

Goldman Sachs Exchanges: The Markets
Why European stocks are beating US equities
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Sam Grobart: New economic data from Europe, China, and Japan shows a mixed picture, so how should investors interpret that? This is The Markets, a new series from Goldman Sachs Exchanges.

Hi, I'm Sam Grobart. Today, we're going to take a quick trip around the world with Luke Barrs from Goldman Sachs Asset Management. Luke, thanks so much for joining us today.

Luke Barrs: Thanks for having me, Sam.

Sam Grobart: Luke, there have been a number of data points this week indicating economies outside the US are showing strong growth. In particular, growth in continental Europe has been surprising to the upside.

While the US Fed is signaling a pause in interest rate hikes. Can the ECB take a similar approach? Or is Europe's economy running too hot?

Luke Barrs: It's a great question. If we take one step back and let's understand what both central banks are having to deal with, it's the challenge of inflation, which is still not at the level central banks want it to be at, and the potential challenge now of tightening credit conditions. When we look at the US economy and we look at the European economy, we do see a little bit of a difference.

The US economy, you start to see the evidence that inflation is coming down. The labor market is starting to loosen a little bit. And you have this concern that, as we go into the back end of the year with credit concerns tightening and financial conditions tightening, that there is going to be a little bit of a growth impact. And so the Fed's signaling that maybe we're at the end of that rate hike cycle.

In Europe, we've seen a rebound in the terms of trade that was very negative last year. That's now turned positive. We've seen a pick up in growth momentum. And we

haven't yet seen a loosening of the labor market. So from our perspective, the ECB needs to stay on that path and continue to raise rates, to dampen inflation, and can run a slightly different policy to the Fed as we go through the course of the next six to twelve months.

Sam Grobart: European equities continue to outperform US stocks in 2023. What factors are driving that?

Luke Barrs: So the key driver here for European equities in our mind is the improvement in the economic backdrop. We've seen a significant decline in commodity prices, which, if we go back 12 months, was the major concern around the European economy. This issue that you had with the context of the Russia-Ukraine crisis, and the dependency that Europe had on Russia for natural gas, that actually was a far more muted issue as we went through the winter than was expected. And so you're seeing the rebound in growth this year, which is very positive for domestic-facing European businesses.

Let's also just recognize that the valuation opportunity in Europe is very different to the US. US equities, whilst

they've come down versus where they were two years ago, still actually price higher than they have over much of their last 10-, 15-year history. European equities, in contrast, look very interestingly valued.

Sam Grobart: All right. Let's move over to Asia. Japan's GDP growth for the first quarter of 2023 has also beat estimates, while the TOPIX, the Tokyo Stock Price Index, hit its highest levels on Tuesday since 1990. Do you think this kind of growth is sustainable for such an export-dependent economy?

Luke Barrs: Japan's a fascinating market. It has always been but right now it really is something we're very interested in. Nikkei hit 30,000 yen. That is a psychological resistance level, and we might see some investors take profit off the back of that. But actually we see a lot of underlying reasons for why Japan market continue to do well. We're seeing this reopening from COVID, both domestically in Japan as well as parts of Asia. There is a growth impulse that should come from China as China reopens. The natural trade and tourist linkages that you have between China and Japan. As well as just the significant impact that a weak yen has on the Japanese

economy.

Now, broad market, there's still some concerns. There's a lot of parts of the Japanese public equity space that we are sensitive towards investing in. These are structurally challenged businesses in an environment where growth well, whilst maybe cyclically positive, still be structurally quite challenged. But if you can be selective in the Japanese market, especially those higher quality growth businesses that are levered into some of those long-term structural fees, be it EV or autonomous driving, be it into the China consumer trade, actually the valuation entry point of those still looks very appealing.

Sam Grobart: While Japanese markets performed well this week, other Asian markets were mixed. Most notably, China was lagging after missing estimates in their April activity data. Is there something fundamentally slowing down in China, Luke? Or do you think this is more a case of expectations being set too high?

Luke Barrs: It's a great question. So take one step back. Structurally, things are slowing down in China but not in a bad way. This is an economy that has gone from being

very externally facing where there's been a significant gross capital formation or government-led investment driver to growth over much of the last 15 to 20 years. And that economy needs to become much more self-sufficient. And so the government has been focused on improving domestic demand, focusing on the quality of growth rather than the quantity of growth.

