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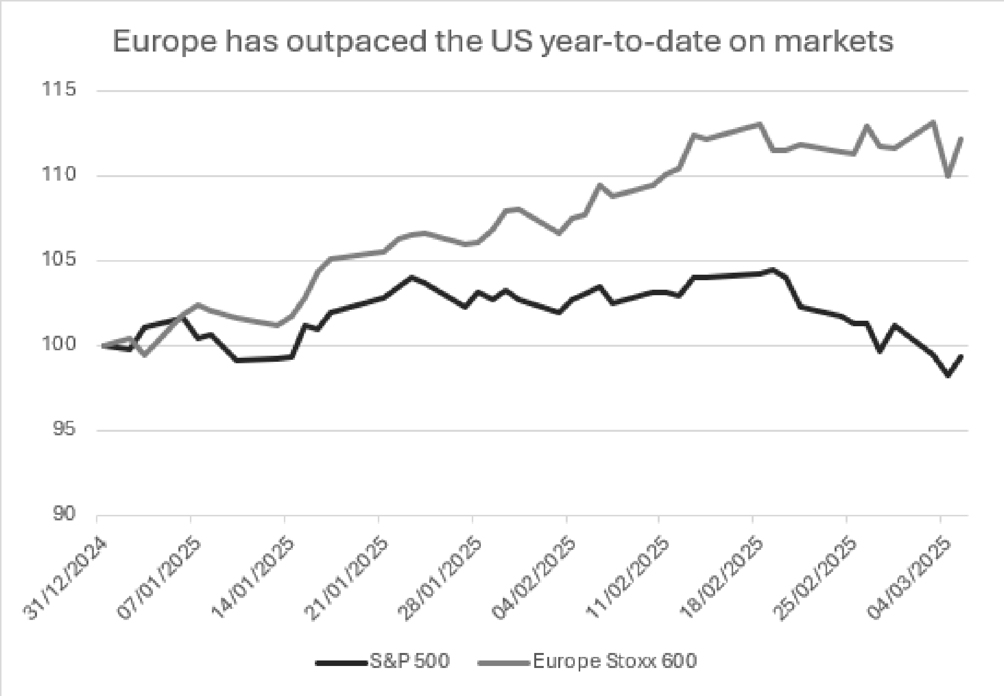
Investors begin to get back their appetite for Europe

Written as at 6th March 2025

European equites have taken centre stage in 2025, defying expectations and outpacing their US counterparts. The Europe Stoxx 600 has risen by around 9% year-to-date, while Germany's DAX has surged by almost 16%, with both indices hitting new record highs. By contrast, the US market is in the red as at the time of writing.



Source: Bloomberg, *BIL* as of 5 March 2025. Data normalized to 100.

Several key factors have fueled the remarkable surge in European equities, from emerging signs of economic stabilisation to geopolitical developments…

The US Administration steers away from universal tariffs

A major catalyst behind the rally was the absence of immediate trade tariffs when President Trump initially took office, with Canada, Mexico and China first in line. When it later became clear that Europe had not escaped the radar, markets still found comfort in the White House's preference for a targeted approach based on "reciprocity", over broad-brushed universal tariffs.

Given that the EU's trade tariff differential with the US is just +1.2 percentage points, this proposal would appear manageable. The asterisk, however, is that the Commerce Department may also include non-tariff barriers such as VAT in its calculations. If this happens, Europe could face more sever trade restrictions.

For now, though, markets remain in a wait-and-see mode, carefully trying to distinguish political posturing from concrete policy shifts.

Economic optimism picks up

Also adding to the momentum is the growing sense that economic indicators are bottoming out. Key measures like the ZEW survey, Germany's IFO Index and the European Commission's Economic Sentiment gauge, are all showing early signs of recovery. Moreover, a nascent rebound in Manufacturing PMIs suggests that the business cycle may finally have reached its trough.

While these soft data points (surveys) are encouraging, the real test lies in hard data. Industrial production, corporate investment, and consumer spending must follow sentiment higher for a sustained recovery to take hold.

It is also worth noting that Germany, once the Eurozone's economic powerhouse, is also showing tentative signs of improvement. Its composite PMI has climbed back into expansionary territory after spending much of 2024 in contraction. The recent election outcome has fueled optimism about fiscal stimulus; the incoming coalition does not have time to waste when it comes to revitalising growth.

Geopolitical developments

The war in Ukraine has been a major overhang on European equities for the past three years, prompting many global investors to underweight the region. The prospect of a potential ceasefire initially brought nimble investors back to the market on hopes of lower risk premia for European equities, renewed confidence, and ultimately stronger economic growth. Larger institutional players are only now reconsidering their exposure. If major global asset managers start adopting more of a neutral stance on Europe, that alone could bring a significant wave of money into the market, adding further fuel to the rally.

One sector in particular that has rallied strongly in Europe is defense.

With the US currently refusing security guarantees for Ukraine, the sea change in European fiscal policy could well be a game changer for the bloc.

The risks that could derail Europe's rally

Despite newfound optimism, several key risks could still disrupt the rally and shake investor confidence.

Firstly, trade remains a wildcard. President Trump has hinted a 25% levy on "cars and all other things", rekindling fears of a new EU-US trade dispute. If that were to materialise, it could disrupt supply chains, curtail the fragile recovery in European manufacturing, and dent corporate earnings.

When it comes to geopolitics, a peace deal in Ukraine is not guaranteed, and even if it materialises, its economic impact remains uncertain. While some European firms may benefit from Ukraine's reconstruction, the financial burden could further strain public finances across the EU and siphon money away from investment in infrastructure, digitalization and other value-adding endeavors.

And while the war in Ukraine was the catalyst for Europe's energy crisis, a peace deal will not make that go away overnight. As of now, it seems Russian energy flows are unlikely to resume fully. European firms could therefore continue to face higher energy costs than their US counterparts, detracting from competitiveness.

Lastly, we can't forget that the ECB is also still engaged in a delicate balancing act. While markets are pricing in two more rate cuts for this year, the central bank's easing campaign could still be disrupted. In particular, if the Fed is forced to keep US rates higher for longer, the ECB may have less room to maneuver if it wants to avoid weakening the euro (which in turn could stoke inflation).

Europe: a sweet spot?

While risks remain, the shift in sentiment is undeniable, and if fundamentals continue to improve, European equities may indeed have more room to run.

Only now, are many investors reconsidering their exposure —This, alongside the fact that valuations are still cheap on a relative basis, suggests that further upside remains.

However, for the soufflé to keep rising, we think three key ingredients are required:

- Hard economic data must validate the optimism seen in sentiment surveys
- The ECB must continue lowering interest rates
- Earnings momentum must continue

None of these factors are guaranteed, while a lot of the upside is already baked into prices.

When eating a cake, sometimes we are cautioned "a moment on the lips, a lifetime on the hips". Investors looking to have a bigger slice of Europe in their portfolio should be thinking about the long-term too, rather than expecting to make quick and easy gains. Timing the perfect entry point is notoriously difficult and the scope for market fluctuations remains quite significant, even if the European economy has really found its bottom.

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