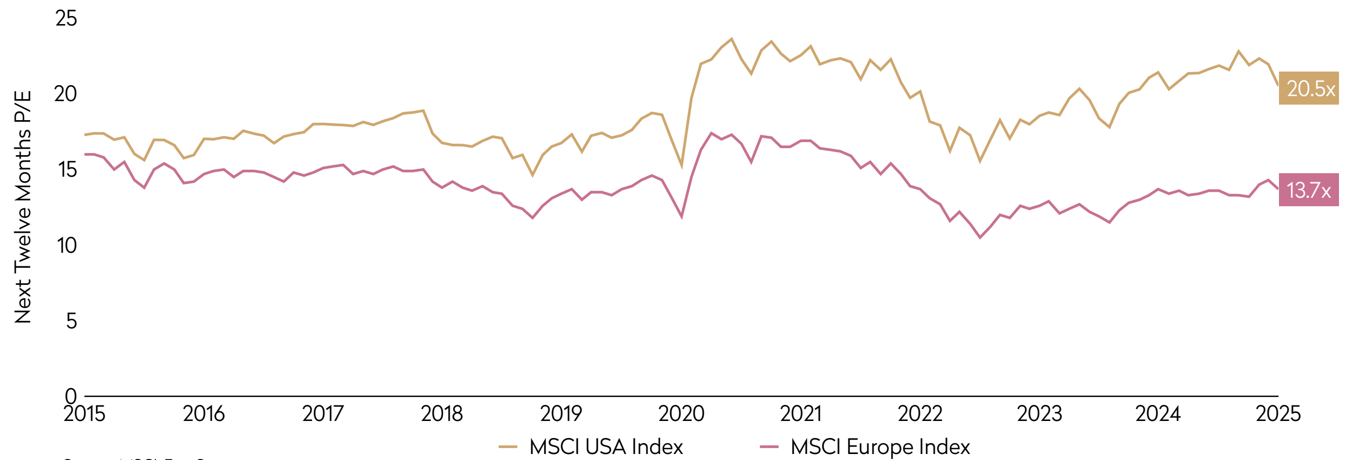


Source: IMF

A differentiated and attractive opportunity set; European equities are not always beholden to the European economy

Even if the change in U.S. administration has perhaps injected some long-dead dynamism into the European system, we acknowledge that Europe is fundamentally a lower-growth economy and that this is not likely to change. This is less important to the investment case than we suspect most people think, however, for a couple of reasons. First, expectations are a critical part of the equation and they are generally low in the case of Europe. Over time, share prices tend to realign with a company's intrinsic value, as the market recognizes the significant discount at which a stock is trading. Recent investment returns attest to that in a way, because the German equity market has handsomely outperformed the U.S. equity market and the NASDAQ over three years, even as its economy has basically flatlined. Valuation multiples in Europe remain low in absolute terms and continue to trade at a historically-wide discount to U.S. valuations (see Chart 6, below).

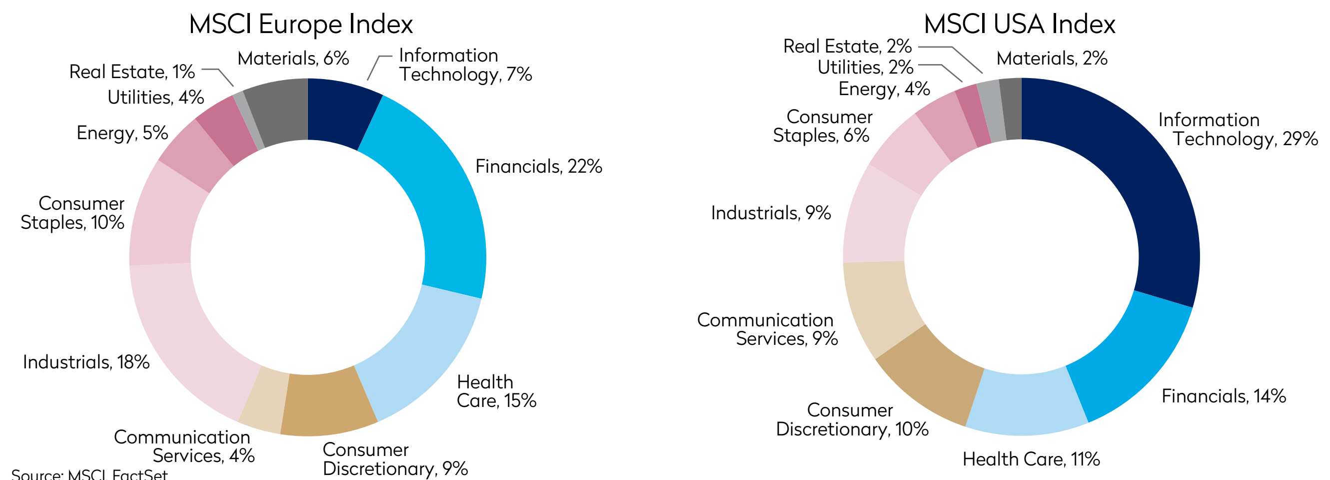
Chart 6: MSCI Europe and MSCI USA Forward Earnings Multiples