So structurally, we should expect China to be progressing towards a 4.5 to 5% growth economy. But from an investor standpoint, that's actually very high-quality growth where we can find businesses levered into that domestic demand cycle in a very appealing way.

Cyclically, which I think is where you're pointing to, there have been expectations that were maybe a little bit too substantial, a little bit too accelerated relative to where we were likely to see. And so what's the argument there? Well, if we go back to the third and fourth quarter last year, we had expectations that China would start to reopen, likely April or May, and you start to see that progression in the domestic economy in the manufacturing sector and the release of some of those supply chain constraints. That happened far quicker.

December-January, we saw the complete release of some of those zero-COVID constraints, and so you did see a very rapid rebound in things like PMIs and manufacturing data. But it's become a little bit more tempered recently, in our minds, predominantly because the consumer has not yet come back in full force. And once I think we see the conviction from the consumer that they are now back into a normalized environment, you'll start to see that rebound in domestic demand.

And anecdotally, when we look at some of the outbound tourism numbers, some of the data around hotel and flight bookings, it starts to signal to us that there is going to be a positive dynamic as we go through the back end of this year. And the government and the central bank will continue to be accommodative to make sure that that growth dynamic is favorable as we progress through to the end of 2023.

Sam Grobart: So Luke, we've talked about Europe, China, Japan. Are there any other regions or countries that you think investors should be paying more attention to?

Luke Barrs: So we do think the opportunity in China is interesting. The reopening that should feed through into domestic demand does give us some opportunity. And I would say, on top of that, the normalization and regulatory pressures around especially the technology and online ecosystems should give us interesting opportunities for those businesses to continue to show very strong positive fundamentals without the lingering concerns around sentiment that have been there for much of the last couple of years.

I would say, more broadly, the market that we look at cyclically and structurally as potentially the most exciting across the landscape is India. India is a market that, for much of the last 20 years, just taking India versus China, has lagged for a variety of reasons. For the last 10 years, they've put a reform agenda in place to give you the backdrop to improve that growth path. And critically, what we're seeing coming out of COVID, from especially Western corporates, is this need to realign supply chains. And that doesn't mean coming out of China in totality, but that China-plus-one strategy of diversifying supply chain we see as a huge incremental catalyst for India because the tax

regime, the bureaucratic issues that you've seen investing in India historically, and, critically, the improvement in infrastructure makes it a much more appealing underlying manufacturing base for especially technology hardware businesses.

And so that high productivity, high value add manufacturing that India has always lacked, whereas China has been able to capitalize on, should be a catalyst to drive domestic demand and really catalyze that into one of the more exciting growth opportunities we see over the coming ten years.

Sam Grobart: I do want to touch upon one issue going on here in the US, of course, which is the continuing debt ceiling tension. How are international investors looking at the impasse?

Luke Barrs: With some anxiety because, to be very frank, the prospect of the US defaulting on its debt is not something I think capital markets have any way of truly valuing or understanding. That would be a very significant risk-off event and something that would be hard to comprehend in the context of the importance of the US

economy, the importance of the US capital markets.

Now, in terms of just the evolution we've seen in market sentiment over the last couple of weeks, the anxiety that was there maybe two weeks ago has started to temper.

We're not saying that the two sides are necessarily completely aligned, but we've started to see evidence -- especially in the last couple of days -- that they're coming slightly closer together.

President Biden coming back from Japan to try and facilitate a conclusion to those negotiations should also be a positive signal. So we've seen in the market in the last couple of days evidence that people think there will be resolution. And so this concern around a June 1st timeline now feels like we will find resolution prior to that. We just need to resolve the final couple of issues that seem to be there between the two sides.

Sam Grobart: Luke, thanks so much for joining us today.

Luke Barrs: Thank you for having me.

Sam Grobart: That does it for another episode of The Markets, a new series from Goldman Sachs Exchanges. This podcast will be rolling off the Exchanges feed as of June 16th, so please be sure to find our brand new feed, The Markets, wherever you find your podcasts. I'm Sam Grobart. We'll catch you next Friday. Thanks for listening.

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