Principal Equities

Evolving economies present timely opportunities in Europe

Key takeaways

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For many years, European stocks have been largely shunned by foreign investors, reflecting lingering pessimism dating back to the Global Financial Crisis (GFC), the subsequent Eurozone Sovereign Debt Crisis, then Brexit, and most recently the outbreak of the war in Ukraine. Although many of those concerns have abated, investor scepticism remains elevated, overly so in our view. Indeed, we are increasingly seeing positive structural change opportunities and improving growth in Europe, including its innovative approach to energy independence, digitalization and a manufacturing revival driven by global reshoring of supply chains. The financial system in Europe has also proven to be much improved after nearly 15 years of deleveraging and consolidation, including important regulatory changes. European banks are now better capitalized, and ultimately better able to weather future challenges, especially in comparison to less well capitalized U.S. peers.

We observe that many investors remain significantly underweight the region, which we see as increasingly sub-optimal and risky. Consistent with our philosophy of focusing on the identification of sustainable positive change relative to market expectations, we are seeing a greater abundance of "businesses becoming better" and positive earnings surprise emanating from Europe in recent months. Our improved sentiment is underpinned by three primary fundamental pillars, as described in more detail in the pages that follow:

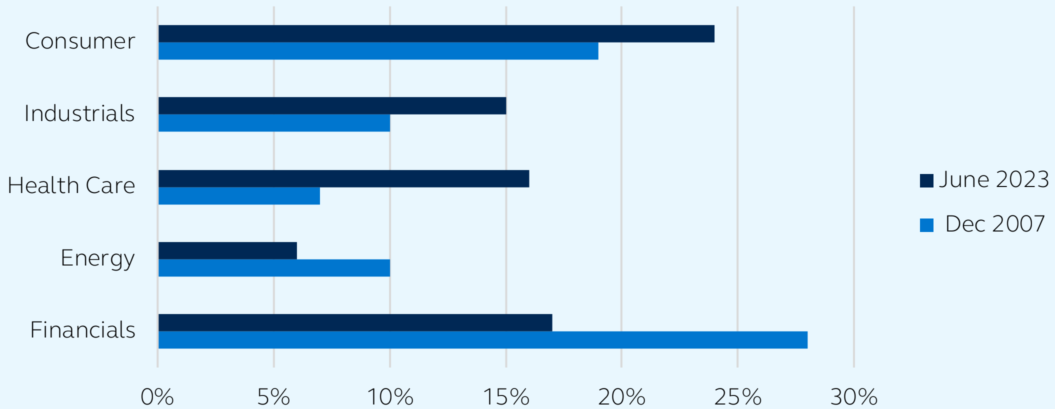
- Structural renovation – we are finally seeing "green shoots" after many years of restructuring and tough policy actions.
- Innovation renaissance – Europe increasingly offers some interesting sources of innovation across sectors, providing valuable diversification.
- Global gateway, at a discount – Despite improvements, European companies continue to trade at historically low relative valuations compared to U.S. and global peers, providing an attractive and timely rebalancing opportunity.

Structural renovation

Investing in European equity markets looks very different than it has in the past. The "old guard" of big banks and big oil companies is being transformed into a more modernized Europe with the potential for attractive investment opportunities.

Prior to the GFC, the financial sector represented nearly 30% of the European market, with banks representing nearly 20%. The percentage represented by banks now stands at less than 10%. The allocation to energy has almost halved, nearly all related to less dependence on coal and oil. Subsequently, we have seen an encouraging rise in exposure to more structural innovation sectors, offering better growth potential and less cyclical volatility.

THEN AND NOW: Sector composition changes favouring innovation, reduced exposure to the "old guard" of big banks and big oil



Source: FactSet, MSCI, Principal Asset Management. Data as of 31 May 2023.

We are also seeing clearer "green shoots" at the national level — exemplified by two of the countries hardest hit by the prior crisis — Ireland and Greece, which are now amongst the fastest growing economies in Europe.

Ireland is well placed as the only English-speaking country in the EU, with a well-educated workforce, and low corporate tax rate, which is making it an attractive gateway to Europe, particularly following Brexit. The "Emerald Isle" has regained its shine! Meanwhile, Greece had been the most strained economy during the sovereign debt crisis and has recently been upgraded to one level below investment grade. That should bode well for the country to regain Developed Market status, after its historic downgrade in 2013. The digitalisation of government services has been one of its most notable success stories, while the economy has opened to international competition with several of America's leading global tech and heath care companies building operations there.