Source: MSCI, FactSet

Second, the attractiveness of Europe to long-term allocators should also be clearer if we consider the specific composition of the European equity market: it looks fundamentally different from the U.S. equity market, which is to some extent the flip-side of the innovation gap (see Chart 7, below). The U.S. equity market is much more concentrated in broadly-defined tech and in particular in the Magnificent 7 (still 29% of MSCI USA). Any re-assessment of future returns from that well-appreciated segment of the equity market would inevitably crimp U.S. index returns. In contrast, the European equity market is better-diversified and may sail through such an episode, as we have observed in recent months.

Chart 7: MSCI Europe and MSCI USA Sector Weights



Source: MSCI, FactSet

Moreover, European stocks are not in all cases beholden to the European economy! European companies overall generate nearly 60% of their revenues outside the region. If we consider the stocks that are held in Mondrian's International Equity and Global Equity portfolios, easily the majority by portfolio weight are businesses that are competing globally, with a revenue base reflecting that (e.g. Pernod Ricard in alcoholic beverages, Sanofi and Roche in pharmaceuticals, etc.). Where businesses are held that have their operations more deeply rooted in Europe, several have clear competitive advantages (e.g. Lloyds' scale/franchise in the UK; Associated British Foods' status as price-leader in the competitive apparel market). In certain cases, the specific context of Europe is central to the investment case. As we have mentioned, Europe is a laggard in the breakthrough digital technologies (cloud computing, AI), but it views decarbonization as an opportunity to take a lead in "clean tech," whilst at the same time shifting power generation to more secure and lower-cost clean energy sources. A number of holdings in our portfolios are beneficiaries of the resulting investments in grids and renewables (e.g. Enel, Vinci).

Conclusion

In contrast to many commentators, we increasingly think Europe is a very interesting market. Expectations have generally been compressed by a pretty weak economic backdrop and an extended period of equity market underperformance. The sharp reversal that we have observed this quarter may reflect a realization that the region is trading at a too-low multiple relative to its long-term fundamental value. While we have not explicitly incorporated it into our central case assumptions, there are indications that some pressures on European economic growth are likely to ease. In any case, many European companies compete globally and are not so beholden to the regional economic backdrop. From a long-term value manager's perspective, the European equity market offers attractive stock-picking opportunities: well-diversified by sector, with sixteen different country markets – many with distinct cultures and different economic and political climates – and approximately 680 companies with a market capitalization over $2.5 billion (c.370 with a market capitalization over $7.5 billion). We believe the consistent application of our disciplined, value-oriented investment approach across this diverse opportunity set can identify a sub-set of significantly mis-priced securities with superior risk profiles.

Disclosures

Views expressed were current as of the date indicated, are subject to change, and may not reflect current views. All information is subject to change without notice. Views should not be considered a recommendation to buy, hold or sell any investment and should not be relied on as research or advice.

This document may include forward-looking statements. All statements other than statements of historical facts are forward-looking statements (including words such as “believe,” “estimate,” “anticipate,” “may,” “will,” “should,” “expect”). Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct. Various factors could cause actual results to differ materially from those reflected in such forward-looking statements.

Neither MSCI nor any other party involved in or related to compiling, computing or creating the MSCI data makes any express or implied warranties or representations with respect to such data (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to any of such data. Without limiting any of the foregoing, in no event shall MSCI, any of its affiliates or any third party involved in or related to compiling, computing, or creating the data have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages. No further distribution or dissemination of the MSCI data is permitted without MSCI’s express written consent.

This material is for informational purposes only and is not an offer or solicitation with respect to any securities. Any offer of securities can only be made by written offering materials. The information set forth herein is a summary only and does not set forth all of the risks associated with the investment strategy described herein.

The information was obtained from sources we believe to be reliable, but its accuracy is not guaranteed, and it may be incomplete or condensed.

It should not be assumed that investments made in the future will be profitable or will equal the performance of any security referenced in this document. Examples of securities will represent only a small part of the overall portfolio and are used to illustrate our investment approach. Any holdings are subject to change and may not feature in any future portfolio. More information on holdings is available on request.

Unless otherwise stated, all returns are in USD.

All references to index returns assume the reinvestment of dividends after the deduction of withholding tax and approximate the minimum possible re-investment, unless the index is specifically described as a “Gross” index

Past performance is not a guarantee of future results. An investment involves the risk of loss. The investment return and value of investments will fluctuate.

Mondrian Investment Partners Limited is authorised and regulated by the Financial Conduct Authority (Firm Reference Number: 149507). Mondrian Investment Partners Limited is also registered as an Investment Adviser with the Securities and Exchange Commission (registration does not imply any level of skills or training).