Innovation renaissance

Energy independence and transition initiatives represent one of the most robust sub-themes of the broader industrial renaissance. Much of Europe was in a state of panic as Russia invaded Ukraine. The conflict laid bare how significant the region's dependence was on Russian gas. Household energy bills were initially forecasted to more than double. But in a time of crisis, Europeans came together. There was a need to reduce energy consumption and forge a more sustainable path ahead. It was a joint effort by local authorities, the corporate sector, and conscientious consumers that helped achieve a 15% reduction in energy demand for 2022[1].

Piped Russian gas now only accounts for 8% of the EU's supply, down from 40% prior to the invasion of Ukraine[2]. The shortfall has been made up by deals with Algeria, Azerbaijan, Egypt, and the United States. In addition, the voluntary 15% reduction in energy consumption in Europe, together with a warm winter enabled energy storage to recover to record high levels. While crisis was averted in the short run, more will need to be done to achieve a sustainable path to long-term energy security.

That's where supportive government policy is playing a key role. The European Union is investing €2 trillion[3] in stimulus, through the NextGenerationEU and the RePowerEU plans, which together will distribute funds in grants and loans to revive the European Union economy post covid, investing in renewables, to make the economy more sustainable, and in digitalization to help ensure the region remains competitive with global peers.

Another competitive advantage for Europe is its leading role at the forefront of innovation in the wind sector. The North Sea is uniquely well-suited to the generation of wind power, as it is consistently one of the windiest places in the world, and the soft seabed makes it easier to fix wind turbines there to transform wind into energy. The conditions mean that wind turbines can be placed out of sight of the land masses, where wind speeds are more consistent, which leads to higher efficiencies. Additionally, investment in hydrogen technologies will enable the energy generated at sea to be stored and transported more efficiently.

The structural change opportunity is about more than just wind farms. Europe's old stock of buildings is a source of considerable heat loss, and their renovation for energy efficiencies will necessitate higher investments – in new windows and doors, and in heat pumps, insulation and more efficient lighting and heating systems. Companies operating within the electrical components and equipment sector stand to benefit with evolving climate solutions. We are still in the early innings of this long-term, sustainable trend. European companies are also increasingly gaining share in the U.S. benefitting from the energy and transportation initiatives within President Biden's Inflation Reduction Act.

Europe is also a critical global hub for advanced research, especially in health care, telecommunications, and electronics. While not as widely recognized as "Silicon Valley" cities such as Cambridge, England, and Eindhoven, Netherlands and several others in Norway, Sweden, France, and Ireland are all home to vibrant research centres, aligning top-tier universities and prominent multinational companies. Especially notable have been Europe's contributions to medical breakthroughs. The European pharmaceutical sector has been a rich source of innovative new drugs – from treatments for cancers, diabetes, obesity, arthritis, and asthma. We attribute this to a steadier,

[1]Financial Times. [2]International Energy Agency. [3]European Commission.

longer-horizon commitment to R&D funding, both public and private, in contrast to the more cyclical research spending culture in the U.S. The region has also recently adopted the EU Critical Raw Materials Act. The Act will help ensure that the EU can rely on strong, resilient, and sustainable value chains for critical raw materials. Nearshoring and diversification will remain in the headlines for years to come.

Global gateway, at a discount

Europe has long been home of many of the world's most prominent multi-national corporations. Indeed, companies included in the STOXX Europe 600 now generate less than half of their aggregate its revenues in Europe. As of 2022, only 42% of revenues were generated in Europe while 24% were from North America and 21% from Asia[4]. Prior to the GFC, the European number was 60% but has steadily declined as companies seek growth opportunities and more sustainable business. As a timely and enduring example, Europe's storied luxury brands have rarely been more coveted, on an increasingly global scale.

Yet, some may well ask, why not simply concentrate investments directly in the Americas and Asia? Increasingly the answer is a simple matter of risk and reward.

Across many sectors, European companies set the standards by which others are judged in terms of corporate governance. This spans many risk considerations from property protections, shareholder rights, board structures/diversity, worker rights and safety, anti-exploitation, and more. Europe provides exposure to emerging markets with higher standards for disclosure, anti-corruption policies, and supply chain monitoring requirements. European governance standards also include more curbs on excessive executive compensation that can contribute to reckless and asymmetrical risk taking among U.S. companies. Investments in Europe can also play an increasingly important role in geopolitical risk mitigation, as a strategic gateway to re-shoring supply chains, to buffer against the escalating tensions between the U.S. and China.

European companies also demonstrate strong shareholder return discipline with stable and sustainable dividend policies, which can be particularly attractive to tax-advantaged retirement and institutional investors. The region is also somewhat further along in paring back quantitative easing, and with lower debt leverage than the U.S.

The bottom line:

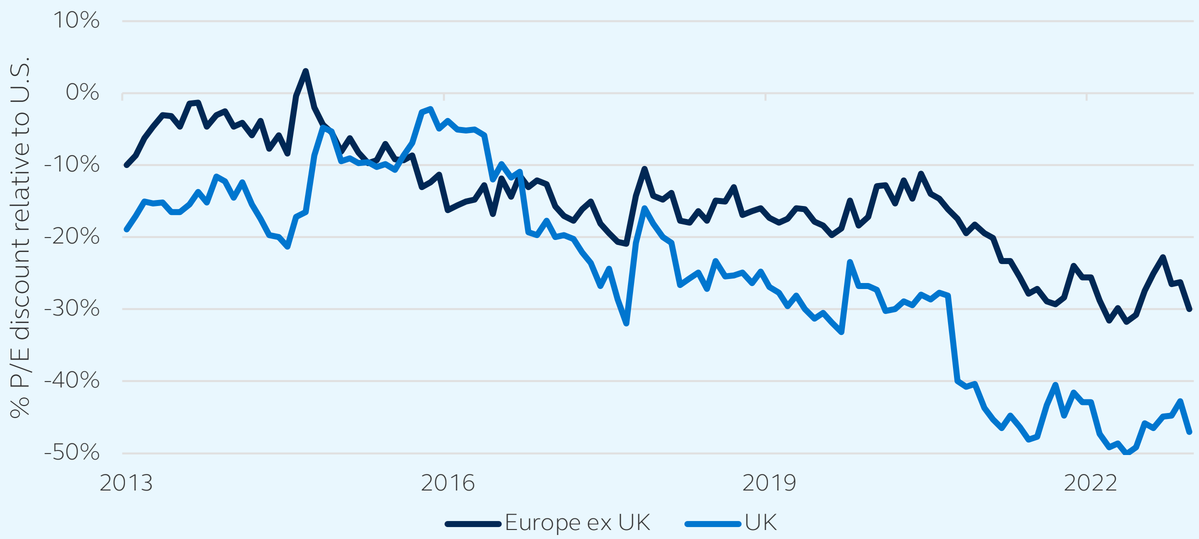
After years of lagging, earnings growth has rebounded in Europe, and is now on track to match or even outpace earnings growth in the U.S. Consensus EPS growth for the MSCI Europe Index is projected to rise just over 16% cumulatively over the next two years, exactly on par with that of the S&P 500. From our bottom-up viewpoint, we suspect the expectations for U.S. earnings are a bit overly optimistic, while those for Europe continue to reflect lingering pessimism by many investors.

Meanwhile, European stock markets remain amongst the world's cheapest and are cheaper than their own historical averages. For example, stocks in Italy and the UK currently sell on average P/E multiples of less than 10x, well below their 20-year averages[5]. For the broad European market, 12-month forward P/E multiples, relative to those of the U.S. are cheaper than they were during the

[4]Goldman Sachs. [5]MSCI.
Dividends are not guaranteed.

GFC. The UK's P/E discount is even more extreme. We believe the evolving conditions in Europe provide rich opportunities to buy high quality global companies at a significant discount to their U.S. peers.

European shares still trading at historically steep discounts to their U.S. counterparts



Source: FactSet, MSCI, Principal AM research. Data as of 31 May 2023.

Catalysts to unlock this valuation disparity have been lacking for many years but are now becoming more apparent. Many European companies are highly profitable, operating in growing markets, and have strong competitive positions. Additionally, the prior multi-year strength in the U.S. dollar has helped enhance cost competitiveness for European exporters and is now turning to a tailwind. This makes for particularly attractive circumstances for USD denominated portfolios, as a hedge against potential future dollar weakness. Structural investments in innovation and R&D, progress on energy independence, paired with its expanding ore "global gateway" status are all making the European economy more resilient. Global growth at a discount is a compelling investment opportunity for the years ahead in our concerted view.

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